Fixed Income Insights

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Generational Opportunity in Fixed Income

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The past decade has posed considerable challenges for fixed income. The aftermath of the global financial crisis saw fixed income yields fall to abnormally low levels due to abundant liquidity. This led investors to make structural tradeoffs, such as sacrificing liquidity or accepting different types of risks, to attain barely acceptable coupon yields. A rigorous tightening cycle by global central banks over the past two years has now triggered a significant decline in fixed income returns. However, we believe that the dark days of fixed income are over. Global fixed income yields have corrected to historically attractive levels. In fact, after a period dominated by alternative sources of investment income, many market participants are noticing the overlooked potential growth and diversification benefits of public debt markets when constructing portfolios.

Despite the improvement in the backdrop for fixed income, there is still uncertainty and volatility at the global level. Global central banks are at different stages in their policy cycles, and given how growth varies across regions and sectors, we have observed several market dislocations. These varying conditions typically bring greater return dispersion within and across markets, but this is not necessarily a bad thing, especially for active managers who can uncover relative value opportunities and thereby gain a performance advantage in this challenging market environment. The typical levers an active asset manager will use to try to generate alpha include relative value, geographical diversification, asset and sector allocation, and credit selection supported by a thorough research process. Overall, while our view on credit is constructive, being selective will be key.

The evolving market backdrop and the implications of rebased yield levels

Interest rate cycles progress at different speeds depending on the local economy, and spread dispersion creates more relative valuation opportunities. Moreover, even if interest rates were to rise, today's high yields would provide an attractive cushion against price declines. In other words, breakeven levels are compelling. Breakeven is the required yield increase needed before one year of coupon income is offset and total return equals 0%.

While the recent positive correlation between bonds and equities did raise doubts about portfolio diversification, we believe that this was a temporary phenomenon. Looking ahead, the correlation between bonds and equities is likely to correct lower as market conditions normalise, we believe.

Today's yields, a product of painful monetary tightening, are at historically attractive levels, which means that risk and liquidity compromises are no longer required to achieve compelling yields. This should resonate with those in a de-risking mode, who know that yield is a substantial part of a bond's return.

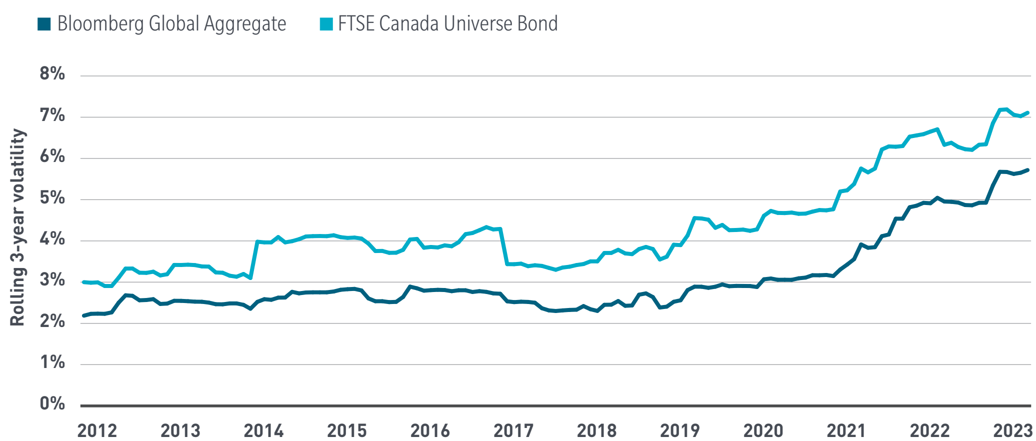
Current starting yields suggest attractive return potential going forward. Although high cash yields have been a good incentive to keep liquid over the past year, our research has shown that longer-duration bonds have performed strongly when central banks have completed their tightening cycles.

The case for global bonds

At present, the trajectory of policy rates worldwide is less synchronised than recently, providing investors the opportunity to allocate capital to markets further along in their interest rate cycles. When we look across global markets, yield curves have different shapes. Fixed income investors may have an opportunity to benefit from these generational valuation levels. From the growth side of the equation, fundamentals such as credit quality also vary across global markets, and some have more potential than others given their economic backdrop. Canadian investors can benefit from attractive yields relative to local yields depending on sectors and from potential rate cuts as the business cycle progresses in other markets.

The Bloomberg Global Aggregate Index is a popular lens through which to view the global fixed income market. Limited to investment-grade issues, the index is less volatile than it is reputed to be, especially when compared to the Canadian bond market (see Exhibit 1).

Exhibit 1: Global bond markets — Surprisingly low volatility



Source: Bloomberg, FTSE. Monthly data from 31 December 2009 to 30 April 2024. Standard Deviation of Bloomberg Global Aggregate Index versus FTSE Canada Universe Bond Index. Volatility shown on a three-year annualised basis. Returns used for volatility are gross and in CAD.

As seen in Exhibit 2, the characteristics of the Bloomberg Global Aggregate index also differ in other ways from the Canadian universe, potentially providing diversification benefits given the limited Canadian bond market overlap (3%) and differentiated quality and sector breakdowns.

Exhibit 2: Comparison of global and Canadian investment-grade bond universe

	Global IG Bonds	Canada IG Bonds
Market Capitalization (Million)	$87,641,343	$2,361,775
No. of securities	30,121	1,614
Yield to Worst	4.1%	4.5%
Historical Yield (10-yr. Avg.)	1.9%	2.4%
Duration (years)	6.6	7.1
Historical Duration (10- yr. Avg.)	7.0	7.8
Currency of Issuance		
USD	45%	0%
Euro	22%	0%
Yen	10%	0%
CAD	3%	100%
Other	20%	0%
Quality Breakdown		
Aaa	12%	45%
Aa	42%	30%
A	32%	15%
Baa	14%	10%
Sector Breakdown		
Treasury	53%	34%
Gov't Related	15%	44%
Corporate	19%	22%
Securitised	14%	0%

Source: Bloomberg. Data as of 30 April 2024. Global IG = Bloomberg Global Aggregate Index. Canada IG = Bloomberg Canada Aggregate Index. Dollar value figures are displayed in CAD.

We believe today's environment for global fixed income offers an attractive opportunity to enhance income, lower risk and provide better downside risk management. In our view, given attractive yields and lower volatility, the risk/return potential from an allocation to global bonds is quite compelling for Canadian investors. If economies turn and policy rates decrease, we believe global fixed income is likely to offer positive contributions to performance and play its role in portfolio construction.

Now is a good time to consider global fixed income

Canadian defined benefit plans may also benefit from an allocation to global bonds. As discussed in our recent paper, The Case for Global Bonds in Liability-Driven Investing, better funded status and lower liability duration profiles can potentially allow US pension plans to cover more liabilities with physical bonds, reducing the reliance on derivatives. Global bonds offer an opportunity for these plans to diversify their fixed income exposure without upsetting the duration profile of typical LDI strategies. While the dynamics of Canadian DB plans differ in some ways from those of their US counterparts, we think that global bonds could be an area for Canadian DB plans to explore.

In a world where capital must be allocated responsibly, the advantage of global fixed income exposure for long-term investors is obvious. Attractive yields, favourable credit conditions and the anticipated easing by central banks underscore the need for robust integrated global research to identify attractive regions and sectors and uncover relative value opportunities during this generational shift in the investment landscape.

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