Insights
Fixed Income

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Piloting Defensive Portfolios During the Powell Pivot

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- Higher yields expected across government bond curves in 2022, may lead to underperformance of fixed rate bonds.
- Duration risk of standard fixed income indices are much higher today and are likely to be poorly rewarded, as yields backup from ultra-low levels.
- Credit likely to perform better in the medium term, as we are still in an expansionary phase of the credit cycle with strong corporate fundamentals and low distress.
- Australian Floating Rate Notes (FRNs) can provide diversification and serve many purposes, positively contributing to a defensive fixed income allocation;
  - As a complement to cash — albeit with higher risk
  - Low duration domestic fixed income and/or
  - A high quality credit exposure

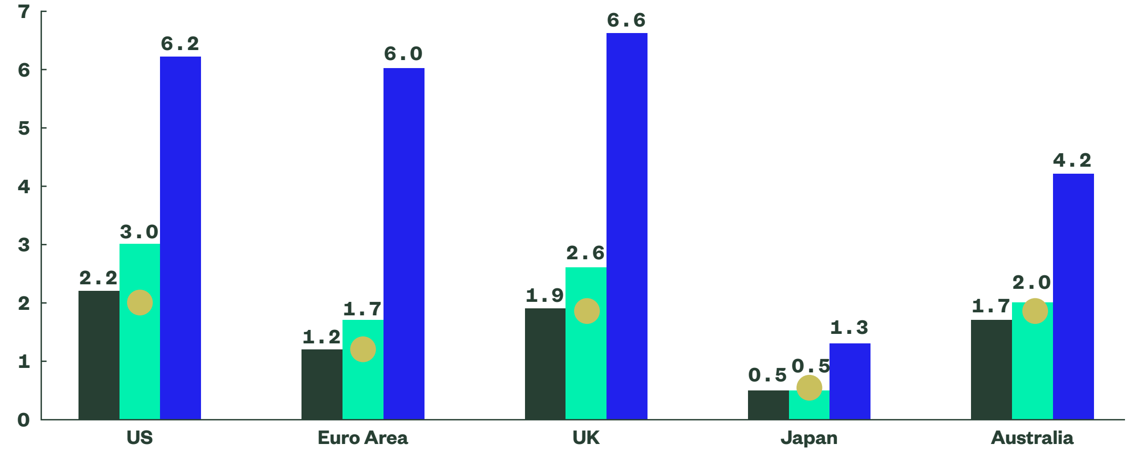
Inflation Has Made Central Banks Decidedly Hawkish

An overarching theme that has been driving global financial markets since October 2021 is the concerted policy normalisation from central banks. By 2019 most central banks had already brought their policy rates well below post-global financial crisis (GFC) levels by announcing aggressive quantitative easing programmes in response to the COVID-19 crisis. This course is being reversed now, through the gradual withdrawal of stimulus, as virus and growth worries are now being replaced with concerns around inflation.

Nowhere is it more apparent as it is in the US, where inflation numbers have seen a sharp pickup since mid-2021, with the last three months seeing year-on-year (yoy) consumer price index (CPI) prints coming in above 7.0%, touching a four decade high. Tightening labour markets which saw the unemployment rate falling steadily to a new post-pandemic low of 3.6% in March 2022, along with the still solid above trend growth expected in 2022 has bolstered market expectations of a strong run of interest rate hikes in the US.

A similar theme of inflation proving much more stubborn and widespread than central banks initially predicted, due to demand and supply issues along with tight labour markets, is being observed in other developed markets. With both the Euro area and the UK facing multi-decade price pressures, and markets pricing in material policy adjustments from the timeline projected just a few months ago (Figure 1). While the recent Russia-Ukraine risks have undermined the argument for aggressive, front-loaded hikes, global economies are facing inflation pressures that seemed a thing of the past, and monetary policy needs to adjust to this new reality.

Figure 1a
Markets Are Pricing in a Sharp Move Upwards in Policy Rates in Response to a Surge in Realised Inflation and Inflation Expectations
2022 YOY Inflation Expectations (%)

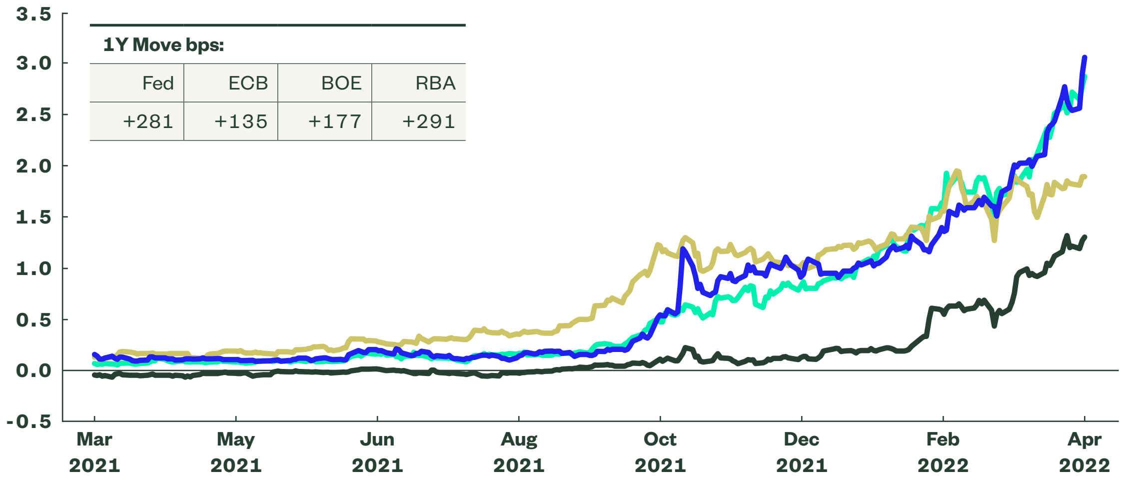


1 Year Back
6 Months Back
Now
10 Year Average (%)

Source: Bloomberg Finance L.P., as of 5 April 2022. The above expectations are based upon estimates and reflect subjective judgements and assumptions. There can be no assurance that developments will transpire as forecasted and that the expectations are accurate.

Figure 1b

Market Implied 1Y Policy Rate Move (%)



Federal Reserve (Fed)
European Central Bank (ECB)
Bank of Engalnd (BOE)
Reserve Bank of Australia (RBA)

Source: Bloomberg Finance L.P., as of 5 April 2022.

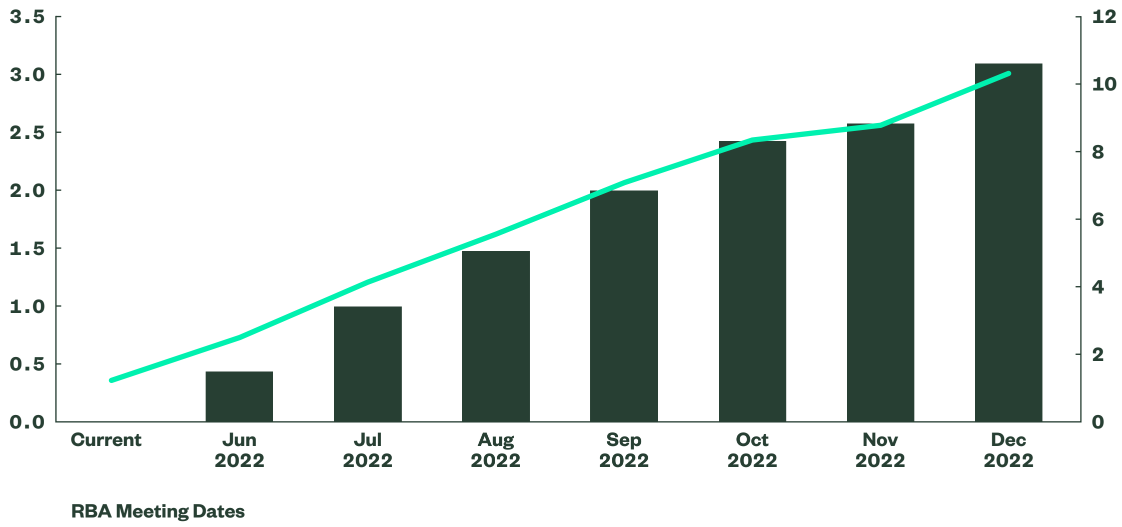
The Australian Perspective

The Reserve Bank of Australia (RBA) had been among the more dovish developed market central banks till as recently as April, but took a hawkish pivot quickly, with a bigger-than-expected rate hike in the middle of an election campaign. On the 3 May 2022 the central bank lifted its cash rate target from the record low of 0.1% to a more than expected to 0.35%, and signaled more rises to come.

It acknowledged that inflation has picked up significantly and by more than expected, with headline inflation coming in at 5.1% and underlying inflation at 3.7% (over the year to the March quarter), the highest levels in more than two decades. The Bank's business liaison also suggested that wages growth has been picking up, in a tight labour market, with the unemployment rate declining over recent months to 4% and labour force participation increasing to a record high.

Cash rate futures markets are pricing in an even more steeper hiking path than before, and signal the RBA will raise to 3% by year's end (see Figure 2a). That's again well ahead of a central bank's cash rate forecasts.

Figure 2a
Market Expectations for the Cash Rate Have Risen, Alongside the Outlook For a Broader Move Towards Higher Yields
Expectations of Implied Cash Rate Differs Significantly From the RBA



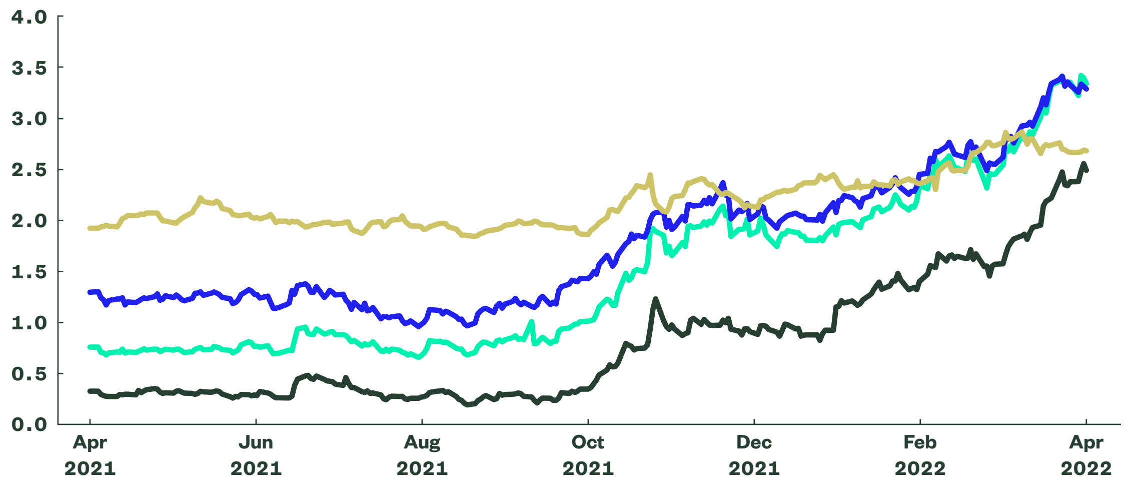
Number of Hikes/Cuts Priced in by Overnight Index Swap (OIS) Markets (RHS)

Implied Policy Rate (%)

Source: Bloomberg Finance L.P., as of 4 May 2022. The above expectations are based upon estimates and reflect subjective judgements and assumptions. There can be no assurance that developments will transpire as forecasted and that the expectations are accurate.

Figure 2b

A Sharp Uptick in Government Bond Yields Seems to be on the Cards



3 Year Australian Comonwealth Government Bonds (ACGB) Spot (%)

1y3y Interest Rate Swap (IRS) (%)

2y3y IRS (%)

Breakeven Inflation (%)

Source: Bloomberg Finance L.P., as of 5 April 2022.

Shifting Portfolio Risk Away From Interest Rate Sensitivity

Overall this ongoing policy pivot across the world has resulted in an uptick in volatility as well as underperformance of global fixed income markets as these markets are more exposed to duration risk since the Fed's shift in approach in October 2021. This is coming at a time where investors are more exposed to interest rate risk than ever, with the duration of many bond indices at their highest levels in history which is best shown in Figure 3. Supply technicals are also turning negative for government bonds globally, as central banks end pandemic-era asset purchases. This holds true for Australia as well, with the removal of A$4 billion of bond purchases a week from the RBA which is a price insensitive buyer and holds ~35% of outstanding Australian Commonwealth Government Bonds (ACGBs).[1] This QE purchasing activity has helped depress term premia and stimulate credit.

While the ongoing events in Ukraine have created broad risk aversion in financial markets and a slight reassessment of hiking trajectories, these risks have not derailed the more dominant narrative of tightening labour markets and above trend growth supporting higher yields over the medium term. Higher energy and commodity prices after this event implies significantly higher inflation profiles for 2022. The longer term consequence of this war and related sanctions will also likely be inflationary. This shift increases the need for investors to reallocate their fixed income portfolios, and we see more investors take advantage of current market dynamics to decrease exposure to long duration, lower yielding assets and increase exposure to shorter duration to diversify sources of return.

Figure 3
Standard Fixed Income Indices Now Have Much Higher Interest Rate Exposure, and Thus Vulnerable to a Pullback in Yields From Low Levels

	Interest Rate Duration (yrs)		
Asset Class	**10 Years Ago**	**5 Years Ago**	**Mar 2022**
Global Treasuries	6.8	7.9	8.3
Global Aggregate	5.9	7.0	7.3
Global Investment Grade (IG) Corporates	5.8	6.6	7.0
Global High Yield (HY) Corporates	4.1	3.9	3.8
US Senior Loans	0.3	0.3	0.3
Emerging Markets (EM) Hard Currency Aggregate	6.4	5.7	6.8
US Mortgage Backed Securities (MBS)	3.3	5.0	5.2
Australia Government	4.1	5.3	5.9
Australia Credit	2.4	3.4	3.6
Australia Composite	3.7	4.9	5.5
Australia Floating Rate Notes (FRN)	0.1	0.1	0.1

Source: Bloomberg Finance L.P., JPM, Credit Suisse as of 31 March 2022.

Risks Across Common Fixed Income Sectors

Fixed income portfolios are exposed to two main types of risks — interest rate risk which is often referred to as duration risk and credit risk. These should be considered together when evaluating their combined impact on total returns for each fixed income sub-asset classes (Figure 4).

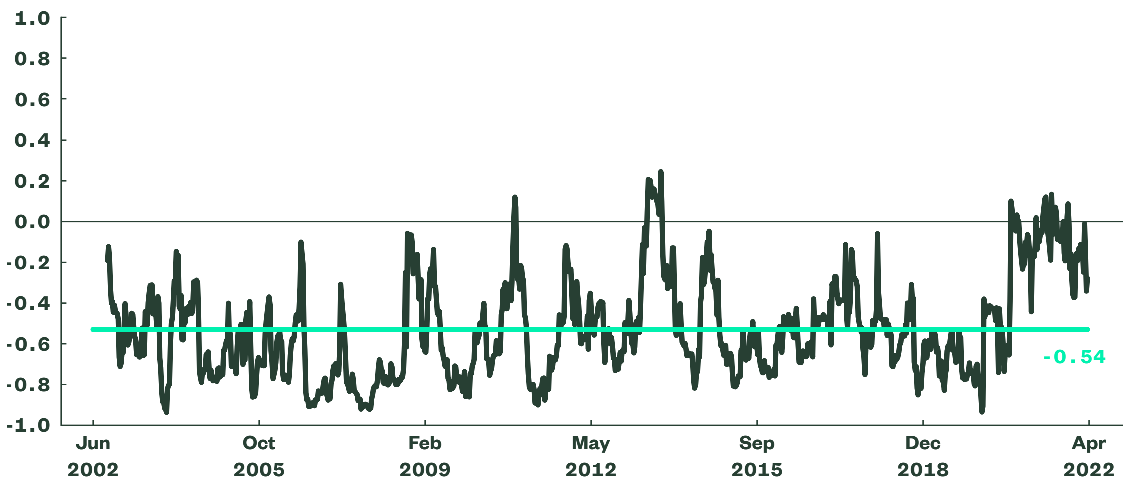
Typically these two risks are negatively correlated, but this relationship may see a short-term breakdown, as we have witnessed over the last year, in response to exogeneous events changing the course of a credit/economic cycle, periods of sudden risk-off sentiment and investor expectations of stagflation (Figure 5).

Figure 4
Split of Risks Across Common Fixed Income Sectors, Sorted by Descending Order of Interest Rate Risk

	FI Sub Asset Class	Interest Rate Risk Measure, Duration (yrs)	Spread Duration (yrs)	Credit Risk Measure, Duration Times Spread	Yield (%)
High Interest Rate Risk, Low Credit Risk	Global Treasuries	8.2	8.2	1.1	1.7
	Global Aggregate	7.3	7.3	3.0	2.3
	Global IG Corporates	7.0	7.0	8.4	3.2
Medium Interest Rate Risk, Medium to High Credit Risk	EM Hard Currency Aggregate	6.5	6.5	19.4	5.3
	Australia Government	5.9	5.9	0.4	2.6
	Australia Composite	5.5	5.5	1.1	2.7
	US MBS	5.4	5.6	1.3	3.2
	Global HY Corporates	3.8	3.6	12.9	6.0
	Australia Credit	3.7	3.6	3.9	3.3
Low Interest Rate Risk, Medium to High Credit Risk	US Senior Loans	0.3	3.6	16.3	5.5
	Australia FRN	0.1	1.9	4.0	2.4

Source: Bloomberg, JPM, Credit Suisse as of 5 April 2022. Please refer to Glossary for explanation of how to read the measures of risk in the table above.

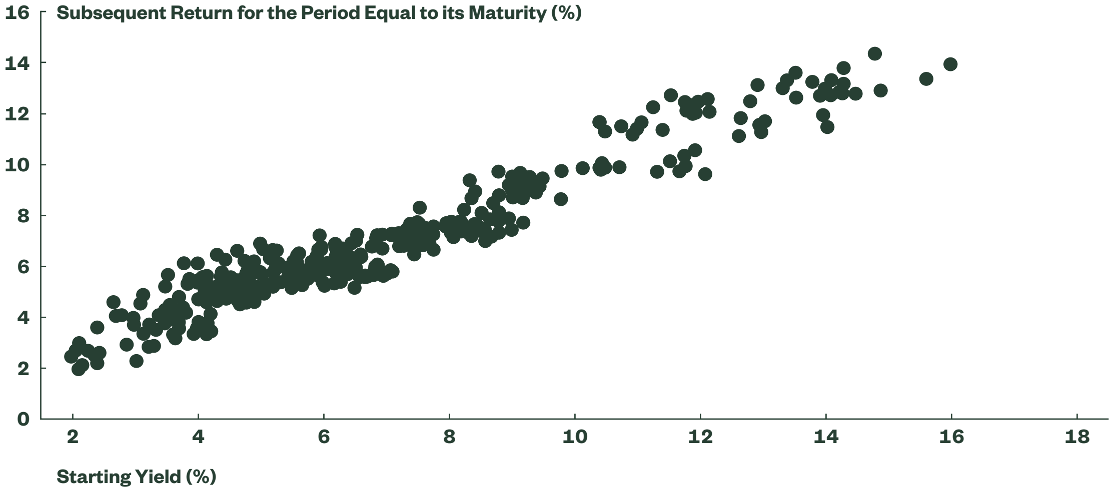
Figure 5
The Relationships Between the Risk Free Rate and Credit Spreads is Typically Negative. Though This Can Breakdown During Extremes from Time to Time
3 Month Rolling Correlations based on Weekly changes of 5 Year US Treasury Yields and High Yield Option Adjusted Spreads



Source: Bloomberg Finance L.P., as of 1 April 2022.

When making fixed income asset allocation decisions, the starting yield and time horizon of investment is an important predictor of expected future returns (Figure 6). High initial yields often provide a cushion for an adverse path of rates in the future, and longer time horizons increase the contribution of income to total returns.

Figure 6
Starting Yields of Fixed Income Asset Classes Have a Strong Relationship With Future Returns
Starting Yields vs. Returns of a Constant Maturity Bond/ Index Rebalanced Continuously



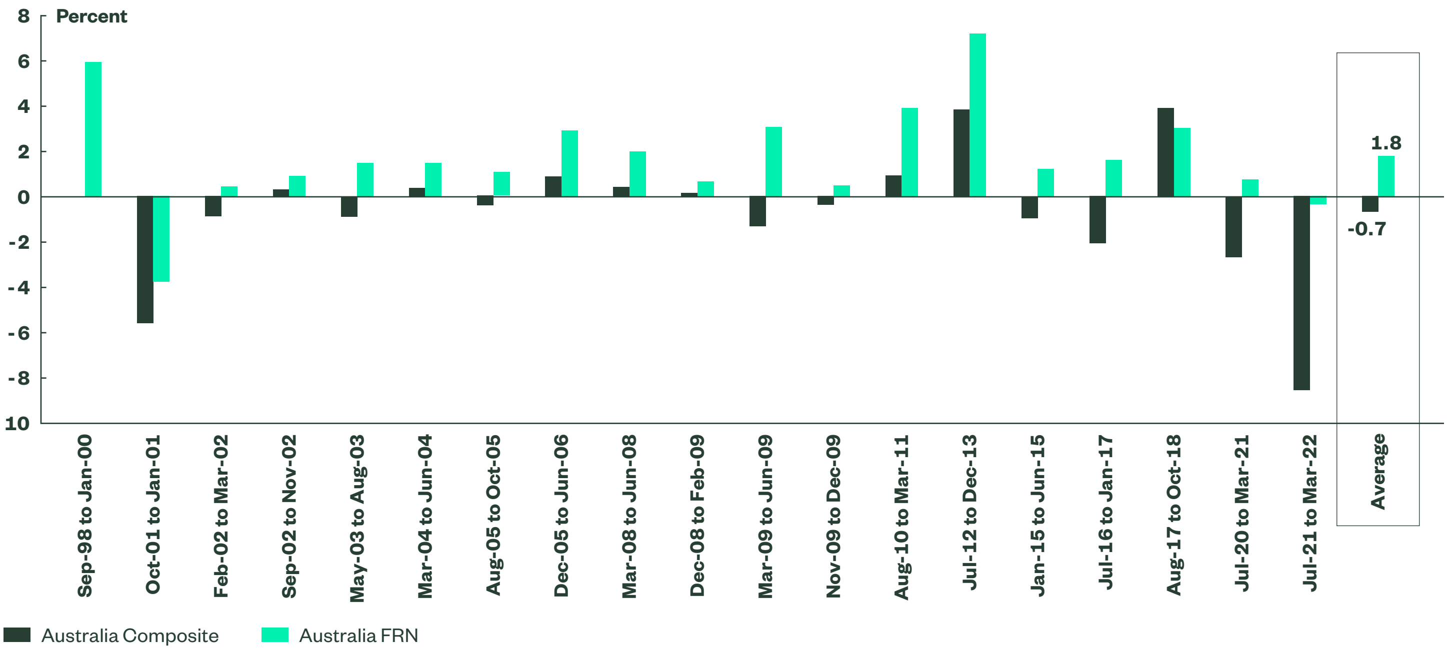
Source: Bloomberg Finance L.P., Barclays as of 31 March 2022. Past performance is not a reliable indicator of future performance.

Floating Rate Notes Can Serve Investors Well

Investors use fixed income in their portfolios for a number of reasons. It provides a source of income, diversification and downside protection and therefore has a strategic allocation in portfolios. But investors can also take a tactical tilt on sectors based on shorter term forward looking interest rate views and the credit cycle but investors still need to maintain a focus on capital preservation and liquidity to navigate different market environments and rebalances.

Currently we believe we are in a period of positive but slowing global economic growth, tighter policy response, repricing of terminal rates, and an accelerated but expansionary credit cycle. Looking back since 1998 at periods of rising yields on average, Floating Rate instruments have outperformed the composite index as demonstrated in Figure 7.

Figure 7
Returns Comparison Over Periods of Rising Rates (Point to Point Returns Shown)



Source: Bloomberg Finance L.P., as of 31 March 2022. Past performance is not a reliable indicator of future performance. The index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment. Australia Composite = Bloomberg AusBond Composite 0+ Yr Index. Australia FRN = Bloomberg AusBond Credit FRN 0+ Yr Index.

Given this, investors are faced with a number of options to improve portfolio resiliency in this changing environment.[2] Investors may:

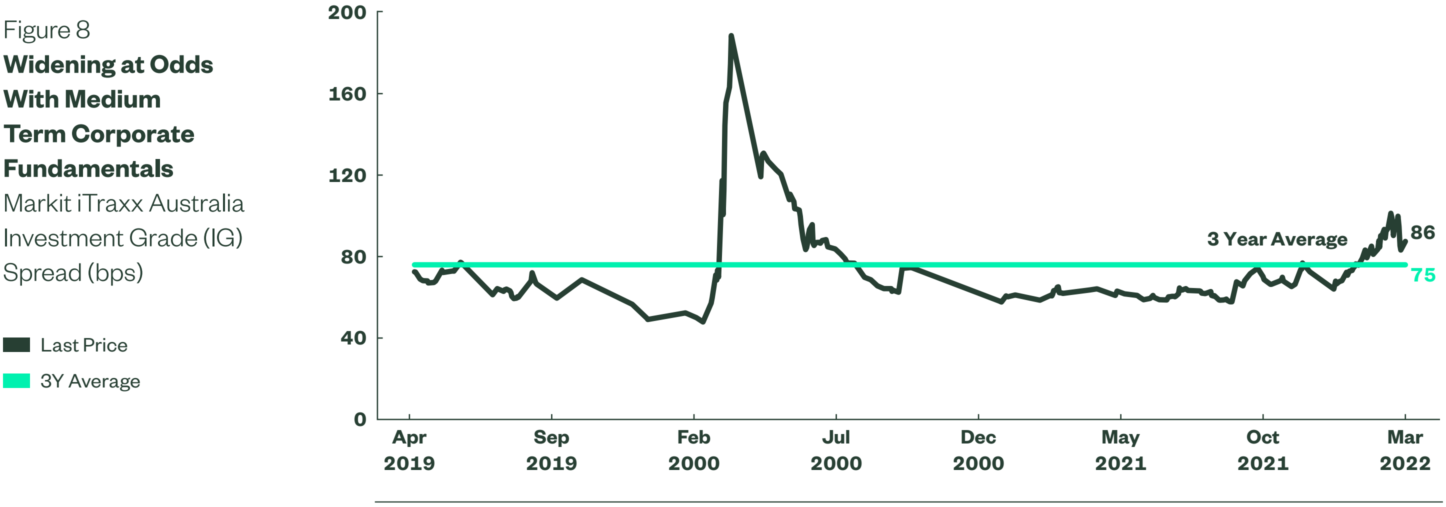
- Reduce portfolio duration by
  - — Allocating to shorter duration core strategies; or by
  - — Reducing the overall allocation to fixed income itself
- Tilt the fixed income section of their portfolio towards credit based yield, which has historically benefited from strong economic growth that often accompanies rate increases.
- Allocate into fixed income segments which are less sensitive to rising rates (FRNs & Bank Loans).
- Hedge inflation by investing in asset classes with direct/indirect high positive correlation to inflation such as FRN's, TIPs, Commodities & Natural Resource based equities.
- Add new sources of uncorrelated return such as Private assets. While these have more inherent risks than traditional fixed income, such allocations can provide diversification benefits.

The global corporate earnings growth outlook is likely to remain constructive in the coming quarters and supportive for credit, and default rates have been relatively low, even in the higher yielding corporate bond market. Over the last year we've witnessed some of the lowest par defaults for corporate bonds at 0.44% and 0.52% respectively for US and European corporates. Expected robust global corporate earnings growth in the coming quarters, earnings before interest, taxes, depreciation, and amortisation (EBITDA) margins for the median credit remaining anchored around all-time highs, ample liquidity on corporate balance sheets and the strong capex led recovery — all seem to indicate that the global credit cycle would continue to remain in its expansionary phase in 2022. Similar trends can be observed in Australia with forecasts for Forward 12 Month earnings for Australian corporates close to 2008 highs.[3]

Australian investors that are seeking to shorten duration in defensive portfolios may consider an allocation to credit through high quality FRNs, as they provide high quality credit exposure that complements cash and domestic fixed income. The Australian Floating Rate Bond market is composed of investment grade bonds issued predominantly by domestic and foreign banks and other lending institutions which make up ~92% of the market. We believe Australian FRNs are attractive because they pay an income set at a margin over the bank bill swap rate (BBSW) that resets on a quarterly basis which ensures a very short duration exposure that resets every 90 days.

The allocation to FRNs is supported by the medium term structural increase in rates but also on a short term basis with current spreads which look relatively attractive. The iTraxx Australia spread, is a proxy for the cost of borrowing in the Australian investment grade corporate bond market above the Bank Bill Swap Rate (BBSW). It's a key reference point for the Australian FRN market and we've recently witnessed a sharp sell-off triggered by global risk-off sentiment and recent geopolitical volatility. The ITraxx is ~11 bps above its 3 year average (Figure 8) and this widening, which we believe provides an attractive entry point or opportunity to increase exposure, given the strong underlying fundamentals of banks. In fact, FRNs would generally receive the benefit of both a tightening back in credit spreads and a rising benchmark rate (typically BBSW, which has historically followed movements in the cash rate closely) making the outlook attractive.

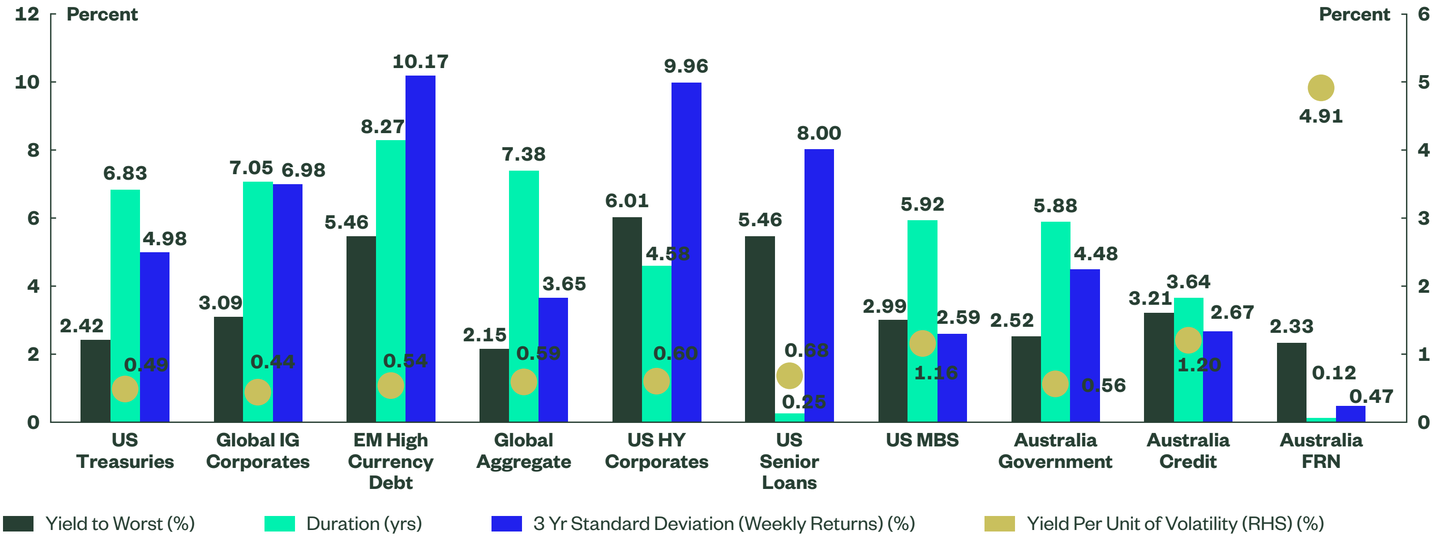
Figure 8
Widening at Odds With Medium Term Corporate Fundamentals
Markit iTraxx Australia Investment Grade (IG) Spread (bps)



Source: Bloomberg Finance L.P., Markit as of 23 March 2022.

In summary, FRNs have historically performed well in periods of rising rates, and they have provided a stable source of income and return. They also may provide investors with an attractive risk adjusted return relative to other segments of the fixed income complex, making the case for allocation into an investor's overall portfolio that can complement cash and traditional fixed income.[2]

Figure 9
Even at Low Yield Levels, FRNs Offer Better Yield Per Unit of Risk Compared to Other Bond Market Segments



Source: Bloomberg Finance L.P., Credit Suisse as of 5 April 2022.
US Treasuries = Bloomberg Barclays US Treasury Index, Global Investment Grade Corporates: Bloomberg Barclays Global IG Corporate Index, Emerging Market Hard Currency Debt = Bloomberg Barclays EM Hard Currency Aggregate Index, Global Aggregate = Bloomberg Barclays Global Agg Index, Global High Yield Corporates = Bloomberg Barclays US Corporate High Yield Index, US Mortgage Backed Securities = Bloomberg Barclays US MBS Index , US Senior Loans = Credit Suisse Leveraged Loans Index Australia Government = Ausbond Govt 0+ index, Australia Credit = Ausbond Credit 0+, Australia Floating Rate Notes = Ausbond Credit FRN 0+ Index.

Endnotes

1 Source: RBA as of 30 March 2022.

2 Before making any investment decisions, investors should seek professional advice and consider their own financial situation and needs.

3 Bloomberg Finance L.P., Earnings Estimate for S&P ASX 200 Index as of 31 March 2022.

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* Pensions & Investments Research Center, as of December 31, 2020.
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Glossary

Credit Risk The possibility of a loss resulting from a borrower's failure to repay a loan or meet contractual obligations. Traditionally, it refers to the risk that a lender may not receive the owed principal and interest, which results in an interruption of cash flows and increased costs for collection.

Duration Percentage change in price of a Bond/Asset Class due to a 100 bps change in yield.

Duration Risk The risk that changes in interest rates will either increase or decrease the market value of a fixed-income investment. Because payments are typically fixed, if the interest rate changes, then the market value of the investment will change.

Duration Times Spread Used for measuring the credit volatility of asset classes. It is calculated by multiplying two readily available characteristics: the spread-duration and the credit spread. The result is a single number that can be used to compare credit risk across a wide range of asset classes.

Spread Duration Percentage change in price of a Bond/Asset Class due to a 100 bps change in option-adjusted spread (OAS).

Stagflation When there is high inflation, high unemployment, and slow or negative real economic growth.

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The value of the debt securities may increase or decrease as a result of the following: market fluctuations, increases in interest rates, inability of issuers to repay principal and interest or illiquidity in the debt securities markets; the risk of low rates of return due to reinvestment of securities during periods of falling interest rates or repayment by issuers with higher coupon or interest rates; and/or the risk of low income due to falling interest rates. To the extent that interest rates rise, certain underlying obligations may be paid off substantially slower than originally anticipated and the value of those securities may fall sharply. This may result in a reduction in income from debt securities income.

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