Insights
Fixed Income

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Global Fixed Income — Is it Time to Hedge?

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The investment landscape in 2020 has been a challenging one for European bond investors. Sovereign bond yields touched record lows as the unfolding COVID-19 pandemic dampened economic prospects and central banks cut interest rates and expanded asset purchases programs. The case for euro and sterling investors to consider investments beyond their domestic markets for diversification benefits and better risk-adjusted returns is further bolstered by a significant decline in currency hedging costs.

With the final quarter of 2020 well underway, the yield outlook for sterling and euro investors looks particularly challenged; rates seem likely to remain close to, or below, zero for the foreseeable future with yield curves staying flat. For investors seeking extra yield, adopting a more global approach and moving into the Bloomberg Barclays Global Aggregate Bond Index (an index of global investment grade debt) seems attractive — this currently offers a higher yield (with lower duration) than their local government and aggregate bond indices.

Figure 1
Key Bond Characteristics

	Bloomberg Barclays Global Aggregate	Bloomberg Barclays Sterling Aggregate	Bloomberg Barclays Euro Aggregate	Bloomberg Barclays Global Treasuries	Bloomberg Barclays Euro Treasuries	Bloomberg Barclays Sterling Gilts
Yield to Worst %	0.9	0.7	0.0	0.5	-0.1	0.4
Duration (Mod. Adj.)	7.4	11.9	7.6	8.8	8.7	13.3

Source: Barclays Live, as of 30 September 2020.

Investing Globally Helps Spread the Risk

The Bloomberg Barclays Global Aggregate Bond Index allows investors to expand their opportunity set and provides diversification across four areas: sectors, maturities, credit quality and currencies/countries, as shown in Figures 2a to 2d. This helps investors to further diversify their exposure to interest rate, inflation and economic cycles, and the political climates of a wide range of markets outside of their home country and region.

Figure 2
Bloomberg Barclays Global Aggregate Bond Index — Diversification Benefits

Figure 2a
Sector Breakdown

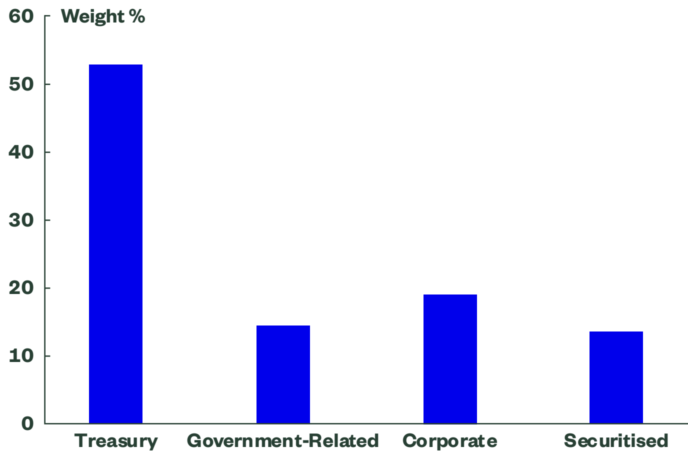


Figure 2b
Maturity Profile

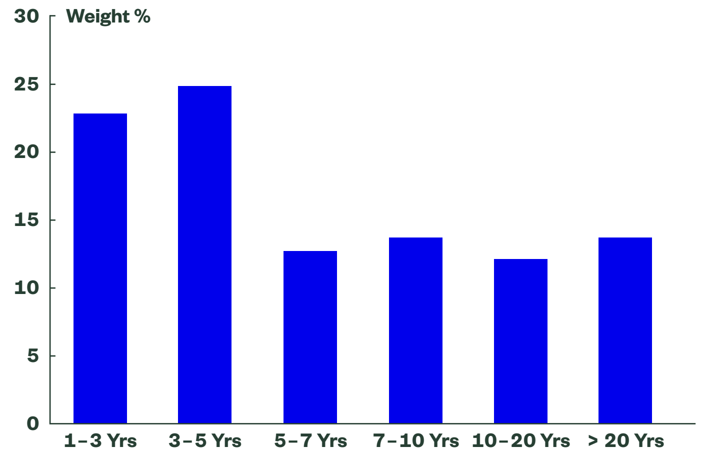


Figure 2c
Credit Rating Profile

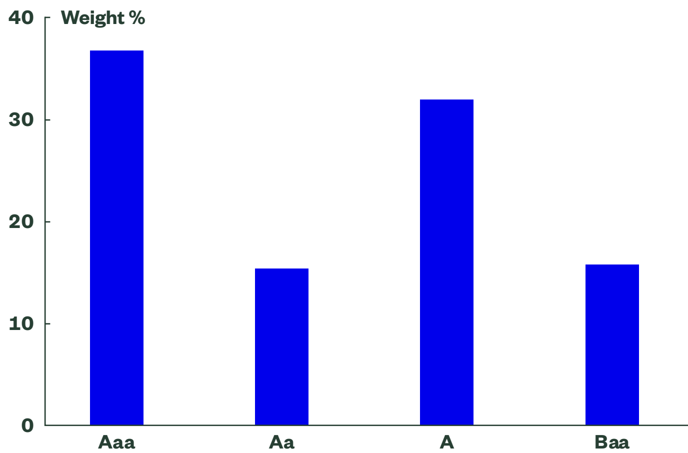
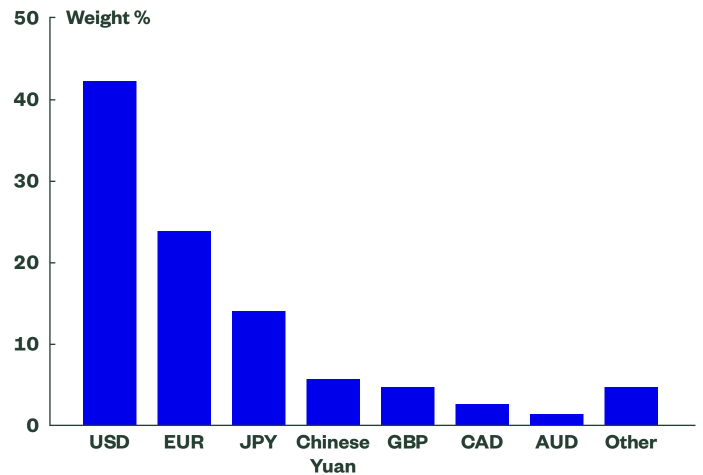


Figure 2d
Currency Breakdown



Source: Barclays Live as of 30 September 2020.
Characteristics are as of the date indicated and shouldn't be relied on thereafter. Credit rating provided by Bloomberg Barclays (based on an average of S&P, Moody's and Fitch).

But Going Global Can Result in Additional Currency Risk

Increased diversification can result in lower volatility and better risk-adjusted returns, but currency risk can present a challenge. When we compare the volatility of a global bond exposure from a hedged and unhedged perspective (Figure 3), we see that currency movement is responsible for a large portion of the volatility in an unhedged investment.

This table shows that, over a 20-year period, the hedged performance in euro and sterling experienced less than half the volatility of the unhedged performance, while hedged and unhedged returns over the longer term are broadly in line with each other. Over the shorter term (3 years) unhedged euro and sterling returns have been flattered by weakening domestic currencies versus the US dollar, the largest currency component of the benchmark.

Figure 3
Risk and Return Characteristics 30/09/2000–30/09/2020 (annualised)

	Bloomberg Barclays Global Aggregate Bond Index*			
	Euro Returns	Euro Hedged Returns	Sterling Returns	Sterling Hedged Returns
1 Year (%)	-1.2	2.4	1.3	3.3
3 Years (%)	4.4	2.6	5.4	3.7
5 Years (%)	2.9	2.2	7.3	3.3
10 Years (%)	3.9	2.9	4.4	3.5
20 Years (%)	**3.3**	**4.2**	**5.5**	**5.3**
Volatility 20 Years (%)	**6.7**	**2.8**	**8.3**	**2.8**
Risk/Return	**0.50**	**1.52**	**0.66**	**1.88**

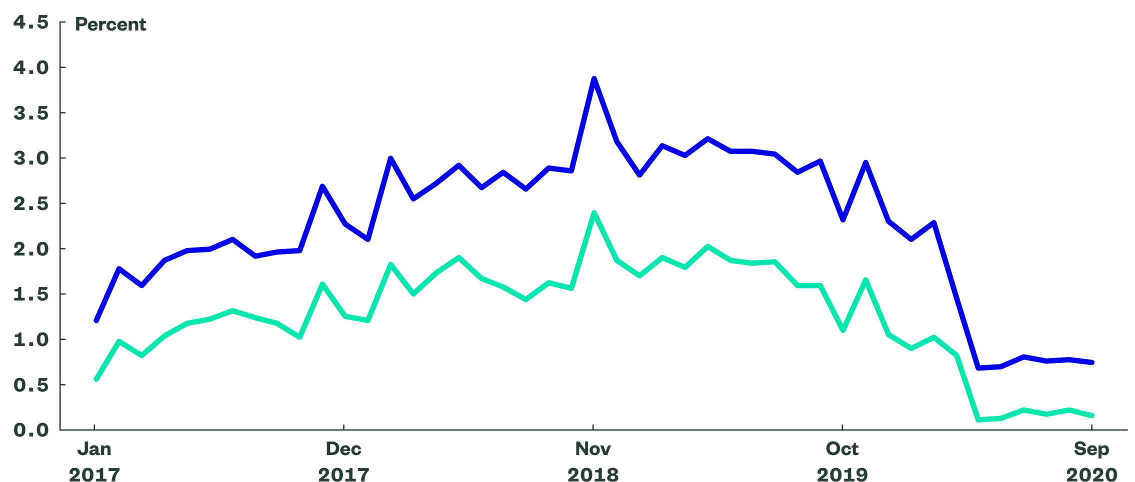
Source: Bloomberg Finance LP as of 30 September 2020. Past performance is not a guarantee of future results. Returns greater than one year are annualised. **Index** returns are unmanaged and do not reflect the deduction of any fees or expenses.
* Inception date: 1 January 1990.

Currency Hedging to Reduce Volatility

So, in theory, hedging the currency risk of a global bond portfolio at least preserves, if not improves, its risk/return attributes. But constructing an FX-hedged global bond portfolio means trading off the cost of hedging against the resulting lower volatility and improved risk/return profile. In the post-GFC period, this cost of hedging has been punitive for a sterling or euro investor because their domestic short rates were low relative to the other components of global bond indices that are mostly made up by the US dollar. This means the cost of FX hedging more than negated any benefits. However, since March 2020, after the US Federal Reserve cut its short rate towards those of the European Central Bank (ECB) and Bank of England (BoE), that cost of hedging has come down to levels where it now makes economic sense, as illustrated in Figure 4.

Figure 4
EUR and GBP Cost of Hedging Versus USD

EUR USD
GBP USD

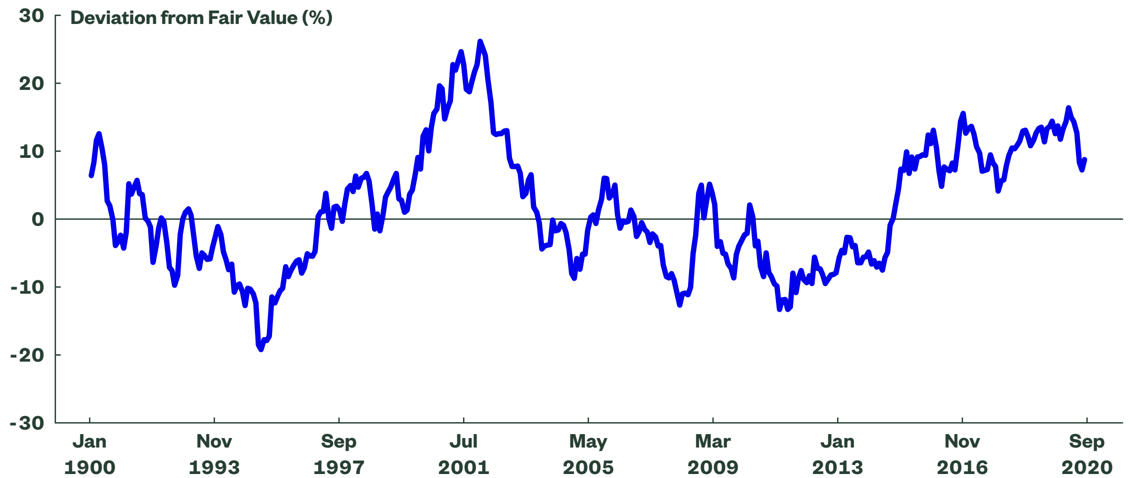


Source: Bloomberg Finance LP as of 30 September 2020.

The Trajectory for the US Dollar Turns Downward

With the cost of FX hedging having come down, we think it is time for euro and sterling investors to reconsider the hedging question, particularly as the long-term outlook for the US dollar has grown more negative. While ongoing economic and pandemic-related uncertainty is likely to result in periodic "flight to safety" rallies by the US dollar, we expect the euro and sterling to gain against the greenback over the longer term.

Figure 5
US Dollar is Expensive Relative to Fair Value

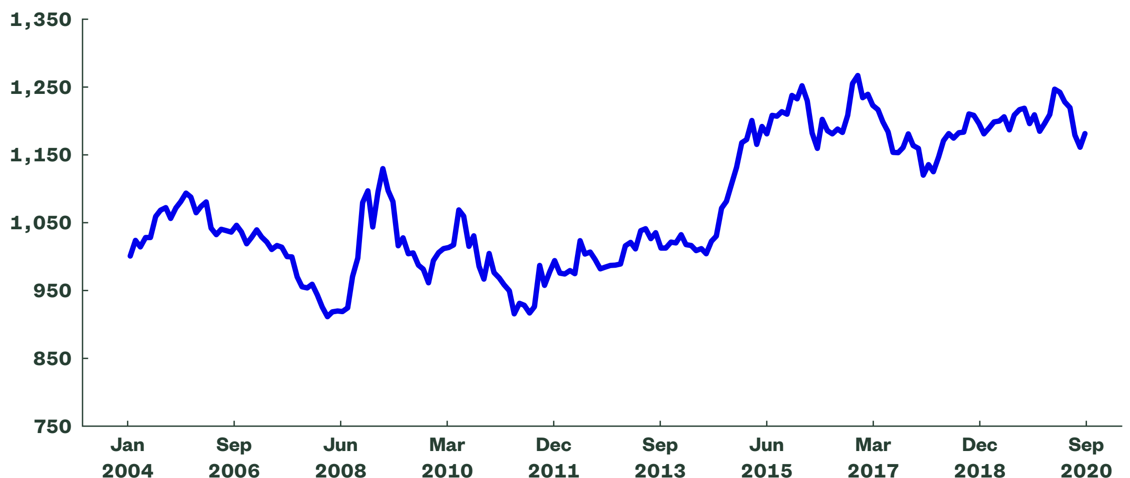


Source: State Street Global Advisors as of 30 September 2020.

Indeed, the cyclical US dollar bull market seems to be losing steam. USD tends to move in bull/bear market cycles of 7–10 years that have resulted in broad swings of 30–40%. The current bull market entered its tenth year in 2020 and reached a peak in March that left it about 40% higher than the 2011 low.

Moreover, we believe that the catalysts for that cyclical bull market to transition to a bear market are in place. Not only is USD historically expensive, but the supportive theme of US exceptionalism has given way to headwinds such as poor management of the COVID-19 crisis (lower expected growth), the yield support has thinned, and the US political landscape continues to be very fractious.

Figure 6
Losing Steam — Bloomberg US Dollar Index



Source: Bloomberg Finance LP as of 30 September 2020.

Conclusion

As outlined in this article, we believe that reduced volatility from greater diversification, along with lower hedging costs and an expensively-valued US dollar underpin the argument for sterling- and euro-based clients with existing unhedged global bond exposures to consider switching to a currency-hedged approach — this should help to lock in the meaningful unrealised gains that accumulated from home currency depreciation over the last few years. Similarly, clients who are considering initiating global bond exposures should consider doing so via such FX-hedged approaches.

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