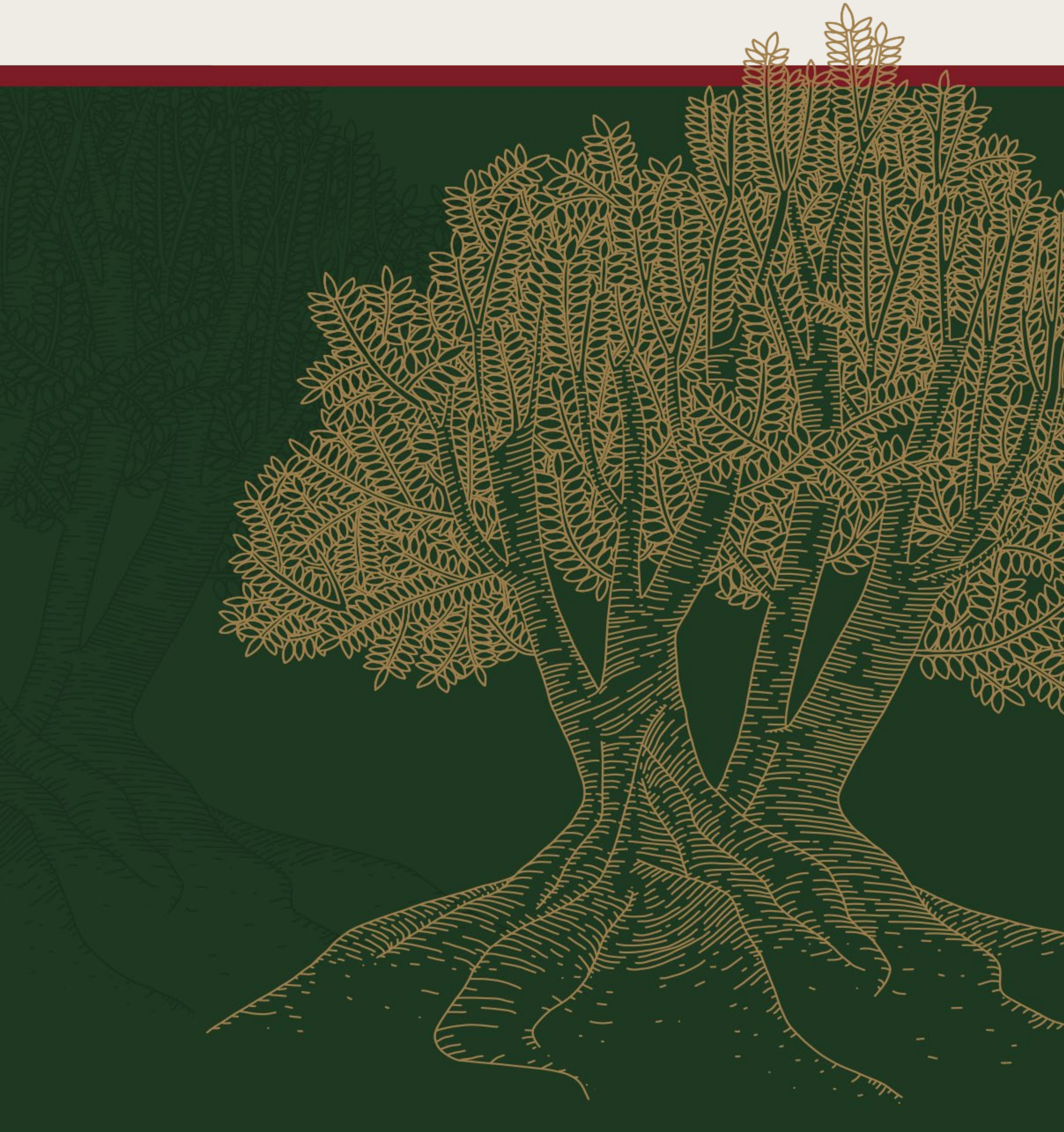
GLOBAL FIXED INCOME NOTE
2021 Q1

March 2021



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INTRODUCTION

Some of the most frequent questions we get from clients these days pertain to inflation and bond markets - particularly those in the US, UK, and Europe. Is this monetary and fiscal stimulus not going to stoke inflation? Will there be an inflation spike? What is the point of owning short-dated bonds when yields are so low or negative? If "long bond" yields continue to rise, which would hurt bond prices, why do I need longer duration bonds in my portfolio? Won't the rapid rise in long-dated rates seen in 2021 eventually result in equities crashing? These are all good questions - and some are impossible to predict with certainty - but we think investors should remember a few important roles that bonds play in a portfolio.

- **Bonds are a deflation hedge.** All other things being equal, a sudden fall in consumer demand would lead to lower prices for goods and services. A sudden drop in prices often sparks concerns that a deflationary trend may persist; motivating consumers to delay purchases in the hopes of getting a better deal. A worst-case scenario would be one in which this circular logic drives a downward spiral in prices and economic growth. This vicious cycle would also cause equities to fall. Government bonds are considered to be risk-free as they mature at par and thus you theoretically receive what you invested (or close to). This is why government bonds can act as a hedge in this type of environment – providing price stability to a portfolio.
- **Bonds provide optionality (certainly shorter dated bonds)** – if savings are 100% invested into equities and markets crash, having safe-haven bonds which retain price stability provides you with capital to deploy into riskier assets when they correct. Note, however, that if one's horizon exceeds 20 years then having a diversified global portfolio of equities would very likely outperform a portfolio of low yield safe-haven bonds. However, few investors have the luxury to think this far out.
- **Bonds generally perform inversely to risky assets in times of market stress.** In almost all deep and quick market corrections, like what we saw in 2020, safe-haven bonds perform well.

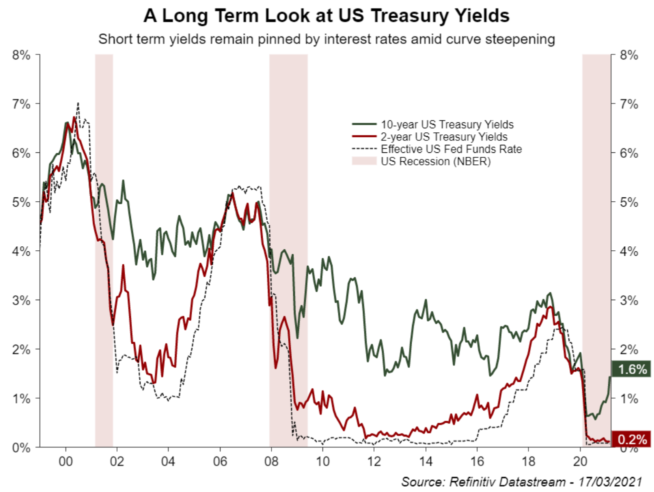
As we consider the balance of views for ***inflation*** against those in for ***deflation*** (and there are many) we think the inflation worries are probably a little exaggerated as compared to the most outspoken market pundits. There is no doubt that all the fiscal and monetary stimulus, coupled with an unlocking post-vaccine world, could be inflationary. On the flip side, there are still many deflationary forces in the world. Technological advancements and mechanisation continue to be deflationary, coupled with that fact that most countries are not near full employment, and thus have labour slack, also supports lower inflation (and certainly wage deflation). One must not forget that despite all the efforts of the Bank of Japan and ECB to increase inflation, it has not manifested in being close to an issue or to overheating. In fact, it has been below target for a long time. The invisible forces at play making things that we consume cheaper have not disappeared. We think a sustained rise in inflation is a risk but remains contained for the foreseeable future.

"We have been living in a world of strong disinflationary pressures - around the world really - for a quarter of a century.... We don't think a one-time surge in spending leading to temporary price increases would disrupt that."

Jay Powell, US Federal Reserve Chair

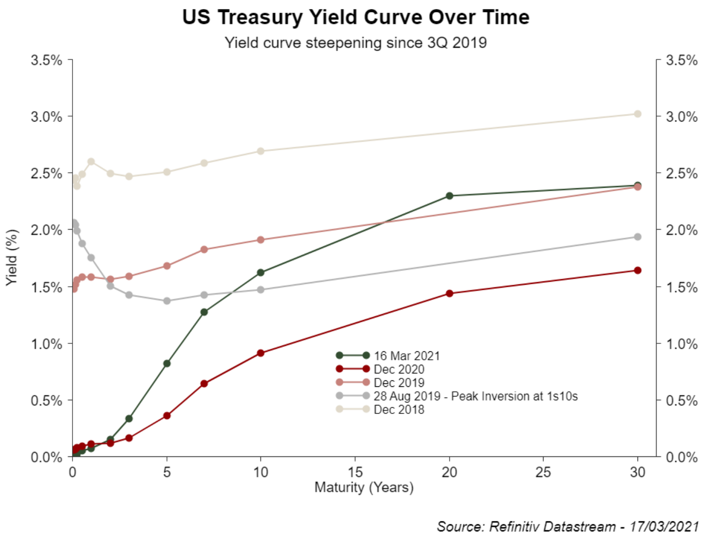
UNITED STATES

Amid the breakneck pace of an emerging Coronavirus recovery, speedy rebound of asset prices, yet seemingly contradictory prolonged economic "pause", many investors have asked themselves "where are we in the economic cycle"? The chart on the right might be the most apt in answering that question, both in terms of the shape of the US Treasury yield curve and the fact that the US economy is emerging from a technical recession. In our view, we are at the early stages of a new economic cycle. Not much more than a year ago the US Federal Reserve was looking at hiking rates in what was the longest ever economic bull market. In response to the Coronavirus, the Fed cut benchmark interest rates 1.5% to the zero-lower bound in a very short timeframe.



Now, given an economic recovery which has even outpaced the expectations of the US central bank itself, market participants are once again asking "when will interest rates rise?". The above chart shows a clear steepening of the US Treasury yield curve, as demonstrated by gap between 10-year and 2-year rates. The front-end of the curve remains pinned down by "dovish" Fed guidance (i.e. an easy monetary policy outlook) although 10-year yields have risen sharply in recent months amid recovery optimism coupled with inflation concerns. The most important question on investors' minds – and perhaps even more important than the Coronavirus itself – is whether or not inflation rises too quickly and prompts the Fed to respond by bringing forward interest rate hikes.

The chart on the left shows the term structure, or shape, of the US Treasury yield curve over time. As one can clearly see, 2021 has been characterised by a steepening with the front-end still pinned on Fed guidance (green line). It also highlights the "normalisation" of yields since it was most inverted on 28 August 2019. Guidance from the recent March 2021 FOMC meeting showed that 7 of 12 committee members expect at least one hike by the end of 2023, an increase of 3 members since the last "dot plot" was released at the December 2020 FOMC meeting. Despite this revision, it remains more dovish than market expectations, which signal almost two full 25bps hikes in 2023.

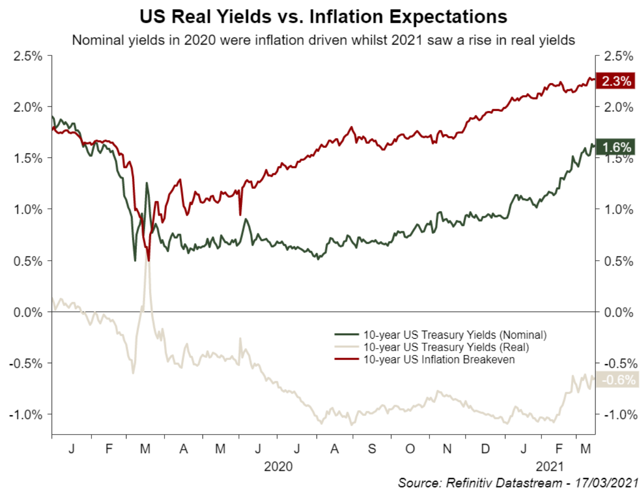


Inflation Measure	Most Recent Value
US CPI YoY	1.7%
Eurozone CPI YoY	0.9%
UK CPI YoY	0.4%
US 10y Inflation Breakeven	2.3%
US PCE Inflation YoY	1.4%
Eurozone Core HICP YoY	1.2%

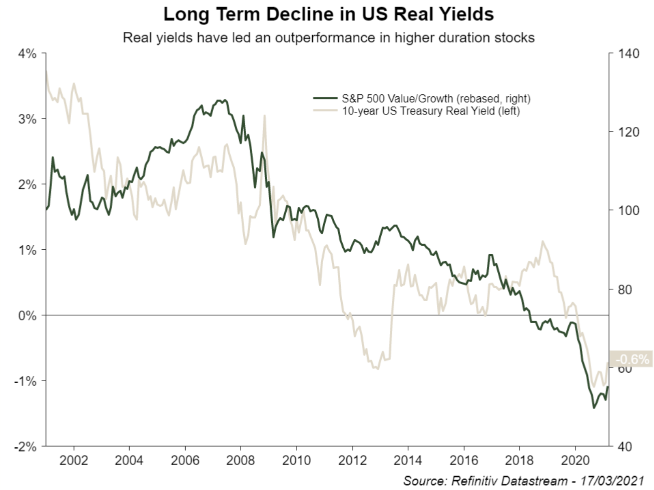
Source: Investing.com

At the most recent FOMC meeting, Fed Chair Powell maintained the Fed's commitment to "lower for longer", citing the need for the US economy to approach full employment. Risks are mounting for a disorderly repricing of yields when the disparate opinions between investors and policymakers come to a head. Omba continues to monitor inflation (realised and forecasted) and growth trajectories as markets wait to see who will blink first in this game of chicken being played between central bankers and "bond market vigilantes". Interestingly rates in the long end from 10 years on are now higher than what they were in 2019. We believe unexpectedly high inflation is unlikely given slack in the economy.

The chart on the right also has strong explanatory power. Real yields are a measure of nominal yields less inflation expectations. Nominal 10-year US Treasury yields (green line) have drifted higher since 2H 2020 on expectations of higher inflation (red line). This initially resulted in 10-year US real yields (beige line) becoming increasingly negative, particularly over 2Q 2020. Coronavirus vaccine optimism, the continued passage of shock-and-awe fiscal stimulus, and "ultra-easy" monetary conditions have all kept inflation expectations elevated. The spike in both US nominal and real yields since February 2021 has been driven by the passage of the US$ 1.9 tn American Rescue Package (ARP) which has driven a repricing of the Fed lift-off date. A poor Treasury auction uptake also contributed to the steep sell-off in prices.

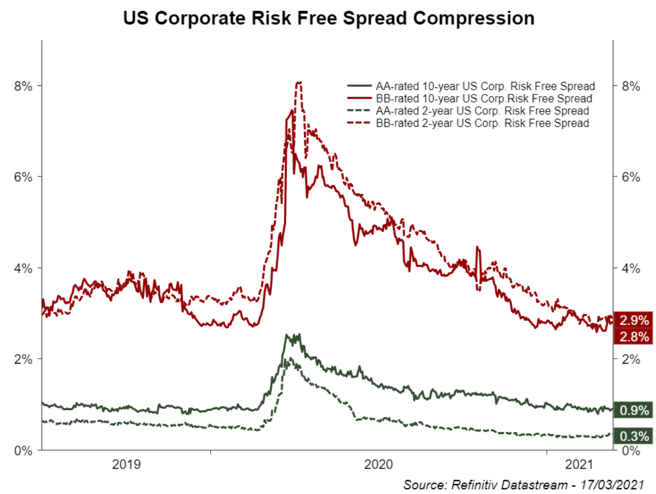


An important consideration in all of this is demonstrated in the chart on the left. It depicts a clear long-term pattern between US real yields and the relative performance between US Value and US Growth stocks. The "chase for yield" has been a pertinent theme for years now, and the long-term decline in real yields can largely explain why investors have preferred "high duration" stocks (i.e. Growth), which promise high earnings growth and cash flows in the future, rather than "low duration" stocks (i.e. Value) which offer reliable but slow-growing near-term cash flows and earnings. These underlying dynamics at play help to explain recent asset price changes.

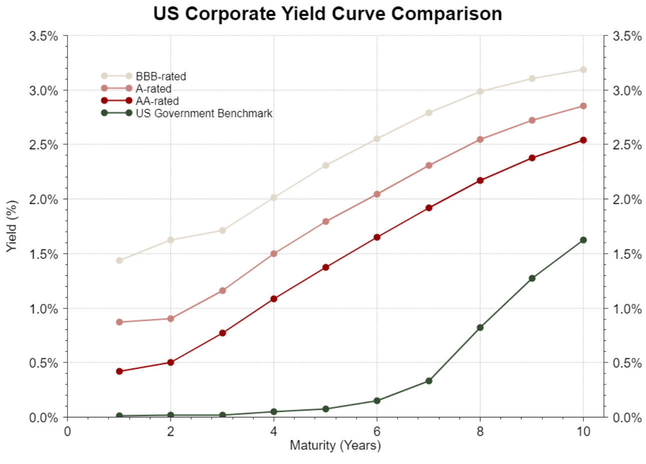


DON'T FIGHT THE FED!

Turning to corporate bonds, on 23 March 2020, the Fed announced that it would set up a special purpose vehicle to buy US Investment Grade (IG) corporate bonds and corporate bond ETFs for the first time ever. This marked the low across many stock and bond benchmarks around the world. The Fed later announced that purchases would also venture into "junk" or High Yield (HY) US corporate bonds. The chart on the right depicts the sharp fall in prices in Q1 2020 and the subsequent recovery across IG and HY US corporate bonds and US equities. The recent outperformance of HY bonds relative to IG bonds, depicted in the aforementioned chart, is due to the lower duration of HY bonds and the pro cyclical nature of high yield credit risk.



The chart on the left shows how credit spreads, or corporate bond yields less risk-free US Treasury bond yields, have changed since the Q1 2020 spike. Not only did credit spreads continue to compress through 2020, but they ended the year near (or better) than pre-Pandemic levels. This trend has continued in 2021 as monetary conditions in the US remain exceptionally easy, thanks to Fed intervention, as well as (more recently) an improved corporate earnings outlook.

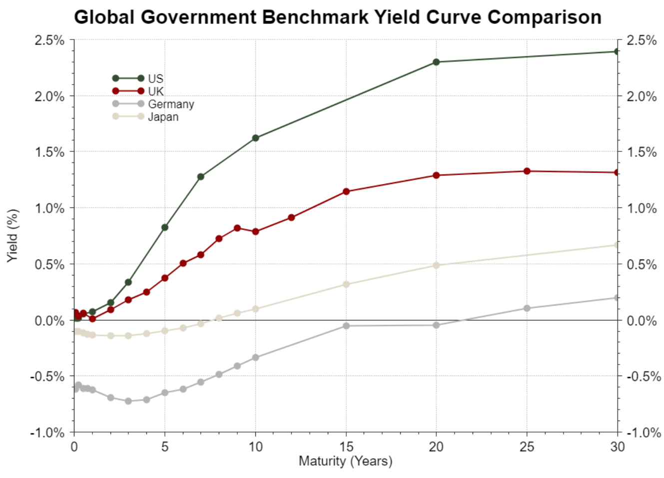


Source: Refinitiv Datastream - 17/03/2021

A different way to depict this anomaly would be to measure the spread between US Government Benchmark yields (green line) and US corporate bond yields (other lines). The steepness and short-dated yield pinning of the US Treasury curve clearly drives this unique pricing of credit risk.

EUROZONE

The European recovery has largely followed that of the US, albeit at a slower pace. The chart on the right compares the government bond term structure of four major currencies. As one can see, the US displays the steepest curve, mostly reflecting the highest growth forecasts. The Fed revised their 2021 US economic growth outlook sharply higher to 6.5% at the recent FOMC meeting. Comparatively, the ECB left growth projections unchanged at 4.0% for 2021. Similarly to the US, Eurozone and UK yields have very low short-term rates due a static outlook of headline benchmark interest rates at -0.5% and +0.1%, respectively.



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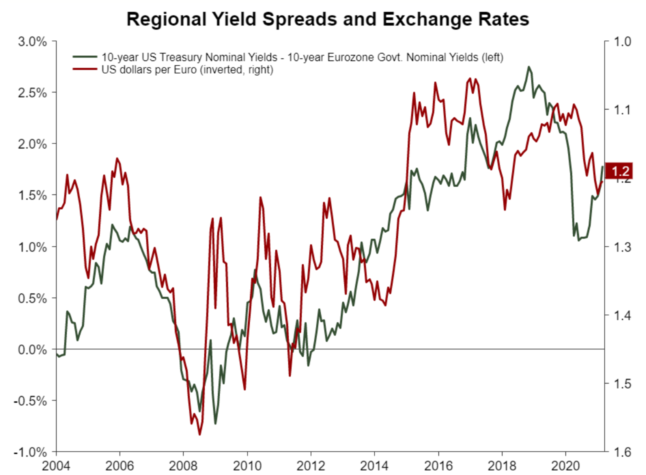
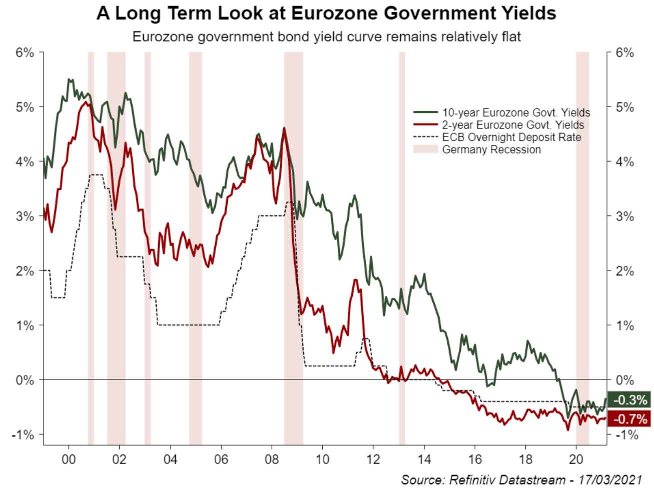


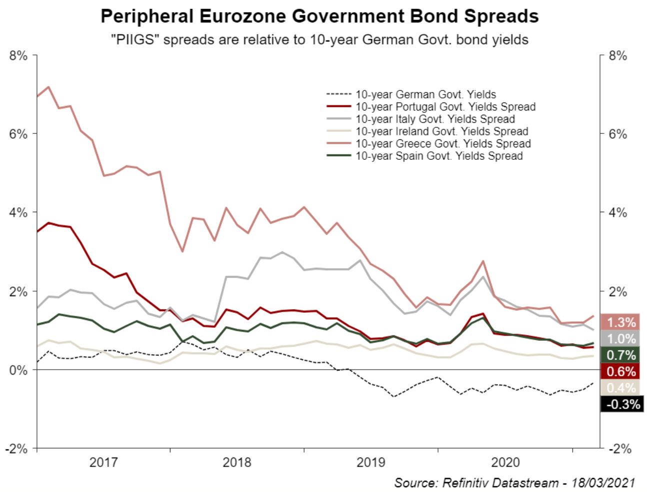
Source: Refinitiv Datastream - 24/03/2021

In the same way that changing US real yields dictate investor flows between US bonds and US equities, divergence between regional yields dictates exchange rates. European investors may chase yield by investing into higher yielding US risk-free debt and will also sometimes hedge the currency risk back to Euros. However, in order to purchase US denominated debt, European investors will need to sell Euros and buy US dollars. These investment flows result in a stronger Greenback amid a higher real yield pick-up. This positive correlation between real yield pick-up and FX rates is clearly demonstrated in the chart to the left.

Again, if one can predict the path of the Fed lift-off, one can better predict global exchange rates given a more static (low!) rates outlook in the Eurozone. The interplay of these dynamics, and the impact on currency forwards, has been explored in depth by Omba's publication **Cash & Currencies in a World of COVID-19 Chaos**.

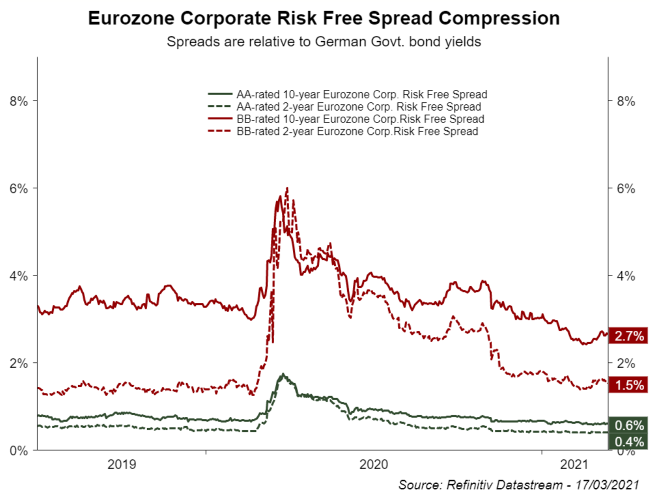
The chart on the right shows the long term historic trajectory of Eurozone yields. The story is similar to that of the US, although Eurozone rates are negative and the yield curve is currently not as steep. This yield curve shape divergence is related to lower European growth forecasts, partly due to a smaller fiscal stimulus, worse vaccine roll-out, greater slack in the Eurozone economy, weak Eurozone bank profitability, and lower inflation expectations. It is worth remembering that the ECB have been trying to stoke inflation with Quantitative Easing (QE) and negative rates with limited success for many years.



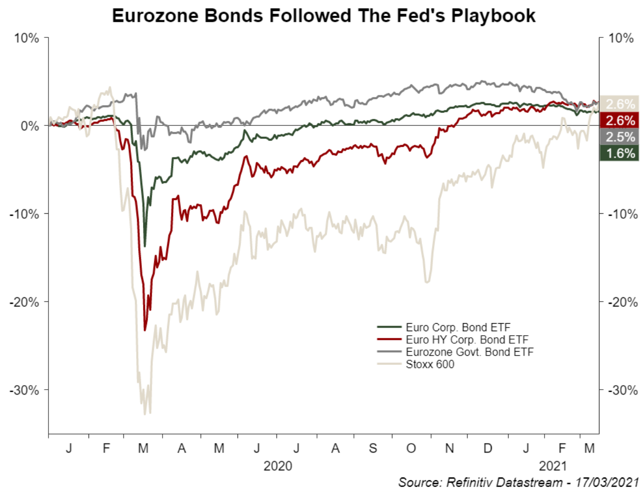


The chart on the left depicts the easy monetary conditions for riskier peripheral Eurozone economies. Credit spreads relative to risk-free German bunds are near historic lows, indicating easy monetary conditions. The ECB, at their most recent meeting, increased the pace of their QE and bond purchasing programmes. This was a *pre-emptive measure* to avoid risks of a tightening in monetary conditions as opposed to a *reaction* to tightening conditions. The dovish policy was supportive for risky assets, and in particular peripheral Eurozone bonds. Greece successfully issued 30-year paper for the first time since the 2008 GFC.

The chart on the right shows a similar pattern in Eurozone yields: a temporary spike in credit spreads in 1Q 2020 followed by a protracted easing. Eurozone corporate debt, more noticeably than US corporate debt, ended 2020 at near-or-better levels than before the Pandemic. Eurozone corporate spreads are broadly comparable to those of the US, although are slightly lower.

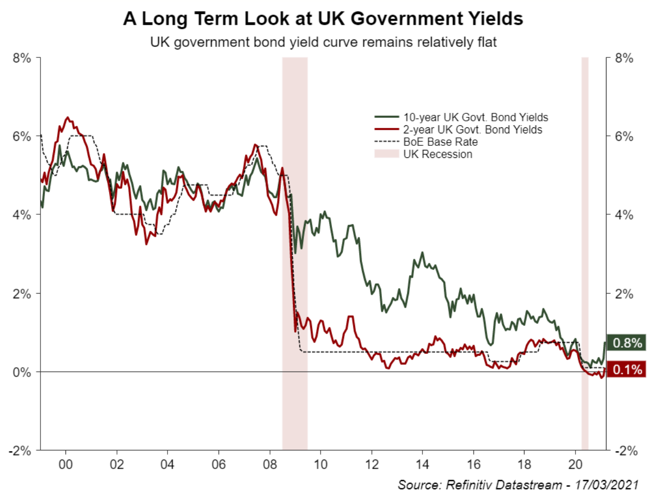


The chart on the right, again, shows a very similar story to the US. European equities have only recently retraced to pre-pandemic levels. Interestingly, Eurozone HY corporate bonds performed in line with the Stoxx 600 equity benchmark over the considered period. Due to easy European monetary conditions at the time, the 1Q 2020 sell off in Eurozone corporate bonds was less than that in the US.



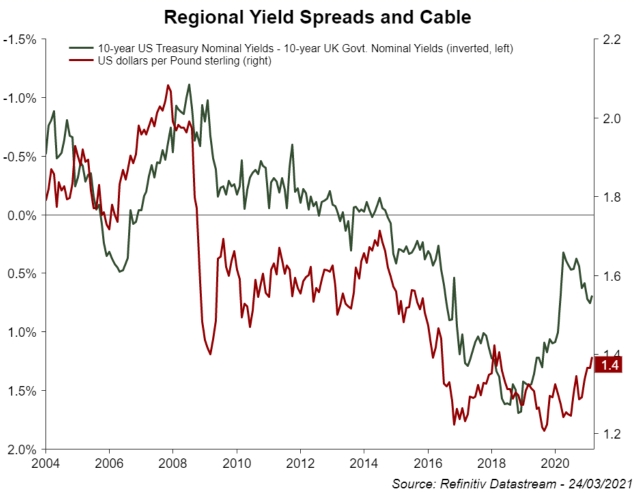
UNITED KINGDOM

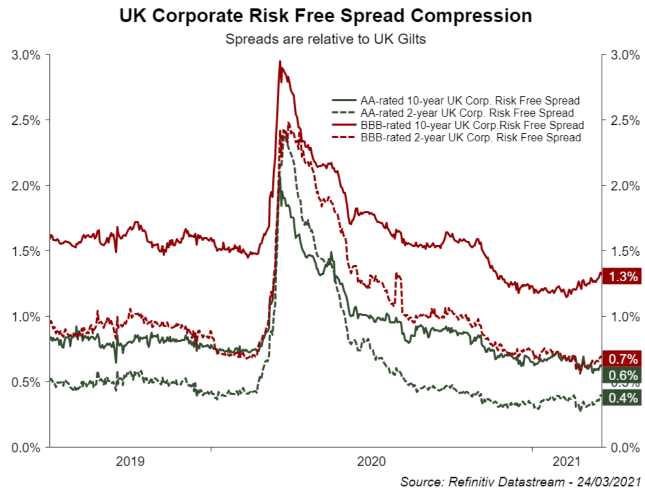
Over the past year, the UK recovery has lagged both the US and Eurozone. Brexit has also weighed on UK risk assets. They have been structurally under-owned and under-loved. The valuation discount, for the most part, has been appropriate given its relatively large decline in GDP (-9.7%), compared to a 5.9% decline in Germany and 4.3% in the US - all in local currency [1]. The UK was also expected to be the last to make a full economic recovery, with GDP levels only expected to exceed the 4Q 2019 highs in early 2022 (compared to 2021 for the Eurozone and the US). However, the outlook for the UK economy has changed in recent months due to less focus on Brexit and a superior vaccine roll-out. An improved growth and inflation outlook, in the same vein as the US, has resulted in a repricing of central bank policy, inflation breakevens, and curve steepness. In the past few months, markets have gone from pricing-in negative UK policy rates to forecasting an improved recovery and a faster interest rate lift-off. Despite being at an earlier stage of recovery than the US and having a smaller fiscal stimulus, we remain optimistic on owning UK risk assets.



[1] International Monetary Fund - https://www.imf.org/en/Publications

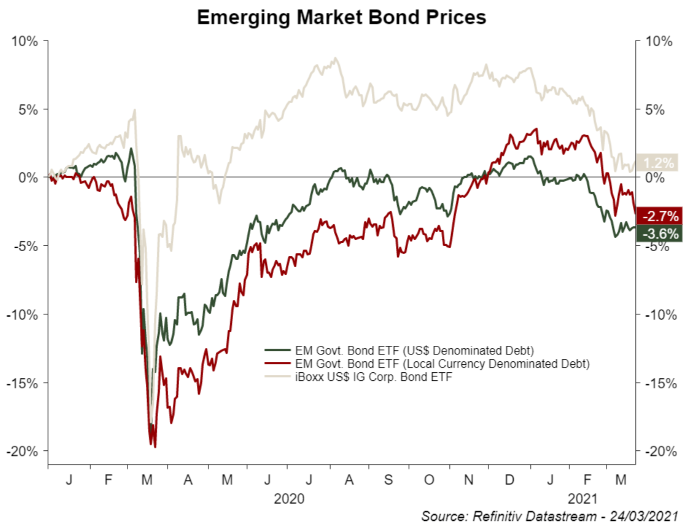
Pound sterling has been a strong performer relative to the US dollar since 2020. As the below left chart depicts, this has been partly driven by changes in relative real yield between the US and UK government bond markets. Cable demonstrates a strong correlation between regional yield spreads over the long term. The below right chart shows a similar 2020 recovery in UK credit spreads, also largely driven by monetary policy.

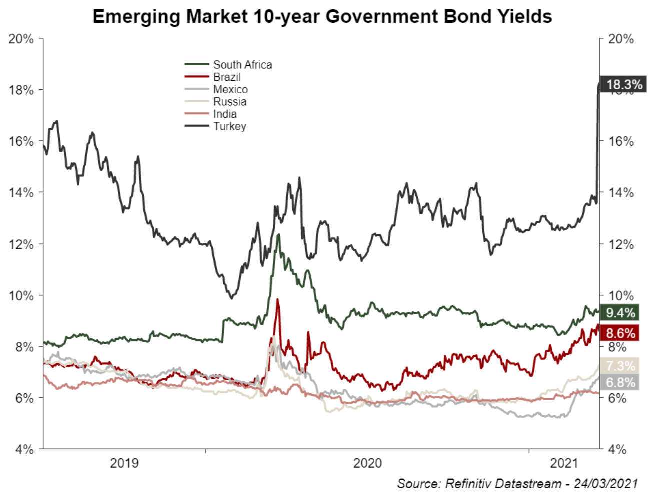


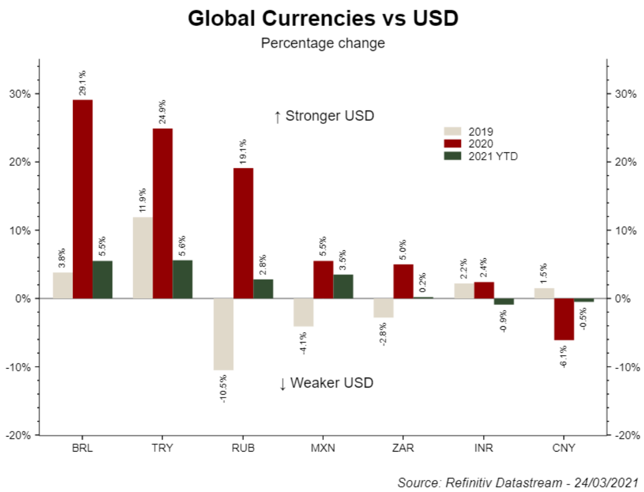


EMERGING MARKET BONDS AND CURRENCIES

Emerging Markets have seen a tightening in credit spreads and appreciating currencies since the Covid19 sell-off. See graphs below. Overall emerging market bonds have underperformed their developed country peers, with divergence between countries. The story is a more nuanced in EM as one needs to evaluate each country on its own merit.







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