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Allspring Global Investments' Fixed Income Expert Sees a Glass at Least Half Full for Global Fixed Income

Hubbis held a fascinating and lively Digital Dialogue event on January 12 that was exclusively sponsored by Allspring Global Investments and that concentrated on the newly re-energised search by private clients for risk-managed yield across the world of fixed income and credit. Henrietta Pacquement, Senior Portfolio Manager and Head of The Global Fixed Income, represented Allspring Global Investments, and had much to say about the different pushes and pulls on inflation, rates, and of course on the challenges and opportunities around fixed income in 2023. Henrietta, originally from France, fits the bill of being somewhat of a rocket scientist in the world of finance, having studied for her masters in Astrophysics at Cambridge University in the late 1990s. This short review combines both her comments at the discussion and her supporting, detailed notes. We hope it offers readers a valuable snapshot of some worthwhile approaches to what is essentially a new era for fixed income investment after so many years of declining and all too often almost non-existent rates.

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Henrietta Pacquement brings well over two decades of experience of the financial markets and particularly fixed income to the table when she speaks at events. When she completed her masters in Astrophysics at Cambridge in 2000, instead of perhaps joining NASA or the European Space Agency, she chose a career in finance. She qualified first as a CFA and then worked as a consultant, then as a financial engineer, and then a quantitative analyst until 2006. Over the next 15 years she then rose the ranks to fixed income portfolio manager, and from 2016 became head of European investment grade credit at Wells Fargo Asset Management, which is now Allspring Global Investments.

To illustrate the challenge in fixed income in recent years, she noted that USD investment grade credit hit a trough in yield of 1.7% in 2020, and worse still European investment grade dropped to 12bps of all in yield in 2021.

"What do you do as an insurance company with 12bp of yield? What do you do as pension fund with 12bps on yield?" she pondered. "Well, not a lot, and thankfully that is all behind us, and we are looking at over 5% in the USD and GBP investment grade credit and over 4% in EUR investment grade credit. With rather flat all-in yield curves as well. All in all, those are much healthier levels to start the year for investors."

"One should not underestimate how much of a wrecking ball the strong dollar was last year putting non-USD economies at a real disadvantage given many commodities are priced in USD, forcing flows into the market to honour currency hedges as well as forcing global central banks to be more aggressive in their hiking cycle than they may have wanted."

Welcome to 2023

She opened her commentary at the January 12 Hubbis panel discussion by reporting that a bruising 2022 has left fixed income markets in a much better place to start 2023. "We have now thankfully left negative rates behind us globally and income is back," she states. "Investors no longer need to stretch down the credit spectrum or into less liquid assets to get yield to avoid the iceberg of negative yielding debt that at one stage peaked at USD18 trillion of paper."

But there are many road bumps ahead

But Henrietta warned that it is not all plain sailing from here. She said that from a valuation perspective, the carry has certainly improved, which is positive for government bond investors, but rolldown is not great, reflecting the current curve inversion.

"Negative momentum in sovereign performance is abating though rates volatility remains elevated," she observed. "From a fundamental perspective, inflation is still hot, even if it is trending in the right direction and growth signals are going south. That gives us overall a more neutral signal on rates at this point, but not a slam dunk either way as yet."

Inflation – not yet reined in

On the inflation front, Henrietta added that in the past there had been way too much stimulus, especially in the US, and then the Fed has been too slow to change course, meaning the drivers of inflation there are more self-inflicted. On the European side, she observed that inflation is more driven by commodity prices, and more dependent on geopolitical troubles in Eastern Europe, and therefore with Russia still waging war on the Ukraine, things remain more unclear as to the future.

Meanwhile, China reopening is going to bring a bit more competition, particularly on the commodity side, and she says it will be interesting to see if that is more of an inflation driver. "China is reopening and that is going to help on many of the supply chain issues that were so acute in 2022," she said. "In reality, there are more push and pull forces on the inflation side begin to play out over the course of the year ahead."

Pluses and minuses

And she told delegates that those caveats for 2023 do not even factor potentialities that cannot yet be modelled.
For example, she listed some of the positive surprises. These include a mild winter in Europe, leading to lower fossil fuel usage, and also the record speed at which German has constructed floating LNG terminals, again

HENRIETTA PACQUEMENT
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reducing fossil fuel demand and climate pollution.

The dollar is off its peak. "One should not underestimate how much of a wrecking ball the strong dollar was last year putting non-USD economies at a real disadvantage given many commodities are priced in USD, forcing flows into the market to honour currency hedges as well as forcing global central banks to be more aggressive in their hiking cycle than they may have wanted," she explained.

On the less positive side, labour markets remain relatively tight and many wage negotiations are ongoing that may impact inflation going forward. The central bank 'put' is a thing of the past for the next little while as they look to continue to rebuild their inflation taming credentials, she said. The conflict in Eastern Europe rumbles on. The impact of a re-opening China can have both inflationary and disinflationary impacts, whilst China's geopolitical goals continue to evolve.

Walking the plank

"As a result of all that, central banks will potentially have a tougher role this year than last as they be looking to walk the fine line of limiting the slowdown in growth to a mild recession whilst keeping inflation in check," she concluded. "But is that going to be mission possible or impossible?"

On the plus side of the equation, corporates have arrived in this phase in relatively good shape. Financials are still living off the lessons learnt from the global financial crisis, and hence have solid balance sheets, and they are still benefiting from low delinquencies and defaults whilst enjoying the increase in interest rates, all of which should limit contagion effects of a slowing property market.

Non-financials are more of a mixed bag with energy companies in fine health while other areas of the economy are feeling the heat, particularly in consumer and real estate related areas that are more sensitive to cost of living and interest rate levels. "It will be interesting what this does to employment and if the lessons of COVID on staff retention modify employer behaviour going forward," she elucidated.

Do not be a hero

Stepping back from the 'ifs' and 'buts', Henrietta maintained that this is the kind of environment where caution should prevail. "You don't need to be a hero in this market amidst these conditions," she stated.

She said rating downgrades and defaults are likely to rise from here. "But the year is at least off to a positive start," she added.

In sub-IG, she reported more interest in the BB space and much more circumspect behaviour in the Bs and CCCs. Given the potential for downgrades, she said CLOs in particular will need to be keep a close eye on their weighted average return on funds this year. "Our general expectation is for a slow rise in stressed, distressed and defaults as many companies have termed out their debt to 2027-2028 and the markets are giving them the benefit of the doubt for now," she summarised.

And she added that if 2022 default rates have been around 1.5%, they may double in 2023 and continue to edge up thereafter leading to an elongated default cycle.

"All this means continued volatility, a better income buffer, but poorer fundamentals," she told guests.

Place your bets...

Henrietta then turned to her recommendations. "We are very interested in the short to intermediate part of the investment grade markets as a great place to harvest carry, with limited price volatility," she reported. "Future hikes are priced in to peak at 5% in Treasuries, 3.5% in German government bonds and 4.5% in UK gilts. Breakevens are attractive in that part of the curve are attractive, implying that with careful security selection, this would be an interesting place."

She added that at that end, investors have a nice cushion in terms of rates, and you have a nice cushion in terms of spread. "You can afford to have a bit of either rates going up a little further or credit spreads going up a little further over the course of the year and still come out in decent shape from a performance perspective," she elucidated.

She also explained that sustainability in fixed income issuance and investment is here to stay, and lessons learnt over the last few years represent a coming of age for sustainable investing. She said the Covid-19 pandemic gave unexpected momentum to ESG investing, but equally the recent commodity crisis had given the ESG type investment approach undue flack.

"Overall, we do see a shift to facilitating outcomes to help with the challenges of climate change and sustainability in general," Henrietta stated. "We also think that the Ukrainian crisis has been a wake-up call globally on key dependencies, be it for energy, food or supply chains. That plays into the hands of sustainability themes particularly for geographies that are fossil fuel poor. We therefore like global strategies focusing on ESG, sustainability considerations, and on climate in particular."

Handle with care

She also reported that Emerging Markets (EM) are now worth another look as the red-hot dollar has cooled somewhat, and EM geographies were faster them DM in their hiking cycles benefitting from past experience and lessons learnt about inflation. That means the yields that are available, particularly in local markets, are pretty attractive at this point.

Additionally, Henrietta told delegates that "as the dollar seems to have peaked and with a better cushion in terms of yield, while not for the faint hearted, EM could be an interesting place to look."

Henrietta also opined on private credit. "The public markets are again attractive for fixed income and the intense drive for private credit exposures was largely pushed by the financial repression from the central banks, hence the very strong demand," she explained. "When you buy private paper, however, you need more yield to compensate for the liquidity of that area of the market. In general, I think it is to be handled with care, particularly as we see the economic environment will become more challenging over the course of 2023, as the central banks are actually trying to engineer."

Looking ahead, her biggest single concern is inflation, which if worse and more enduring than expected will push back what the central banks can do. But if not, and a recession can again be skirted, as in 2022, equity and credit could both fare better than expected.

A year of two halves?

She closed her observations by anticipating that 2023 could be a year of two halves. The first half would be more appropriate for fixed income investments in sovereigns and investment grade paper. The second half might open the doors more to the riskier areas of the market, such as sub-investment grade paper.

"In short, perhaps a year of two halves, and definitely a lot of opportunity to add fixed income to portfolios over the course of the year," Henrietta concluded. ■