Bond investment for tough times

CHRISTOPHER WALKER

Martin Horne is the new global head of public assets at Barings bond investor, but he is a bond guy through and through.

"I am a credit guy by training and experience. You could say this makes me have a naturally pessimistic disposition, in the sense that credit guys are always looking for what may go wrong whereas equity guys are always looking for what will go right. But in spite of this fundamental bias in my makeup, I have to say I think for fixed income and credit investors an awful lot of things are going the right way right now and we are in a market that offers far more potential than first impressions may give."

MARTIN HORNE
- 2023-: global head of public assets Barings, and head of Barings Europe
- 2019-: head of public fixed income, Barings
- 2002-19: various roles within global and euro high yield team, Barings/Babson Capital (Babson Capital became Barings in 2016)

BARINGS
- AUM $347bn (€317bn)
- $186.8bn public fixed income AUM as of 30 September 2023
- Over 1,800 investment professionals based in North America, Europe and Asia Pacific
- Over 1,200 external clients

Positive outlook for credit

A large part of Barings' asset management growth has been driven by new money from existing clients. "In my view, this indicates the quality of service and the level of trust which our relationships with them have delivered," Horne says. "We maintain our edge by maintaining our relevance to our investors. We certainly don't tell clients what to think about rate movements."

He believes the opportunities for an idiosyncratic research-led approach to credit have never been better. "I don't see as many over-leveraged companies in the classic cyclical areas of the market as we have seen in prior downturns. In many ways, any impending recession will be the longest talked about recession in history and this has led companies to take a more cautious approach and to run their businesses for cash. We have seen nothing like the excesses which preceded the 2008-09 downturn. This really does not look like a cliff-edge moment for me. Rather one of significant opportunities."

Geographically, Horne thinks investors' inherent preference for US capital markets seems unlikely to change. "This is likely to be the foundation for investing for the rest of our careers." The US continues to outperform other developed markets in terms of GDP growth and the size and scale of its capital markets.

However, this can mean that there are significant opportunities in European and emerging market assets. "The smaller, slower growing markets are compelled to make more noise to attract investors – by offering higher return through spread with lower leverage profiles. In these less-established markets, you just have to be more selective."

> **"This really does not look like a cliff-edge moment for me. Rather one of significant opportunities"**

A new era for fixed income

Horne has a very definite view on the background of markets and believes fixed income investments now are a very different proposition from what they have been in the last 30 years.

He sees several technical effects playing out around the world. The speed of the rate rise means now that many long-dated investments are priced below par. "Most fixed income asset classes are now priced in the top decile, by which I mean the likely future returns have a greater degree of protection against future rate movements than they have had for a very long time. This gives us considerable upside."

He also sees a central bank dilemma. "Essentially, we are in a situation where central banks can't shift from their 2% inflation targets. At the same time, they're nervous about the damage that will be inflicted by going that particularly troublesome last mile to get to those targets. I think when you look more generally, we may well be in a new era – a higher inflationary environment globally."

Horne cites energy transition requirements which he believes will be inflationary; the effects of climate change on agricultural yields pushing prices up; political policies around immigration and the retrenchment of supply lines; and structural deficiencies in the global energy market.

"All of these are inflationary and convince me that a 2% target may be outdated. When I look at the inflationary wage deals struck recently, such as that by the Ford car workers, this tells me we are in a fundamentally different epoch to the one we have lived in for the last 30 years. Globalisation helped deliver deflation. But post the pandemic, there are other structural forces that we may have to consider."

We have to remember where that 2% target comes from. "It was something invented by the Bank of New Zealand 30 years ago which has then been adopted by one central bank after another. Is it still relevant? Maybe not. Conditions have changed globally."

Asset allocation

Horne's big picture has asset allocation implications. The soft versus hard landing debate is a "distraction" in this new world, as the fundamental difference in corporate earnings between these two outcomes "may not be significantly different – either low levels of growth or contraction".

Yields will continue to remain high and there is a lot of technical focus around the growth of sovereign debt, particularly when it comes to the US where he believes "we will not get lower interest rates as quickly as the market assumes. The Fed is likely to be cautious in an election year and there is a real prospect that 10-year rates could go up, not down".

It is therefore not surprising we are "experiencing significant capital reallocations in the current circumstances. This is investors realising that we've moved into an environment of 'higher for longer'. For example, there has been a significant flight of capital to the comfort blanket of the money markets which is now worth in excess of $5.5trn [€5.1trn] globally".

Every investor must therefore be far more thoughtful about how they tailor their fixed-income positions. "Some clients attempted to take the safe option and switch into investment grade versus high yield, but this simply doesn't take account of the very attractive pricing of high-risk assets."

In this new era, fixed income yields appear particularly attractive. "I think when you consider what the world looks like, that the overall share of fixed income and credit within any diversified assets portfolio is likely to rise. Fixed income offers a level of certainty around income that is contractual and therefore considerably more attractive than prospective dividend streams from equities."