



FIXED INCOME

Positioning Liquid Credit Portfolios For Rising Rates & Inflation



BARINGS CONVERSATIONS

Martin Horne, Head of Global Public Fixed Income, discusses how to mitigate the risk of rising rates and inflation, touching on the potential benefits of floating-rate assets and short-duration strategies.

How is today's environment for rates and inflation similar to past cycles, and how is it different?

There are certainly similarities between the environment we're in today and what we've seen in past cycles. For one, the rising inflation and potential for rates hikes that we're grappling with is positioned against the backdrop of an economy that is in reasonable shape, as has been the case historically when at the early stages of rate-hiking cycles. That's important to keep in mind despite the heightened market volatility that has characterized the early part of this year.

There are also unique elements to what we're seeing today, mostly related to the underlying causes of the inflation we're facing. Energy is clearly undergoing significant structural changes—accelerated by climate policy and the movement toward renewables—and prices have risen as a result. This has been further exacerbated by Russia's invasion of Ukraine, with oil prices recently reaching multi-year highs and Brent crude surpassing \$100 barrel for the first time since 2014. Supply chain disruption amid ongoing Covid flare-ups around the world is another contributing factor. While parts of the world are opening up, particularly developed markets, others are still experiencing manufacturing delays and disruptions. Finally, higher wages are also a contributing factor as the worker shortage continues in many parts of the economy even if there are debates around its exact cause. Government subsidies have been criticized for incentivizing workers to stay out of the active workforce, but even in areas where those subsidies have largely fallen away, like the U.S. and U.K., there are still record numbers of vacancies. One cause may be the reliance, particularly in more rural areas, on a transient workforce that was willing to travel and provided a supplemental supply of workers to sectors like agriculture and service. Another relates to the so-called "great resignation," as workers over the last two years have changed their career path or removed themselves from the workforce altogether, either by choice or necessity.

“One notable point with regard to the volatility we've seen in fixed income markets this year is that it may not necessarily be tied to higher inflation itself, but more to investors trying to predict central banks' reaction to it.”

One notable point with regard to the volatility we saw in fixed income markets earlier this year is that it may not have been tied to higher inflation itself, but more to investors trying to predict central banks' reaction to it. As we saw in January, the realization that base rates may be moving up faster than expected pushed U.S. Treasury yield curves higher and caused equity markets to sell off. But that begs the question: do base rate movements actually control things like the deficit of workers, ongoing supply side disruptions, and structural deficits in the energy market? I think you can argue that's a somewhat inadequate assumption, which suggests we may be more exposed to policy mistakes at this point.

How much of the concern around rates and inflation is already priced in given current valuations and the moves in the 10-year Treasury yield we have seen recently?

It's difficult to say exactly how much is priced in because there are so many factors at play. On the one hand, the recent rise in interest rates has been quite rapid, and its impact has been widespread. We have witnessed portions of fixed income markets underperform, most notably higher-duration segments like investment grade corporate and sovereign credit. We also recently seen a significant drop in negative-yielding debt around the globe (**Figure 1**). On the other hand, we have to remember that a zero base rate world is not normal by historical standards. And while rates have risen rapidly, we are only back to 2019 levels. You can debate the health of the economy now vs. before the pandemic, but if you zoom out, the normalization in rates seems logical and again, possibly a sign that the economy is healing. All things equal, that should be a positive backdrop for credit markets.

Figure 1: A Large Portion of Negative-Yielding Debt Around the Globe has Turned Positive (\$mm)

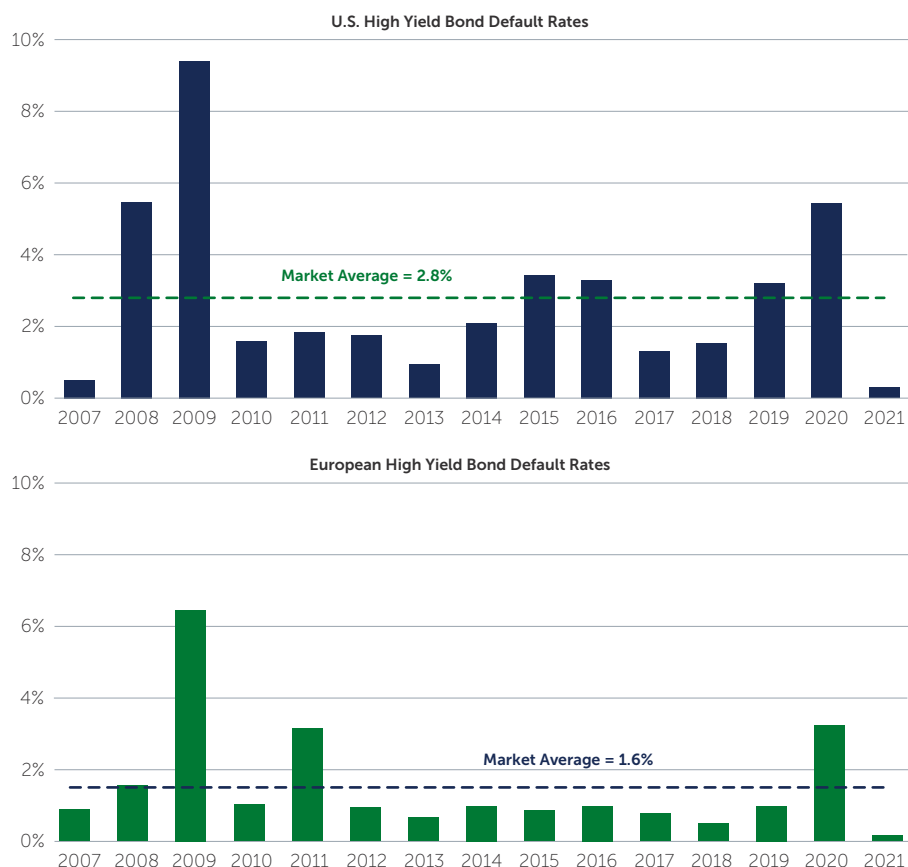


Source: Bloomberg Global Agg Negative Yield Debt Index. As of February 17, 2022.

Against this backdrop, and given the dramatic moves in the market, there are certain areas that seem to be more than compensating investors for the fundamental risk they are taking. As an example, single-B spreads in the high yield market were recently above 5%—a risk premium that implies default levels in line with what we saw following the collapse of Lehman Brothers.¹ Yet, the credit environment is nowhere close to that, with defaults in developed markets expected to remain below long-term historical averages this year, particularly given that only a very small portion of the market was trading at stressed levels as of year-end. To be clear, there are still technical risks that exist, which could lead to wider price points going forward. As we saw last year, when Treasury yields remained very low despite rising inflation numbers, there is always the potential for the market to price in scenarios that subsequently turn out to be incorrect.

1. Source: ICE BofA.

Figure 2: Defaults Expected to Stay Below Historical Levels This Year

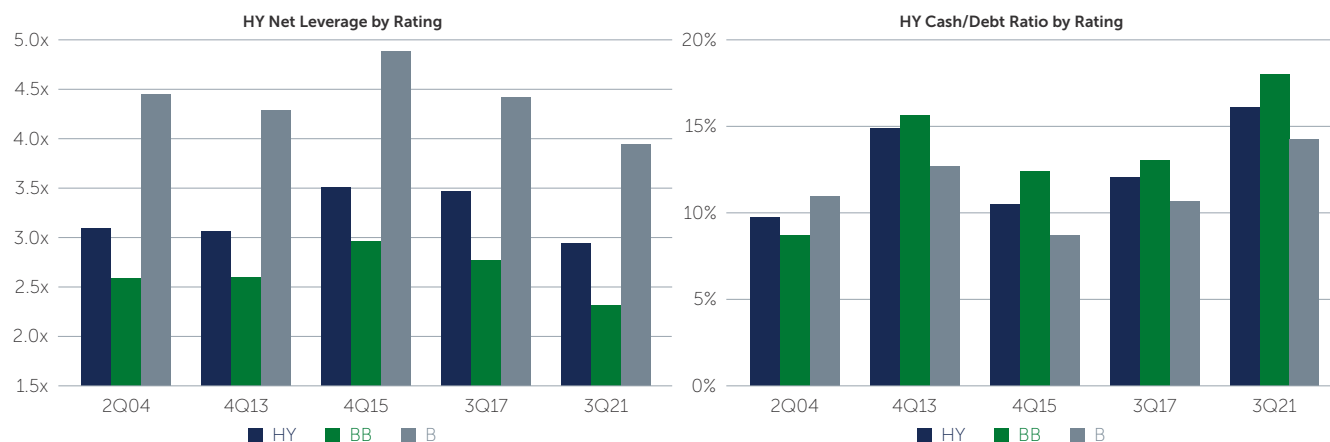


Source: Credit Suisse. Historical trailing 12-month market default rates. As of December 31, 2021. Although default rates are a trailing measure, the market can provide a guide to expectations for future default rates.

What are you seeing from a bottom-up perspective as you consider credit issuers’ ability to weather higher inflation and higher rates?

At a high level, developed market issuers today have lower leverage and a much higher level of liquidity relative to past periods of rising rates, which should help them absorb higher inflation in the near term (Figure 3). Another factor to consider is that from late 2020 through 2021, new issuance skyrocketed across the fixed income universe, as companies built up capital reserves to help weather the pandemic. At the same time, increased refinancing activity pushed out companies’ maturity walls by several years (Figure 4). Now that we seem to be nearing the end of the pandemic as a result of ongoing vaccine and booster rollouts, many of these companies have a positive—albeit unintentional—buffer to get through the inflationary pressures at hand. In my view, this is as good of a profile as you could ask for, given the extent of the technical challenges these companies will face as we transition away from a zero base rate environment and see central banks unwind the assets they’ve accumulated on their balance sheets.

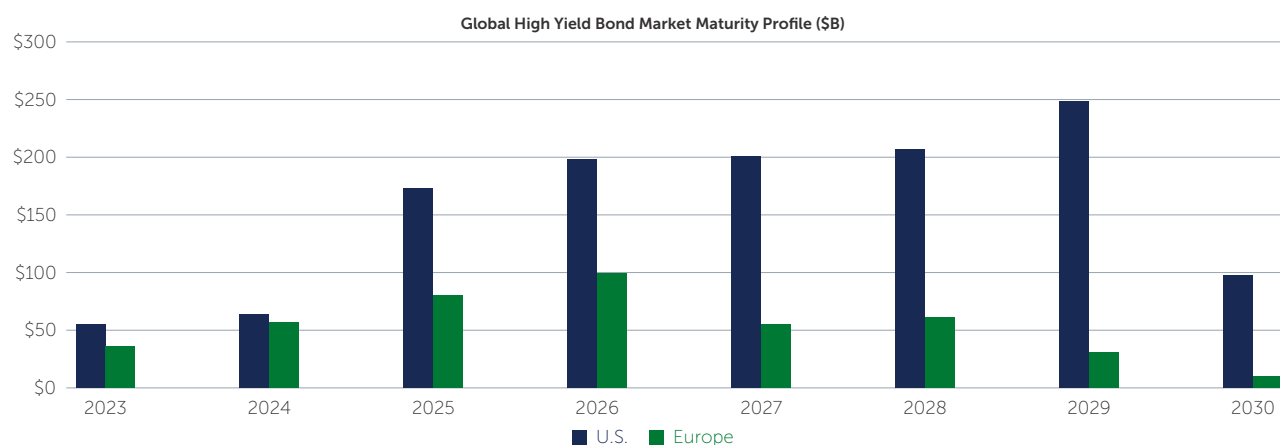
Figure 3: High Yield Net Leverage is Lower, and Liquidity Ratios are Higher, Relative to History



Sources: Morgan Stanley; Bloomberg; S&P Capital IQ.

That said, a lot going forward will also depend on consumer health. On the positive side, coming out of the pandemic, consumers seem to have a greater ability than in the past to absorb higher inflation, at least in the near term. One byproduct of the pandemic was an increase in consumer savings, especially in developed markets—as an example, the IMF estimates European households have saved €1 trillion, or 50% more, in the last two years than they otherwise would have.² In many jurisdictions, company data reflects this, and suggests a continued ability to pass through higher prices without any material impact on demand. However, we’re still early in the inflation cycle, and there is a very real possibility that higher prices for food and fuel begin to chip away at demand, particularly among lower-income segments of the population. In the medium term, particularly on the back of the Russia-Ukraine conflict, we would expect to see alternative sources of oil come on-stream and provide some normalization to prices. Longer term, however, a prolonged period of higher prices would clearly have implications, and could present significant challenges, for issuers in certain sectors.

Figure 4: High Yield Issuers Have Capitalized on Favorable Market Conditions to Refinance Their Debt



Source: ICE BofA. As of December 31, 2021.

2. Source: IMF. As of February 2022.

What advice would you give investors who are thinking about their own fixed income allocations and how to navigate the next couple of years?

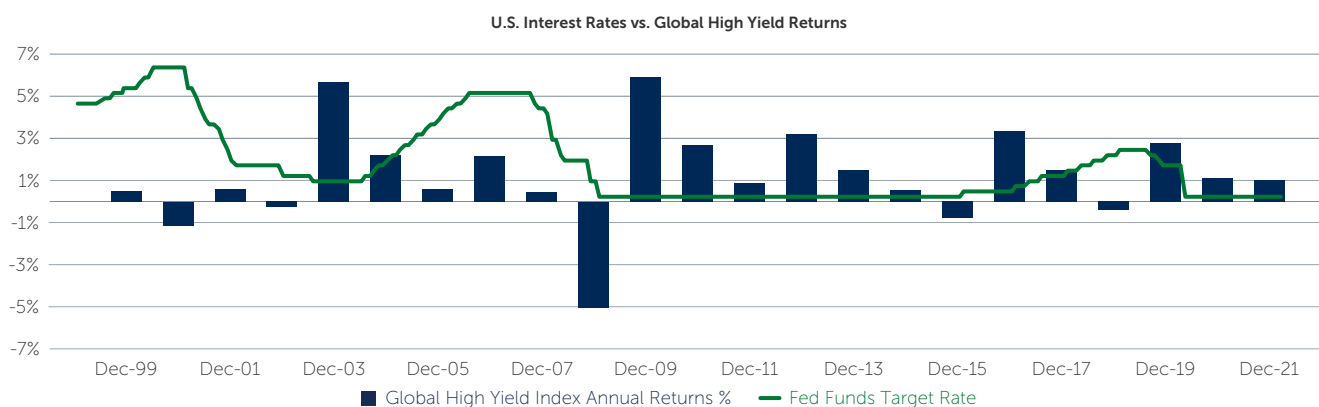
While it very much depends on the objectives of each individual investor, fixed income investors generally have quite a few options in a rising-rate environment.

Floating-Rate Products: The most obvious strategies are straightforward floating-rate and inflation-linked products, from Treasury Inflation-protected Securities (TIPS) to pure floating-rate corporate loans—both public and private. **Loans**, in addition to providing a hedge against rising rates, offer credit risk protection through capital structure seniority and security in the form of asset-backing and covenant restrictions. Because loans are secured by collateral, they have also historically offered high recovery rates relative to other fixed income asset classes. Perhaps less well-known, the **collateralized loan obligation (CLO)** market also offers a range of opportunities across the capital structure. Prices on CLOs, as a result of their floating-rate coupons, have historically been stable in rising-rate environments relative to fixed rate asset classes like high yield or investment grade corporate bonds. CLOs also tend to offer a considerable spread premium over similarly rated corporate assets.

Duration-controlled or short-duration strategies are another option, which could be emerging or developed market, with different collateral mixes involved. Short-dated bonds have lower duration risk, which means the price of the bond is fundamentally less sensitive to changes in interest rates compared to longer-dated bonds. By definition, short-dated bonds also have a shorter time remaining until maturity, and accordingly tend to experience less severe price swings in response to changes in the economic backdrop. **Short-dated EM corporate debt**, in particular, looks attractive given that it can provide the additional benefit of an incremental pick-up in credit spread. However, credit selection matters and will continue to be a big differentiator in performance, helping to identify the issuers that can withstand any forthcoming uncertainty.

Shorter-duration fixed rate assets: There are also benefits to considering shorter-duration fixed rate assets. **Global high yield bonds**, for instance, have duration of roughly 3.82 years, compared to 7.04 years for investment grade corporate bonds.³ As a result, even in periods of rapidly rising U.S. Treasury yields/interest rates, high yield returns have only been marginally impacted, while longer duration asset classes have tended to sell-off more aggressively.

Figure 5: Global High Yield Bond Returns Have Been Resilient in Past Periods of Rising U.S. Treasury Yields/Interest Rates



Sources: ICE BofA; J.P. Morgan. As of December 31, 2021.

3. Sources: ICE BofA; J.P. Morgan.

“There can be rewards for being contrarian to the market if—and that’s a big ‘if’—you have the analytical capability to carefully choose your spots.”

Flexible Credit Mandates: When it comes to fixed income, it is very difficult to make top-down calls and effectively time the market. For this reason, there are a number of benefits to flexible or multi-credit mandates. Unlike more traditional fixed income strategies, most multi-credit strategies are benchmark agnostic, giving a portfolio manager the ability to quickly and efficiently pursue the most attractive relative value opportunities across asset classes, sectors and geographies as they arise. The result is a more diversified approach to credit that can potentially deliver more consistent risk-adjusted returns over time relative to single-sector strategies.

It sounds like there could be an argument for investing in bonds, particularly given the still-strong fundamental backdrop and technical rotation into loans. Is that fair to say?

To an extent, yes. But more to the point, our philosophy around investing in credit has always been that there can be rewards for being contrarian to the market if—and that’s a big ‘if’—you have the analytical capability to carefully choose your spots. We tend not to subscribe to the idea that the market is all-knowing or all-seeing. As we have observed over time, markets almost always overreact, sometimes significantly, in the face of uncertainty. For credit investors and managers, the ability to look beyond the surface-level noise and identify solid companies is key. The beauty of credit is that companies have maturity walls; regardless of what is happening in the market, sooner or later these companies have to repay their investors.

To put it another way, periods of uncertainty and volatility are the moments when active asset selectors should really shine. Certain fixed rate assets have been beaten up quite a bit, perhaps too much, given the combination of a positive fundamental backdrop and strong refinancing and M&A activity. For fundamental buyers able to pick their positions in pursuit of the best value, these conditions can result in opportunities to pick up significant premiums. Given the volatility we expect to continue to see this year, I think we may see some of the best asset selection opportunities we’ve seen in a while.

If you put yourself in the shoes of our clients, what key areas are worth watching over the next 12–24 months?

There are a number of factors to watch going forward. From a macro perspective, the conflict between Russia and Ukraine is top of mind, and has created considerable levels of uncertainty across markets. Events in China may also lead to further bouts of volatility this year. For fixed income investors in particular, central banks and inflation will be worth monitoring closely. To use a somewhat exhausted metaphor, we're in uncharted territory today given the size of the potential tapering programs and the nature of the inflationary conditions we're facing. As central banks react in this environment, and markets respond to new data points suggesting the policies being enacted are having positive or negative effects, volatility is very likely.

As mentioned, however, periods of transition and volatility can result in opportunities for active, bottom-up managers to generate alpha. We have seen this through multiple market events, from the sovereign debt crisis, to the commodity crisis to the Covid selloff. Regardless of what asset class or geography you're in, taking a top-down, helicopter view on the markets will likely result in missed opportunities. Rather, I would again emphasize the importance of active management and rigorous, bottom-up credit analysis, which in addition to allowing managers to capitalize on relative value opportunities as they arise, can also help in the avoidance of unwanted risks.

This Q&A is based on a recent podcast. Listen to the full conversation [here](#)*.

*Full podcast URL: <https://www.barings.com/viewpoints/combating-higher-rates-inflation-in-liquid-credit-portfolios>

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