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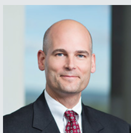
PUBLIC FIXED INCOME

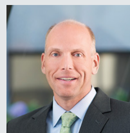
Five Reasons to Consider IG Credit in 2024

Given normalizing yield levels, attractive total return potential and ongoing uncertainties, there is a compelling case to be made for IG credit in the year ahead.

INSIGHTS



Charles Sanford
Head of Investment Grade Credit



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After one of the most challenging years ever for fixed income returns in 2022, investment grade (IG) credit staged a partial comeback in 2023 with total returns of 8.7%.[1] This is within the context of a market that has grown nearly three-fold since the Global Financial Crisis (GFC), to $15 trillion, when prevailing yields were last at the levels seen today.[2] With nearly 20,000 securities to choose from, global IG credit is also a liquid and diverse market offering a wide range of investment opportunities—across different issuers, geographies, maturities, currencies and even levels of seniority.

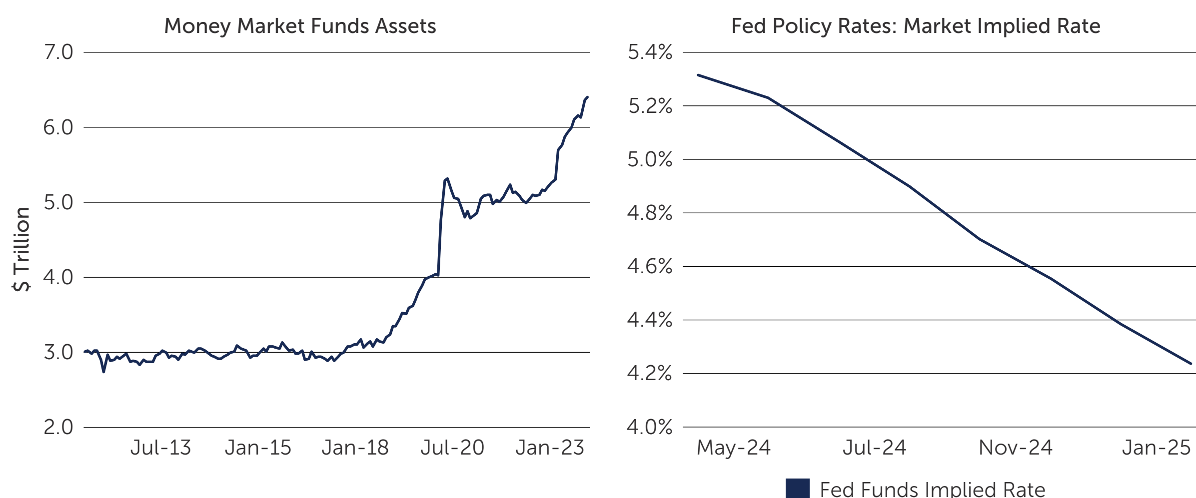
Does the positive momentum building across the asset class signify the beginning of a renaissance for IG credit? It's certainly possible, in our view, for five key reasons.

1. Cash is No Longer King—It's Time to Put it to Work

Over the past two years, with the U.S. Federal Reserve (Fed) rapidly raising interest rates, the term premium in bond markets, i.e., the additional yield that investors expect from owning riskier, longer-duration bonds, has hovered in predominantly negative territory. In other words, investors were being asked to pay to assume more interest rate risk, rather than being paid for it. The negative term premium, coupled with the inverted yield curve, has meant that cash has become an increasingly larger part of investor asset allocations. Indeed, money market funds witnessed record flows of more than $1.2 trillion in 2023 **(Figure 1)**. Waiting on the sidelines, in cash, made sense during this rapidly rising-rate environment. But with the Fed likely at or near peak rates, and consensus estimates pointing to lower policy rates this year and into 2025 **(Figure 1)**, we believe it is time to put the cash back to work into assets that can offer attractive total return potential, such as IG credit.

By stepping out of cash and into opportunities further down the yield curve, while the Fed is still on hold, investors can position themselves to potentially benefit from the pickup at the front end of the curve, while kicking the proverbial reinvestment risk can further down the road.

Figure 1: Cash is Waiting on the Sidelines, While Fed Policy Rates Expected to Fall This Year



Source: Bloomberg. As of February 20, 2024.

1. Source: Bloomberg. As of December 31, 2023.
2. Source: Bloomberg. As of January 31, 2024.

2. Income is Back in Fixed Income

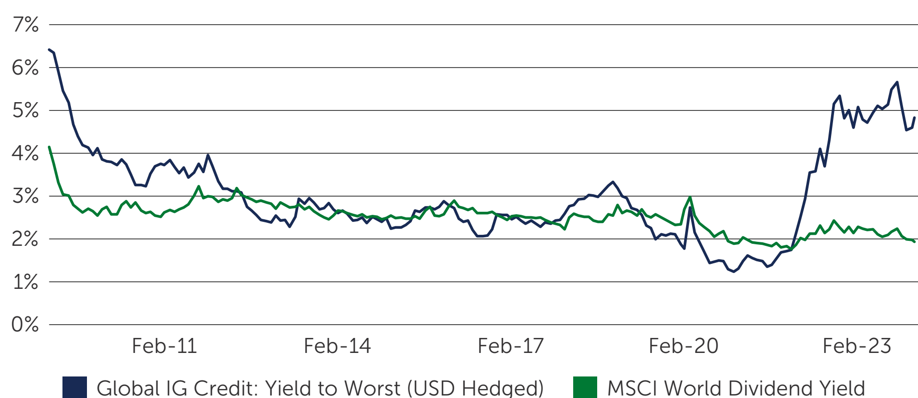
Following the GFC, as central banks around the world engineered a prolonged low interest rate environment, the fundamental premise of income from bonds all but disappeared. Consequently, traditional fixed income fell out of favor and investors found themselves reaching for yield by allocating to alternatives and to riskier segments of debt markets.

The swift path to higher yields over the last two years has been equally painful for bond investors. However, the normalized rate environment that investors now find themselves in has meant that yields—and therefore income—across IG credit are at levels rarely seen in the last 15 years **(Figure 2)**. Indeed, at current levels, income from global investment grade bonds is 2.5 times higher than the dividend yield of the MSCI World equity index **(Figure 3)**. Layer on the potential for capital appreciation from lower rates, and IG credit offers investors the potential for equity-like returns in 2024.

Figure 2: Current Yields Are at Levels Rarely Seen in the Past 15 Years

Source: Bloomberg. As of February 20, 2024.

Figure 3: Fixed Income Appears More Attractive Relative to Equities

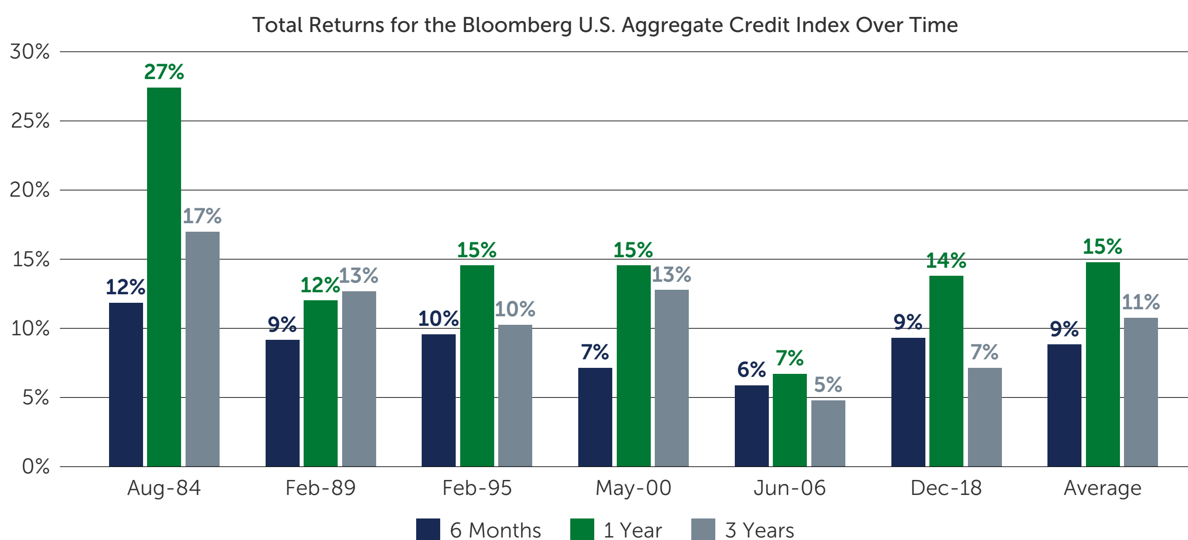


Source: Bloomberg. As of February 20, 2024.

3. History May Provide a Guide

The potential for equity-like returns over the coming months and years from IG bonds is supported by historical evidence as well. Over the past 40 years, following the end of central bank rate-hiking cycles and ahead of rate cuts in subsequent years, allocations to IG corporates and core global bonds have significantly outperformed **(Figure 4)**. During that period, following the last rate hike in the Fed's tightening cycle, the average total return for the asset class was 9%, 15% and 11% in the following six months, one year and three years (annualized), respectively.

Figure 4: IG Credit Total Returns Following Final Fed Rate Hike



Source: Bloomberg. As of February 20, 2024. Returns for periods longer than one year are annualized.

4. Idiosyncratic & Technical-driven Opportunities

The Fed's unexpected pivot late last year re-injected exuberance into markets—and since then, spreads across fixed income have experienced meaningful compression. While spreads in the IG market are currently below long-term averages, all-in yields remain firmly in the 80th–90th percentile.[3] Notwithstanding current spread levels, the landscape is ripe for bottom-up security selection.

In particular, the wide dispersion across the IG credit sub-sectors is shaping compelling idiosyncratic investment opportunities. For example, technical dislocation in the U.S. agency-backed mortgage market is presenting an attractive opportunity today. U.S. agency mortgages have been trading at valuations that have rarely been this wide over the past decade.[4] The sector has seen two of its largest holders, the Fed and banks, shed their holdings. Simultaneously, amid increased supply emanating from FDIC liquidations of failed bank balance sheets, the onus to absorb the supply has fallen on asset managers, hedge funds and REITs—but this thinner buyer base pushed spreads wider. Now, with FDIC liquidations mostly complete and the potential for a steadier Fed policy ahead, the sector presents an attractive entry point for long-term investors.

3. Source: Barings. As of February 21, 2024.
4. Source: Barings. As of February 21, 2024.

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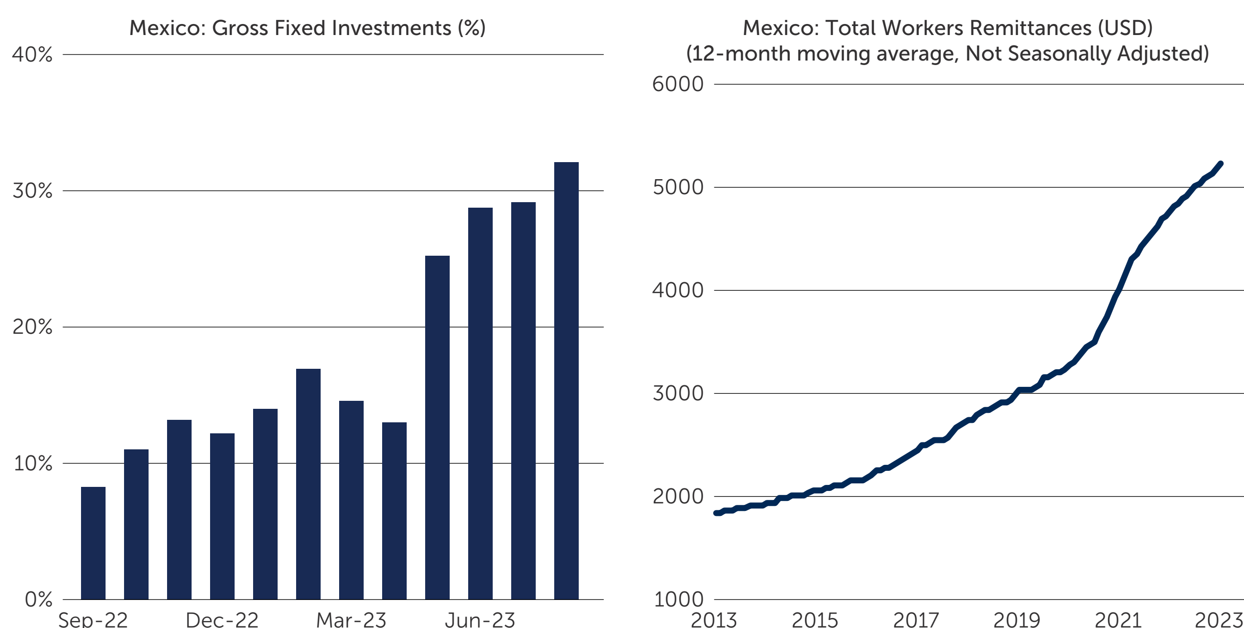
"In the event the "landing" ends up being rockier than anticipated, IG credit can function like ballast in investor portfolios, a diversifier against equities, most private markets, and alternatives."

Meanwhile, emerging markets (EM) have experienced heightened volatility emanating from geopolitical tensions and the repercussions of a strong U.S. dollar in recent years. However, the resilience of the U.S. economy, coupled with emerging trends such as "nearshoring", are presenting unique IG-rated opportunities in U.S.-linked EM countries like Mexico **(Figure 5)**. Moreover, if the Fed does initiate its rates easing path, the consequent impact on the U.S. dollar will likely be a strong tailwind for EMs more broadly.

Figure 5: Opportunities Emerge in IG-Rated EM Bonds



Source: World Bank. December 31, 2023.

Similarly, some of the most interesting opportunities in the IG corporate market today are of a more idiosyncratic or catalyst-driven nature. For instance, there has been an uptick in equity-financed acquisitions, particularly in the insurance sector, in which a higher-rated company acquires a lower-rated issuer. Our research into IG-rated sub securities and hybrid securities has presented opportunities in shorter-duration bonds that we believe have a high probability of being called over the next two years, such as select AT1s and preferreds.

Last but not the least, the technical backdrop is presenting a number of attractive opportunities in European IG credit. In particular, the end of reinvestments by the European Central Bank (ECB) within its Corporate Bond Purchase Programme in 2023 removed a stable source of demand and arguably led to wider spreads. Specifically, European IG credit is currently trading at a meaningful spread premium to U.S. IG, despite its shorter duration.[5] And with the Euro Area's 2024 growth projections being tepid at best and roughly half the growth expected in the U.S., European IG total returns could also potentially get a boost from more aggressive interest rates cuts by the ECB relative to the Fed—although in this scenario, fundamentals will likely come under pressure and will require close monitoring.

5. The Portfolio's Liquid Ballast

The global economy was remarkably resilient in 2023 amid surging inflation, geopolitical tensions and the fastest rate hike cycle in recent history. However, while economists continue to converge around a "soft landing" scenario, much of the positivity has been fueled by the optimistic outlook for the U.S. economy. In particular, the U.S. remains a bright spot, but the outlook is mixed for many other developed markets such as Germany, the U.K. and Japan. Even historically high growth economies such as China are struggling to stimulate growth in the face of internal and external pressures or imbalances.

Adding to the growth challenges are geopolitical tensions that have once again taken center stage, most recently in the Middle East. In the event the "landing" ends up being rockier than anticipated, IG credit can function like ballast in investor portfolios, a diversifier against equities, most private markets and alternatives. And importantly, in volatile markets, the liquidity and depth offered by the asset class allows for nimble positioning. While U.S. treasuries remain the deepest and most liquid market in the world, other segments of the IG credit market also offer deep liquidity. For example, the U.S. agency MBS market, with more than $12 trillion outstanding, sees daily trading volumes close to $300 billion on average.[6] Similarly, the U.S. IG corporate market, with over $5 trillion[7] outstanding, witnesses over $25 billion exchanging hands daily[8]. Additionally, roughly 40% of the IG corporate bond market trades exclusively on electronic platforms with trades settling within a day.[9] In summary, if a downside market scenario were to play out, not only would IG bonds potentially diversify against riskier segments of an investor's portfolio, but the liquidity on offer could be an important tactical tool in an asset allocator's toolbox.

5. Source: Bloomberg. As of February 21, 2024.
6. Source: JP Morgan. As of January 2024.
7. Source: SIFMA. As of February 2024.
8. Source: SIFMA. As of May 2023.
9. Source: SIFMA. As of February 2024.

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Key Takeaway

As some of the headwinds facing IG credit have subsided or turned into tailwinds, the asset class looks poised for strong performance going forward. In particular, there are five reasons why IG credit may be worth a closer look.

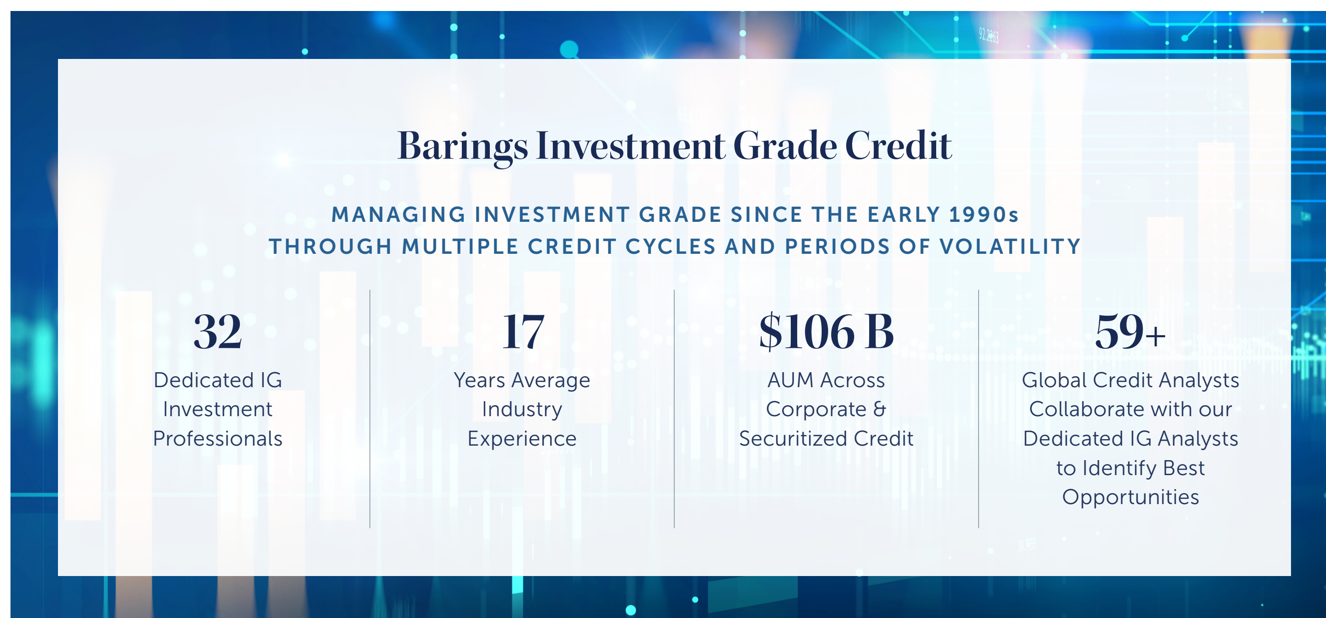
1. **CASH IS NO LONGER KING**
   It's time to put it to work: With the rate-hiking cycle at or near its end, investors may benefit from seeking opportunities further down the yield curve, in assets that offer strong total return potential.

2. **INCOME IS BACK IN FIXED INCOME**
   Yields—and therefore income—across IG credit are at highs rarely seen in the last 15 years, suggesting the potential for equity-like returns in 2024.

3. **HISTORY MAY PROVIDE A GUIDE**
   IG credit has experienced strong outperformance in the months and years after past rate-hiking cycles have come to an end.

4. **IDIOSYNCRATIC & TECHNICAL-DRIVEN OPPORTUNITIES**
   The wide dispersion across IG credit sub-sectors is creating compelling idiosyncratic investment opportunities, including in areas like U.S. agency mortgages, emerging markets and European IG credit.

5. **THE PORTFOLIO'S LIQUID BALLAST**
   If the "landing" ends up being rockier than anticipated, IG credit can function like ballast in investor portfolios, a diversifier against equities, most private markets and alternatives. Additionally, in volatile markets, the liquidity and depth offered by the asset class allows for nimble positioning.



Source: Barings. As of December 31, 2023.

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**As of December 31, 2023*

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