Bonds: The Ballast to Your Portfolio

Prepared by: Affin Hwang Asset Management

In collaboration with:

PIMCO

Investors have reason enough for concern. Markets are volatile. Inflation is persistent. Recession risk looms.

However, there is a bright spot to consider: With yields now higher across maturities, bonds offer compelling value to investors seeking higher income potential. In our latest article, we discuss the case for bonds and the important role it plays as part of a diversified portfolio in offering capital preservation as well as providing a potential source of stable returns.

But first, here is a lay of the land of what is happening in markets.

The Economic Backdrop

1 Recession is Likely, But Should be a Shallow One

Recession and rising unemployment rates across large developed markets (DMs), especially the Euro area and UK, appear quite likely despite further government efforts to support their economies.

The geopolitical tumult has compelled Russia to greatly reduce and even halt gas flows through various pipelines into Europe – the major source of European energy imports. As European industrial production and trade flows are impaired, disruption will likely spill over to the UK, US, and other DMs.

Meanwhile, US real GDP will also likely experience a period of modest contraction that is expected to result in a higher unemployment rate.

We don't expect a recession in China, though we do see downside risks to real growth emanating from the country's zero-COVID policy and property sector slump. Falling exports to the US, Europe, and other developed economies will likely also be a strong headwind for China's policymakers as they try to maintain their growth targets, despite some rising trade with Russia.

Despite this challenging outlook, our baseline view is for relatively shallow recessions across the major DMs given that

i) household and private sector balance sheets have remained strong, on average,

ii) debt constraints become less binding in inflationary environments, and

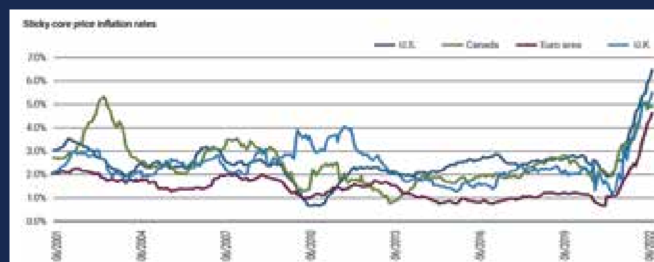
iii) to date, the rapid tightening in financial conditions hasn't yet resulted in widespread bank funding market stress.

2 Inflation is Sticky

Core inflation rates that are above central bank targets now appear more entrenched, and although headline inflation is still likely to eventually moderate meaningfully over our cyclical horizon, it now looks likely to take more time. Rising inflation has broadened beyond categories affected by pandemic-related global goods production disruptions to include components of the price basket that tend to be more cyclical, including shelter and services. Indeed, measures of "sticky" inflation have generally accelerated across major DMs, with the acceleration in the US being the most pronounced.

Furthermore, measures of longer-term inflation expectations have been trending generally higher over the past two years while tight labor markets have pushed up wages. This is especially true in the US, where wage pressures have broadened from the low-wage, low-skill service sectors to a range of industries, occupations, and skill levels. While our baseline sees core inflation taking more time to subside than central banks had recently hoped, downside risks to the real growth outlook also point to higher-than-usual inflation uncertainty, and a non-remote possibility of a more dramatic disinflationary bust.

Graph 1: Core inflation has become more entrenched in developed markets



Source: Haver Analytics and PIMCO calculations as of September 2022. "Sticky" price baskets are constructed using the least volatile categories across each country/region from 2012 to 2019. Methodology is based on research by Michael F. Bryan and Brent Meyer, "Are some prices in the CPI more forward looking than others? We think so," (Federal Reserve Bank of Cleveland, 2010).

3 Monetary Policy: Tighter for Longer

The combination of higher unemployment and stubbornly above-target inflation has put central bankers in a tough spot, but their overall actions to date suggest they are squarely focused on bringing inflation down.

In the US, we expect the Fed will raise its policy rate to a range of 4.5%-5% and then pause to assess the impact on the economy of its tightening. How high DM policy rates ultimately rise to provide sufficiently restrictive financial conditions will depend on the sensitivity of the respective economies to interest rates. Judging by recent housing market performance, central banks of Canada, Australia, and New Zealand may reach a point where they pause before the US, and especially the UK.

In the UK, as a result of the announced fiscal expansion, the ultimate destination of the Bank of England's (BOE) policy rate could be well above that of other DM central banks, despite the BOE's recent shift from shrinking its balance sheet to once again expanding it in an effort to mitigate the systemic risks to the UKpension system from the swift adjustment in longer-term interest rates.

The Bank of Japan (BOJ) is the one exception to this outlook, since inflation in Japan has thus far remained surprisingly muted. If Japan's inflation dynamics eventually follow in the footsteps of their international peers, we expect the BOJ to adjust policy accordingly.

Investment Implications

With higher yields across maturities, we believe the case is now stronger for investing in bonds. We believe high quality fixed income markets can now be expected to deliver returns much more consistent with long-term averages, and we think the front end of yield curves in most markets already price in sufficient monetary tightening.

We see abundant opportunities to look to harness this growing value in bond markets. For example, investors could combine exposure to high quality benchmark yields – which have increased significantly in the past year – with select exposure to high quality spread sectors, and add potential alpha from active management. We believe the return potential is compelling in light of our cyclical outlook, and that many investors could be rewarded by returning to fixed income.

Further, in addition to higher income potential, yields are high enough to provide the potential for capital gains in the event of weaker-than-expected growth and inflation outcomes or in the event of more pronounced equity market weakness. We expect that more normal negative correlations between high quality bonds and equities will re-assert themselves, thus improving the hedging characteristics of quality core bonds, which generally should rise in value when equities fall. Also, the higher yields offered in bond markets today could help compensate those who choose to wait out this period of uncertainty and potentially higher volatility.

Still, caution is warranted. If inflation is stickier than we expect, central banks could be forced to hike rates by more than is priced in currently, and if recessions are as shallow as we expect, then policymakers may be slow to cut policy rates to boost growth, given the high inflation starting point.

Thus, in core fixed income portfolios, this is an environment where we are prepared to take the active and deliberate decision to reduce risk across a range of risk factors and to keep some dry powder (i.e., maintain liquidity). Liquidity management is always important but is especially important in a difficult and highly uncertain market environment. In line with our secular outlook, we will look to maintain portfolios that will be resilient across a range of economic, geopolitical, and market outcomes.

In summary, we believe the anticipated real economic and financial market volatility will lead to attractive opportunities for investors with patience and fresh capital. The gap between private and public asset valuations remains extreme, but as private markets adjust and challenges become apparent across the corporate credit and real estate space there should arise opportunities to potentially generate outsize returns. This is one of our highest conviction views.

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Greater Income Potential	**Source of Stability**	**Income Stream**
The return potential in bond markets appears compelling given higher yields across maturities. High quality fixed income markets can now be expected to deliver returns much more consistent with long-term averages.	Given downside risks in equity markets which may not have sufficiently priced-in earnings downgrade, fixed income provide an added source of diversification. Its negative correlation with equities is expected to gradually reassert itself in the coming cycle.	Chances of a central bank "put" appears slimmer with interest rates expected to stay higher-for-longer as policymakers seek to rein in inflation. Higher yields offered in bond markets may help investors wait out this period of uncertainty through a potentially steady income stream.

Build Portfolio Resilience with Bonds

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Scan here:

Through a flexible multi-sector approach, the Fund balances higher yielding and higher quality assets to deliver consistent income to investors.

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