A Special Report from

SAVVY INVESTOR

Fixed Income: Winners and losers during regime change

Industry experts discuss where to find sources of return at a time of rising rates

Authored by Savvy Investor

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Special Report

Fixed Income: Winners and losers during regime change

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SEBASTIAN CULPAN-SCOTT
EDITORIAL DIRECTOR
SAVVY INVESTOR

Sebastian Culpan-Scott is a Chartered Member of the Chartered Institute for Securities & Investment. Prior to joining Savvy in 2020, Sebastian worked as an Investment Manager at Sanlam Wealth and Investec Wealth & Investment.

"DESPITE THE BLEAK OUTLOOK, IT MUST BE REMEMBERED THAT WITH VOLATILITY OFTEN COMES OPPORTUNITY."

The first half of 2022 has brought more challenges for investors as both fixed income and equity assets have experienced a significant repricing due to the volatile economic environment. Investors are having to cope with an uncertain market environment with levels of inflation not seen for over four decades, and central banks which are aggressively tightening monetary policy.

Despite the bleak outlook, it must be remembered that with volatility often comes opportunity. One area in particular that looks to benefit from this period of rising interest rates is higher-quality fixed income securities that have longer durations or more exposure to interest rate increases. Yields are already higher now than they were a few months ago, and investors are expected to continue allocating more to fixed income assets as rates continue to rise.

In BlackRock's paper, 'Seeking Resilience: 2022 midyear global credit outlook', they discuss markets' volatile response to the combination of geopolitical events, inflationary cost pressures and tightening financial conditions. Within the paper they also highlight the rising risk from soaring prices, declining liquidity and increasing dispersion, and they outline what implications these factors are likely to have on global credit markets.

In our 'Ask the Expert' interview, BlackRock's investment experts discuss how an unconstrained approach to fixed income can be beneficial to investors during times of uncertainty, and how it can enable them to meet their investment goals.

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At BlackRock, the institutions we serve – from foundations to large pension funds – collectively serve hundreds of millions of individuals around the world. That's why we work alongside them as they contribute to the financial futures of the people who depend on them.

BlackRock Institutional's Investment Experts

Rick Rieder
CIO of Global Fixed Income, Head of Fundamental Fixed Income and Head of Global Allocation, BlackRock

Rick Rieder, Managing Director, is BlackRock's Chief Investment Officer of Global Fixed Income, Head of the Fundamental Fixed Income business, and Head of the Global Allocation Investment Team. Mr. Rieder is responsible for roughly $2.4 trillion in assets. He is a member of BlackRock's Executive Sub-Committee on Investments, its Global Operating Committee, and Chairman of the firm-wide BlackRock Investment Council.

Bob Miller
Head of Americas Fundamental Fixed Income, Global Fixed Income, BlackRock

Bob Miller, Managing Director, is head of Americas Fundamental Fixed Income within BlackRock's Global Fixed Income group and a member of the Global Fixed Income Executive Committee. He is a portfolio manager of BlackRock's Core Bond, Total Return, and Strategic Income Opportunities Funds.

David Rogal
Managing Director, Multi-Sector Mutual Fund, Global Fixed Income, BlackRock

David Rogal, Managing Director, is a member of the Multi-Sector Mutual Fund team within BlackRock's Global Fixed Income Group. He is a portfolio manager of BlackRock's Core Bond, Inflation Protected, Total Return, and Strategic Income Opportunities Funds. Mr. Rogal focuses on broad macro positioning, with specialties in interest rates, inflation, and volatility trading.

Featured Paper from BlackRock Institutional:

2022 Midyear Global Credit Outlook – Seeking Resilience

CLICK TO VIEW FULL REPORT

"WHILE RECESSION RISKS HAVE INCREASED, WE DO NOT EXPECT A DEEP RECESSION WITH THE USUAL DEFAULT SPIKE AND BELIEVE INSTEAD THAT POLICY WILL HAVE TO ADAPT TO SLOWING GROWTH..."

Midway through 2022, markets have become substantially more volatile in response to the combination of geopolitical events, inflationary cost pressures and tightening financial conditions. While recession risks have increased, we do not expect a deep recession with the usual default spike and believe instead that policy will have to adapt to slowing growth, and companies will focus on balance sheet preservation and strategies to withstand near term uncertainty. Looking ahead, the key themes we are focused on are rising risk from rising prices, declining liquidity, and increasing dispersion.

Pricing pressures abound

Global prices for everything from oil and gasoline to cereal and milk are significantly higher this year, escalating pressure on consumers and companies alike. Median global inflation is nearly 8% compared with approximately 3% a year ago, and the high absolute level of inflation will have lasting effects. High and persistent inflation can become more difficult to eliminate outside of a recession, and those risks are important when assessing credit fundamentals.

Food and energy insecurity are a threat to global market stability. Emerging economies tend to be affected first, and the potential human toll of these crises cannot be understated. The war in Ukraine has accelerated these risks and may create political instability in already unstable regions and unexpected outcomes beyond that. These growing risks drive our preference for developed markets in the near term, although energy, in particular, is a headwind to consumers everywhere as well as a politically sensitive topic in a market simultaneously focusing on the global energy transition.

The number of opportunities is increasing though, as inflation pressures persist. We favor companies with pricing power and variable cost structures, such as technology and services businesses, which are more efficient in adapting to changing market conditions. Supply chain disruptions are beginning to moderate, which may help goods companies, while greater technology adoption and an ongoing focus on scaling back high fixed cost structures are critical to defending margins.

No longer a rising tide

Regime change is difficult to quantify, especially when it is occurring in real time. And yet the shift in monetary policy of both higher interest rates, an end to asset purchases and, in particular, a reduction to the Federal Reserve's balance sheet highlight a significant policy shift in response to the highest inflation levels experienced in 40 years. A variable but persistent tailwind of many years has died down, and now we'll see which

"A VARIABLE BUT PERSISTENT TAILWIND OF MANY YEARS HAS DIED DOWN, AND NOW WE'LL SEE WHICH BUSINESSES ARE TRULY READY TO WITHSTAND TIGHTENING FINANCIAL CONDITIONS."

businesses are truly ready to withstand tightening financial conditions. Corporations have benefitted from years of declining interest rates, which have provided immense flexibility to reduce a business's cost of capital. Higher rates and tightening financial conditions impact both the calculus on debt and equity as markets discount future earnings. The result is more differentiation on balance sheet fundamentals. If the math no longer makes sense, M&A or other corporate actions may quickly transition from opportunistic to critical.

After enormous pandemic-related government spending worldwide to help consumers during lockdowns, we see increased relative fiscal restraint as high inflation has crushed political support among incumbent leaders and continued political polarization limits opportunities for meaningful compromise, particularly in the U.S. ahead of the mid-term elections.

Winners and losers

As companies react to higher input and financing costs, the idiosyncrasies of individual business models begins to diverge. At a time of slowing economic growth, the risks and opportunities can be more pronounced and offer greater alpha potential to those able to navigate them.

One consequence of slowing economic growth and tighter financial conditions is that not all companies will make it without a restructuring or balance sheet re-sizing. Defaults are near historically low levels, so a higher default rate ahead should not be surprising. However, we don't expect a default spike in the near term as the majority of issuers have taken advantage of open capital markets to refinance and term-out debt.

Tightening financial conditions and volatility can undermine traditional financing paths for issuers. Growth M&A, overdue capital expenditures and complex business problems can often prevent companies from accessing traditional forms of capital. We expect this environment to provide significant opportunities to deploy capital, take advantage of market mispricings and dislocations, which would benefit from our partnership.

"WE VIEW A WIDE LENS AS CRITICAL TO UNDERSTANDING THE RANGE OF MARKET OPPORTUNITIES TODAY..."

Navigating greater uncertainty

A wider distribution of outcomes is a function of more uncertainty. We view a wide lens as critical to understanding the range of market opportunities today, while selectivity remains critical to positioning us to be able to create differentiated outcomes. Strategic views across global credit markets today:

Developed market and U.S. preference: We prefer the U.S. over non-U.S. markets with a view towards relative growth and stability in developed economies in the near term.

Loan vs. bonds: With rates having already priced in a lot, there is potential for a rotation leading to bond outperformance in the months ahead which we are monitoring closely.

Public vs. private credit: Opportunistic transactions are less comparable to traded markets, but we expect a higher volume of deals to provide attractive illiquidity and complexity premium.

Click here to download the full report.

Ask the Expert with BlackRock Institutional:

An Unconstrained Approach For Uncertain Times

Rick Rieder, Managing Director, is BlackRock's Chief Investment Officer of Global Fixed Income, Head of the Fundamental Fixed Income business, and Head of the Global Allocation Investment Team. Bob Miller, Managing Director, is head of Americas Fundamental Fixed Income within BlackRock's Global Fixed Income group and a member of the Global Fixed Income Executive Committee. David Rogal, Managing Director, is a member of the Multi-Sector Mutual Fund team within BlackRock's Global Fixed Income Group.

Rick Rieder
CIO of Global Fixed Income, BlackRock

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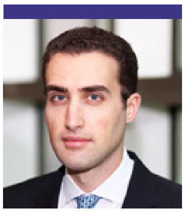

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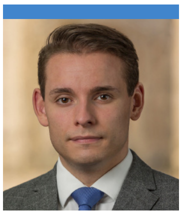
Managing Director, Multi-Sector Mutual Fund, BlackRock



Sebastian Culpan-Scott
Editorial Director, Savvy Investor

Sebastian Culpan-Scott: How can an opportunistic, unconstrained approach to fixed income be beneficial to investors in the current market environment?

> **"It is true that rising wages have supported the consumer, but blistering inflation is hurting consumer confidence and spending."**

Rick Rieder: We have seen extraordinary turmoil in the economy and markets over the past few years. Investors have faced an intensifying trade war between the U.S. and China, an ongoing multi-year global pandemic and an extremely contentious U.S. election, which held huge policy implications. More recently, soaring inflation and the associated turn in monetary policy has stoked volatility across asset classes. It is true that rising wages have supported the consumer, but blistering inflation is hurting consumer confidence and spending. While futures markets for the Fed Funds rate are pricing in several policy rate hikes over the next 6 months or so, slowing growth means it's not clear that the Fed will be able to execute on its plan.

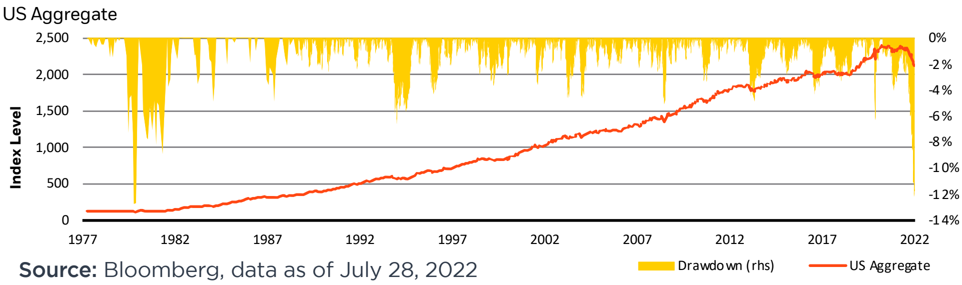
All of this is to say that we are witnessing maximum uncertainty on almost all fronts. That uncertainty, combined with the historically low yields in recent years and the tremendous shocks the market has faced of late, have led to dramatic drawdowns in fixed income markets (**see Figure 1**).

> **"In this kind of an environment, an unconstrained manager's ability to actively adjust duration can be particularly valuable."**

In this kind of an environment, an unconstrained manager's ability to actively adjust duration can be particularly valuable. Compared to strategies that are tethered to a specific benchmark, such as the Bloomberg U.S. Aggregate Bond Index, unconstrained strategies can pursue additional avenues for generating return while protecting client capital on the downside.

We believe a sound unconstrained approach does not rely on taking outsized positions or betting on difficult-to-predict macro moves, but rather on seeking to earn a little money a lot of times. We favor opportunities to add more attractive yield, within a risk-aware process that attempts to keep risks modest and well-diversified. That approach is intended to provide a return that hopefully achieves the client's portfolio goals with a path they can maintain comfortably.

Figure 1: *For the U.S. Agg Index, only the Volcker shock was greater*



Source: Bloomberg, data as of July 28, 2022

Sebastian: How can an unconstrained approach help investors meet their investment goals?

"OUR GOAL IS TO DELIVER A CONSISTENT, ATTRACTIVE RISK-ADJUSTED RETURN IN DIFFERENT MARKET ENVIRONMENTS."

Bob Miller: Our goal is to deliver a consistent, attractive risk-adjusted return in different market environments, whilst maintaining a risk profile that's analogous to a traditional fixed-income investment vehicle. We seek returns from a highly diversified range of fixed-income sectors, many of which are outside the purview of most core bond fund managers and are not held in any size in the U.S. Aggregate Index.

Our experience has been that pursuing opportunities throughout the fixed-income universe makes it possible to deliver a return that is highly differentiated from the Agg index and is less volatile than that index. That said, success requires an extraordinarily well-resourced platform of talent in every subsector of global fixed income. In many respects, an unconstrained approach is ideal for taking advantage of that breadth and depth of talent.

BlackRock's strategy combines top-down direction-setting by portfolio managers with bottom-up opportunity identification and security selection by specialists in each sector. The first step is to use economic and financial market data to establish a macro view of the markets. When we have set the aggregate portfolio's risk level, we leverage our sector specialists' bottom-up analysis as we allocate risk across geographies and sectors.

Rick pointed out the extraordinary uncertainty in today's macro backdrop. While the Fed has a way to go in its tightening cycle, the yield curve has already priced in a good deal of this policy work. Both the European and global economies are slowing, and how much the U.S. economy also will slow is an open question. Again, this backdrop suggests being able to adjust the duration exposure of a portfolio dynamically is incredibly important.

"In this environment, we're maintaining a defensive posture in rates, given tightening central bank regimes around the world."

In this environment, we're maintaining a defensive posture in rates, given tightening central bank regimes around the world. However, as growth has showed signs of slowing and yields have reached more balanced levels from a risk-reward perspective, we've been adding duration at the topline level recently.

In addition, we tactically added to TIPS as valuations look attractive and for its inflation hedging benefits. Within spread assets, we continue to prefer high-quality paper, particularly within U.S. & Non-U.S. IG Credit, Municipals and high-quality securitized products, while opportunistically adding to EM Local Debt and rotating out of Bank Loans and into U.S. HY Credit. We still maintain an elevated position in cash to help us manage the increased volatility in both the rates and equity markets.

Sebastian: **How can investors incorporate an unconstrained fixed income strategy in their portfolios?**

"The ability for an investment manager to actively adjust duration exposure is extremely attractive in the current market and monetary policy climate."

David Rogal: The ability for an investment manager to actively adjust duration exposure is extremely attractive in the current market and monetary policy climate. So is the ability to support an investor's yield and total return targets and to preserve their principal. Taking a structurally diversified approach to risk can help provide a more stable return profile over time.

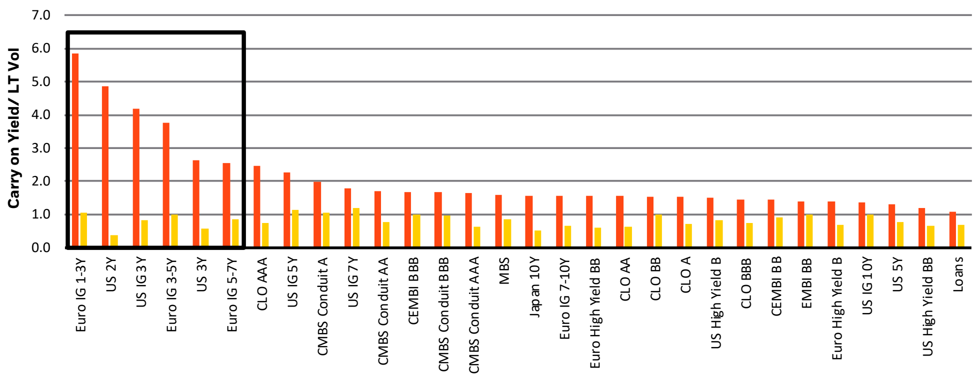
We recognize that many investors want to maintain exposure to traditional fixed-income strategies and benchmarks. However, adding an unconstrained approach to a traditional fixed-income portfolio can help support both the goals of generating return and mitigating volatility.

"WE BELIEVE CERTAIN SHORTER-DURATION ASSETS HAVE SOME SOLID YIELD EMBEDDED IN THEM AND HAVE PRICED IN A LOT OF FED TIGHTENING."

Rick Rieder: The return carnage that we have witnessed in high-quality fixed income in recent months is due to a combination of very low yields over the last two years, the amount of debt issued at those yields, and the tightening of monetary policy. Any further tightening, and/or unexpected withdrawals of liquidity by central banks could exacerbate those drawdowns.

We believe certain shorter-duration assets have some solid yield embedded in them and have priced in a lot of Fed tightening (**see Figure 2**). In fact, the carry/volatility profile on a set of higher-quality assets today suggests it would take a move of -2 standard deviations in markets to wipe out these assets' carry, assuming a normal distribution. That setup implies a strong tailwind for returns over the coming year. In our view, this profile looks pretty good in this environment of great uncertainty.

Figure 2: *After an extraordinary re-pricing, front-end sovereign and high-quality credit assets offer interesting carry*



Source: Bloomberg, data as of July 28, 2022. Index returns are shown for illustrative purposes only. It is not possible to invest directly in an index. Past performance is not indicative of future results.

Savvy Investor's Top Recent Fixed Income Papers

The following table features 30 of the top fixed income papers uploaded to the Savvy Investor site.

Man Group and LGIM provide outlooks for the credit markets, highlighting how much investors will learn in the next downturn and how they expect investor behaviour to change. They also share their views on current market conditions and where they expect to see opportunities across different markets.

In their respective papers, Invesco and Wellington Management provide reviews of global debt markets for the first half of the year, and share their expectations for the second half. They also highlight the current risks to investor portfolios and where they expect opportunities to present themselves over the coming months.

A number of papers also discuss the resilience of emerging market debt, the importance of private credit, and highlight current opportunities in credit markets.

SAVVY INVESTOR'S TOP RECENT FIXED INCOME PAPERS (BY DATE)

PAPER TITLE	DATE PUBLISHED
Seeking Resilience: 2022 midyear global credit outlook (BlackRock)	01/08/22
The ECB, Italy and Russia Provoke Market Volatility Across Europe (Invesco)	28/07/22
Mid-year Outlook: Chronicle of a recession foretold (BNP Paribas AM)	27/07/22
Financial Market Review: Second Quarter 2022 (Wellington Management)	27/07/22
Performing Credit Quarterly Q2 (Oaktree Capital, 2022)	26/07/22
Debt Sustainability and Monetary Policy: The case of ECB asset purchases (BIS, 2022)	26/07/22
Podcast: Fixed Income, 5 Key Themes – July 2022 (RLAM)	25/07/22
Q3 Outlook: A Changing of the Guard? (LGIM)	25/07/22
Q3 Credit Outlook: After the Storm, Opportunity (Man Group)	22/07/22
2022 Mid-Year Outlook: The balance of power (Special Report, 2022)	21/07/22
Strategic Sector Selector July 2022 (Invesco)	20/07/22
The Bond Market Selloff in Historical Perspective (FRBNY, 2022)	19/07/22
Midyear Outlook: Income arrives in many shapes and sizes (Franklin Templeton Investments)	19/07/22
Stock-Bond Correlation: A Global Perspective (PGIM)	18/07/22
Uncommon Truths – Global Debt Review 2022 (Invesco)	14/07/22
UK Q3 Guide to the Markets (JP Morgan AM, 2022)	12/07/22
U.S. Q3 Guide to the Markets (JP Morgan AM, 2022)	12/07/22
Multi Asset Quarterly: Global strategy (NN IP)	11/07/22
Private Credit: Mid-year Outlook (LGIM)	08/07/22
Fixed Income Insights – US Edition – July 2022 (FTSE Russell)	08/07/22
Global Fixed Income Strategy Report (Invesco)	06/07/22
Global Structured Debt Insight – June 2022 (Janus Henderson Investors)	05/07/22
Mid-2022 Asset Allocation & Investment Strategy Outlook (Wellington Management, Jun 2022)	30/06/22
Credit Quarterly Outlook: The mess after the largesse (Robeco, Jun 2022)	30/06/22
Mid-2022 Asset Class Outlook (Wellington Management, Jun 2022)	30/06/22
Walk, Don't Run: Mid-year update 2022 (KKR)	28/06/22
Look to Credit Opportunities Amid Bond Market Rout (Capital Group, Jun 2022)	28/06/22
Midyear Outlook 2022 (Capital Group)	24/06/22
Fixed Income Outlook: The inflation game (Robeco, Jun 2022)	23/06/22
Global Investment Outlook: Summer 2022 (RBC GAM)	21/06/22

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Breakdown of Savvy Investor Membership

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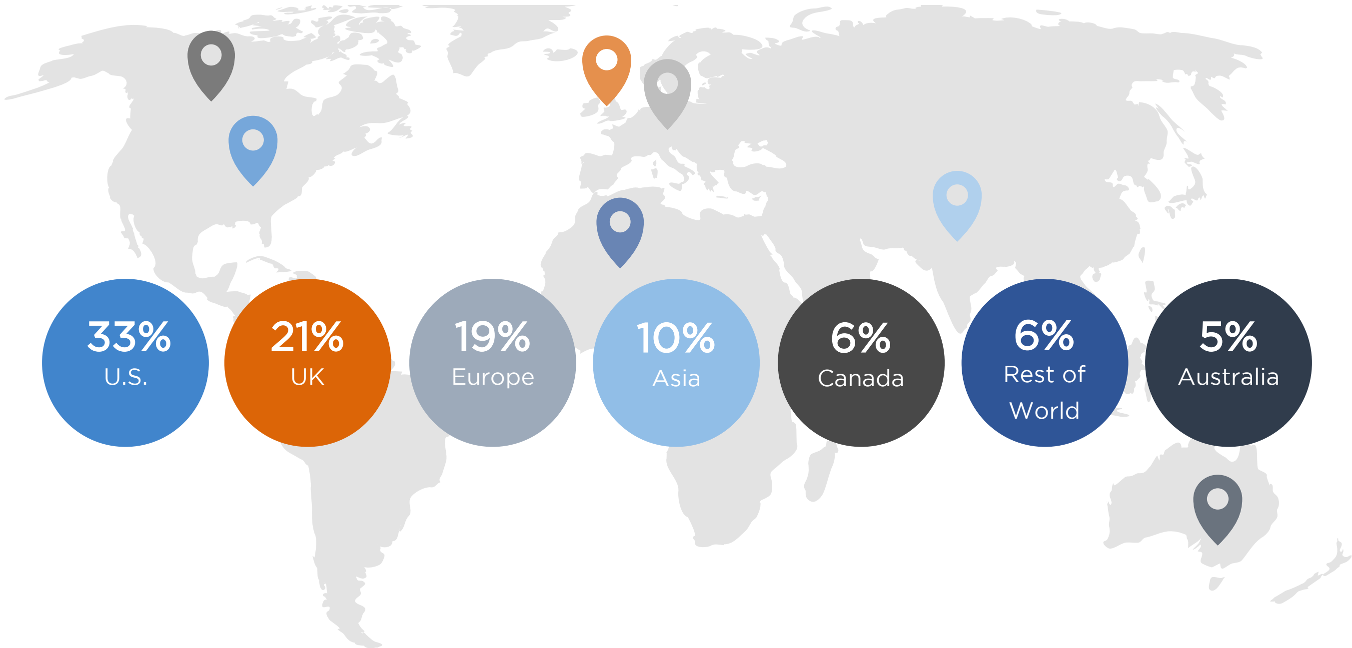

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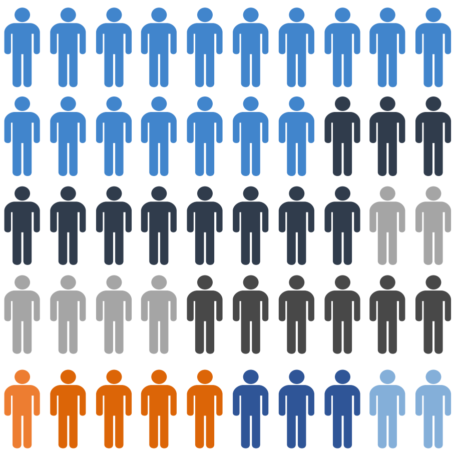

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12% Investment Consultants & Professionals

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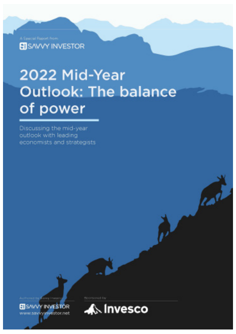

August 2022

Inflation Portfolio Implications

Fixed Income Outlook

September 2022

ESG Investing

Retirement Solutions

October 2022

U.S. Outlook

Megatrends

November 2022

Real Assets Outlook

COP 27 Implications

Subject to demand (at any time)

The Business of Asset Management

Insurance Asset Management

Asset Allocation Quarterly

Fund Management Technology

Quant Strategies

Other topics upon request...

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Authored by Savvy Investor

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