May 2020

Global Opportunistic Bond Q&A

By Brian Tomlinson, Portfolio Manager, Allianz Global Investors

Summary

- An unconstrained global strategy has the ability to rotate risk between these themes to target a positive outcome regardless of the market environment.
- Identifying "fallen angels" will be a powerful source of outperformance within credit positioning.
- Focusing on high quality, less cyclical companies could provide a defensive way to harvest elevated spread risk premia.

Brian Tomlinson
Portfolio Manager

Q: What investment advantages are available to an unconstrained approach that a more traditional fixed income strategy may find difficult to replicate? With particular reference to the current uncertain environment, what role can flexibility play in providing the best possible outcomes?

A: Traditional benchmarks suffer from inherent deficiencies such as market-cap weighting construction (bias to own the most indebted companies) and an over-reliance on credit ratings. A flexible approach can take advantage of these inefficiencies and avoid being a forced seller or buyer of securities at inopportune times.

As we transition through an economic cycle there will be periods where duration risk is well-rewarded, periods where credit risk is favourable, and others where curve, currency or geographical diversification may be most important. An unconstrained global strategy has the ability to rotate risk between these themes to target a positive outcome regardless of the market environment.

Q: The outlook for an economic recovery is unclear; are there any exceptional risk/reward opportunities in the credit space that can be targeted under an unconstrained approach?

A: Currently a wave of fallen angels are likely to appear in credit markets, given rating downgrades on the back of lower growth and activity forecasts related to the

Active is: Hunting for Income

6 rules on hunting for income

- Multi-Asset Supplement
- High Yielding Variations
- Unconstrained Approach
- Quality Bias
- Short Duration Approach
- Multi-Asset Diversification

Coronavirus crisis. Many of these companies, although being downgraded to high yield, will still be able to survive the economic cycle and adjust their businesses to eventually target a re-rating back to investment grade. The positive credit improvement required to re-gain investment grade status has historically provided strong total returns. Identifying these fallen angels will be a powerful source of outperformance within credit positioning.

In the near-term, until the shape of the global economic recovery is clear, focusing on higher quality, less cyclical companies could provide a defensive way to harvest elevated spread risk premia.

Q: How does the unprecedented volume of government bond "buybacks" by central banks affect your view on duration? What yield curve strategy might make the most sense under these circumstances?

A: We believe that fixed income as an asset class will remain well-supported given the unprecedented policy intervention by central banks. Yield compression has undoubtedly lowered the potential future return outlook, but whilst growth remains fragile and central banks remain accommodative, we believe there is a ceiling on bond yields. The global move towards very low policy rates, coupled with large fiscal spending programmes, is likely to encourage yield curves to steepen from current levels therefore one might consider exploring 2y versus 10y yield curve steepening strategies.

Q: Do emerging markets offer any compelling opportunities under an unconstrained approach in the current uncertain environment?

A: The impacts of Coronavirus on growth dynamics for many EM countries may be severe in the near-term, and a number of frontier sovereigns have already approached the International Monetary Fund for rescue financing. From a bond market perspective these countries comprise a relatively small proportion of the eligible universe (~5%), whilst another ~7% of the universe contains already distressed or likely-to-default credits. These events are well-flagged and easy to avoid – the remainder of the universe offers many interesting opportunities. Some EM economies will be sensitive to oil prices, but half of the universe is oil importing nations, and many have strong balance sheets and flexible macroeconomic frameworks that should allow for adjustments in response to a growth downturn. Therefore investors could allocate to EM sovereign risk under a flexible strategy and see good room for healthy performance from here.

Q: Are we likely to see continued US dollar strength in a post-pandemic world?

A: Although currency valuations for the US dollar now look extremely stretched, post-Corona crisis, and the dollar remains poor on a fundamental basis (i.e. fiscal and current account deficits in the US), at this juncture, the safe haven flows into the US dollar continue to dominate FX movements. Whilst we do not believe it is time to sell the US dollar just yet, we are beginning to think about re-engaging in a Developed Market FX basket via a selection of commodity-driven currencies against a funding basket of EUR and USD.