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Global Fixed Income

Volatility and Uncertainty Here to Stay

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In brief

- **Uncertainty isn't in short supply** — Macro uncertainty and market volatility are expected to prevail for some time due to the ongoing Russia-Ukraine conflict, China's zero-COVID policy and growth trajectory, tighter monetary policy in response to high inflation prints and re-emerging financial fragility.
- **Dislocation breeds opportunity** — Active management is designed to take advantage of volatility and dispersion in the markets. The higher levels of starting yields and spreads offer the potential to generate long-term returns, especially in the context of a global fixed income mandate. It is imperative to maintain a strong focus on risk management.
- **Anchored in fundamental views** — As active investors, we aim to look through the noise and focus on the fundamental, valuation and technical factors supporting an investment thesis and then determine our conviction versus the consensus that's priced into the market. Security selection is paramount.

Two words come to mind when describing the fixed income markets at present: volatility and uncertainty. Numerous macro factors have coalesced to create the current macro and market environment. These include the legacy of COVID, war in Ukraine, high inflation, rapidly tightening monetary policy and a strong dollar. Markets have reacted to this confluence of uncertainties with heightened volatility and significant selloffs.

Macro uncertainty abounds

The factors mentioned have led to numerous questions centered around global growth, elevated inflation and policy expectations. The uncertainty is comprised of a few key components, increasingly reflected in the volatility indicators we follow. For one, in the post-COVID world we have come to doubt the validity of some of the data collected over the last couple of years, which has cast doubt on the comparability of the data. The uncertainty regarding the data is also reflective of the fact that we have witnessed distorted transitions from goods to services as economies came out of lockdowns at a different pace.

The macro mix is difficult to predict at present. We're beginning to see monetary and fiscal policy diverge in some economies, leading to uncertainty regarding the drivers of inflation and growth. Some of the key leading indicators such as manufacturing PMIs (Purchasing Managers Index) are pointing to a significant slowdown in growth, while inflation prints are also volatile, making it difficult for investors to assess the likely outcomes.

The macro uncertainty will likely continue for some time, particularly as there are still a couple of key outstanding issues dominating the markets. One is the Ukraine-Russia situation in Europe and its impact on energy markets. It is very difficult to predict how the war will play out and the impact it will have on a large engine of global growth like Europe. The second is China with its zero-COVID policy, which has cast a shadow over the country's growth outlook with a domino effect in Asian markets, in particular. These two fluid situations have large effects on suppressing global growth and pushing inflation higher (through supply side constraints).

Monetary policy in the driver's seat

Most of the major central banks are coordinated in their intention to reduce inflationary pressures with tighter monetary policy. In contrast, we are beginning to see some variability around fiscal policy, exemplified by the recent UK government actions that led to very significant market dislocations. However, most of the anticipated action resides with central bankers. While they are for the most part on a similar path to quell inflation, we are starting to see some uncertainty around how fast to hike, how far the hikes should go and for how long to maintain these tight financial conditions. The reality is we still need to see inflation peak in most countries. It's very difficult to foresee a slowdown in the current hiking trajectory of central banks until this happens.

Nevertheless, some central banks are signaling a step down in the tightening process: Iceland, Australia and Norway have already started trimming their hawkish rhetoric, whereas others, like the US Federal Reserve, have yet to apply the brakes. This uncertainty creates opportunities across markets depending on how much (or not at all) is already priced in.

Our role as active investors is to assess growth, inflation and policy risks across economies and determine if these are fully reflected in the pricing in rates, FX and credit markets. We determine our view and conviction based on a fundamental, valuation and technical perspective and then decide whether our view deviates from what the market is pricing.

Market fragility emerges

At present, one of the most notable effects to emerge from the macro factors in play is an increasing sense of fragility in the bond markets. We're accustomed to seeing a certain amount of fragility in the credit markets. It's an over-the-counter (OTC) market, after all, where liquidity can dry up quickly, especially in the riskier parts, for example, in emerging market debt and high yield. Now, we're starting to see that stress translate into the government bond markets as well, which adds another layer of complexity in managing fixed income assets and constructing portfolios. Financial stability is now also a tail risk and, alongside inflation and growth, a variable that central banks must also consider.

The experience in the UK in recent weeks was eye opening for most policy makers around the world as they saw how quickly volatility can translate into market fragility through a violent unwinding of leverage. One of the key things we look for when assessing financial stability risks is hidden leverage, which by its very nature is hard to identify. A way for investors to guard against this is to maintain liquid diversified portfolios, to be positioned as a provider of liquidity during periods of larger dislocation in the markets.

In essence, volatility adds to opportunities, but it requires investors be more mindful about the trajectory of risk in a portfolio and the need to be ready to provide liquidity in the areas of the market where potential dislocation appears. It's very important when considering active fixed income managers to assess their capability to be nimble in their decision making to take advantage of these dislocations.

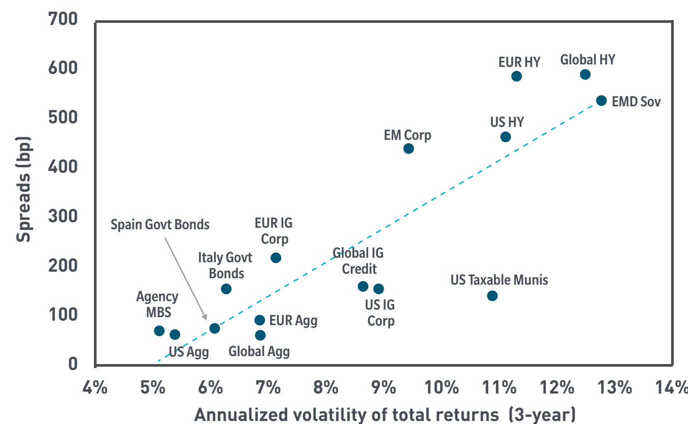
Investment opportunities

Active managers are meant to take advantage of volatility and dispersion in the markets; it's where we seek to thrive. Given our anticipation of a significant slowdown coupled with stubborn inflation, we believe these dislocations are likely to persist for at least six months, providing opportunities to active investors with strong research platforms. Within the context of a global mandate that includes the option of investing in most asset classes within fixed income, the higher levels of starting yields and spreads offer the potential to generate historically attractive long-term returns.

In examining the dislocations across the different markets, we try to identify what our anchor fundamental view is. In other words, we go back to the basics of the fundamentals of the various asset classes and the different types of risks they carry, determine what risk premia is warranted and compare that to existing valuations. Then we identify whether there are any catalysts for the investment to perform within a certain investment horizon.

In putting it all together, we look at charts like the one shown in Exhibit 1. This chart plots spreads versus annualized volatility on a three-year basis for different components of the credit markets and assets we can invest in.[1]

Exhibit 1
Fixed income spreads vs. volatility



Spread Valuation Scores[2]

EUR IG Corp	3.42	Cheap
EMD Sov	2.89	
EUR HY	2.55	
EUR Agg	2.10	
Global IG Credit	1.77	
Global Agg	1.61	
US Agg	1.48	
US IG Corp	1.22	
US HY	1.08	
US Taxable Munis	-0.13	Rich

Sources: Bloomberg. Annualized volatility is calculated based on monthly returns over past three years. European Government bond spreads calculated as yields above Bunds. RHS: Bloomberg. Monthly data from November 2012 to October 2022. Data for October as of 11 October. See Endnote 2 for additional information related to the indices used and spread valuation scores.[2]

We look at these kinds of charts along different dimensions with various investment horizons to pinpoint the potential opportunities within an asset class. We then tap into the wealth of the firm's global research platform to identify the individual stories, the individual companies or issuers, on which the analysts have very high conviction. For example, if we have exposure to a specific issuer the research team likes, we may be able to pick up additional basis points (one hundredth of one percent) by buying the exact same issuer, and sometimes the same maturity, in a different currency and swapping it back.

These dislocations exist because different types of investors in fixed income are faced with disparate challenges. Basis opportunities may exist where one has exposure to a cash bond but can pick up basis points by having the identical issue exposure in a single-name credit default swap (CDS). These opportunities may also exist when considering structured credit versus corporate credit, or securitized assets versus high quality investment grade risk. With our observation that many bonds are trading significantly below par (below the bond's face value), there are also new opportunities when thinking about secondary markets versus primary markets.

While we may still have a lot more turmoil and volatility in the markets, we believe a lot of the bearishness is already priced in the markets and market positioning is generally defensive. In global credit, for example, there is significant divergence between the euro investment grade credit universe and the US dollar investment grade credit universe. It's no secret that Europe is facing significant challenges associated with war and an energy crisis. The spread differential between the two markets is currently significant. If we dig further, we see there's more dispersion in the US credit universe, but there's more opportunity overall in the euro credit universe.

With the ability to invest in both bond markets, an investor can create risk-adjusted portfolios that match the opportunity set with regards to the directionality of the two markets, but also the dispersion between the sectors in some of these markets.

Looking ahead: market outlook

It's clear that recessionary "hard landing" scenarios are increasingly being priced into the markets. We expect to see more divergence in rates as the macro policy mix adjusts to reflect economies' varying sensitivity to hikes in rates.

As a result, we see a lot more opportunity to express our relative views on countries and yield curves. In credit, we see an opportunity set arising in the euro investment grade market, particularly for dollar investors. In high yield, bottoms-up, idiosyncratic selection of risk is key.

In structured credit, we're focusing on some of the collateralized loan obligations (CLOs) that have recently moved a lot in price, as well as some consumer-related, asset-backed securities. In emerging markets, we're exploring the foreign exchange markets and opportunities in local currency debt. For the foreseeable future, given disparate growth and rates paths, we believe the dollar is likely to maintain its strength.

Key takeaways

A few important points stand out for investors at this juncture in the markets. First, in our view, we have little choice but to live with macro uncertainty and volatility for the near-term. Second, the data volatility along with the policy volatility are expected to continue. As active investors, we aim to look through the noise and anchor ourselves in the fundamentals, and then determine our view versus the consensus priced into the market.

The third takeaway is that we need to be aware of the tail risks in relation to financial stability. This requires operating with certain buffers with regards to risk and liquidity in portfolios to be able to access the opportunities that emerge when financial stability issues arise.

Finally, stay focused on security selection. Ultimately, preserving the capital invested is very important and, therefore, choosing the right names and the right issuers to populate the risk profile is vital.

In environments like these where dislocations are rife, the ability to go global and select from a wide pool of opportunities with more alpha levers,[3] in effect, can make a decisive difference. While investing in the current markets may be unnerving, we expect active and flexible allocations will serve investors well as it allows one to consider the full spectrum of opportunities that present themselves.

Endnotes

[1] Bond credit spread is a snapshot of the different yields between a Treasury bond and a corporate bond or municipal bond of the same (or similar) maturity.

[2] The valuation scores are calculated using Z-scores. Z-scores are estimated using a 10-year average rolling window. A positive z-score indicates a valuation that is more attractive than the long-term average. Conversely, a negative z-score indicates a valuation that is less attractive than the long-term average. A value of 0 for the z-score indicates that the current valuation is in line with the 10-year average. A Z-score is a measure of deviation from the average in units of standard deviation. Agency MBS = Bloomberg U.S. MBS: Agency Fixed Rate MBS Index. US IG Corporate = Bloomberg US Aggregate Corporate Index. US Taxable Munis = Bloomberg Taxable Muni US Aggregate Eligible Index. US HY = Bloomberg US Corporate High Yield Index. EUR IG Corp = Bloomberg EuroAgg Corporate Index. EUR HY = Bloomberg Pan-European High Yield (Euro) Index. EMD Sov = J.P. Morgan EMBI Global Diversified IG Sovereign Spread Index. Global IG Credit = Bloomberg Global Aggregate Credit Index Unhedged USD. Global HY = Bloomberg Global High Yield Index. EM Corp = J.P. Morgan Corporate EMBI Broad Diversified Composite Index. Global Agg = Bloomberg Global Aggegate Index. US Agg = Bloomberg US Aggregate Index. EUR Agg = Bloomberg Pan-European Aggregate Index. Italy Gov't Bonds = ICE BofA Italy Government Index. Spain Govt Bonds = ICE BofA All Maturity Spain Government Index.

[3] Alpha refers to the return on an investment in excess of the benchmark index.

Source: Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). Bloomberg or Bloomberg's licensors own all proprietary rights in the Bloomberg Indices. Bloomberg neither approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection there with. The views expressed in this presentation are those of the portfolio manager, and are subject to change at any time. These views do not necessarily reflect the views of MFS or others in the MFS organization, and should not be relied upon as investment advice, as securities recommendations, or as an indication of trading intent on behalf of any other MFS investment product.

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