

POSITIONING FOR THE TURNING POINT



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**UNSEEN MARKET
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THEIR HEADS
ABOUT HOW TO
ALLOCATE TO
FIXED INCOME.**

As we roll from headline to headline, where geopolitical shocks muddle with macro data surprises, markets have come to operate on a degree of hope.

Whether naive or ignorant, the general expectation remains that central banks will step in to support financial markets if things get too tough. The US Federal Reserve (Fed) has been trying to contradict this sentiment, but we're still seeing indications that markets are anticipating a Fed 'pivot' – by that I mean the Fed will stop raising interest rates as we begin to see some softening of conditions, or, in the extreme the case, a systemic problem within financial markets.

This combination of hope and uncertainty is creating a great deal of volatility almost on a daily basis.

US 10-yr bond yields have bounced from 3.9% to 3.6% to 4.2% in the space of a month (26 Sept-26 Oct 22). The notion of Treasuries being a risk-free asset class should perhaps be questioned.

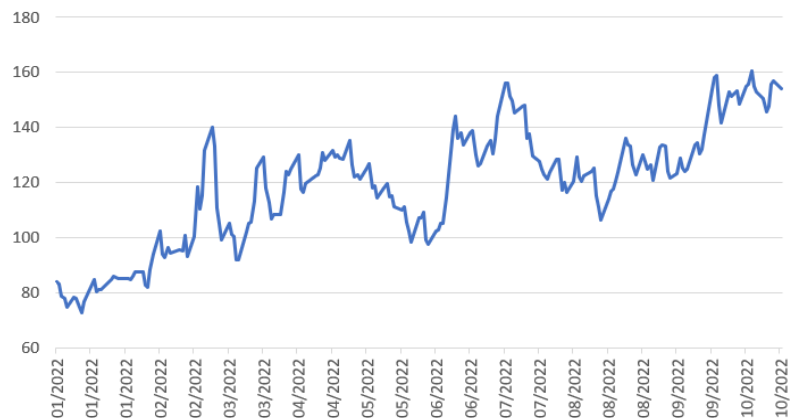
This paradigm shift in dynamics has permeated down to underlying markets – we are now operating in a world where investors face significant daily volatility, great uncertainty and big swings in performance across both high and low-risk assets.

Unsurprisingly, now is not the time for making long-term, rigid decisions about the direction of your investment strategy. These unseen market dynamics are leaving many scratching their heads about how to allocate to fixed income.



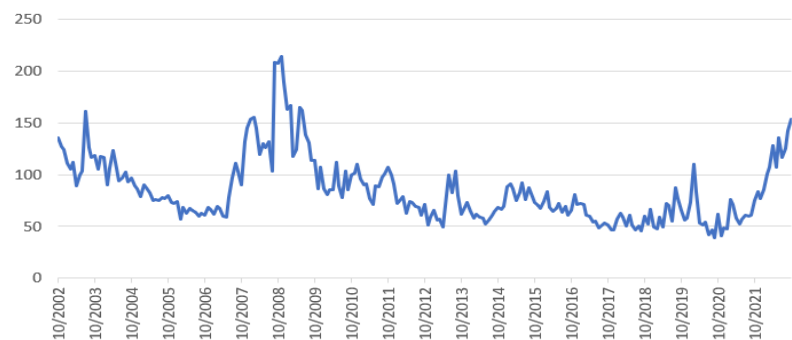
BOND MARKET VOLATILITY

Move Index year-to-date



Source / Bloomberg, 25 October 2022

Move Index 20yr view – volatility levels now match those seen during 2008

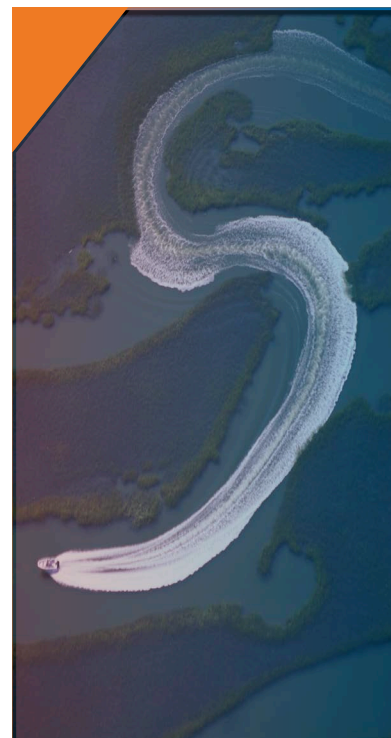


Source / Bloomberg, 25 October 2022

Some investors have retreated to cash because of the lack of market direction – we don't see this as a considered investment strategy and feel it will prove costly on a 12-month view.

When your universe is as vast and diverse as fixed income – totalling USD 130 trillion (Barclays, June 22) – there are always options that outweigh retreating to cash. The key is having the scope, flexibility and commitment to access them.

Despite the turmoil, I think there are some interesting potential investment opportunities in fixed income for those with a medium to longer-term view.



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REGIONAL DIFFERENCES

UK

The UK is facing a double-pronged issue – it's lost its political credibility and its central bank credibility, meaning positioning long Gilts is not an appealing trade.

The UK is in a unique situation. The government made a hash of the 'mini budget', making a number of unfunded changes that weren't pressing but which caused systemic risk in the financial system (due to over-levered pension funds).

This is a good example of the greater issue in the UK; the system we operate in is over-levered, there's abundant risk-taking without full acknowledgement of the risks involved and the market has continued to appreciate thanks to central bank support. That's all changing now and the market is struggling to adjust.

Europe

Europe continues to operate within tighter bounds than other developed markets. While the European Central Bank (ECB) has been very clear in its commitment to fight inflation, it also has to be cognisant of heavily indebted nations like Italy, where bond yields have already risen to very high levels. It is also dealing with an economy that is weaker than the US but with similar inflation levels, thus somewhat limiting its room to manoeuvre. Europe may well go into recession before the US – with the effect of the interest rate hikes still to come.

The energy support that has been announced by governments across Europe should go some way to alleviating the potential energy crisis and cost inflation that goes with it, but this is just one of the headwinds Europe faces.

US

Unlike the UK, the US shows no indication of systemic risk in the broad market at present. While the housing market is challenged, the problems are a long way away from the extreme leveraging issues of 2008. The Fed has been clear in its messaging that it is no longer operating to prop-up financial markets – its primary goal is to tackle inflation, with a secondary objective of increasing employment levels.

It's this directional shift that caused a repricing in financial markets both domestically and globally, and going full circle, it's this correction that will create investment opportunities once the repricing is complete. We think most of the correction has now played out and hence developed market fixed income is beginning to look interesting.

Emerging markets

Emerging markets have struggled alongside all risk markets this year, but have also had a lot of idiosyncratic headwinds to deal with. The outlook is dependent (as with most risk assets) on Fed policy and investor confidence has been shaken by the Russian invasion of Ukraine and its knock-on effects on commodity-dependent countries. China's Covid-19 and housing market



woes have not been resolved, and with President Xi embarking upon an unprecedented third term, there are fears of a more authoritarian regime going forward.

CASH IS NOT THE ANSWER: OPPORTUNITIES IN FIXED INCOME

Developed market government bonds

Survey data shows many UK wealth managers are looking to put more money into cash, Gilts and other developed market government bonds over the next 12 months.

As traditional fixed income 'safe havens', combined with a degree of home bias, it's understandable why investors are looking to sovereigns, but will they perform?

If you think of the UK as a company, it has low productivity, a very high tax burden, a flailing government (with four different Conservative leaders in the past 10 years alone), systemic debt issues, a currency valued at all-time lows, and a sophisticated central bank that's having to deal with a

government that's pursuing opposing policies. The likelihood that Gilts will go higher at the longer end is quite high, as inflation is likely to remain sticky until we see a proper recession.

In addition to the unstable government, we have ongoing self-inflicted problems with Brexit and the cost-of-living crisis.

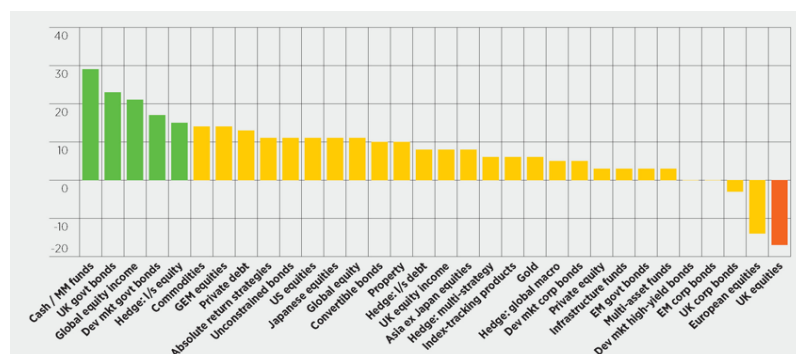
I don't see the UK as a particularly interesting investment opportunity right now. The short end is fine as the country isn't going to go bankrupt, but the longer end of the curve is likely to display ongoing volatility and we have no direction as to what the government's next move will be.

Beyond the UK, short-dated fixed income is looking attractive for the more risk-averse investor. 2-year Bunds are yielding over 2% and US Treasuries over 4%.

Investment grade corporates

Investment grade is one of the primary areas within fixed income where we see opportunities. Spreads are pricing in a lot of bad news and with the entire curve re-pricing,

UK WEALTH MANAGERS' FUTURE BUYING INTENTIONS



Source/ Bonhill Intelligence, September 2022



CAPTURING THE TURN THROUGH UNCONSTRAINED INVESTING

Alongside where to look for opportunities, we should also consider how to get to those opportunities. The case for active management during times of elevated volatility has been made, with a clear argument in favour of targeting specific opportunities versus blindly tracking a whole market. But not all active approaches are alike.

Today's complicated, fast-moving markets demand unprecedentedly levels of investment flexibility and conviction. We believe global unconstrained, benchmark-agnostic strategies, which have the ability to invest across the universe, both regionally and by sub-asset class, offer the best way to capture upside amid the turmoil while managing downside with active hedging.

there are persuasive arguments to invest in both short and long-maturity bonds. Once interest rates peak and we see inflation begin to fall and the economic slowdown take hold, we see the potential in owning longer-duration assets. For the more conservative, shorter-date bonds now offer very attractive yields.

High yield corporates

High yield is sometimes misunderstood with all non-investment grade bonds lumped into the same category. As with all the fixed income sub-asset classes, there are nuances depending upon geographical region, sector and rating. Spreads are looking interesting again, while overall yields are close to 10%. We see the first opportunity set in higher-quality high yield debt, focusing on robust companies with strong balance sheets.

Emerging market debt

EM's vast landscape doesn't lend itself to being viewed as one homogenous market. The universe as a whole is not a good buy at the moment, but given it totals over USD30 trillion spread across over 80 economies, there are pockets of opportunity within it. Brazil, Mexico and the Middle East are markets we have been finding attractive investments in recently.

With metrics across the market at 20-year extremes, now is an interesting time to consider adding to select, quality positions.

OUTLOOK

The markets will remain volatile for the foreseeable future and we are seeing some signs of stress relating to liquidity, but nothing systemic at this point. The fear is that the Fed (and as a second derivative, the ECB) hikes too aggressively and precipitates a much more severe recession than markets are anticipating.

The risk of this has risen, but much will depend upon inflation coming down. All the indicators we look at are suggesting that inflation is beginning to roll over, but not as quickly as the Fed would like. I would still expect a pause at some point in the next several months to allow the effects of the existing hikes to feed through.



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