Consider this

Pension fund investors should consider global bonds

July 2023

Sandile Malinga
Co-Head of Multi-Asset

For the first time in over a decade, global bonds are finally an appealing option for South African investors, particularly those such as pension funds who require a steady long-term real income and diversification, as well as downside protection for their portfolios. In our view, global fixed income instruments of various kinds – sovereign bonds, corporate bonds, inflation-linked bonds, emerging market bonds and developed market bonds – are offering attractive real yields that will compensate investors well for the risk of owning them over time. However, this comes with a caveat: given the large differences in investability across different countries, sectors and issuers, and the still-high level of uncertainty prevailing in the global macroeconomic environment when it comes to inflation, interest rates and growth, investors should be selective and somewhat defensive in their exposure, we believe.

For investors considering adding global bonds to their portfolios, these tricky conditions require the in-depth expertise of seasoned portfolio managers like our team at M&G Investments (UK), who manage the **M&G Global Bond Fund**. The fund gives investors the advantage of being managed by a team of highly experienced fixed income portfolio managers, supported by a large and well-respected credit analyst team that provides detailed, fundamental analysis of credit risks and opportunities and distinguishes M&G's funds from our peers. Their bottom-up research across much of the global debt spectrum pinpoints the most appropriate securities to include in the fund, with the aim of building a portfolio that can perform well in both "risk-on" and "risk-off" environments.

Bonds finally offer a real reward

Following more than a year-long interest rate hiking cycle by the US Federal Reserve (and other central banks) and a total increase of 5.0% in its federal funds rate, nominal US Treasury bonds are finally offering meaningful real returns across the yield curve, with the 30-year UST real yield at approximately 1.6% -- a level last seen back in 2013. This longer-dated paper is one of the preferred holdings in the M&G Global Bond Fund currently.

Nominal European government bonds, on the other hand, are less desirable for now given that the European Central Bank (ECB) has lagged its counterparts in raising interest rates, and inflation remains relatively high in the region. This increases the odds of more rate hikes to come and for rates to remain higher for longer in the region, adding extra risk versus the US. Even certain emerging markets (EMs), which started lifting interest rates early in the current cycle, can provide a better potential return for the risk involved, in our assessment.

Developed government inflation-linked bonds (ILBs) are also a sound option for investor portfolios currently, with longer-dated US Treasury Inflation-Protected Securities (TIPS) particularly going some way to protect against inflation, as are UK and German ILBs. Emerging market ILBs are generally less attractive than their developed market counterparts in our view, however, as they offer no real yield spread benefits, and a lower real return potential than EM nominal bonds.

Meanwhile, investment-grade (IG) corporate credit yields are also at 10-year highs in both the US and UK markets (with five-year bonds at around 5.8% and 5.6%, respectively, as shown in the graph) thanks to rising interest rates and higher credit spreads. Yet in our view, corporate balance sheets are generally healthy and default risk is lower than what the market is pricing in. We think that at current yields, investors are being overcompensated for any reasonable expectation of default, plus IG corporate bonds offer extra portfolio diversification across different sectors and levels of credit rating. In fact, in our view “BBB”- rated corporates are offering the most attractive yields for the risk involved, but investors must do careful analysis because spreads in this one credit rating category range anywhere from 75bps to 700bps. This huge dispersion gives M&G’s analyst team a significant opportunity to add value to client portfolios. High-yield corporate bonds, on the other hand, are best avoided because they present the most risk in the rising-rate environment and, broadly speaking, are not offering adequate compensation for the risks involved.

Proceed with caution

Looking ahead, while high levels of uncertainty around inflation, interest rates and growth continue to impact negatively on the global investment environment, in our view it is best for investors to remain relatively defensive in their fixed income positioning. This is true for the M&G Global Bond Fund. The impact of global central banks’ aggressive cycle of rate hikes has only recently begun to be felt across economies as growth slows and inflation falls, and data show that reactions vary in different countries. The potential for negative surprises is high. This gives investment managers good reason to be cautious as that impact plays out, but also presents an unusually large variety of opportunities to add value to global portfolios. With fixed-income instruments, this means enhancing both return potential and downside protection. At M&G we believe we are well-equipped to do exactly this for our clients.