Audio Transcript: Attractive Starting Point for Multi-Asset Fixed Income March 15, 2024

Katie Klingensmith [00:00:02] Welcome, everybody, to Brandywine Global's Around the Curve series of podcast conversations. I'm Katie Klingensmith with Brandywine Global, and I am delighted to be joined by my colleague, Brian Kloss, who is a portfolio manager in the global fixed income portfolios and has a really deep expertise on all things credit, global credit, and multi-sector. There's a lot to cover today, so it's especially exciting to have Brian here. Brian, I'll just start out with this elephant in the room. Equity markets have done really well, and we still have cash that's paying much more than any kind of recent memory. Can you just lay the groundwork and make the case for why you think investors should be considering investing in fixed income right now?

Brian Kloss [00:00:53] Great to be here with you, Katie, today. And absolutely, let's dive into this. And let's really put it in perspective. It's about bond math. It's about risk management. And also the total return opportunity set. I'm not going to sit here and argue with you about the performance of equities. They've done very well. But at this point in time, we look at what the prospective returns are going forward as we think about where equity valuations are today. And I think they could potentially still do reasonably well. But if you think about a larger portfolio and diversification, and you think about the starting point with where your yields are in fixed income, and again, this is on a global perspective, looking across global fixed income assets. We think mathematically it's going to make a lot of sense to allocate to fixed income at this point in time, given the equity valuations. They might be a touch stretched. But also as we think about the challenges that the world could face as we move forward. So, I would argue it's a diversification as well as the risk management and an opportunity set for investors to take advantage of an attractive starting point in global fixed income assets.

Katie Klingensmith [00:02:05] That's all pretty compelling. I know one concern, unlike last year, is that we think interest rates could actually fall, or at least policy rates. How does that complicate the case for fixed income?

Brian Kloss [00:02:17] In the short term, it is actually an opportunity. As those rates fall, and if you think of developed market bonds, those markets are going to offer an attractive return opportunity from that total return perspective as we've highlighted. In addition, as rates fall, that's actually going to start to provide credit instruments the ability to refinance at lower rates and provide a little bit more liquidity into the market. Or, that opportunity to refinance at a lower rate, which was going to be constructive ultimately for credit, for that credit business model, as you think about the cost of capital coming down, it's an easing of financial conditions. So, we're actually pretty excited about what we see as the possibility for both developed markets as well as spread products moving forward. And within spread, I think you can also think about emerging markets as well. There's a credit component to those.

Katie Klingensmith [00:03:13] Let's just stop there for a minute and think about spread. I think that the discussion around the curve and taking on that duration risk or not, you've made that pretty clear. But I think a lot of people are concerned that spreads are so tight, both in the high yield and investment grade space, that it's potentially not worth it to have that volatility and credit risk. What--make the case for spreads. Why? Why bother, given the risks?

Brian Kloss [00:03:38] Let's make that argument, or let's think about it. Let's think, we're only talking about spreads. I can't sit here and tell you that spreads are wide today. I mean, that would be disingenuous. But what we can talk about is the other part of a fixed income asset within the credit spectrum, and that's the yield component. If you look at the starting point with respect to yield, and to some extent, if you think about yield, that's where your ultimate return is going to come from. It's that payback period that you're getting from that coupon or from the coupon--and if you bought the bond at a discount--that current yield, as we like to think about it, that is what's going to be very compelling. But most importantly, to really be able to add value when you think about going out the credit spectrum. It's really about the underwriting standards and the due diligence. So yes, maybe one could argue that lower-quality credit might struggle. So, if you have that active management and you're able to select securities, we would argue that credit would actually allow you to have that incremental return or that, return-seeking ability for your manager to be able to outperform a benchmark or an index or some type of return bogey that you have, that you've set for your managers.

Katie Klingensmith [00:04:52] You did mention that it matters about picking the right ones, that active management approach. Before we think about the global and the emerging markets that have broader ideas of what spread can include, talk to me about what you're finding attractive in the US. Are there particular industrial sectors, particular angles as an active manager where you'd like to be putting your money to work?

Brian Kloss [00:05:15] Fantastic question because we address this question every day in our investment meetings. So, every time we're talking about our portfolios, we're looking at this. And what we find attractive in the very short term here is to think about shorter-dated maturities, quality type of companies. And that doesn't necessarily mean exactly by rating, but there will be a correlation to that. But what we mean by that is those companies that have a strong management team, the ability to refinance a financial position, whether that's through the income statement and balance sheet that you're looking at, revenue and debt that they can refinance in this environment, or within an environment where there's either inflationary pressures or if we hit a harder landing in a recessionary period. Those are, sort of, the short-term characteristics we're looking for. And if you talk about sectors, we are intrigued by those that are commodity driven. We do like the transition that the global economy is going through. So, those commodities will play a significant role. And we also do think that there might be some opportunities as we think about artificial intelligence and how that is going to play into the global economy as we figure out as a society how to harness this technology and increase productivity.

Katie Klingensmith [00:06:35] So, it sounds like there's some sector trends, but you're also going to look for gems across.

Brian Kloss [00:06:41] Absolutely.

Katie Klingensmith [00:06:41] Alright. So, that's within the US. I know that your opportunity set is always global, even if credit markets are deepest closer to us. What are you seeing different? Is it are we seeing similar trends globally? How's the global credit landscape comparing to the US right now?

Brian Kloss [00:06:58] So, as we delve into that question, let's pause one second and just remind ourselves that the global economy is not always in sync. So, if we look globally, there's different parts of the world that are going to be entering recessions or leaving recessions, or have different fiscal policies, or have different economic outcomes. So, again, having that ability to look globally is critical. So, as we look around the world and what we're seeing, the questions are really going to be is what type of recovery China is going to have. And then how does that translate into the opportunity set? What does Europe look like with exiting the pandemic as well as exiting their negative interest rate policy? And how does the Western Hemisphere, especially Latam and South America, what does that look like? And so, when we sort of sit here today and we look at the growth in the US, and we look at the--I'm not going to call it a reshoring of the global supply chain--I'm going to call it a reordering or a rebalancing of the global supply chain. We think Latam will win out as well as certain other areas, maybe Central/Eastern Europe. Again, companies are going to focus on where their end customer is and are going to ensure that those supply chains. So, when we think about that, we think that Brazil, Colombia, Mexico all stand to benefit as there's a transition away from maybe sourcing things in just one jurisdiction to having multiple jurisdictions. So, there are opportunities around the world, and we want to take advantage of those when they're provided to us.

Katie Klingensmith [00:08:37] So, I think you answered the question around Latin America and made the case for why we might see some better growth there and some investment opportunities. But you posed a question around what might happen with the Chinese growth outlook, as well as European, obviously different factors. What are your expectations around China and the implications that might have for global credit? And then we can subsequently, hopefully get to Europe.

Brian Kloss [00:09:03] You're asking a difficult question because that's continuously evolving. As we get more and more data out of what the Chinese economy is going to look like going forward, that continues to change. It appears after the Party Congress that we just saw over the past two weeks, it does appear at this point in time that it's going to be a very targeted recovery and a targeted economic plan, and so growth is not going to be anywhere near as robust as maybe we have seen after several of the other events that have transpired, the financial crisis or after the European sovereign crisis. So, as it appears to be more targeted, we're probably going to see a less robust growth pattern. A 5% target or area, as they have indicated, probably means credit does well, but it may not necessarily translate into a robust credit environment. But again, that is not necessarily a bad scenario for credit. It just may not be what we had seen in the past. Now, what that does mean, though, is that Europe could be potentially challenged given the significant linkage between Chinese economic growth and European growth. So, we're going to have to understand the policies that are going to unfold both on the continent as well as in the UK. We need to make sure we distinguish between those two economic zones, as they do have different economic policies.

Katie Klingensmith [00:10:36] Well, and we could get really different monetary policies coming out of the ECB, Bank of England than we're seeing from the Fed right now. I know we can spend a whole conversation just talking about the different curves and monetary policy, but in terms of your assessment of the different credit opportunities, are things opening up in Europe in a way that they may not be yet in the US?

Brian Kloss [00:10:58] I think we've gone back and forth on that. I think they've got a very different credit system. It's more of a banking system. So, we do think that the credit opportunities are a little bit different than in the US. And again, there's deeper markets, but we are finding opportunities in Europe, especially at that front end that we're talking about and those that are tied into those commodities that we had highlighted earlier in our conversation. So, I do think there are some, but again, it's going to be very nuanced as we move forward.

Katie Klingensmith [00:11:31] You mentioned earlier that emerging markets can be considered a spread sector. You mentioned that there's some macro tailwinds for some Latin American economies. What else are you seeing in the emerging market space?

Brian Kloss [00:11:46] I think first and foremost what we've seen over the past two, let's even call it maybe three years, an independent monetary policy. Central banks have been very keen on making sure they address their inflation concerns. So, they were much more robust in their actions as opposed to the developed central bankers with respect to targeting and hitting inflation with that response. So, that is first and foremost in our mind. In addition, what we're seeing is much more disciplined and economically or market friendly policies. So, as you think about, sort of, the policies that might be a little bit more lenient and using a little bit more fiscal hasn't necessarily come to fruition. So, when you think about a disciplined fiscal environment, that has been very attractive. And then really based in the commodity, if you think about, hard commodities, soft commodities, proteins, grains, all of those areas are what is an input into the rest of the world and that economic activity and growth that we're seeing. So, we're seeing economic growth globally starting to rebound, which is benefiting these countries that that we're talking about. And then within that, it's been a really reasonable perspective to take that the management teams have actually been disciplined with respect to running their businesses and haven't gotten, as we would like to say, over their proverbial skis with too much leverage.

Katie Klingensmith [00:13:22] Brian, you run portfolios that really have a broad remit in terms of the multi-sector universe that they can consider. And I know that one of the areas that you look at is securitized. Can you talk to me, especially on a relative basis, about the opportunities that you're seeing right now in securitized credit?

Brian Kloss [00:13:39] Securitized is one of those opportunity sets that are unique. You do have to actually have that expertise in those markets. It's very difficult for individuals to go out and be able to access those types of markets. So again, what we're seeing is, fundamentally, a very strong market, especially in the residential mortgage-backed securities market. So, if you think about those being secured by the residential housing market, the labor market still remains very robust. House price has remained fairly stable. I think we've seen some pockets of weakness, some of those maybe down in Florida, maybe in Texas there's been a little bit of weakness. But it's still a very stable market. But what we're really seeing, and again, we're breaking this down between the agency market, which is more of an interest rate market, which is government guaranteed, versus the private mortgages or the non-agency mortgages, as we would call it in our parlance. The non-agency mortgages are more of a function of yield at this point. So, there is a little bit of reinvestment risk as you think about it. But a very attractive yield at this time. And again there is this opportunity set that even if they do get called away from us, we do think we have the ability to redeploy that in other sectors at this point. But again, I think it's really about where that running yield is within this residential mortgage-backed securities sector that we're talking about, Katie.

Katie Klingensmith [00:15:13] So, those are a lot of different sectors and opportunities globally. Brian, is there still a case to be made for holding developed market treasuries, US and otherwise?

Brian Kloss [00:15:25] There's always a case. And again, it's really about sizing. And again, what part of the curve you want to take that exposure on. So again, as you think about a multi-sector type of strategy or just thinking about risk management in general, you should think about where that risk-off scenario could unfold and how to try to insure against that type of event. So yes, we would argue that there is. In addition, if you look at historical type of data and you look at when the Fed starts to cut and how developed market sovereigns perform at that point in time, I think there's a total return opportunity to argue for, in addition to that risk management piece that we just walked through.

Katie Klingensmith [00:16:05] Bring this all together for us. It seems like there are a lot of opportunities in the fixed income space, but also a lot of different unknowns going into the second quarter of 2024. Walk us through what you think will be the biggest drivers determining the opportunities in multi-sector fixed income.

Brian Kloss [00:16:26] Let's think about that and what the risks are as we're sitting here today. First quarter was or so far has been pretty good. One probably shouldn't expect that to be through the balance of this year. There's always ups and downs in markets. So, we always have that volatility. I think in the first part of the year, we might have a little bit of a resurgence on inflation or in inflation and really have to understand of whether or not those are just anomalies or is it really going to hit the Fed's 2% target? So, are goods and service inflation going to be stickier? Are we going to see a resurgence or not? So, I think we need to look for that. And I think the other one is the wars that we have globally. You think about Ukraine, and you think about the Middle East. I think we're starting to see the potential for ceasefires in the Middle East. Ukraine's probably going drag out a little bit longer. But again, as those, sort of, start to wind down, that would be constructive for global growth. Then again, I think the last thing that we have to think about as we think about the longer term here in 2024 is really around the event in November in the US, the elections. I think shorter term, you probably have some elections in Mexico and in South America that are going to be pivotal, but it's really going to be how does the US set up for 2025 and what the consequences are going to be of that election and what the policy responses are going to be. So again, it's going to be volatile again. So be active. Make sure you're taking profits when profits are there, being defensive, and then taking advantage when the valuation anomalies appear. So again, we would sit here and continue to argue for that active management of portfolios.

Katie Klingensmith [00:18:17] Thank you so much, Brian Kloss, for outlining multi-sector fixed income, the case for that, and the reasons to be very attentive to the many different factors in the world right now. And thank you to our listeners for joining us at Brandywine Global's Around the Curve podcast conversation.