Why Global Bonds?

GLOBAL BONDS: AN OPPORTUNE INVESTMENT

Global bonds are a unique opportunity class that can produce superior returns and diverse sources of alpha for a purely domestic bond portfolio. We believe an allocation to global bonds provides domestic portfolios with complementary sources of return by investing in multiple country yield curves, as well as through prudent currency management. Active global bond investors, therefore, have an intrinsic advantage due to an expanded opportunity set. Investors who focus on government bonds in a single country are limited largely to binary duration decisions, while global managers who have the skill to manage country rotations can capture much more complex relationships. In allowing managers to invest globally, investors diversify their sources of return and, in our view, allow greater potential for outperformance.

An appropriately positioned strategy is critical to success when investing in global bonds. In our view, global fixed income investment portfolios built around indices are less likely to provide strong returns because index weights are directly proportional to the size of a country's debt issuance. Therefore, investors in benchmarked strategies are led to increase holdings in countries with huge debt loads, not huge opportunities. In the current environment, this paradox is truer than ever as private sector borrowing and spending have been replaced by massive government debt issuance and spending in the developed world.

This paper discusses the reasons why investing in global bonds makes sense, what current investment opportunities are present within the asset class, and how even more upside can be captured in the asset class through a well-structured portfolio.

Q: *Why are global bonds a unique opportunity class?*

A: *Global bonds offer a larger, more diversified opportunity set of return sources relative to single-country portfolios.*

GLOBAL BONDS OFFER A GREATER OPPORTUNITY SET

Historically, the dispersion of returns across sectors of domestic bond markets has been narrow and tightly clustered. By extrapolation, some investors mistakenly presume that the same must be true of the dispersion within global bond indexes. This faulty assumption leads some to shun the asset class because they believe they would assume incremental risk without incremental upside potential. As seen in **Figures 1 and 2** on the next page, investors have the potential to achieve significantly more outperformance if they overweight the right countries in a global portfolio than if they overweight the right sectors in a single-country portfolio.

Past performance is no guarantee of future results.

David F. Hoffman, CFA
Managing Director & Portfolio Manager

Francis A. Scotland
Director of Global Macro Research

Theodore W. Fetter
Head of Global Sales & Client Services

Brandywine Global Investment Management, LLC
1735 Market Street, Suite 1800 / Philadelphia, PA 19103
North America: 215 609 3500 (U.S.)
416 860 0616 (Canada)
Europe: +44 20 7786 6360
Asia: +65 6536 6213
brandywineglobal.com

For Institutional Investors Only

By investing in a single country, investors limit their potential sources of return. Conversely, by investing in global bonds, investors can limit risk and improve returns by focusing only on the countries with the most attractive economic and interest rate cycles. This broader scope creates the potential to produce superior returns and enhance diversification benefits relative to purely domestic bond portfolios.

Investors tend to have a home-biased view of global bond investing. What they fail to realize is that nearly 65% of the world's sovereign debt is issued outside of the U.S. (see **Figure 3**). In contrast, approximately 43% of the world's publicly traded equity value is outside of the U.S. using the MSCI ACWI Index as a proxy for outstanding issuance. While global equity exposure is considered a natural portfolio choice, many investors still fail to advocate for global fixed income exposure.

GLOBAL BONDS HAVE MORE FACTORS FROM WHICH TO DRAW RETURN

The dispersion of returns across global bond markets is wide and often offers significant upside relative to U.S. bonds. A historical analysis of global fixed income returns shows repeatedly that the top performing country in one year could be among the worst performing the next and vice versa. Currency provides an additional source of alpha on top of the standard factors for bond investors. A country's bond market may produce average performance in local-currency terms in a given year, but a cheap and appreciating currency can provide investors with an additional source of return. Conversely, a good bond return can be negated without prudent currency management. Investing in the right countries, coupled with currency appreciation or selective hedging, and relatively higher real yield offer return potential usually far in excess of any one domestic market. Such a strategy has the potential to also provide an additional, uncorrelated alpha source to a multi-asset portfolio.

Q:	*Why is now an important time for investing in global bonds?*
A:	*Policy shifts of monetary authorities in G3 economies are likely to result in poor returns for G3 domestic bond portfolios.*

LOW RATES INCREASE RISKS, CONSTRAIN OPPORTUNITIES IN CORE DEVELOPED MARKETS

Developed market rates are hovering at or below zero and are projected to remain low for a prolonged period. It will be very difficult for a domestic core manager to navigate the duration risk presented by a low rate environment. In the face of this threat, some managers may sacrifice credit quality and overlook a lack of strong fundamentals in the search for higher yields. We believe that an investment in global bonds is a more prudent choice, offering more opportunities for improved return potential and risk management.

Figure 1 Domestic Bond Index Dispersion/Opportunity[1]
Annual Total Returns (%); As of 12/31/2020

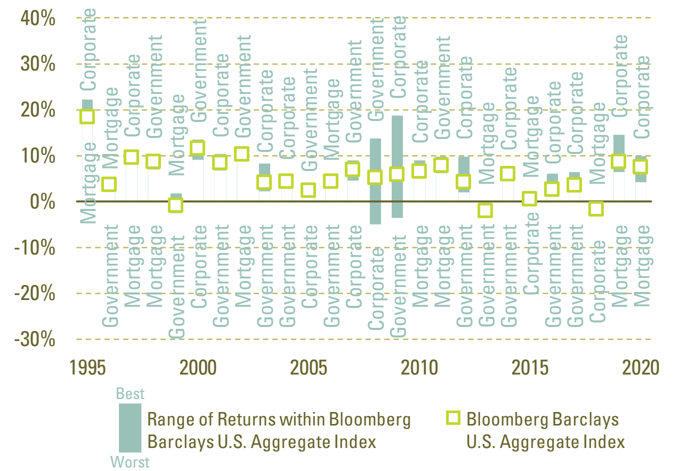


Figure 2 Global Government Bond Dispersion/Opportunity[2]
Annual Total Returns (%); As of 12/31/2020

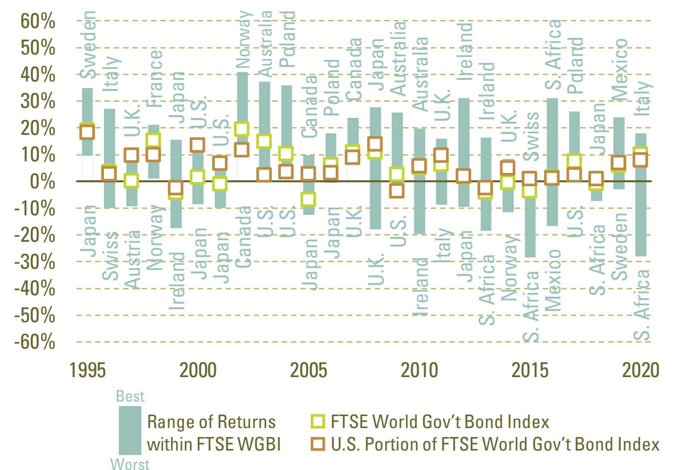
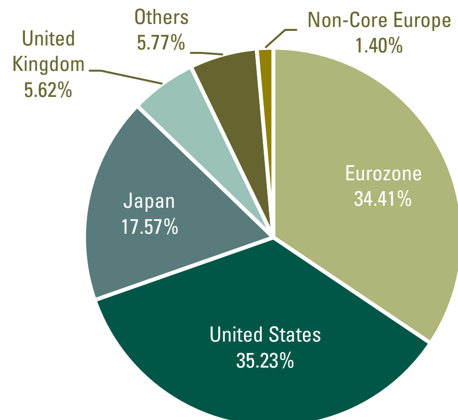


Figure 3 Investment-Grade Sovereign Debt Outstanding[3]
As of 12/31/2020



Past performance is no guarantee of future results.

INVESTING IN THE BROADER G20 COUNTRIES MAKES SENSE

Opportunities across the global bond market are even more compelling from a risk perspective. Improving commodity prices and global trade are increasing the attractiveness of natural resource-linked countries in both developed and emerging markets. Many of the countries in the G20, in our opinion, offer compelling long-term prospects relative to the smaller subset of G3 sovereign markets. Investors who are wary of the euro can find opportunity elsewhere in Europe through peripheral countries that benefit from regional economic expansion but maintain independent central banks and currencies.

A weakening trend in the U.S. dollar also has helped lend support to commodities and developing countries. The Fed's stated shift to average inflation targeting, keeping rates lower for longer and allowing inflation to overshoot its target for a sustained period, could put downward pressure on the greenback. We would expect that a stable to weaker U.S. dollar would benefit developing countries, and the combination of attractive nominal yields and currency valuations should create opportunity. Additionally, central banks and governments in these nations have become more responsible in recent years and have succeeded in reining in inflation, building reserves, and strengthening their economies.

Investors are gradually appreciating the structural improvements in many countries outside of the traditional G3 economies. This trend has led to an increase in credit quality (see **Figure 4**) and liquidity, which has also reduced risk premia. Furthermore, lower borrowing costs have improved the ability of these countries to withstand volatility in global growth and financial markets. Given this financial cushion, we believe emerging market spreads would not reach the historically wide levels seen during the previous Argentinian or Russian defaults (see **Figure 5**).

Despite lingering memories of volatility, emerging market real yields remain attractive, which creates enormous opportunity for global bond investors. Additionally, the potential for currency gains exists, particularly against a range-bound or declining U.S. dollar. Many developing countries that once resisted a rise in currency valuations to keep export sectors competitive during the 10 years of anemic global growth now may be amenable to currency appreciation. While some appreciation has occurred, further potential returns are likely in anticipation of the trajectory of the U.S. dollar as well as the Chinese yuan.

Figure 4 Improving Credit Quality in Developing Markets[4]
S&P Credit-Quality Distributions Across Developing Markets; As of 12/31/2020

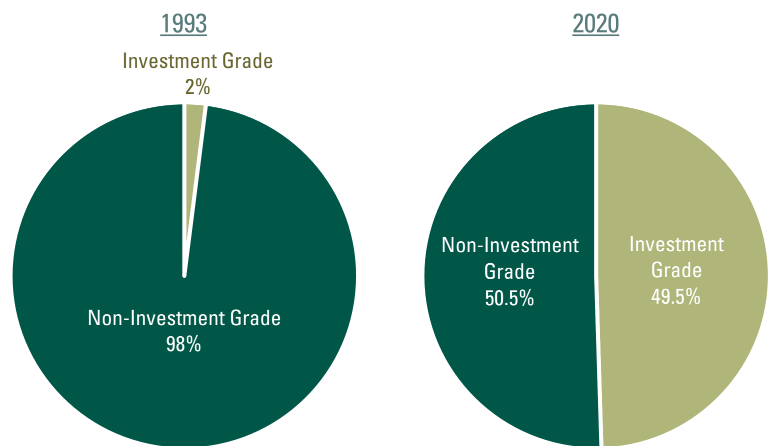
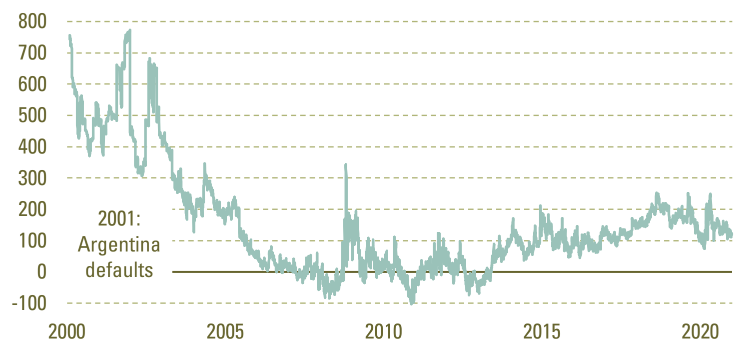


Figure 5 Credit Spreads of Emerging Market Sovereigns vs. U.S. Corporates[5]
J.P. Morgan EM Bond Index Less Baa-Rated U.S. Corporates*; basis points; As of 12/31/2020



*Moody's Baa

MANY DEVELOPING COUNTRIES ARE LIBERALIZING MARKETS

Global capital markets have become increasingly intertwined over the last two decades, particularly as emerging markets seek to attract inflows of long-term foreign investment. Therefore, many countries in the emerging world are implementing policies designed to attract foreign investment. Several emerging markets have favorable demographics in terms of relatively young populations and labor market slack to pursue ambitious infrastructure improvements. Both developed and emerging market governments are also incentivizing foreign capital mobility using a combination of policy initiatives that offer attractive interest and corporate tax rates and improve the ease of doing business. Collectively, these factors should produce stronger performance relative to the G3.

THE WORLD OUTSIDE THE G3 IS STIMULATING DOMESTIC CONSUMPTION

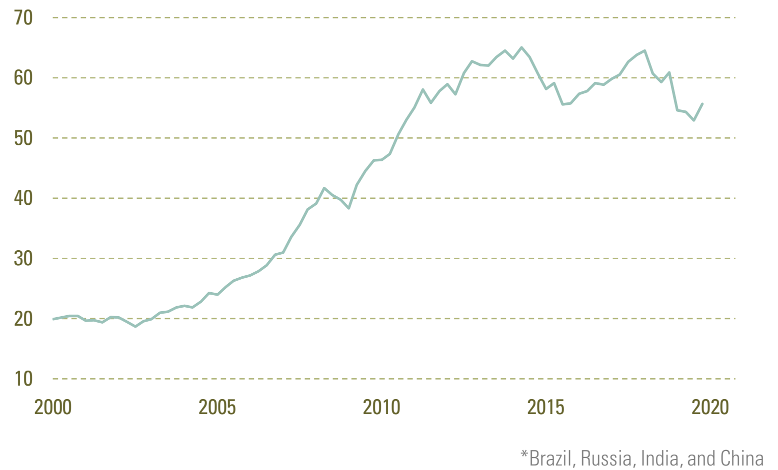
Going forward, the rest of the world can no longer rely on the U.S. consumer as the backbone of global demand, and the developing world is taking initiative to stimulate spending domestically. For over 15 years, there has been a unique balancing act between the U.S. and China, the two anchor economies of the global financial system. China's excess production and savings were absorbed by excess U.S. borrowing and spending. This combination fostered the impression of rapid, non-inflationary growth around the global economy for almost two decades. This period is now over.

Private sector deleveraging combined with new lending standards and the recapitalization of the banking system mean that China and other developing economies need to find new sources of demand. Every indication suggests that this shift is happening. The emerging countries stimulated their economies to overcome the drag from the global financial crisis and, more recently, the global pandemic. From a longer-term perspective, they are encouraging domestic spending as well. Brazil, Russia, India, and China (BRIC) personal consumption as a percentage of U.S. consumption has nearly tripled in about 15 years (see **Figure 6**). Additionally, the share of global GDP outside the G3 has continually increased over time (see **Figure 7**). Going forward, we expect these economies to strengthen without relying on the U.S. as the main driver of growth.

Q: *How should investors allocate to global bonds?*

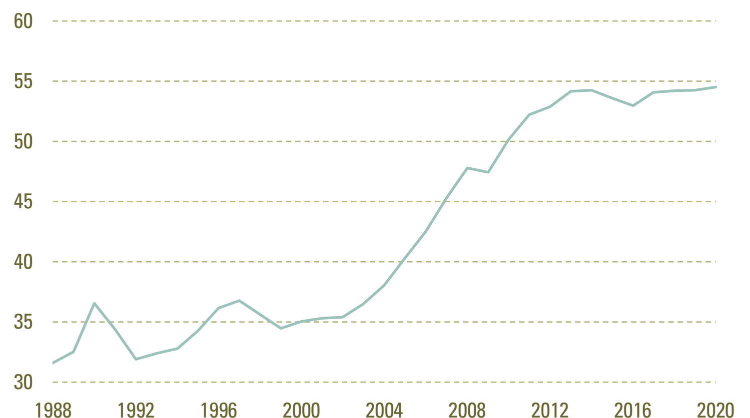
A: *A macro-based, index-agnostic investment strategy that focuses on bonds and currencies is best suited for today's environment.*

Figure 6 BRIC* Personal Consumption Relative to the U.S.[6]
Absolute Values Compared at Market Exchange Rates (%); As of 12/31/2019



*Brazil, Russia, India, and China

Figure 7 Non-G3 Share of Global GDP[6]
At Market Exchange Rates (%); As of 12/31/2020



GLOBAL BOND INDICES MISLEAD INVESTORS AWAY FROM VALUE

Stock indices are meritocracies. The biggest companies in the S&P 500 made money for investors, achieved profitability and growth, and rose to positions of respect and prominence. Conversely, the countries with the largest allocations in capitalization-weighted, global fixed income benchmarks achieved that status by being the most indebted. They ran the biggest deficits and were the least disciplined in their control over costs relative to revenues. Using fixed income indices as a framework for taking risk simply does not make sense. Investing in an index-like strategy leads investors to hold positions in countries that issue significant debt without any consideration for the return potential of those securities. In the current environment, major developed countries are issuing massive amounts of debt at extremely low yields. We believe this trend represents a significant misalignment of interests between issuers and investors, since issuers are seeking to minimize their interest costs while investors are seeking to maximize their return.

In our view, the current massive debt issuance in the developed world illustrates the flaws of index-relative investing. Now more than ever, the index conceals opportunities and exposes investors to risk by driving them toward newly issued sovereign debt, "crowding out" the world's emerging powerhouses.

Furthermore, fixed income indices distort interest rate risk through the so-called "duration paradox." As yields fall for a particular country, duration associated with that exposure extends. This relationship means that a portfolio's value becomes more sensitive to interest rate risk as yields for a particular country fall. Therefore, an index-driven investment strategy implies taking on more interest rate risk in low-yielding countries and less

interest rate risk in higher-yielding countries–the opposite of what a rational investor might want. On a duration basis, a portfolio that deviates from the benchmark is considered to have higher active risk.

World government bond indices further distort risk-taking by biasing investors toward markets with overvalued currencies. A country's weight in the index rises as its currency appreciates. Therefore, index-oriented strategies encourage investors to allocate more capital to markets where price risk is high and rising. Conversely, when currencies are undervalued and have the most potential to appreciate, their index weights are at a minimum. From an investment standpoint, this approach is counterintuitive.

We believe the mainstay of a successful investment approach in global bonds is to focus where intrinsic value exists both with respect to interest rate levels and currency valuations. Our approach at Brandywine Global focuses first on identifying high real-yielding bond markets. We then employ a macro-driven, rigorous country analysis to gauge the structural strength and weakness of an economy, exposure to shifting global forces, and the significance of economic policy from the perspective of a fixed income investor. Given the index construction paradox, we believe that successful investing in global bonds relies as much on avoiding loss as pursuing gain. Rather than owning bonds issued by large index countries when we expect them to underperform, our strategy has the courage of conviction to concentrate investments in countries and currencies where we see the greatest total return opportunity. In some instances, our positioning may appear "concentrated" relative to the index since we avoid owning overvalued countries and currencies. However, this is an example of where concentration, we believe, does not equal risk. In fact, the opposite may be true.

SUMMARY

We believe global bonds offer a superior and diverse opportunity set and allow the potential for increased active return. Focusing on a single market's economic and interest rate cycle to generate returns is one dimensional, risky, and restricts an investor's return potential. The impacts of the 2008 crisis, the recent global pandemic, and ensuing policy responses further reinforce the need to look beyond the largest domestic markets and embrace a global approach built not around an index but around the greatest opportunities within the global bond investment universe.

[1] Source: Bloomberg Barclays Fixed Income Research, Global Family of Indexes. Represents the dispersion of the best and worst annual U.S.-dollar returns (unhedged) for the Bloomberg Barclays Mortgage Backed Securities Index (BMBSI), Bloomberg Barclays Corporate Bond Index (BCBI), and the Bloomberg Barclays Government Index (BGI). The BMBSI includes GNMA, FNMA, and FHLMC mortgage pass-through securities. The BCBI includes U.S. corporate bonds, Yankee debentures, and comparable issues. The BGI includes U.S. Treasury and agency securities. Charts created by Brandywine Global.

[2] Source: FTSE World Government Bond Index (WGBI). Represents the dispersion of the best- and the worst-performing countries utilizing annual total returns measured in U.S. dollars (unhedged). Also pinpoints the annual return for the U.S. portion of the WGBI and the annual total return for the index itself. The WGBI is a market-capitalization weighted benchmark that tracks the performance of 18 government bond markets. Charts created by Brandywine Global.

[3] Source: Bloomberg (© 2021, Bloomberg Finance LP) - Index provider for FTSE World Government Bond Index data. Charts created by Brandywine Global.

[4] Source: J.P. Morgan. Charts created by Brandywine Global. Data represents the JP Morgan EMBI Global Bond Index, which consists of three bond indices that track emerging market bonds: the JP Morgan Emerging Markets Bond Index Plus, the JP Morgan Emerging Markets Bond Index Global, and the JP Morgan Emerging Markets Bond Global Diversified Index. Credit qualities represent S&P ratings.

[5] Source: Bloomberg (© 2021, Bloomberg Finance LP) and Macrobond, which Brandywine Global believes to be accurate and reliable. Charts created by Brandywine Global.

[6] Source: International Monetary Fund (IMF), which Brandywine Global believes to be accurate and reliable. Charts created by Brandywine Global.

©2021, Brandywine Global Investment Management, LLC. All rights reserved. The views expressed herein represent the opinions of Brandywine Global Investment Management, LLC, and are not intended as a forecast or guarantee of future results. This information should not be considered a solicitation or an offer to provide any Brandywine Global service in any jurisdiction where it would be unlawful to do so under the laws of that jurisdiction. Fixed income instruments are subject to credit risk and investment rate risk. International securities may be subject to market/currency fluctuations, investment risks, and other risks involving foreign economic, political, monetary, taxation, auditing, and/or legal factors. International investing may not be suitable for everyone. It should not be assumed that investment in the regions or currencies discussed and account quality ratings or duration ranges were or will prove profitable, or that investment decisions we make in the future will be profitable. S&P® is a registered trademark of Standard & Poor's Financial Services LLC. **Past performance is no guarantee of future results.**