Why Global Bonds?

GLOBAL BONDS: AN OPPORTUNE INVESTMENT

Global bonds are a unique opportunity class that can produce superior returns and provide 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 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 source of return and, in our view, allow greater potential for outperformance.

A decade after the financial crisis, global bond markets present a compelling investment opportunity as the major central banks of the developed world begin to unwind unprecedented stimulus and unorthodox monetary policy. In the U.S., the Federal Reserve (Fed) has steadily tightened conditions, and now the central banks of other developed economies are poised to normalize. In this environment, the bond markets of developed nations appear more synchronized and riskier with yields expected to move higher from their artificially low levels. Comparatively, the broader G20 and emerging markets have seldom been more appealing from a risk-reward perspective. Many of these countries are undergoing broad-based fiscal reform, expanding upon infrastructure, diversifying their economies away from a heavy reliance upon manufacturing, and increasing domestic demand and consumption. In light of these factors, we think these countries are well-positioned for independent economic growth and prosperity.

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. This is 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 In the current environment, this paradox is truer than ever as private sector borrowing and spending have been replaced by massive government debt issuance and spending in the developed world.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.

Past performance is no guarantee of future results.
Why Global Bonds? | p2

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 assume incremental risk without incremental upside potential. As seen in Figures 1 and 2, investors have the potential to achieve significantly more outperformance if they overweight the right countries in a global portfolio relative to overweighting the right sectors in a single-country portfolio.

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 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 48% 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 class portfolio.

Figure 1 Domestic Bond Index Dispersion/Opportunity

Figure 2 Global Government Bond Dispersion/Opportunity

Figure 3 Investment-Grade Sovereign Debt Outstanding

As of 6/30/2018
Q: Why is now a unique time for investing in global bonds?
A: Following the 2008 crisis, the policy response of monetary authorities in G3 economies is more likely than ever to result in poor returns for G3 domestic bond portfolios.

THE U.S. BOND MARKET IS MORE HOMOGENOUS AND RISKIER THAN EVER BEFORE

Many institutions and agencies across the U.S. government responded to the 2008 breakdown of the financial system in concert, implementing massive fiscal and monetary stimulus. Congressional Budget Office projections show that the U.S. government remains on course to accumulate record debt as a share of gross domestic product (GDP). As a result of decade-long policies, debt backed by the U.S. sovereign as a share of the dollar-denominated bond market has also risen substantially. Government-related securities (e.g. Treasurys, agency debt, and Federal Deposit Insurance Corporation-guaranteed paper) now represent around 72.5% of the broad U.S. Aggregate Index. The U.S. bond market has become increasingly homogenous with all this issuance backed by the same entity, the U.S. government. Furthermore, we expect more inventory to flood the market as the Fed continues to shed assets as part of its continued efforts to reduce its balance sheet while the pace of new issuance remains strong.

For 10 years, the U.S. and other countries issued debt at extremely low yields; the average yield to maturity for the U.S. Aggregate1, for example, remains close to 3.3%. With developed market rates still hovering at or below zero, it will be very difficult for a domestic core manager to navigate the duration risk presented by a rising 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 much more prudent choice.

INVESTING IN THE BROADER G20 COUNTRIES HAS NEVER MADE MORE SENSE

With the U.S. further along in its business cycle and post-crisis economic expansion, opportunities across the global bond market are even more compelling from a risk perspective. Investors who believe that commodity prices have likely bottomed and that the Chinese government is implementing the right fiscal and monetary policies might be enticed by natural resource-linked countries in both developed and emerging markets. Those 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. Many of the countries in the G20, in our opinion, offer compelling long-term opportunity relative to the smaller subset of G3 sovereign markets.

Although a large number of developing countries have been affected by the strong U.S. dollar and the deceleration in Chinese economic growth, the combination of 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 has led to an increase in credit quality (see Figure 4) and liquidity, which has also reduced risk premia. This, in turn, provides for lower borrowing costs and underpins 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 as seen during the previous Argentinian or Russian defaults (see Figure 5 on top of next page).

Despite lingering memories of volatility, emerging market real yields remain attractive, which creates enormous opportunity for global bond investors. Additionally, the pent-up potential for currency gains exists, as the U.S. dollar’s extensive multi-year rally remains range bound and poised for a deceleration. Many developing countries that once resisted a rise in currency valuations to keep export sectors competitive during the 10 years of anemic global growth are now amenable to currency appreciation. While some appreciation

Figure 4 Improving Credit Quality in Developing Markets
S&P Credit-Quality Distributions Across Developing Markets

<table>
<thead>
<tr>
<th>Year</th>
<th>Investment Grade</th>
<th>Non-Investment Grade</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>2%</td>
<td>98%</td>
</tr>
<tr>
<td>2017</td>
<td>Non-Investment Grade 30.5%</td>
<td>Investment Grade 69.5%</td>
</tr>
</tbody>
</table>

As of 12/31/2017
has occurred, further potential returns are likely in anticipation of the trajectory of the U.S. dollar, as well as the Chinese yuan.

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 also 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 rates, 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 in reaction to the fall off in U.S. consumption. 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. In hindsight, it is now clear that the U.S. was only able to sustain its excessive consumption through an unsustainable decline in lending standards and reduced cost of risk. 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 is happening. The emerging countries have stimulated their economies quickly to overcome the drag from the crisis. From a longer-term perspective, they are encouraging domestic spending as well. Brazil, Russia, India, and China (BRIC) 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 the reliance 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

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 represents a significant misalignment of interests between issuers and investors, since issuers are seeking to minimize their interest costs while investors seek 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 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 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. Frankly the opposite may be true.
ACTIVE DISCRETIONARY HEDGING; THE COUNTRY AND CURRENCY DECISIONS ARE INTERTWINED

Global bond investors must make allocation decisions relative to both bonds and currencies. As the chart in Figure 8 indicates the total return in the worst markets is often driven by currency movements, which can be much more volatile than performance, attributable to interest rate changes. Ideally, an investor would like to own an unhedged local bond, since that allows for two sources of return. Successful investors, though, realize that this might not always be possible. Sometimes, looming interest rate cuts can make a local market attractive, while the same scenario could lead to currency devaluation. In such a market, a manager must be willing to hedge currency risk. On the contrary, in some very strong economies, a currency may be attractive and its bonds unattractive. While currency adds complexity, it also adds opportunity.

Going forward, active hedging will be extremely important as a source of return because policymakers’ main weapon for fighting deflation is currency devaluation. Mean reversion plays a very important part in our process of price/value discovery. Many managers use price swings in a momentum sense. Our approach looks for swings in prices that are so far away from underlying valuations that they trigger economic/policy reactions, which, in turn, lead to reactionary processes that cause mean reversion. Many times these inflection points are signaled by changing human behavior.

Currencies and interest rates are economic regulators, and will often continue to trend until they change people’s economic behavior, signaling that valuations have run far enough to start mean reversion. We look for these signs of behavioral change and monitor economic statistics, using them to inform both the currency and bond decisions. This is especially important in evaluating currency valuations as they tend to stretch but not break. Our style of discretionary hedging seeks to exploit these anomalies and has served us well as a global fixed income manager for over 20 years, with almost half of our excess returns generated from currency decisions.

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 impact of 2008’s crisis and ensuing policy response further reinforces 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 Data Source: Barclays Fixed Income Research, Global Family of Indexes. Represents the dispersion of the best and worst annual U.S.-dollar returns (unhedged) for the Barclays Mortgage Backed Securities Index (BMBSI), Barclays Corporate Bond Index (BCBI) and the 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 Data 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 Data Source: Bloomberg - Index provider for FTSE World Government Bond Index data. Charts created by Brandywine Global.

4 Data Source: J.P. Morgan. Charts created by Brandywine Global. Data represents the J.P. Morgan EMBI Global Bond Index. The J.P. Morgan EMBI Global Bond Index consists of three
Why Global Bonds? | p7


5 Data Source: Bloomberg and Macrobond, which Brandywine Global believes to be accurate and reliable. Charts created by Brandywine Global.

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

7 Data Source: FTSE World Government Bond Index (WGBI). Represents the performance of the worst-performing bond market utilizing annual total returns measured in U.S. dollars (unhedged). Also represented is that total return broken into the portion associated solely with currency appreciation/depreciation and the portion associated with local market appreciation/depreciation. The WGBI is a market-capitalization weighted benchmark that tracks the performance of 18 government bond markets. Charts created by Brandywine Global.

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