

It's All Over for Global Bonds...Or Is It?

Richard Lawrence |

If one were to assess the viability of global bonds as an asset class solely by reviewing recent headlines, most investors would be running for the hills—or going to cash. Articles about ultra-low to negative rates and bond yields abound, headlines scream about the \$12 trillion of government debt now trading with negative yields, and talking heads prophesize a global bond market crash.

Perceptions of the opportunity set in global bonds tend to be distorted by the inefficient structure of most global bond indices. Most of the popular global bond indices (e.g. Citigroup World Government Bond Index also known as the WGBI, and the JP Morgan Global Government Index) are capitalization-weighted, with the countries issuing the most debt being reflected as the largest weights in the index. Furthermore, much of this issuance has occurred recently at abnormally low yields. For example, the yield on the WGBI index is currently 0.58%. The WGBI's current yield does not reflect the richness of the complete global opportunity set, and investors should broaden their perspective beyond the lower-yielding segment of this universe.

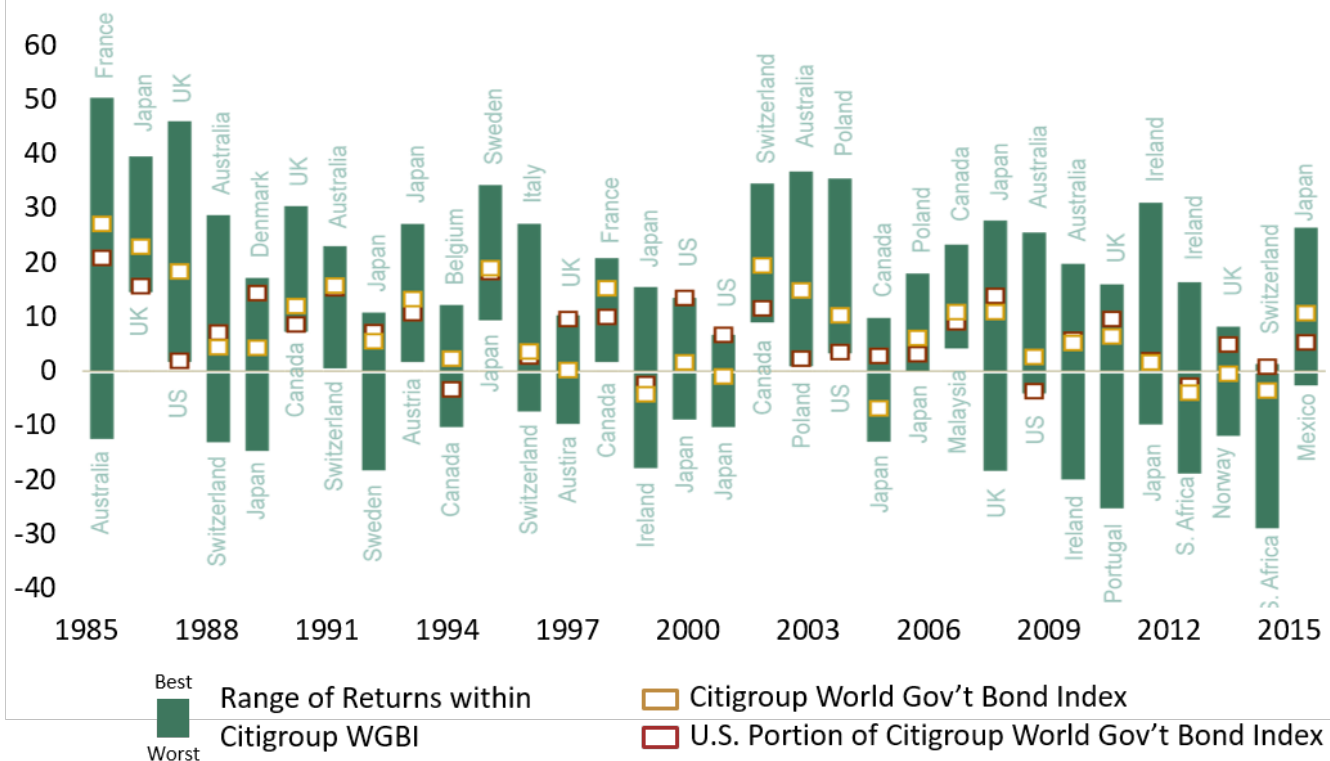
We remain more sanguine about the prospects for the global bond market for several reasons, some of which speak to the evergreen nature of the opportunity set, while others speak to the current environment.

The Evergreen Nature of Global Bonds

In our view, the power of taking a global approach lies in the recognition that the investment universe is comprised of roughly 30-40 markets with business cycles that are not directly aligned with one another. As a result, the dispersion of returns across global bond markets is wide and typically 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.

Chart 1: Global Government Bond Dispersion/Opportunity

Annual Total Returns, Percent, As of 6/30/2016



Data Source: Citigroup 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.

Currency provides an additional investment opportunity on top of the typical return factors for bond investors. A country's bond market may produce average performance in local-currency terms in a given year, but an undervalued 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—offers 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.

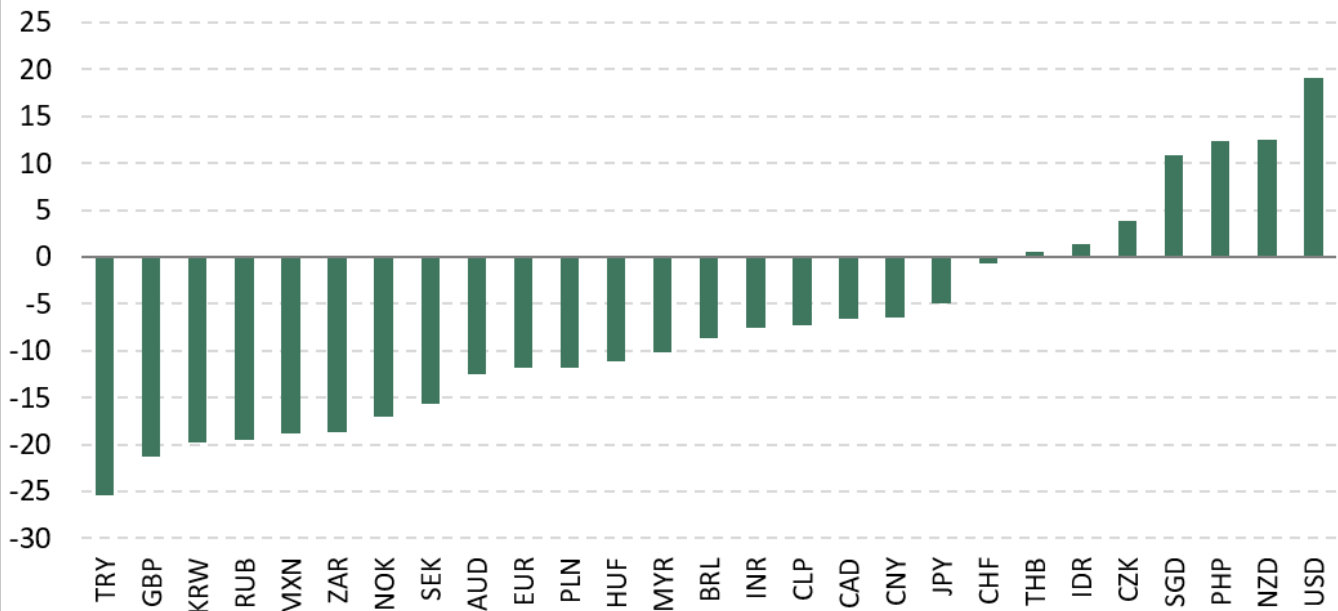
The Opportunity Set Today

Despite historically low yields in major developed markets, we still believe that global bonds offer the opportunity to earn attractive returns for a few reasons:

Firstly, with the Federal Reserve (Fed) likely to maintain an extremely shallow trajectory of rate hikes, we continue to expect the U.S. dollar to weaken from its currently overvalued level. Based on our purchasing power parity (PPP) proprietary metric, the dollar remains the most overvalued currency according to our research.

Chart 2: 2016 Valuation Opportunities in Currencies

Percentage Deviation from BGIM PPP, As of 7/31/2016

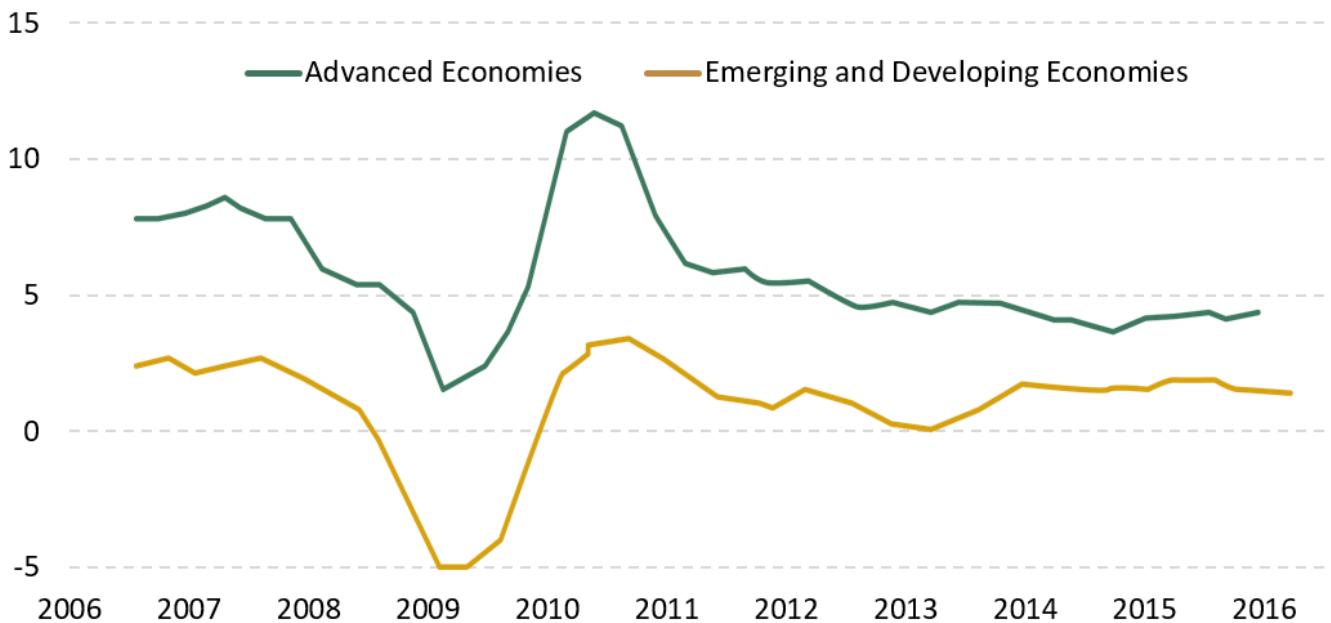


Source: Thomson Datastream

Furthermore, Fed officials have recently acknowledged the role of the dollar in changing financial conditions. Vice-Chair Dudley recently stated “if the economic outlook abroad deteriorates and this causes foreign countries to pursue a more accommodative set of monetary policies, then the dollar would likely appreciate—other things equal—reflecting expectations of lower interest rates abroad relative to U.S. interest rates. In this case, the U.S. may need to adjust its own monetary path. If the [Federal Open Market Committee (FOMC)] did not make this adjustment, the stronger dollar could result in an undesired tightening of U.S. financial conditions.” Vice-Chair Dudley was talking primarily about the dollar relative to other major developed currencies. We believe that the dollar is likely to fare better against the majors than against the broad trade-weighted basket. Given this backdrop, we continue to see attractive opportunities to own other currencies that remain undervalued despite the gains already enjoyed in non-dollar currencies since late January.

Secondly, we continue to see strong flows into emerging market (EM) debt markets. Some of this flow is likely explained by the global search for yield. The bull case, however, is that we are seeing signs of stabilization in EM economies. Growth in EM countries has been weak since 2011, following the end of the commodity supercycle.

Chart 3: EM vs. DM Real GDP Growth Rate GDP, Annual Percent Change, As of 6/30/2016



Source: Thomson Datastream

As growth has slowed, EM currencies have adjusted lower which has helped fuel inflation pressures in some EM markets. Their central banks have responded to this inflation pressure, as well as concerns about Fed hikes, by raising rates. Now we are moving into the next phase of the EM cycle where currency stabilization is helping to reduce the inflation pressures. As noted above, we see limited potential for Fed hikes, creating an environment in which we expect EM central banks to adopt more accommodative monetary policy postures which should support an improved growth outlook.

Thirdly, despite the headlines about negative rates, there are still plenty of opportunities in markets where nominal and real yields remain attractive on both an absolute as well as a relative basis. In a world where the WGBI yields 0.58% and the Barclays US Aggregate yields 1.87%, a global portfolio yielding 3.7% with the potential to add value through currency and duration positioning looks to be an attractive proposition.

In summary, despite the persistence of abnormally low yields in developed world bond markets, we believe an opportunity still exists to allocate capital across bond and currency markets around the world in a way that adds value as well as portfolio diversification benefits to a multi-asset portfolio.

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