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A Prudential plc company

The art of turning risks into opportunities

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EXECUTIVE SUMMARY

- **With the market positioning for a Fed pivot, investors in money market funds face the risks of declining returns and not meeting their investment objectives. Bonds offer the opportunity to lock in current attractive yields plus the potential for capital upside. That said, investors should watch out for not-so-straight-forward duration plays and the market's deemed "sweet spots".**
- **The hype over ESG investing may be ebbing, but we feel that ESG risks are still underrated. Understanding and harnessing these risks can be a potential source of alpha.**
- **Active bond managers can turn risks into opportunities through nimble duration management, deep credit research and continuous ESG engagement.**

Fed chairman Powell sealed the deal for a September rate cut at the Jackson Hole meeting in August as he warned that the downside risks to the US labour market had increased. At the point of writing[1], the bond market is pricing in 100 bps of rate cuts for the rest of 2024, but the bond market tends to get ahead of itself - at the start of 2024, the market was pricing in 7 rate cuts.

GO LONG AND STRONG

With the market positioning for a Fed pivot, one of the biggest risks potentially confronting investors are the declining returns from their monies that are parked in money market funds. It is reported that there is currently USD6.2 trillion in money market funds globally[2]. Bonds, especially longer duration bonds, stand to benefit from capital gains as central banks cut rates. Over in Asia, decade-high bond yields also present investors with attractive income streams.

That said, while longer duration bonds appear to be a straightforward trade, we caution that much uncertainty still lies in the months ahead. A broader conflict in the Middle East could result in an oil supply shock and trigger inflation concerns again. The shifting dynamics of the US election could also affect market confidence and risk premia. As the Fed treads a fine line between avoiding a recession on the one hand and managing a resurgence in inflation on the other, periods of market volatility cannot be ruled out.

The longer-term picture is further complicated by the US budget deficit. There is a risk of more fiscal spending if

Source: [1]As at 27 August 2024. [2]Bloomberg. As of August 2024.

the Republicans were to gain control of the House, Senate and Presidency in the upcoming election. This can pressure yields to go higher. As market narratives can change quickly, duration positions need to be managed in a nimble manner. At the same time, a bias towards quality within bond portfolios should help investors navigate market volatility better.

HUNT FOR THE REAL SWEET SPOTS

As investors move to lock in yields, the BB-rated credits within the Asian bond universe have been viewed by some as a sweet spot. BB bonds lie below the investment grade bonds on the ratings band, and while they are non-investment grade, many of these bonds are viewed to have stable fundamentals with rating upgrade potential. As such, the yield pick-up which they offer above investment grade credits, which can range between 100 to 150 bp, looks attractive, especially when considered against their low volatility. Based on our analysis, BB bonds appear to have even lower volatility than BBB-rated bonds. See Fig. 1.

Scratching beneath the surface, we find reasons for the low volatility nature of BB-rated bonds in Asia. The current BB universe is dominated by Indian credits that are underpinned by India's strong structural growth narrative and flush domestic liquidity, and hence trade more like Investment Grade bonds.

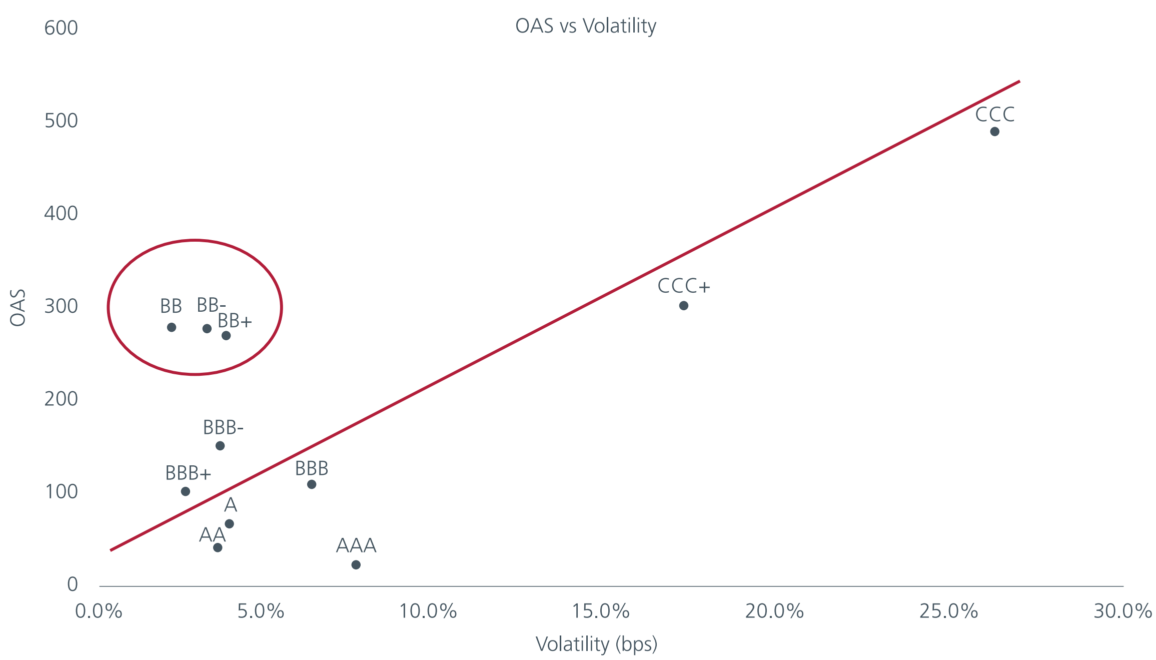
The above analysis is also distorted by the long periods of low volatility in the bond market, which tends to create a favourable environment for BB-rated credits. However, if we were to consider two recent periods that were marked by high bond volatility – such as during the COVID-19 pandemic outbreak and during the second half of 2022, when the Fed began its latest and aggressive rate hike cycle, BB-rated bonds sold off much more than their BBB-rated counterparts. Fig. 2.

Therefore, *caveat* emptor. This is not to say that there are no attractive BB-rated bonds but clearly not all BB credits are created equal, and we remain strong advocates of deep credit research and robust due diligence.

NAVIGATE ESG RISKS FOR ALPHA

While investors ponder over duration, credit and currency risks, one risk that is perhaps still underrated by investors is financially material Environmental, Social and Governance

Fig 1: Option adjusted spread versus volatility

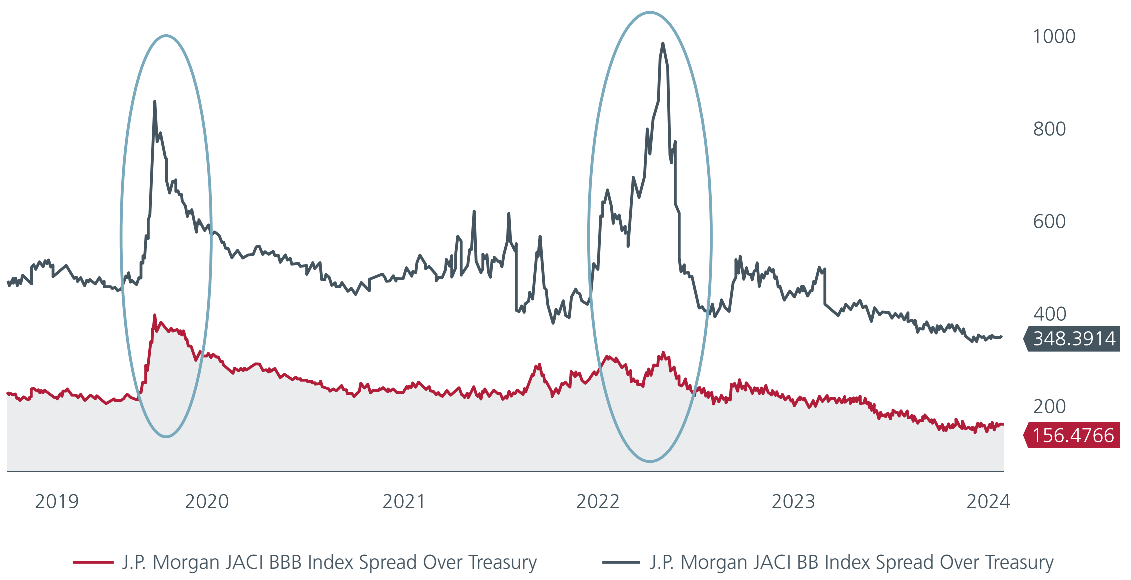


Source: As of end June 2024. Analysis based on Eastspring's Asian Fixed Income team's Internal Credit Ratings and over the period of end June 2022 to end June 2024 (last 2 years).

(ESG) risk. If we apply the Gartner hype cycle, which tracks the over-enthusiasm and disillusionment of how new technologies or innovation matures, to ESG investing, ESG investing appears to be past the hype and investors may be in a period of general disenchantment[3] following greenwashing concerns and the backlash on ESG activism. Fig. 3.

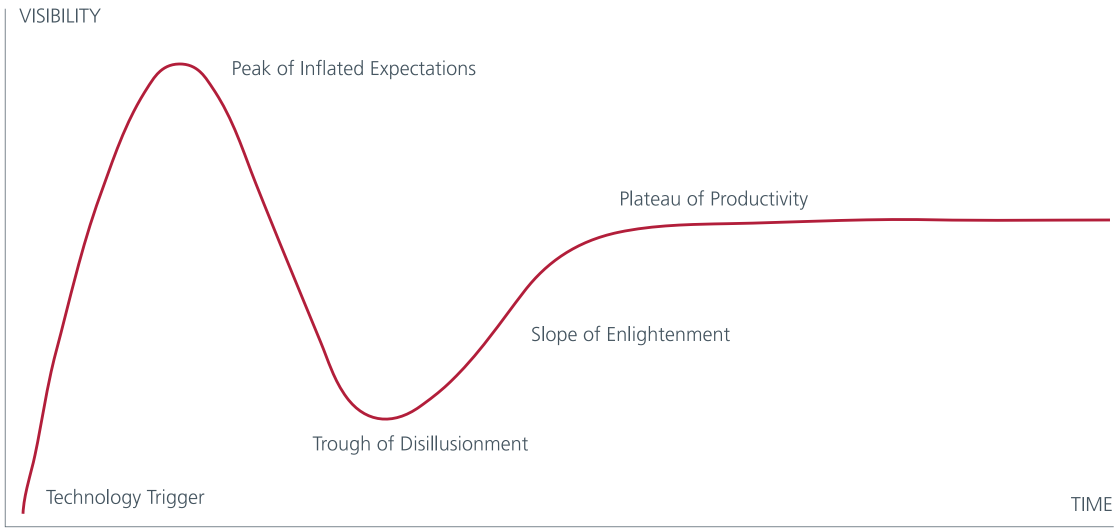
We view the decline in hype over ESG investing as positive and an opportunity for conversations on financially material ESG risks. The reality is that climate, social and governance risks deliver real financial impact to companies and affect their economic viability and profitability over the medium term. In recent months, labour disputes have disrupted

Fig 2: Spread performance Asia BB and BBB rated bonds



Source: Bloomberg as of 31 July 2024. JACIBBBS: J.P. Morgan JACI BBB Index Spread Over Treasury. JACIBBBB: J.P. Morgan JACI BB Index Spread Over Treasury.

Fig 3: Gartner hype cycle



Source: Gartner.

Source: [3]https://www.weforum.org/agenda/2023/08/heres-where-we-are-in-the-esg-investing-hype-cycle/

operations at a few automakers in Asia. Meanwhile, water scarcity can increase operating stress on businesses that are highly reliant on water as an input. Besides agriculture and food & beverage industries, it would also affect textile, steel production and pharmaceuticals industries. Extreme climate events like flooding can also significantly impair asset values. Understanding these risks, their materiality as well as how companies are adapting their business models to address these risks can help deliver superior returns to investors over the medium to long term.

CONVERTING RISKS TO OPPORTUNITIES

The different risks described in this article are by no means exhaustive. However, all risks present the opportunity for active bond investors to generate alpha, through credit analysis, duration, currency and liquidity management. This is especially key in the coming months as market volatility is expected to remain elevated and the US embarks on a new interest rate regime. Navigating ESG risks and opportunities can also be an important source of alpha. Beyond simple exclusion and avoidance of companies which may face regulatory sanctions, social issues and governance failures, it is also about uncovering undervalued opportunities through active engagement and identifying companies that are committed to assessing and addressing the financially material ESG risks they face. With transition bonds, which help high carbon emitting companies finance their shift towards more sustainable practices, expected to grow rapidly given the region's high potential for accelerated energy transition[4], there should be plenty of room for active bond managers to turn risks into opportunities.

Source: [4]https://www.theasset.com/article/52120/global-sustainable-bond-issuance-falls-20-in-q2

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