Using golf strategies to navigate fixed income markets

BlackRock.

Author

James Douglas, CFA
Director, European Fundamental Fixed Income Product Strategy

Quick read

Focus on the short game

Opportunities in short duration strategies present a huge change from recent history.

Avoiding the hazards

Markets have enjoyed a good round thus far but economic uncertainty enhances idiosyncratic risks.

Incorporating creativity

Elevated market volatility creates opportunities for unconstrained funds and relative value trading strategies.

Learning from Rory McIlroy's success

Derived from a previous career as a greenskeeper and current role, two of my favourite interests are golf and markets. In both disciplines, patience and experience are key with one mistake possibly having severe implications on overall performance. Watching the Scottish Open this year I was struck by the fundamentals driving Rory McIlroy's success, and how they can relate to Fixed Income investing. Playing golf in 30mph wind is challenging but for an investor navigating a market where interest rates have risen materially, there are also considerable headwinds. However, adopting the principles which brought Rory McIlroy success may be beneficial at this juncture.

Focus on the short game

Whilst his 400+ yard drives may gain a lot of attention, the ability to manage his short game was a key driver of success. Impressive putting statistics are testament to this with recent activity in markets encouraging investors to place a similar emphasis on their own short (duration) game. A relatively unloved part of the market due to ultra-low interest rates, the scale and velocity of monetary tightening has seen investor interest in short duration markets return[1] . Trying to combat inflationary pressures, the European Central Bank (ECB) has increased rates materially in the last year. As a result, yields at the front end of the curve have risen, providing compensation to investors when previously there was little (1-3 year European Investment Grade (IG) yields now above 4% from 0.03% at the end of 2021[2]). Markets have reacted to this tightening by inverting curves, a huge departure from recent history and adding further reason for investors to consider short duration strategies. Chart 1 illustrates this by plotting yields on IG European corporates across different maturity baskets through the last year.

The re-pricing of Fixed Income securities in 2022 ensured a tough year for investors in terms of total return. As central banks looked to tame inflation, higher interest rates were prioritised over the potential impact to economic growth with bonds losing some of the diversificational benefits traditionally associated with the asset class. However, in 2023 this dynamic has shifted with the collapse of Silicon Valley Bank and takeover of Credit Suisse in March seeing duration markets rally materially. Emphasised at the short end of the curve, 2-year German Bonds yields displayed their largest daily move in 30 years, rallying by over 50bps[3] as bonds once again displayed their risk-off benefit.

1 Source: BlackRock internal data, 21st July 2023.
2 Source: Bloomberg data, 21st July 2023.
3 Source: https://www.reuters.com/markets/rates-bonds/dysfunction-wildly-illiquid-bond-markets-unnerves-investors-officials-2023-03-17/

Exhibit 1: European Corporate Investment Grade Yields across different Maturities

Source: BlackRock, Bloomberg 21st July 2023.

Whilst it's not our base case, there is the risk yields climb higher given resilient economic and wage growth coupled with tight labour market. The market forecasts an additional 40bps[4] of hikes although even if a hawkish ECB or strong data supports higher yields, elevated breakevens provide further protection to the investor. Calculated through dividing yield by duration, this number illustrates the additional increase in yields which may occur before an investor incurs a negative total return on a 1-year basis. Due to the rise in yields and duration remaining relatively constant, breakeven protection at the short end of the curve has grown materially higher relative to other parts of the curve[5] . For example, with a duration of 1.94 years and yield to maturity of 3.71%, the current breakeven on the Euro Agg 1-3 year index is 193bps[6].

Avoiding the hazards

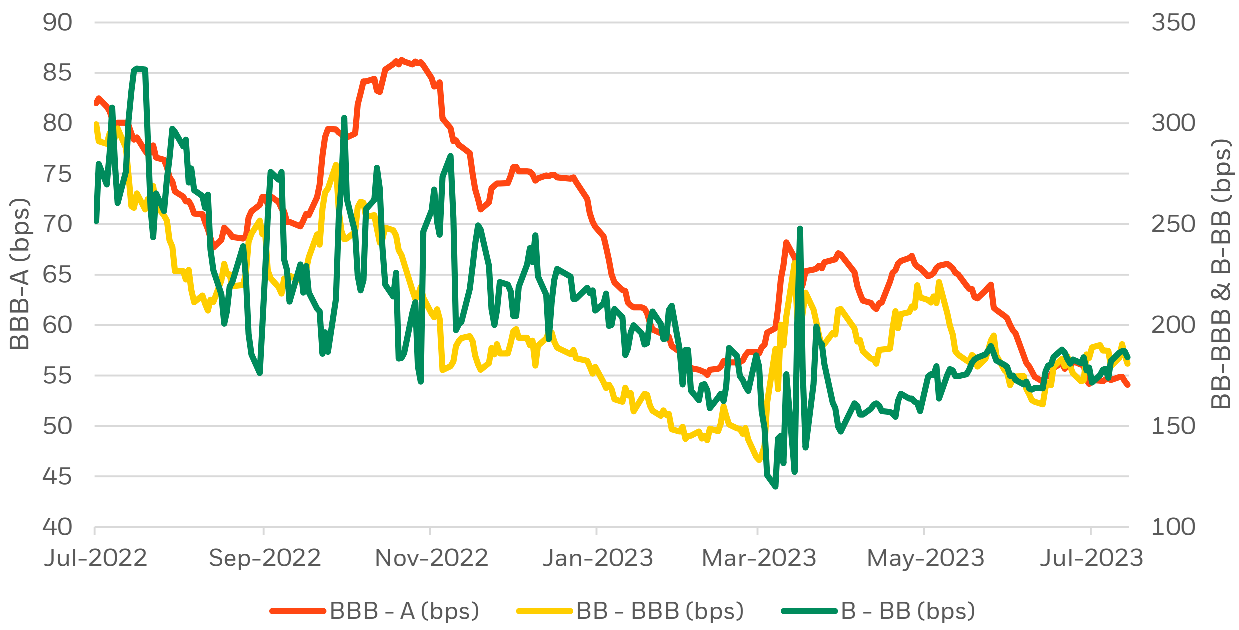
Finding a bunker, water or deep rough can spoil a round of golf. The (frustrating) nature of the sport ensures this can happen anytime and therefore remaining conscious of the risks throughout a round is important. We could describe markets as having a good round thus far in 2023 with many asset classes displaying positive returns to date. The disruption in March provided a timely reminder to the risks of aggressive monetary tightening although on reflection this is best described as a crisis of certain banks rather than a banking crisis. However, the specificity of issuer (Silicon Valley Bank, First Republic Bank) or issue (Credit Suisse Additional Tier 1's) emphasise the importance of active management practices in this uncertain environment. Adding to this point, although corporate earnings remain resilient thus far, economic cracks are developing with over 122 U.S. public and private companies with liabilities over $50mio already filing for bankruptcy protection this year. Implying a run rate of more than 200 by year end, this would be comparable to that during the great financial crisis and pandemic[7] . In Europe, recent profit warnings within the chemicals sector[8] provided a timely reminder to the importance of sector allocation given its underperformance versus the broader corporate index in June[9]. This backdrop suggests a selective approach maybe favourable where an investment universe is condensed to ensure asset allocations are based on detailed bottom-up fundamental analysis to separate the potential leaders from the laggards.

.

4 Source: Bloomberg, 21st July 2023.
5 Source: BlackRock, 21st July 2023.
6 Source: Bloomberg, 21st July 2023.
7 Source:The MacroStrategy Partnership News Review, 19th July 2023.
8 Source: https://www.investorschronicle.co.uk/news/2023/07/04/chemical-stocks-in-profit-warning-panic/
9 Source: Bloomberg, 21st July 2023.

As a Euro Fundamental Fixed Income team we retain an up in quality bias to assist avoiding 'hazards'. Centred on investment grade corporates, the change in prices throughout the last 18 months ensures investors no longer need to move down the credit curve for compensation. For example, the yield on an A rated European corporate is currently 4.27%, in July of last year BBB securities were yielding 3.43%[10] . Of course, yields on lower rated assets have also adjusted higher however when the additional compensation is considered, valuations appear stretched with incremental change in credit spreads failing to reflect economic uncertainty.

Exhibit 2: Spread differential for alternatively rated European corporate securities



Source: BlackRock, Bloomberg 21st July 2023

Given this uncertainty, investment grade credit also provides the benefit of a very strong historical record concerning defaults. For example, S&P Global reported on a calendar year basis, the highest one-year default rate for AAA, AA, A, and BBB-rated bonds (investment-grade) were 0%, 0.38%, 0.39%, and 1.02%, respectively[11].

Incorporating creativity

Whether utilising the contours of the green or playing a 2-iron into the final hole to win the tournament, creativity was evident throughout Rory McIlroy's 4 rounds in Scotland. In this environment where volatility in Fixed Income (MOVE Index) remains elevated compared to equity (VIX Index) or foreign exchange (Deutsche Bank FX Vol Index) markets, incorporating creativity can assist, both from a fund and trade idea generation perspective.

Flexibility and ability to be nimble are key variables when navigating the current environment. Unconstrained strategies move away from benchmark limitations in favour of a more flexible approach to portfolio composition. Possessing the ability to dynamically adjust duration and credit allocations independent of a traditional bond benchmark, the strategy aims to capture investment opportunities through a variety of drivers. This may include removing interest rate sensitivity from the portfolio when yields are likely to rise or overweighting a corporate sector relative to what is traditionally found in a benchmark-based strategy. Incorporating this creativity is important to navigating a volatile environment with disruption in markets also generating numerous opportunities on a trade level.

10 Source: Bloomberg, 21st July 2023.
11 Source https://corporatefinanceinstitute.com/resources/fixed-income/investment-grade-bonds/.

Across all fundamental fixed income funds, we employ relative value trading strategies as the platform to building risk-efficient alpha. Aiming to pair a long position with a short, the two ingredients required for this style of investing are volatility and time, volatility to move asset pairs outside their historical range, and time for this relationship to revert. The alternative pace of tightening by central banks, differing economic conditions and dependence on commodity imports have assisted breaking down historical macro relationships. In addition, slowing economic growth and diminishing liquidity have also stretched historical relationships within credit markets. The table below[12] demonstrates this, highlighting a selection of asset pairs whose historical relationship are at extremes. Trading close to the widest spreads in 5 years i.e. 100th percentile, these examples illustrate the opportunities within both macro and credit markets.

Asset pair	Description	5yr Percentile
2yr UK versus 2yr US	Long 2yr UK Gilt versus Short 2yr US Treasury	95%
5Y5Y US Inflation vrs 5Y5Y Europe Inflation	Long US 5Y5Y inflation (expectations for 5yr inflation in 5yrs time) swap versus Short Europe 5Y5Y inflation swap	93%
Euro IG versus Italy	Long Euro IG versus Short Italian Sovereign Bonds	88%
Euro IG versus US IG	Long Euro IG versus Short US Investment Grade	83%

In summary

Golf is often described as 'a good walk spoiled' with markets also possessing the ability to adversely disrupt one's day. As described in this article, we believe there can be parallels drawn towards the variables required to create a successful golf or market strategy. Focusing on the short game, avoiding hazards and incorporating creativity are 3 elements which we hope may assist both your golf or markets game.

Want to know more?

blackrock.com

12 Source: Bloomberg, 21st July 2023

Risk Warnings

The opinions expressed are as of 8th August 2023 and are subject to change at any time due to changes in market or economic conditions. The following descriptions are meant to be illustrative. **There is no guarantee that any forecasts made will come to pass.**

BlackRock:

This document is marketing material: Before investing please read the Prospectus and the PRIIPs KID available on www.blackrock.com/it, which contain a summary of investors' rights.

Risk Warnings

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.

Changes in the rates of exchange between currencies may cause the value of investments to diminish or increase. Fluctuation may be particularly marked in the case of a higher volatility fund and the value of an investment may fall suddenly and substantially. Levels and basis of taxation may change from time to time.

A main risk related to fixed income investing is credit risk. Credit risk refers to the possibility that the issuer of the bond will not be able to repay the principal and make interest payments.

Important Information

This material is for distribution to Professional Clients (as defined by the Financial Conduct Authority or MiFID Rules) only and should not be relied upon by any other persons.

In the UK and Non-European Economic Area (EEA) countries: this is Issued by BlackRock Investment Management (UK) Limited, authorised and regulated by the Financial Conduct Authority. Registered office: 12 Throgmorton Avenue, London, EC2N 2DL. Tel: + 44 (0)20 7743 3000. Registered in England and Wales No. 02020394. For your protection telephone calls are usually recorded. Please refer to the Financial Conduct Authority website for a list of authorised activities conducted by BlackRock.

In the European Economic Area (EEA): this is Issued by BlackRock (Netherlands) B.V. is authorised and regulated by the Netherlands Authority for the Financial Markets. Registered office Amstelplein 1, 1096 HA, Amsterdam, Tel: 020 – 549 5200, Tel: 31-20-549-5200. Trade Register No. 17068311 For your protection telephone calls are usually recorded.

For information on investor rights and how to raise complaints please go to https://www.blackrock.com/corporate/compliance/investor-right available in Italian.

For qualified investors in Switzerland: This document is marketing material.

This document shall be exclusively made available to, and directed at, qualified investors as defined in Article 10 (3) of the CISA of 23 June 2006, as amended, at the exclusion of qualified investors with an opting-out pursuant to Art. 5 (1) of the Swiss Federal Act on Financial Services ("FinSA").

For information on art. 8 / 9 Financial Services Act (FinSA) and on your client segmentation under art. 4 FinSA, please see the following website: www.blackrock.com/finsa

For investors in Israel: BlackRock Investment Management (UK) Limited is not licenced under Israel's Regulation of Investment Advice, Investment Marketing and Portfolio Management Law, 5755-1995 (the "Advice Law"), nor does it carry insurance thereunder.

Any research in this document has been procured and may have been acted on by BlackRock for its own purpose. The results of such research are being made available only incidentally. The views expressed do not constitute investment or any other advice and are subject to change. They do not necessarily reflect the views of any company in the BlackRock Group or any part thereof and no assurances are made as to their accuracy.

This document is for information purposes only and does not constitute an offer or invitation to anyone to invest in any BlackRock funds and has not been prepared in connection with any such offer.