TRANSCRIPT: EPISODE 259

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[INTRODUCTION]

**Staci West (SW):** Welcome back to the 'Investing on the go' podcast brought to you by FundCalibre. In today's episode, we discuss the magical world of fixed income, explaining terms such as 'duration', looking at the opportunities in different parts of the market and trying to forecast the path for the UK economy and inflation.

**Darius McDermott (DM):** I'm Darius McDermott from FundCalibre. Today we are here to talk about the magical world of fixed income investing. Invesco run many fixed income funds, and this is their most flexible offering. So, I'm delighted to be joined by Stuart Edwards today. He's the manager of the Invesco Tactical Bond fund. Good morning, Stuart.

**Stuart Edwards (SE):** Good morning, Darius.

[INTERVIEW]

**DM:** So, your fund, I'm aware that you have a broad range of products, huge amounts of colleagues and resource. This is the 'go anywhere, do anything' fund. Tell us a little bit about the fund and what you've been doing in the last 12 to 18 months. Because for once bonds have not been boring, in fact, maybe they've been a bit too exciting! What do you say?

**SE:** Yes. Look, I mean, if you go back prior to the last 18 months or so, I mean, really, our asset class - bonds - were just offering no value. You know, it was a very, very tricky period for a long period of time. As we know, central banks, in the wake of the financial crisis, set interest rates very low. They employed lots of unconventional policies, quantitative easing, et cetera, which really did - to my mind at least - distort valuations. And of course, in the past 18 months, that has changed significantly. And we know the reasons why, we can come on to that a bit later.

So, the Tactical Bond fund yes, it is our most flexible strategy in our stable of products. It's conceived or it was conceived with a view to draw upon the resources within the team, all the best ideas be that credit, so investment grade credit, high yield, interest rate strategies or emerging markets as well. So, you know, really to my mind, it's a great product for the macro environment that we are in, which, as you've alluded to, is very volatile.

**DM:** And have you made any …interest rates have moved dramatically, and as we know there's a direct relationship between interest rates and returns on bonds. How have you been playing that over the last year

or so? To either try and defend when it was a bit trickier last year or maybe more into the rebound when markets bottomed around the October time?

**SE:** Yeah, so I mean, the first point I'd make is that valuations have changed significantly. So, if you think about the three-year period up to the end of 2021, 10-year UK government bond yields - that's gilt yields - were [for] most of that period less than 1%. And actually, if you look at the equivalent German government bonds, it was negative, which now seems quite extraordinary. So, there's been a massive, massive change in valuations, and in that earlier period, we just didn't like valuations. We just felt that bond yields were too low, and you really weren't getting paid for taking risks.

And, of course, that's changed. So, we have adapted our strategy over the past 18 months, even though we would happily concede that the macroeconomic risks as they relate to growth and inflation have increased, valuations have changed. So, we have adjusted the portfolio, we've taken our interest [rate] exposure up - that's our duration exposure, that's the sensitivity of bond prices to changes in interest rates, we've increased that, recognising that with all of the monetary tightening that's in the system, eventually - and it is complicated to pitch it because there's lots of conflicting data - but eventually, that will lead to slower economic growth. So, in that type of environment, it does make sense to us to increase the duration exposure of the fund.

**DM:** So, look, that gives me a perfect segue into I think one of the things that most investors struggle to understand, which is duration. Would you be kind enough to have a stab at explaining duration in layman's terms for our listeners, and then just follow up on your last point about the movement in duration and how you might actually make money.

**SE:** Yeah, sure, I'll try and explain that [**DM:** It's not easy, I get that!] It's more easily said than done, [**DM:** It absolutely is!] but yeah. So, look, you know, most assets that have an income stream do have an element of duration. I mean, what has been interesting in the last couple of years is that there were periods when tech stocks, for example took a really big hit. And that was less to do with views over the structural outlook and the ability to generate profits and it was more about changes in interest rates. And in so far as that affects what are essentially long growth assets. So, most assets do have a duration element to them.

Now, fixed income assets, by definition because they have a fixed income stream over a period of time, are more sensitive to changes in interest rates. So, think of it like this. You have a stream of interest payments or income, an income stream over a period of time. And that income stream, when interest rates change – so, either current interest rates or expectations over interest rates - then the value today of that future stream changes. So, if interest rates go up, that means the future income stream is discounted at a higher rate and the price of that income stream - or the price of the bond - falls. And of course, the longer the maturity of the bonds, that means that there's more income streams in the future, the greater the sensitivity to changes in interest rates. So, it works in both directions. When interest rates fall, then bond prices rise.

**DM:** So, you are a bond investor, that means you lend money to companies and governments, and some of those loans are shorter in time, a shorter duration, and some are longer in time, so, you add up the average of those maturities - or durations - to get a maturity on the fund. So, I know a neutral duration, or a neutral average, is roughly 7% in investment grade world. So, to my mind, that means if interest rates go up by a full 1% - not one interest rate rise, but a full 1% - that if the maturity average or duration on the fund is say 7 [years] then you might expect to lose 7% of your capital plus or minus a little bit for some technical reasons that we are definitely not going to go into today. And then the converse is true, that if interest rates go down, actually the value of your bonds actually go up, based on those future cash generations that you've described.

**SE:** Yes, that's right. I couldn't have put it better myself. That's basic sort of bond maths as it relates to duration. And of course, it's also not just about, as I think I mentioned, the interest rate today, but it's also expectations for the future. And if you expect economic growth to progressively become more challenged as we do, then you can have more confidence in, given current valuations, in increasing the duration profile of the fund. Now, I mean, if you go back 18 months in this fund, because of the nature of the fund and the fact that it is very flexible, we had a very, very, very defensive position on duration. In fact, it was around zero, it was that low, and as you've said, in a typical investment grade fund would've been closer to seven. So, we just really did not like valuations at the start of 2022.

**DM:** But that extra lever that you have within this fully flexible mandate is you don't have to be anchored around that seven-year neutral duration like lots of corporate bonds. That's not to say that that's a bad thing, it's just you've got that extra flexibility and as long as you are right in your assumptions, you can actually be more defensive or indeed more aggressive with that rate movement over time.

**SE:** Yes, that's right, yes.

**DM:** So, let's just delve into to the fund. So, I see it looks like you've got a bit more emerging markets exposure in the fund, which to my mind increases risk. Have you increased risk on the fund? And what have you done with that sort of area where - crossover area, as it's known - where investment grade meets high, high yield? Are you actually increasing risk or at this time, are you decreasing risk?

**SE:** Well, it's an interesting question because the answer, it's a bit nuanced. So, firstly take the bigger picture. If I'm framing the world that I'm operating in - and really to simplify, 2022 to my mind was about inflation. It was the inflation shock and it was the way central banks responded to that. They were behind in the interest rate cycle, and they had to hike rates aggressively, which as we know has led to this huge drawdown in fixed income markets and bond markets.

And then 2024, if we think forward, I can foresee a situation where economic growth really does start to deteriorate as the lagged impact of monetary tightening really does start to bite. But this year is quite messy. You know, I describe it as a transition year between inflation risks and growth risks. So, in a sense, it's not necessarily obvious that you want to be really loading up on risk or be really defensive at the same time; we have to acknowledge that valuations are a lot better. So, it's about finding pockets of value whilst also thinking about the big picture.

So, what does that mean? Well, in one sense, and as we've already talked about, yes, we've taken the interest rate exposure up of the fund - so we've taken the duration risk up. We could take it up further by the way - it could increase further - but we've taken it up, recognising that bond yields, government bond yields, are more attractive, and recognising that we're probably in a progressively deteriorating economic environment, but it just takes time. At the same time, we've reduced our high yield exposure. So, that's corporate bonds at the lower end of the credit spectrum. So, you have investment grade and you have high yield. So, we've reduced the high yield exposure thinking that this deteriorating economic environment raises the medium to longer term risks of holding that asset class.

And you mentioned emerging markets. Emerging markets is a really broad church, and we have to remember that. So, you have hard currency emerging market bonds, and by that we're talking about typically US dollar denominated bonds. But we also have local currency bonds as well. So, that's bonds issued by the larger emerging markets in their own local currencies, where the sensitivity to their own interest rate cycles is a lot greater.

So, the reason why we've found some selective … or why we've increased our exposure in some, I would say, very selective opportunities, is because some of these central banks have, if anything, been even more aggressive than the Bank of England, than the US Federal Reserve. So, think Mexico, think Brazil, you know, these are two countries that really did raise rates quite aggressively. And as a consequence, we've found some quite attractive valuations in these markets and they've - in the face of some real global challenges, geopolitical challenges, US dollar strengthening at times - actually what we found is that it's been a really good diversifier, looking at opportunities in these markets, because they sort of held their own and they're paying some very attractive yields.

**DM:** So, to my mind, I think all fund managers have to consider the world around them and what's happening because it affects, but I think within fixed income particularly, having a view on future growth and hence future interest rate movements and hence currency, which we just touched on a little bit, you have to be a bit of a forecaster. And I know that previous to your job as a fund manager, you worked for Standard & Poor's [now S&P Global Ratings], which is a bond ratings agency, apart up from other things. And one of your roles was to forecast UK economic data, which must have been lots of fun and slightly challenging over the years. So, what, as somebody with that background, is your outlook for the UK today?

**SE:** Well, Darius, that does take me back a while, I have to say. You know, that's how I sort of cut my teeth as a UK economist. That was in the late nineties, just as the Bank of England had been or at least [when] the Bank of England's gained operational independence for setting monetary policies. So, it was a great period and actually you know, back then it was a very data-rich, macro-rich environment as perhaps you yourself will remember. You know, it was the new sort of game, trying to predict UK interest rates, et cetera. And then as I said earlier, we had what really amounted to a fallow period because interest rates were suppressed in the wake of the GFC [Global Financial Crisis] so, it became boring again. And now we've come full circle and you know, we were in this incredible environment where not only were we predicting interest rate rises, but it's also the size of the rises as well. So, it's quite extraordinary you know, where we've come from and where we are at the moment.

You know, I don't envy economists now because, it's difficult to really to get right and it's an extremely tricky environment and we know that from what the central bankers are telling us. I mean, they don't really know at the moment. So, it was almost easier last year, when they were hiking interest rates aggressively, sort of playing catch up. Now we're in this period where, you know, we suspect they're not far away from a pause now, but we don't know what the aftermath of that looks like - maybe we'll get rate cuts or indeed, whether there is a risk that they'll have to hike further, and I wouldn't totally dismiss that. So, it's a very, very tricky environment. You know, and that's my way of sort of saying, there is a sort of some caution to my own predictions, and I don't make point forecasts anymore.

The way I'd frame the UK economy, if you go back a few months, back to the autumn of last year, it was a particularly tricky period. We had the onset of the cost-of-living crisis, which was clearly being exacerbated by the higher energy crisis which impacted the UK's terms of trade. The pound fell and it was a very, very precarious environment. And then of course, we had the mini budget as well in the UK, which led to an increase in expectations around Bank of England policy rates. So, all of these things sort of conspired to create a very, very negative narrative for the UK economy.

So, actually what we find now, relative to those expectations, is actually the UK economy hasn't been as bad as what most analysts had really been expecting. So, we have to sort of set that context. Things haven't turned out quite as bad; energy prices have come off and actually the Bank of England hasn't had to hike as much as what was projected at the time.

But what I would say is that you know, going forward, we've still got a lot of the monetary tightening still to feed through. Only recently the Bank of England themselves did an analysis of the transition mechanism monetary policy as it relates to the mortgage market, for example, and they made the point that interest rates have gone up - for new mortgages - have gone up 300 basis points, that's 3%. But actually, on average, for most people who have a mortgage, rates have only gone up by three quarters of a percent because there's far more fixed mortgage rate deals now than there were when, you know, I was making these forecasts 20 years ago. So actually, this transition mechanism is a lot slower. And so, you know, I think that it's going to remain challenging, the economic environment and as more and more mortgage deals come up for renewal, then you know, that's going to hit people's pockets. So, you know, I'm reasonably downbeat, I think on the economic environment heading towards the end of this year and into 2024. So ultimately that should sort support certainly government bond yields in the UK.

**DM:** So then to my mind, the final piece of the puzzle, not just for fixed income but potentially for equities as well, is a view on inflation. A potential disinflation - not my base case, I might add - but because inflation is the sort of thing causing central banks to do these rate rises. What's your view on inflation? Again, I predict you'll have slightly different views depending on the geographies, but if we start with maybe a few words on the UK just to finish off the UK, and then maybe on the US?

**SE:** Yeah, sure. I'd make the point upfront, I'm quite skeptical about inflation or this idea, some people call it an immaculate disinflation. Now I'm quite skeptical about that. So, in other words, you know, I think it's going to be a bit of a tall order for inflation to head back towards central bank targets in a sort of clean manner anytime soon. And that's not just in the UK, that's elsewhere [too]. You know, on the other hand, what I would say is we are probably past peak headline inflation. And that stands to reason given that energy prices have come off and, you know, barring a significant reacceleration in energy prices or commodity prices, then I think we've probably seen peak headline inflation that was likely last autumn.

But core inflation you know, it's a real mixed picture. On the one hand, goods prices have come off because many of the supply bottlenecks that we witnessed last year and in 2021, have eased; so, think transportation costs, shipping costs, et cetera, they've come off. But then on the other hand, services inflation is proving somewhat stickier than people had hoped for. You know, why is that? Well, you know, I would cite two reasons. Firstly, as we've come out of Covid and economies have opened up, there's a lot of demand for travel and leisure and restaurants, et cetera. And then there's also private sector wage stickiness as well. It's not surprising that private sector workers and indeed public sector workers - as we've seen with a lot of the strike action in the UK - are pushing for higher wage settlements, because of the high levels of inflation. So, it just takes time.

Now, eventually inflation pressures will ease because if the economic environment is slowing, then it makes sense that profit margins, which up until this point have really held up and been supported, will likely be eroded away as the economic environment becomes a lot more challenging. So, I think eventually inflation pressures will ease, but it's a tricky path to that destination to my mind.

**DM:** Stuart, thank you very much for your time this morning. That's been a really interesting run through, not just of your fund, but also the prevailing macro-environment in which you have to operate in.

**SW:** Invesco Tactical Bond has just been awarded an Elite Radar badge from FundCalibre and, as we've heard today – it's the most flexible fund in Invesco's fixed income range. This means the team can make the most of all the opportunities presented across the market. To learn more about the Invesco Tactical Bond

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