TRANSCRIPT: EPISODE 323

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. This week we're covering the current landscape of inflation and interest rates and their implications for bond investments. We also look ahead to what could be in store for fixed income in the second half of the year.

Darius McDermott (DM): I'm Darius McDermott from FundCalibre, and today I'm delighted to be joined by Richard 'Dickie' Hodges, who is the manager of the Nomura Global Dynamic Bond fund.

Richard Hodges (RH): Hi Darius. Thank you for having me.

[INTERVIEW]

DM: So look, it always tends to be an opening question when we discuss fixed income with bond managers: What is your view on inflation and rates? And then how you implement those in the fund? So we've had a sort of a 'will they, won't they cut' view on rates in the first half of the year, ECB having done a cut, but seven cuts were priced in in America and that hasn't happened yet. Obviously we're in an electoral cycle in the UK. What's your view on inflation rates and how are you implementing those in the fund?

RG: Well, first and foremost, the view is for us, certainly in the UK, that inflation will come down to target, we're only marginally above target. At the moment, no interest rates in developed economies – well, we've had one as you said, by the Central Bank of Europe – but the fact is that inflation remains above the target levels, so it's been very difficult for central banks to begin implementing any policies whereby they are cutting interest rates from these restrictive areas that we all know we are in.

The fact of the matter is, in the UK we believe inflation will come lower and below target over the next coming months, which indeed will allow the Bank of England to begin a rate cutting cycle.

Presently in the UK, there are only one and a small bit of UK interest rate cuts priced into markets. So a cut in the month of this month in June would come as a surprise to markets and would certainly lead more to positive returns from fixed income for the remainder of this month and over the summer because logistically, the probability is that more rate cuts will come than is currently being priced.

And the same thing is mirrored across the ECB. There is still one further full interest rate cut by December of this year. And in the US, we've only got one and a bit interest rate cuts, again by the end of this year. So the optimism that we saw in financial markets and the way we saw bond yields in the UK drop by 100 basis points or 1% – we saw 30-year yields go from 4.7% to 3.7% – that optimism was all but priced out of markets until more recently.

DM: And those yields have actually reverted now, as you say, as that expectation of rate cuts have either diminished or the number of rate cuts have certainly diminished, those sort of government bond rates have gone back up again now, haven't they?

RH: Yeah, if we look over the course of the, say the last 12 months, in government bond markets, so this is in the UK, US and in Europe and Germany specifically, we are round about, we are range trading. And what I mean by that is, as we saw in the UK, bond yields can go up, they come back down, they go back up…so in the last quarter, the last two months of 2023, long-dated UK government bonds or gilts gave a positive 20% return. Unfortunately, in the first four months of 2024 this year, they gave a negative 24% return. Now yields are a little bit lower today, gilt market is small positive so far, month to date for June.

But realistically we need conviction as much as the central bank needs conviction, the Bank of England needs conviction that bond yields are actually going to move meaningfully lower. We believe that will be the case over the course of the next couple of years. But then we've obviously got to decide on how low interest rates go and how quickly they fall.

DM: And how then do you implement that Dickie into the fund? You know, you talked about range trading. What do you do within the fund to try and take advantage of those? And maybe as just as a brief reminder, if rates go down and yields follow them, prices actually go up. So it's an inverse relationship. So if you are holding a bond, you actually want the yield to go down, so as you actually make a capital gain. So how do you implement this?

RH: This is true. So if we think about three potential scenarios for economies, interest rates and inflation as we move forward over the course of the next couple of years. So essentially not just looking towards the end of this year, but looking further afield, there were three central scenarios and I'll talk about briefly how we can structure a fund to capitalise from this.

The first scenario is we have a softer landing. So at the moment, the market is expecting growth to actually slow, but we are not expecting a severe recession, as we saw from UK GDP numbers; we are stagnating, but at least it's not falling considerably. So that's what's classed as a soft landing.

Under the terms of a soft landing, we can expect inflation to come back down to target and moderately stay at target and therefore we can see interest rates being cut gradually. And as you said, as your interest rates are cut gradually, bond yields should also fall gradually. And so we are getting at the moment on UK government bonds that are 10 year, we're getting a 4%, just slightly over 4% yield – so that's essentially a 4% income – and then we should get some capital return which should lead us to some positive market returns over the course of the year. Under this scenario, the world is a nice place. You know, you should see higher yielding assets, high yield performing reasonably well. Emerging market debt should also perform reasonably well. The yield achievable on that is considerably greater. And then we look at other asset classes, which generically is a positive for equity market returns as much as it is for fixed income returns.

The other scenario that we have to think about is what if we go into a hard landing? And what I mean by a hard landing is economies deteriorate sharply. Now obviously there is evidence that economies are deteriorating, but if we actually have a real hard landing, we know from experience and historically, central banks cut rates very, very quickly. Under that sort of scenario, that would give negative returns for equities and risk assets. But it means that the borrowing costs will fall very quickly. So the cost of financing borrowing falls, and we should all be investing if we see equity markets falling 15% to 20%.

The third scenario, which reasonably is remote, but nonetheless we should consider is interest rates continue to go higher across developed economies. Now we know and we've been told by central banks that that is not going to be the case, but nonetheless, we have to consider that option. Under that option, you don't want to have a lot of exposure to long-dated bonds, you want to have short duration or short maturity bonds that give you a greater yield. Now under these instances, you want to probably have a portfolio that's delivering not that much interest rate sensitivity – we call it duration in bond markets. And very simply, the larger the duration number, if bond yields and interest rates are cut, the greater the return any fund manager's going to deliver, a positive return. Obviously a smaller duration, and it means less positive returns when interest rates are cut.

Because we're in this environment where we've yet to have interest rate cuts but we have great expectations that they will begin soon, on this portfolio, we are choosing to run a sensitivity to interest rates of around about five. Now, what that means is if interest rates are cut by 1%, the return on this fund will be a positive 5%. It's very simple, that's what duration is. It's really just a measure of how much total return you are going to generate. So obviously somebody with a duration of 12, a hundred basis points lower or 1% lower, and they're going to deliver potentially a 12% positive return. But because we have not cut rates yet, there is still this uncertainty. So we are choosing to manage the fund with the duration closer to five, but implementing strategies that will benefit from interest rates being cut later in the year in the final quarter, so we're talking September, October, November and again December.

Principally though, we believe most of the interest rates that are coming collectively around the world, those cuts will be coming more so in the first half of 2025.

DM: Now I know this fund very well because I've known you for a long time, but it's called the [Global] Dynamic Bond fund. That means you've got that the full set of tools available to fixed income managers, but also geographies. Just a quick look at your most recent factsheet, so you've got some UK holdings, but also holdings in Bahrain. How have you used this flexibility recently and how are you using this flexibility for the second half of the year?

RH: Yeah, well, I'll give you some examples of where we look to generate returns. Principally, first and foremost – and you are aware of this Darius and likely some of your investors are also – the UK has been the worst performing bond market in 2023 and so far year to date, out of all bond markets in the world, the UK government bond market and investment grade credit market, corporate bond market, is the worst performing anywhere. Obviously one of the better performing bond markets, however, still negative returns, is that of Europe and again that of the United States. So if we just invested the fund into UK bonds, sterling denominated that were sensitive to UK interest rates and UK inflation, UK borrowing requirements, fiscal requirements, electoral, political risks, then obviously the returns would be would be negative.

The fact of the matter is we diversify across different countries where we see attractive returns. And just as one example for you, Darius, we have exposure to South Africa in local currency bonds. Obviously if an investor, one of your investors invests in this fund, they will be investing in the sterling fully-hedged share class, they would have no problems themselves about having exchange rate risk between the British pound and the South African Rand. But nonetheless, I will just tell you, month to date, UK government bond market returns are probably about plus or half a percent. South Africa bond market returns, fully hedged back into pounds, month to date is plus 3%. And a year to date, South Africa has positive bond market returns on a fully-hedged basis – so no exchange rate risk, back to pounds – it's got positive year to date returns when the UK government bond market at the close of business yesterday was minus 4%. So that just

gives you a reason why we look to internationally diversify our exposures to give a higher level of yield and a more attractive level of potential income and future capital returns.

DM: Where are you are seeing opportunity and again, how you're implementing it in the fund. Where can we get some positive bond returns or are we back to part one where we talked about rates and those rates that have been delayed or deferred or canceled or whatever we want to call it, that they actually now will come and then we might get some positive returns from the developed UK, Europe and United States that we've touched on.

RH: I think we have to look first and foremost at where we've got returns today and are they likely to continue those returns tomorrow – and I mean today, since the beginning of this year – so best performing returns we've seen out of asset classes have come from deeply subordinated bank debt. We call these in the fixed income world, these are called AT1s. They're the equivalent of equity for a fixed income holder. We essentially have bank equity risk because these bonds can default. And I think some of your readers might have been aware that last year Credit Suisse, they had some deeply subordinated AT1s that were priced at 100 and they actually got wiped out to zero; they suffered a full default.

So the fact of the matter is, these asset classes deeply subordinated bank debt has already returned year to date plus 5%. And I just mentioned in context, UK gilts are minus 4%, CoCocos [Contingent Convertibles] plus 5%. So they've delivered strong returns. We still believe from an income perspective, these are yielding 7-8% as opposed to UK government bonds yielding 4%. So we still see we've got a better potential income return and capital return. And one of the reasons why they've delivered such strong returns is year to date European bank equity stocks have delivered a positive 20% return, and over the last 12 months, they're almost 40% returns, some of the best returning asset classes. We still see opportunities there. If we are investing for a world which is just softer landing, interest rates get cut, inflation comes down and is manageable, economies slow but they don't collapse, then we believe that all of these examples, some emerging markets and elsewhere will still deliver returns.

If I look at high yield. Now, what I mean by high yield, well, in the world of fixed income, we have investment grade bonds, so these are bonds that are rated BBB or higher, AAA being the highest. The fact of the matter is high yield are those bonds that are issued by companies that don't have a very good credit rating. In fact, they have a high yield credit rating. So that's BB going all the way down to D for default. So BB high yield has actually delivered some really exceptionally strong returns, not only this year, but last year in 2023. In fact, I would say it was the best performing asset class in 2023 in fixed income. The fact is much of those spread compression, much of that outperformance is done in our opinion.

So what we're doing now from a dynamic perspective, we are hedging out the risk that we have a harder landing. We actually have 30% of the fund hedged which will protect it against a harder landing and sharp falls in asset prices in fixed income. We actually have some hedge on to protective equity markets <inaudible> deliver some sharp negative returns. These aren't very expensive for the point of view of the fund. They don't in eat into a lot of the income that we can distribute. But we do think it's appropriate thing to do given the uncertainty that we've got, especially if we look at politically, and I think we've all seen the headlines over the last couple of days as Macron dissolving part the government and actually going for an even earlier election which has caused a fair degree of volatility in financial assets.

So we still see these sort of things, we do see asset classes in fixed income delivering, but some of the highest yielding ones have delivered a considerable amount of turn so we think there's less capital opportunity and maybe more of an income opportunity there.

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DM: And then finally what we might expect for the second half of 2024. I know we've sort of touched on rates and you've given nice examples of some of your overseas holdings and where you've made some money in the first half of the year. Is fixed income a good asset class for the second half of 2024?

RH: Well, it all depends on your view on interest rates. If, let's say bond interest rates remain where they are, bond yields remain where they are, that means from a fixed income perspective, you've still got six months worth of carry from an investment grade credit fund. That means you are probably going to generate another, let's say 3-3.5% return, positive return, just in carry. And that will deliver positive returns year to date. With the UK and with government bond yields, and if we believe, if the market starts believing that there are going to be more than one interest rate cut this year, that is presently not priced into markets, that would lead to greater capital returns, and potentially you are looking at from here on in a 5-7% positive return in fixed income from this moment in time for the remainder of this year, plus 1-2% carry, or the income you get from holding these bonds for another six months.

DM: I was just going to say, could you just give a, if possible, a layman's description of what you mean by carry?

RH: Carry, is just like, in layman's terms, just means income or yield. So, if a bond has 4% it means that – a total return of a bond is made up of capital return and made up of income. When I refer to carry, what I mean is just the income element, so it's just the yield. So if a bond yields 4% on the 1st of January of this year and it yields 4% at the end of the year, then we've just had 4% carry. It just means that it's a fixed income term for the income element of a fund – you get carry.

Another one we tend to use over summer months when everything tends to be benign. If you hold a fixed income portfolio, us fixed income guys will talk about clipping a coupon over the summer. You know, you are sitting there with a portfolio, not much activity historically because everyone's on holiday; there's not an awful lot of liquidity, so essentially you are just holding onto the positions for two months and that's referred as clipping a coupon over the summer.

DM: Dickie, thank you very much for your time today. Not just your views on interest rates, but also a little bit of a lesson on some of the terminology that you use on a daily basis in fixed income.

SW: Nomura Global Dynamic Bond fund is an unconstrained strategic bond fund, with a focus on total returns. The manager invests in the entire range of bond sectors including government bonds, corporate bonds, emerging market bonds and inflation-linked bonds. We believe this fund offers an excellent option for all market conditions in terms of both yield and capital return. To learn more about the Nomura Global Dynamic Bond fund please visit fundcalibre.com