



# Is now the time to consider an allocation to government bonds?



**Attractive yields and expected return of diversification benefits are supportive**

July 2024

## Key Insights

- The pain of recent years has reset yields to meaningfully higher levels that offer investors an attractive and reliable income stream opportunity.
- As the impact of inflation subsides, a negative correlation environment should return with bonds expected to provide better diversification benefits going forward.
- We believe that an actively managed global government bond portfolio works well in this environment and can help pursue sustainable alpha while simultaneously mitigating downside risks.



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Fixed income has navigated a precarious two years, as policymakers and investors contended with multi-decade high inflation following the global economy's emergence from a pandemic as well as war in Europe. Whilst the transition from a period of record low interest rates to more "normal" levels has been a turbulent one, investors now find themselves presented with potentially attractive and reliable income levels for the first time in over a decade. As of June 2024, the 10-year U.S. Treasury bond yield traded in the mid-4% range, whilst you can expect to pick up just shy of 5% within shorter segments of the U.S. Treasury curve. Similarly, the Euro Agg Treasury Index is yielding over 3%, the same level as 2011 and in stark contrast to the -0.3% investors endured during the pandemic.

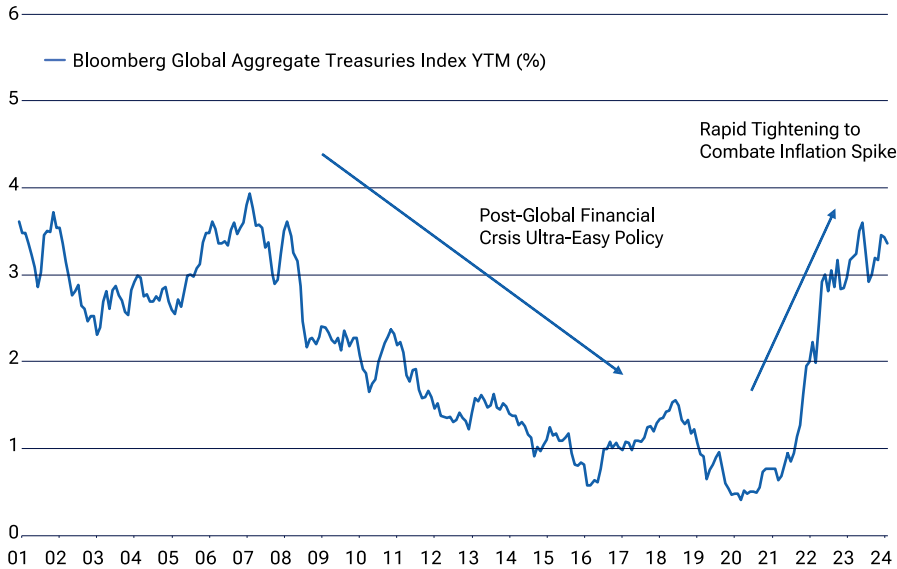
## Income opportunity as rate cycle transitions

With inflation rates easing, central banks have begun their easing cycles with some of the early movers including the European Central Bank, Bank of Canada, and the Swiss National Bank, who have all cut rates this year. However, the days of sub-1% interest rates across developed markets are over. Therefore, we believe there is good opportunity for investors to lock in income at these current elevated levels in high quality government bonds.

Having navigated the inflationary spike, cash rates have peaked and are now set to recede, presenting opportunities to increase duration exposure and actively manage positions across the curve.

Extending duration should provide greater exposure to interest rate cuts and help ensure that current levels of elevated yields are locked in for a longer period. In this disinflationary environment that induces rate cuts, we can expect the curve to steepen, providing an opportunity to dynamically manage exposures across the curve. For example, overweighting the belly is one option that could potentially benefit from rate cuts. By contrast, unsustainable fiscal issuance and the rising risk of a loosening of the 2% inflation target warrants an underweight to the long-end of curves, in our view.

Global Bond Yields Offered Attractive and Reliable Income



Past performance is not a reliable indicator of future performance.

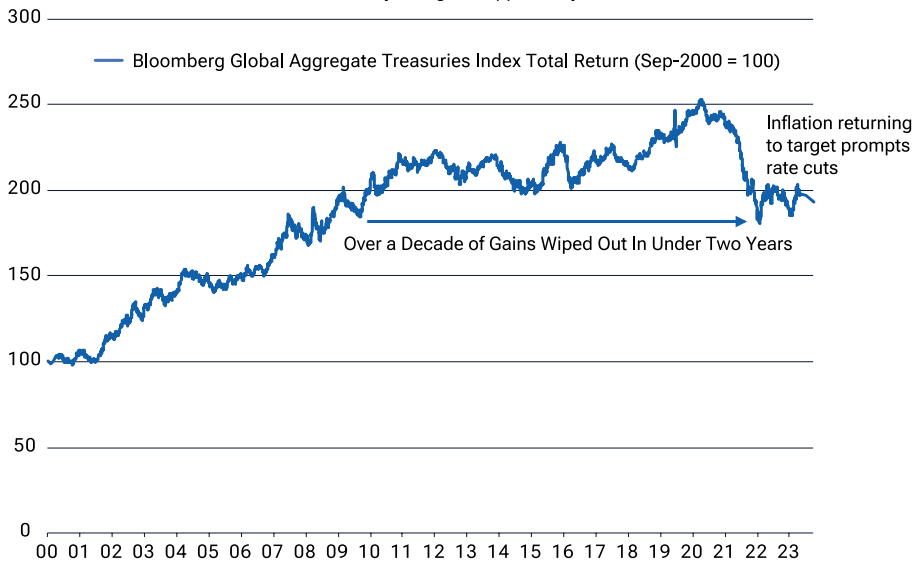
Source: Bloomberg. As of 06/30/2024.

### Income return potential rising

Importantly, these elevated yield levels offer investors a potential opportunity to generate a powerful source of *total return*. The response of central bankers to raise interest rates in order to combat inflation severely impacted the total return profile of fixed income assets these past few years, destroying the capital appreciation enjoyed in the post-GFC era. However as inflationary forces ease and we exit this period of peak monetary tightness, we move to an environment where there is

potential to generate stable income at attractive rates and benefit from capital appreciation assuming interest rates fall. Over the last five years to 25/06/24, the Bloomberg Global Treasury Index has returned approximately -15%, with price return unsurprisingly generating 14% of losses and offsetting a coupon return of over 9% (currency returns also played a meaningful role). As investors pursue this new monetary policy regime, with income returns starting at a high level, we can also expect the capital losses endured over the last two years to reverse as monetary policy is loosened.

### Turn in the cycle signals opportunity



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Source: Bloomberg. As of 06/30/2024.

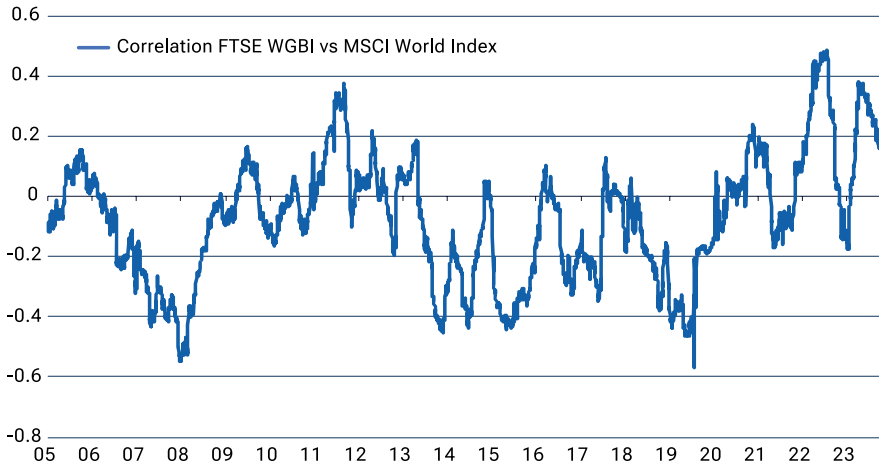
## Need for active duration management.

The prospect of stable and reliable income, normalising correlations and diversification against risk-off events - are we seeing a return of the traditional merits of high quality government bonds? We believe so and the environment is ripe to take advantage of this attractive conditions.

However, the environment remains highly data-dependent with policymakers still guided by monthly cycles of data. The normalisation of inflation, rates and correlations will not be a straight line and

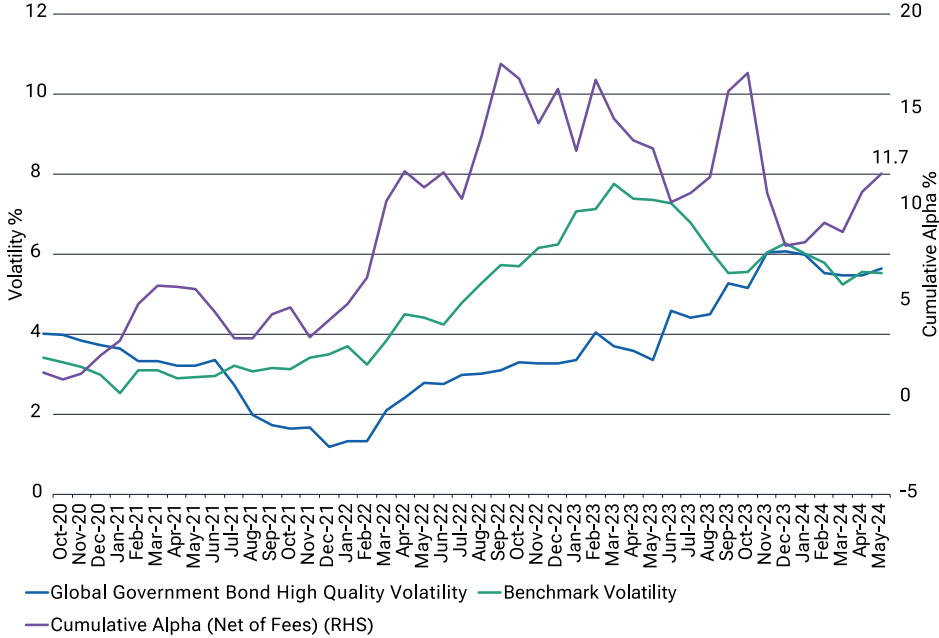
navigating this backdrop requires highly active duration management to help mitigate risk levels. The Global Government Bond High Quality strategy aims to achieve exactly that. We utilize our wide duration guidelines to run a large tracking error as a method to reduce overall risk exposures as markets normalise. For the period from the strategy's inception on 30th September 2019, the Global Government Bond High Quality (USD Hedged) Composite has generated 250bps of alpha versus the FTSE WGBI, net of fees, on an annualised basis, underpinning over ability to successfully navigate highly volatile markets. This has been achieved with lower volatility than the benchmark.

Easing inflation to normalise correlations?



Past performance is not a reliable indicator of future performance.  
 Source: Bloomberg. As of 06/30/2024.

Significant alpha generation and lower risk



Past performance is not a reliable indicator of future performance.  
 Source: Bloomberg. As of 05/31/2024.

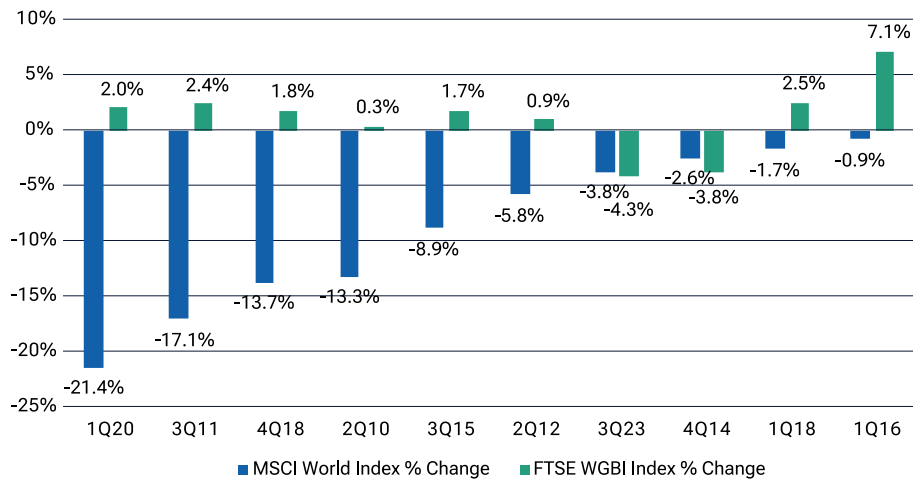
## Diversification benefits in non-inflationary environments

Faced with a whole host of uncertainties, central banks had little choice but to move to a *data-dependent mindset*; in other words, they had little confidence in their forecasting ability, particularly on inflation. This proved fatal for bonds in 2022. Policymakers fell behind the curve and inflation eroded the nominal values of debt, ultimately sparking rapid interest rate rises which meant fixed income failed to help mitigate against the risk-off moves within equity markets.

The worst year for fixed income in decades ultimately confirmed what we already

knew; sovereign bonds do not always provide an effective risk-off hedge sparked by inflation. However, the ability of bonds to provide diversification during periods of heightened volatility, against “traditional” risk-off catalysts or black swan events e.g. the collapse of Silicon Valley Bank or the Covid pandemic, remains firmly intact, in our view. With the exception of 2022, in the top ten negative quarters for the MSCI World from 2009-2023, the FTSE World Government Bond Index generated positive performance in eight of those quarters. Importantly, as we navigate this increasingly volatile geopolitical climate set against electoral uncertainty, high quality government bonds should provide a place to “hide out” and help mitigate against risk-off scenarios.

Diversifying in non-inflationary environments

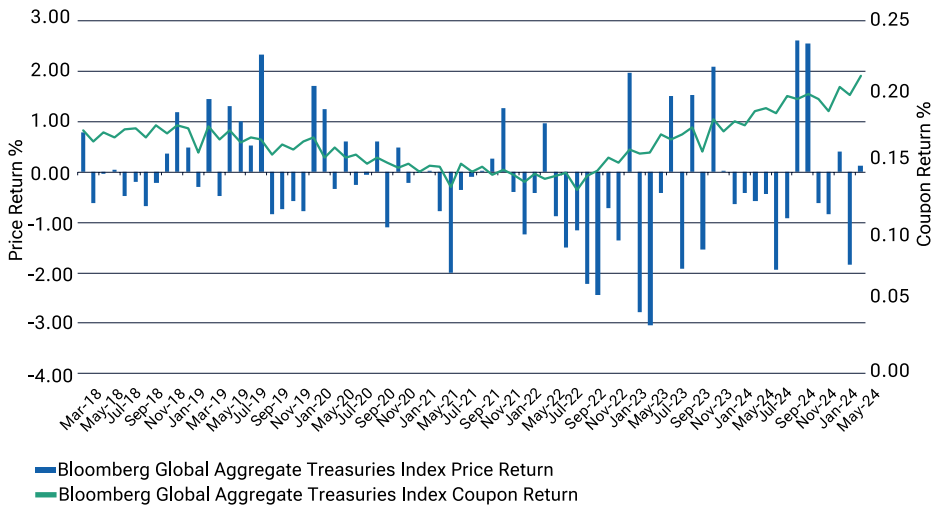


Past performance is not a reliable indicator of future performance.

Source: Bloomberg, FTSE LSEG. As of 12/31/2023.

As the impact of inflation subsides, and we navigate this more sensitive geopolitical backdrop, we expect to move back to a 1990s correlation environment, with bonds providing better diversification as a traditional safe haven.

Income return on the up and capital losses to reverse?



Past performance is not a reliable indicator of future performance.

Volatility is represented by standard deviation and based on monthly net returns. Figures would have been lower as a result of the deduction of such fees.

Source: Bloomberg. As of 05/31/2024.

The flexibility of this actively managed global government bond portfolio aims to minimize the risk of capital losses when interest rates are rising, whilst seeking to enhance performance when interest rates are falling. It's a concentrated portfolio of high-conviction, high-quality government bonds from liquid sovereign markets, with no exposure to emerging market risk or to sub-investment grade that typically have higher yields. We believe that the Strategy offers government bond exposure with active interest rate risk management and higher tracking errors versus a global government benchmark.

After years of negative returns and significant volatility, the high-quality global government bond sector has largely been

overlooked by the investment community. Its positive correlation with risk assets has diminished its appeal, leaving investors hard-pressed to identify redeeming qualities. The pressing question now is whether the narrative has shifted. Are the advantages of this asset class making a comeback? And if doubts persist, is there a global government bond strategy that capitalizes on its strengths whilst navigating the sector's shortcomings of positive correlations or being permanently long duration? We believe the Global Government Bond High Quality strategy provides the solution to both these questions.

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