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INSIGHT INVESTMENT THOUGHTS FOR 2025

INSTITUTIONAL CLIENTS

NOVEMBER 2024

BNY | INVESTMENTS

EXECUTIVE SUMMARY

INVESTMENT // 4

- Global rates – time for a reality check: Real policy rates have moved from deep negative territory to the highest levels since before the global financial crisis, providing central banks with the flexibility to start easing. Although prudent rate cuts are necessary to underpin growth and ensure a soft landing, the exuberance of rate markets is questionable. Markets are now pricing in a faster easing cycle than previous crises, which seems at odds with an economy that is still growing and an equity market close to record highs. Unless economic data deteriorates significantly, markets may need to reassess expectations for both how rapidly rates will decline and the terminal level of rates.
- Global inflation – the best news is behind us: The outlook for global inflation remains uncertain despite the gravitation of headline rates towards central bank targets. We believe factors such as the shift from globalization to deglobalization will keep inflation structurally high in the coming years. In the US, sticky inflation, monitored by the Atlanta Fed, is declining at a slower rate than the headline consumer price index and has stabilized at around 3%. Stickier inflation is just one of the challenges facing central banks, with food prices and money supply turning upwards once again.
- Asset allocation – a simple approach is unlikely to work in 2025: Our regime-based framework became more neutral in Q3, and we adjusted our cyclical exposures downwards. However, we are conscious that easier monetary policy should support economic activity, potentially shifting us into a more positive growth regime in 2025. One concern we have is the lofty valuation of US equity markets, as history suggests valuations do matter. This may mean a more targeted approach to risk-asset allocations may be necessary in the year ahead.
- Investment grade credit – time for active managers to shine: Robust investor demand has compressed spreads to below long-term average levels. Despite this, absolute yields remain high relative to the past decade. We believe this environment presents the opportunity for active managers to enhance returns. In a striking contrast with research focused on active equity managers, data from Mercer indicates that median managers in global credit and aggregate strategies have historically outperformed their benchmarks. High levels of issuance should provide ample opportunities for stock selectors to capitalise on new issue premiums and unique investment stories in 2025.
- Municipal bonds – prudently enhancing yield: Taxable municipal bonds typically offer a higher yield compared to US Treasuries and can periodically even offer higher yields than US investment grade corporates. These issues are backed by tax revenue streams and have historically had a low likelihood of default. In our view this puts taxable municipal bonds in a sweet spot between Treasuries and investment grade credit, offering a prudent way to potentially enhance yields while minimising credit risk.
- High yield credit – maximizing exposure to the higher rates environment: High yield credit is particularly suited to compounding returns over time, with current market yields high enough to amplify the power of compounding. High yield corporates have weathered the sharp increase in interest rates over recent years, and defaults in the current cycle are at relatively low levels. We believe a focus on shorter-dated strategies and larger corporate issuers that have been downgraded from investment grade can help reduce default risk.
- Structured credit – an esoteric future: The esoteric structured credit market includes unconventional asset pools and innovative private structures and is the fastest-growing segment in non-traditional credit. This rapid growth is being driven by digital infrastructure, where demand for AI is accelerating the need for data centers and fiber-optic cables. Esoteric structures typically offer significant premiums over corporate bonds but require specialist teams with experience in ABS and esoteric private lending. Despite challenges like uncertainty and complexity, esoteric structured credit can extend core fixed income holdings and enhance liquidity portfolios.
- Global currencies – check your hedge: Managing currency risk can reduce the volatility of an international portfolio and improve overall returns. However, currency-hedged share classes are often inefficient. We outline five reasons why we believe investors should rethink the use of hedged share classes – including the potential for significant performance drag over time. We believe a dedicated currency manager can offer transparency and achieve lower transaction costs compared to fund structures.

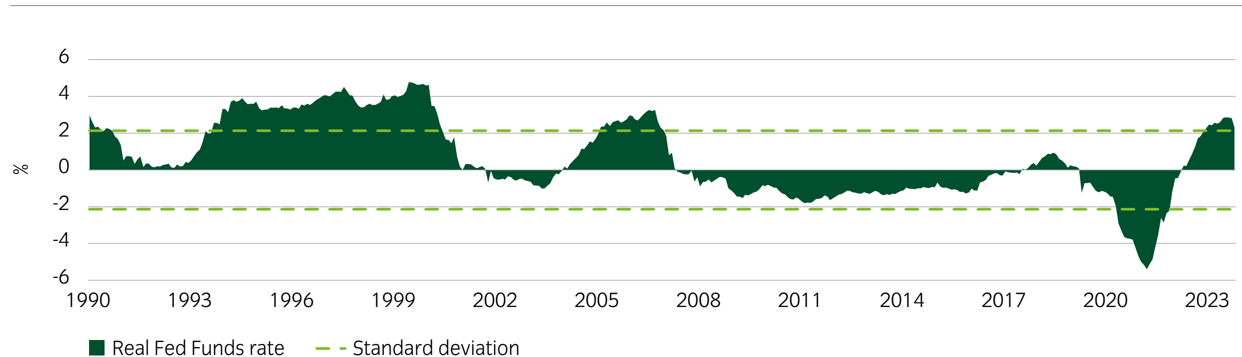
INVESTMENT

TIME FOR A REALITY CHECK

High real policy rates provide flexibility to cut

With inflation having declined significantly from peak levels, real policy rates have moved from deep negative territory to the highest levels seen since before the global financial crisis (see Figure 1). It is difficult to justify policy rates being at such restrictive levels given softer economic data, and this has provided central banks with the flexibility to start easing, despite ongoing inflation concerns.

Figure 1: Real policy rates moved to overly restrictive levels[1]



Did we miss a crisis?

Although we agree that prudent rate cuts are necessary at this stage of the cycle to underpin growth and ensure that central banks can engineer a soft landing or mid-cycle slowdown, we question the exuberance of rate markets. Looking back at history, markets are now pricing in a faster easing cycle than the tech bust, global financial crisis and pandemic (see Figure 2). This seems at odds with an economy that is still growing, and an equity market close to record highs.

Figure 2: The spread between overnight rates and 2-year Treasury yields reached crisis levels[2]

Steeper yield curves ahead

Unless data meaningfully deteriorates in the months ahead, we believe markets are likely to be forced to reassess expectations for both how rapidly rates will decline and the terminal level of rates. We believe this is likely to put a floor under yields in the intermediate area of the curve and that yields at the very long end of the curve could even drift upwards, resulting in steeper yield curves.

[1, 2] Source: Insight and Bloomberg. Data as of October 31, 2024.

THE BEST NEWS IS BEHIND US

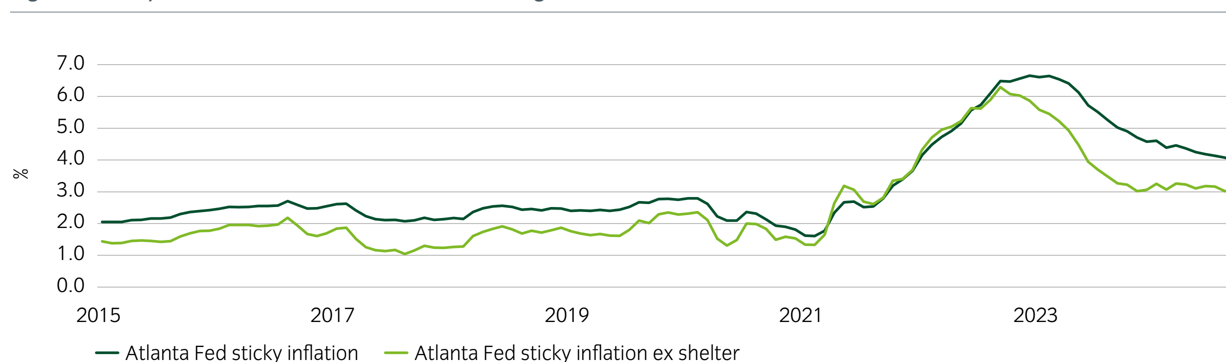
Gravitating to central bank targets

With the post-pandemic inflation spike still fresh in investors' minds, we believe many are underestimating medium-term inflation risks. Although headline rates of inflation have moderated and are gravitating to central bank targets in the short term, the longer-term outlook for inflation remains highly uncertain. In our view, factors such as the shift from globalization to deglobalization will keep inflation structurally high in the years ahead.

Inflation remains stubbornly sticky behind the headline numbers

The Atlanta Fed monitors "sticky inflation", which is a basket of goods and services that normally change price relatively slowly. This index is declining at a far slower rate than the headline consumer price index and excluding shelter it has stabilized and started to trend sideways at around 3%.

Figure 3: Sticky inflation has started to stabilize at a higher level[3]



Central banks have a lot to worry about

There are other worrying signs for policymakers. September saw the fastest increase in global food prices since 2022, with sugar prices spiking by 10.4% due to drought and wildfires impacting Brazil. Food prices, and commodities more broadly, appear to have bottomed and are now slowly trending upwards again, along with the broader commodity complex (see Figure 4).

Money supply is another data series that some central bankers will be carefully watching. A surge in money supply was arguably one driver of the post pandemic inflation spike, and a contraction in money supply likely proved helpful in bringing inflation back down to earth. But money supply growth is now firmly in positive territory and tending upwards once again (see Figure 5).

Figure 4: Commodities are trending upwards again[4]

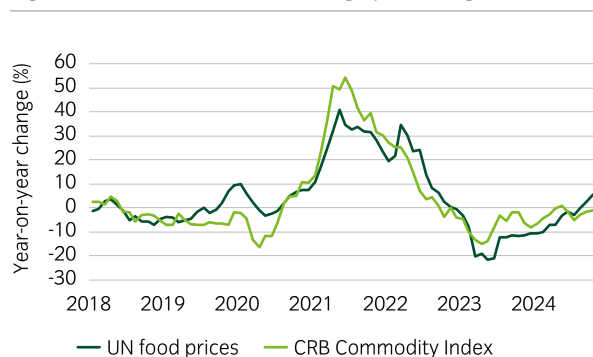
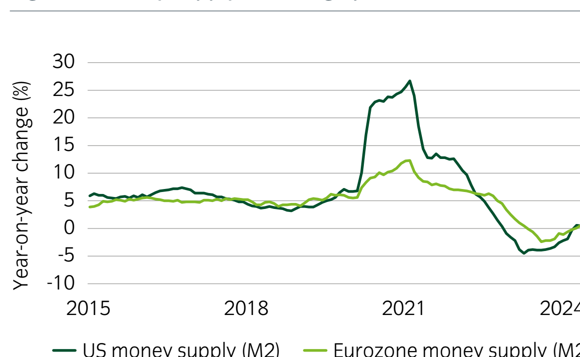


Figure 5: Money supply is turning upwards[5]



[3, 4, 5] Source: Insight and Bloomberg. Data as of October 31, 2024.

A SIMPLE APPROACH IS UNLIKELY TO WORK IN 2025

Waiting for growth to stabilize

In August 2024, our regime-based framework shifted into a falling growth regime, with inflation falling but above target and real rates falling. Normally a falling growth regime would be a negative environment for risk assets, but when combined with falling real rates and inflation, returns have historically been acceptable. With this in mind, we reduced our cyclical exposures towards long-term average levels in Q3, a level which still provides us with meaningful participation in risk markets, without leaving us overly exposed should data more meaningfully slow.

As we look forward to 2025, we are conscious that the recent weakness in growth could be short lived. Easier monetary policy should support economic activity, and this would potentially shift us back to a "stabilizing" growth regime. As long as the outlook for inflation and real rates remains stable, stabilizing growth regimes have historically been a much more positive backdrop for risk assets. It is also often followed by a shift to an accelerating growth regime, which has historically been the most positive regime of all.

Although this suggests that 2025 could end up being another good year for asset returns, one concern we have is how much US equity markets can rally from already lofty valuations. This is an important question given US dominance of global equity indices.

When assessing the outlook, equity valuations do matter

From an equity market perspective, US outperformance, high valuations, and the dominance of the Magnificent-7 (Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla)[6] all complicate historical comparisons. In recent years, US economic outperformance has translated into better corporate performance and earnings per share (EPS) growth and, in turn, US equity outperformance. Nevertheless, the S&P 500 Index is currently trading on a 24.5 times (historical) P/E ratio. Even excluding the Magnificent-7 the Index is trading on a 21 times ratio which, in a historical context, appears expensive.

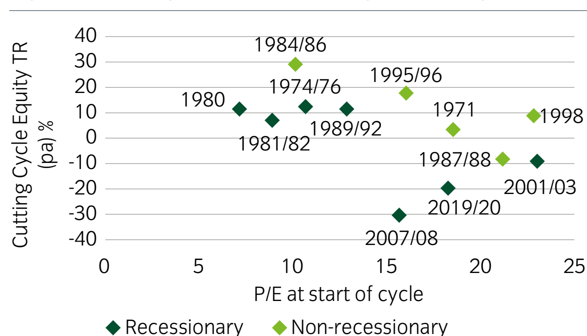
Does valuation matter, in the context of rate-cutting cycles? Figure 6 looks at US equity returns based on the P/E (trailing) at the start of a Fed easing cycle compared to the forward return (over that easing cycle). The results are not clear-cut, but lofty valuations are tricky starting points for equities, with a P/E over 15 time showing mixed results historically. As is usually the case with valuations, there are historical instances (1998) when an expensive starting point hasn't stopped further gains. Moreover, for the two worst experiences shown – the global financial crisis (2007/08) and Covid (2019/20) – it is hard to argue that high equity valuation was the main cause of the subsequent period of distress. Perhaps the main example where that reasoning applies is 1987/88.

A more targeted approach is likely to be necessary in the years ahead

Should a broader reacceleration in growth occur in 2025, there may be an increasing appeal in expanding risk asset exposures. But we are conscious that simply increasing allocations to global equities may not be the best way to benefit from this environment given the dominance of US markets in that index. However, there is plenty of value in equity markets outside of the US, and targeted exposures to those markets with strong earnings outlooks may be one way to capture an upswing in global growth.

Another way to play this view would be to diversify some of your equity exposure into contractual risk assets such as high yield credit.

Figure 6: Starting P/E vs return during Fed cutting cycle[7]



[6] The mention of a specific security is not a recommendation to buy or sell such security. The specific securities identified are not representative of all the securities purchased, sold or recommended for advisory clients. It should not be assumed that an investment in the securities identified will be profitable. Actual holdings will vary for each client and there is no guarantee that a particular client's account will hold any or all of the securities listed.
[7] Source: Insight and Bloomberg. Data for S&P 500 Index as of September 30, 2024.

TIME FOR ACTIVE MANAGERS TO SHINE

A combination of high absolute yields and tight credit spreads

Robust investor demand through 2024 has caused spreads in investment grade credit to compress (see Figure 7). Absolute yields have declined from their peaks, in part due to the compression in spreads, but remain high relative to the last decade (see Figure 8). This combination of tight spreads but high absolute yields mean some investors are waiting for spreads to widen before increasing allocations. We believe this overlooks the potential for active managers to enhance returns in fixed income markets beyond yield alone.

Figure 7: Spreads have tightened significantly[8]

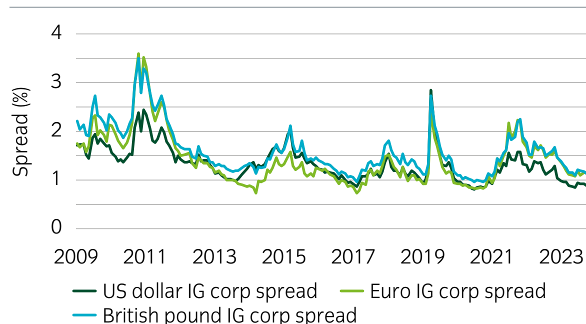
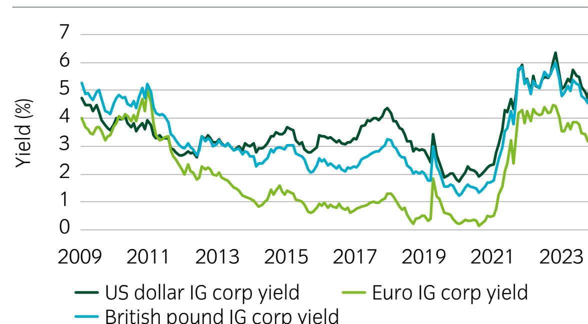


Figure 8: Absolute yields remain attractive[9]



Active managers have real potential to add value in fixed income

Many investors believe that active managers struggle to outperform or even match their benchmarks and extrapolate this idea across all investment assets. But this isn't true in fixed income markets, which are far less efficient and transparent than equity markets, presenting inefficiencies that can be exploited by active managers. The rise of passive investment in fixed income has, if anything, exacerbated these inefficiencies.

As we can see in Figure 9, data from MercerInsight shows that the median manager for both global credit and global aggregate strategies have historically generated long-term returns well above traditional benchmarks. For managers able to consistently achieve top quartile performance, there is an even greater potential to add value. This means that it is important not to view fixed income investment via the view of yields alone, but to also ensure that careful thought is given to manager selection, focusing on their history of generating consistent performance in excess of market returns.

JP Morgan forecast that gross US investment grade issuance will reach $1.5 trillion in 2024, with elevated levels of issuance expected to continue into 2025 as corporates seek to refinance debt issued around the pandemic (see Figure 10). Euro-denominated markets are following a similar trend. This should create an environment with significant opportunities for security selectors, who can exploit new issue premiums and home in on idiosyncratic investment stories.

Figure 9: Median managers have outperformed in fixed income markets[10]

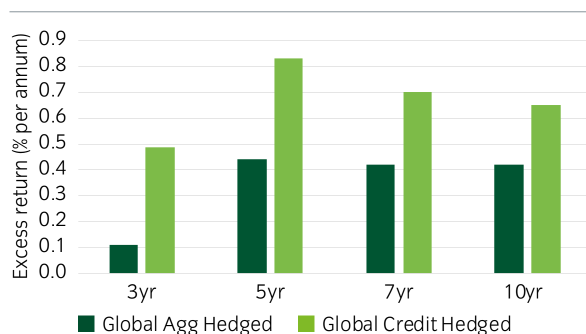
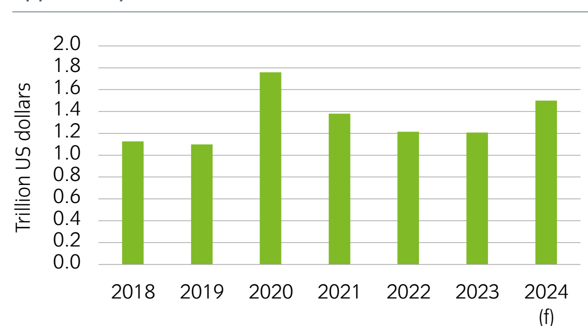


Figure 10: High levels of issuance should provide plentiful opportunity[11]



[8, 9] Source: Insight and Bloomberg. Data as of October 31, 2024. **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.** [10] Source: MercerInsight data as at Q2 2024. This is a customised universe and not an official Mercer universe. Net of fees and hedged into US dollars. **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.** [11] Source: JP Morgan research published October 2024. Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialize or vary significantly from the actual results. Accordingly, the projections are only an estimate.

PRUDENTLY ENHANCING YIELD

Yield enhancement

For those looking to enhance yields, but unable to take outright credit risk, we think taxable munis sit in a sweet spot between Treasuries and investment grade credit. Taxable municipal bonds currently offer a higher yield compared to US Treasuries (see Figure 11) and may periodically even offer higher yields than US investment grade corporates (see Figure 12).

Figure 11: Taxable muni versus US Treasury 30yr yield[12]

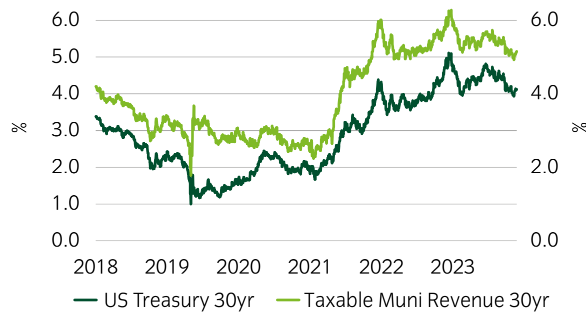
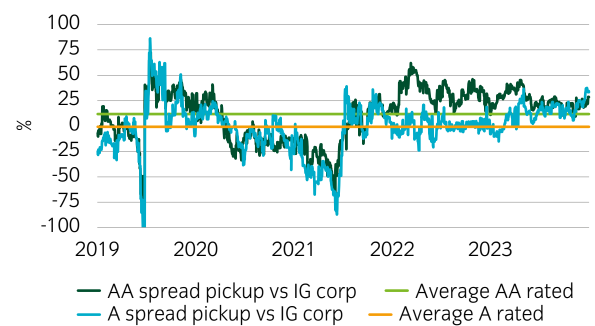


Figure 12: Taxable muni revenue bonds versus US IG corporate spread (bp)[13]



Potential diversification benefits

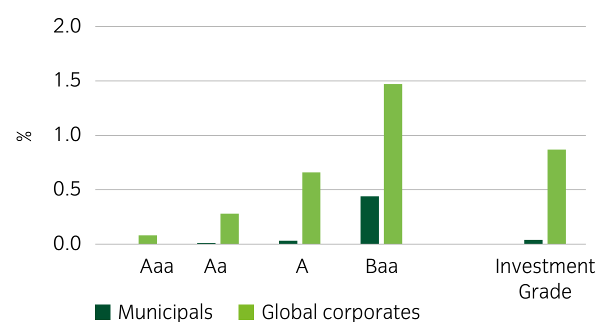
Municipal bonds can help diversify a portfolio as taxable municipal bonds have historically exhibited a more stable volatility profile than US investment grade corporate credit, while offering a comparable spread over US Treasuries. For example, the 360-day spread volatility of the US Bloomberg Taxable Index is 21.7%, significantly lower than the 360-day volatility of the Bloomberg US Corporate Agg at 30.4%.[14] There are also considerably more long-duration issues available than for global corporates.

A low risk of default

Municipal bonds typically have a high credit quality with low default risk:

- **High credit quality:** Taxable municipal bonds are backed by tax revenue streams, with many state issuers having built sizeable rainy-day funds over recent years. The credit quality of the muni universe is on a gradual improving trend despite a deterioration of the Federal governments credit rating.
- **Low default risk:** Municipal bonds generally have a low likelihood of default (see Figure 13) and when defaults do happen, recovery rates have been significantly higher than for global corporate issues.

Figure 13: Municipal bonds have a superior track record for defaults[15]



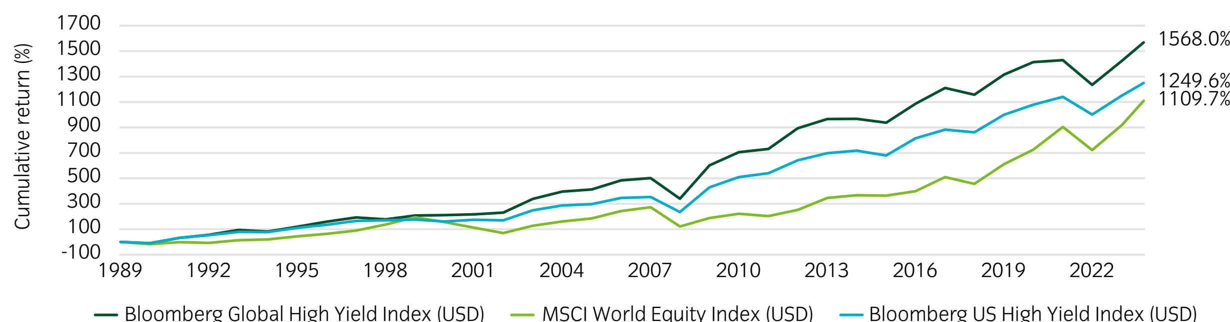
[12] Source: Bloomberg US Taxable Municipal Revenue AA 30yr, as of September 30, 2024. **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.**
[13] Source: Bloomberg US Government 30yr, Bloomberg US Corporate AA 30yr, as of September 30, 2024. **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.**
[14] Source: Bloomberg and Insight, June 2024. Diversification cannot ensure a profit or protect against loss in declining markets. All investments involve some level of risk, including loss of principal.
[15] Source: Moody's US municipal bond defaults and recoveries 1970-2022 (published July 2023).

MAXIMIZING EXPOSURE TO THE HIGHER RATES ENVIRONMENT

Harnessing the power of compound returns

One of the most powerful tools for investors is the concept of compound returns. This is where returns earned on investments increase the capital of the investor, resulting in the exponential growth of their investments over time. The higher the returns that can be generated, the greater the power of compounding. We believe high yield credit is an asset class that is particularly suited to compounding returns over time. With current market yields sufficient high to amplify the power of compounding, the potential for long term growth is especially compelling. As we can see in Figure 14, over the long term, investors in global high yield have even outperformed global equity markets.

Figure 14: Global high yield has generated impressive returns over time[16]



Minimizing defaults maximizes returns

Defaults are an important factor for high yield investors. Although the impressive long-term returns in Figure 14 include the impact of defaults, the potential returns could be even greater if defaults can be avoided.

High yield corporates have weathered the sharp increase in interest rates over recent years and defaults in the current cycle are at relatively low levels (see Figure 15). There has been a structural change within high yield markets which should help make high yield more resilient to defaults than it has been in the past. Data from Bank of America shows that between 2007 and 2023, the proportion of US high yield issuers rated BB, the best rating category for high yield, increased from 37% to 47%, while the proportion rated CCC declined from 21% to just 13%. In European high yield, just 5% of the market is now rated CCC. Private credit investors have increasingly provided a bespoke financing solution to more stressed companies, which also improves the overall credit health of the HY market.

High yield credit has been an asset class that has allowed investors to generate returns in excess of global equities with lower historical volatility (see Figure 16). Given our view that defaults are likely to remain low for some time to come, we believe this situation could persist in the years ahead.

Figure 15: Global high yield defaults remain low[17]

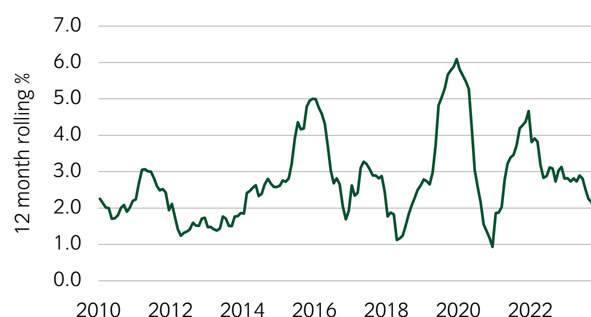
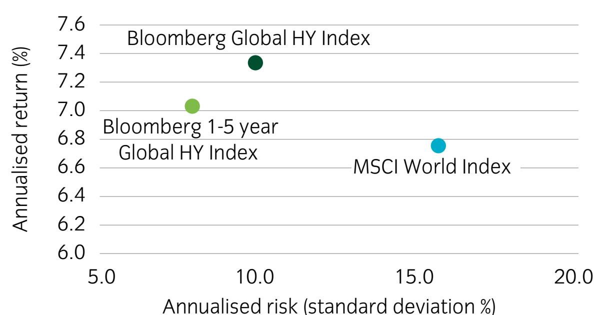


Figure 16: Reducing volatility without sacrificing returns[18]



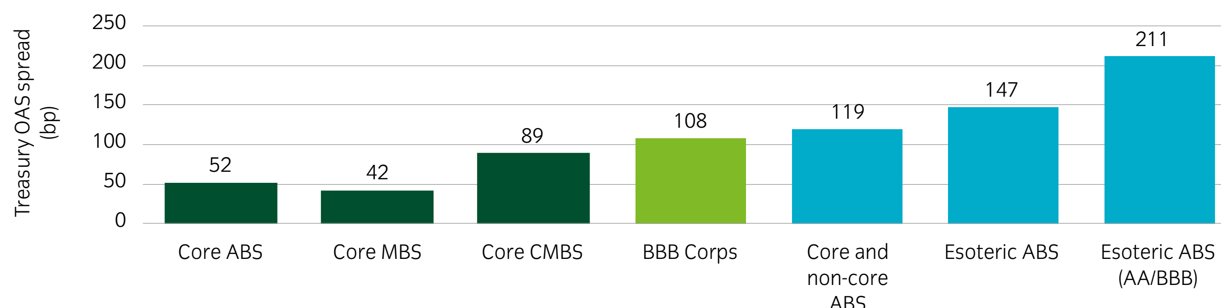
[16, 18] Source: Insight and Bloomberg. **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.** Data as of September 30, 2024.
[17] Source: Bank of America. Data as of September 30, 2024. **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.**

AN ESOTERIC FUTURE

Esoteric structured credit is the fastest-growing "non-traditional" credit market, estimated at $400bn at the end of 2023, up approximately $100bn since 2020[19]. It extends traditional structured credit and includes unconventional asset pools or innovative private structures.

Esoteric credit has offered a significant "complexity premium" above traditional structured credit, typically ranging from +50bp to over 300bps versus comparably rated corporate bonds. We believe this is attractive in the current environment of narrow credit spreads in traditional credit.

Figure 17: Esoteric structured credit has typically offered a premium over core ABS[20]



In recent years, the market's rapid growth has been increasingly driven by trends in digital infrastructure, such as datacenters and fiber-optic cables. The rise of AI has accelerated the need for this infrastructure and the finance needed to build it. With banks retrenching from this type of lending due to capital and liquidity constraints, it has opened the door for institutional investors.

Issuers in esoteric credit markets often prefer low levels of disclosure, which can guarantee a seat at the table for investors if they will underwrite the deal. For those wanting greater liquidity, public deals are easier to access and can provide attractive opportunities during market liquidity stress.

When partnering with a manager in esoteric structured credit, investors should look for specialist teams with experience in ABS and esoteric types of private lending. Depth of relationships and the ability to bring sizeable investment commitments are crucial. Legal resources, specialized knowledge, and quantitative models are essential for underwriting esoteric ABS.

Investors can use esoteric structured credit as an extension of their core fixed income holdings to address liability streams with contractual and predictable cashflows. It can also help secure an enhanced liquidity portfolio. However, some investors have been slower to embrace esoteric investments due to uncertainty, lack of familiarity, and complexity. Despite these challenges, what is considered "esoteric" today may become "traditional" in the future.

[19] Source: Finsight, proxied by trailing 5-year issuance, as of December 31, 2023.
[20] Source: Bloomberg, ICE, as of October 31 2024. **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.**

CHECK YOUR HEDGE

Currency-hedged share classes are often inefficient

Investing in international assets can improve portfolio diversification and broaden the pool of available opportunities. One of the unintentional by-products of an international portfolio is the introduction of currency risk. There are two key features of currency exposure: the first is that, given the volatility of the asset class, currency risk can meaningfully impact overall portfolio returns; and the second is that currency exposure stemming from international assets is expected to generate zero returns. As such, managing currency risk can both reduce the volatility of an international portfolio as well as improve overall returns.

For investors gaining exposure to international assets via publicly traded funds, a common way to manage currency risk is to subscribe to a currency-hedged share class of the fund. Although this may seem an efficient and cost-effective option, our analysis shows that they are often neither.

Five reasons to rethink using hedged share classes

1. **Hedged share classes often only hedge the largest currency risks in the portfolio and leave other, smaller currency risks unmanaged.** This leaves investors with a residual currency risk that can be significant, depending on the allocation of assets and the volatility of the unmanaged currency component.

2. **If investors hold several funds with international asset exposures, holding numerous hedged share classes can lead to implementation inefficiencies and higher transaction costs, as the investors would not benefit from any netting across different currency exposure positions.** This is a particular issue if the assets in the various funds have a low, or negative, correlation.

3. **Currency risk is typically managed using derivatives, such as FX forwards, which require periodic funding of profits and losses at regular settlement intervals.** An equity manager would need to maintain a cash buffer to meet any losses that arise, which leads to a structural reduction in exposure to the underlying equity index. This has two direct implications: firstly, cashflows or collateral requirements managed at the individual investment level are not optimal and create additional drag; secondly, the fund manager of the hedged share class would be consistently under-investing in the underlying asset in order to maintain appropriate cash buffers for the FX hedges.

4. **The overall fees charged by currency-hedged share classes can be high and not transparent.** A currency-hedged share class can be both expensive and opaque. Indeed, we have observed that these types of structures can charge 1bp to 2bp more than currency managers typically charge. Furthermore, as neither management fees nor trading costs are clearly monitored, there is a notable risk of non-competitive trading costs.

5. **Most importantly, currency-hedged share classes can often experience significant performance drag relative to benchmark.** Our analysis suggests that share classes that undertake a currency hedge can persistently underperform an unhedged share class using a dedicated currency manager simply taking a passive hedging approach. This can be by close to 100bp per annum in some cases.

A simple approach may not be the best approach

In a nutshell, investing in a currency-hedged share class can be both less efficient and more costly than managing currency risk via a dedicated currency manager. Our experience is that a dedicated currency manager can offer transparency and achieve lower transaction costs through curated trading relationships when compared to fund structures.

A significant additional benefit of using a dedicated currency manager is that they can be responsible for managing all currency risk at the overall portfolio level, after working out the net currency exposures from the full underlying list of international asset exposures. This type of approach should be expected to lead to more comprehensive and efficient currency hedging as well as more efficient management of the collateral pool.

FIND OUT MORE

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