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The past, present, and future of bond markets

We believe the search for return over the next decade will move away from managing macroeconomic risks, such as term structure, duration, and currency risk, toward the credit channel.

As active managers seeking alpha for our investors, we are focusing on the next generation of corporate leaders and seeking to invest ahead of the beta crowd.

We see opportunities in earlier stages of firm capital creation as found in convertible bonds, high-yield credit, and leveraged loans, along with potential in emerging markets.

A decade ago, as central banks began to unwind quantitative easing (QE) after the global financial crisis (GFC), we explained in a series of papers why we found the most attractive fixed income sectors were outside the Bloomberg U.S. Aggregate Bond Index. In 2022, we revisit this perspective as we face a new landscape for global fixed income markets — one that has been altered by the Covid-19 pandemic and Russia's invasion of Ukraine.

We will explore some of the shifts in the market and what they mean for the future, including outside-the-index investing, government borrowings, capital formation, inequality, economic growth, labor markets, and environmental, social, and governance (ESG) investing. As a preface, we note three key forces reshaping the global economy and financial markets:*

Debt: Fiscal responses to the pandemic have lifted government debt to its highest levels in decades. We believe sovereign real yields — nominal yields adjusted for inflation expectations — will likely hover near zero and limit the ability of monetary policy to stimulate demand.

* We will go into greater depth on these three “Ds” — debt, demographics, and disruption — in a forthcoming analysis.

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Demographics: Higher savings levels in an aging world are likely to keep interest rates low and constrain monetary policy, while owners of financial and hard assets will tend to benefit disproportionately, worsening inequality.

Disruption: Automation will reduce income, slowing both demand and growth, even as the transition to sustainability imposes costs on consumers, corporations, and governments. Deglobalization will reshape capital investment needs.

In this paper, we analyze central bank influence, capital formation trends, and the pivot toward sustainable investing. We discuss the following:

1. Credit markets have come to depend on central banks
2. Focusing research on capital formation to identify opportunities
3. The potential of emerging market debt versus developed market debt

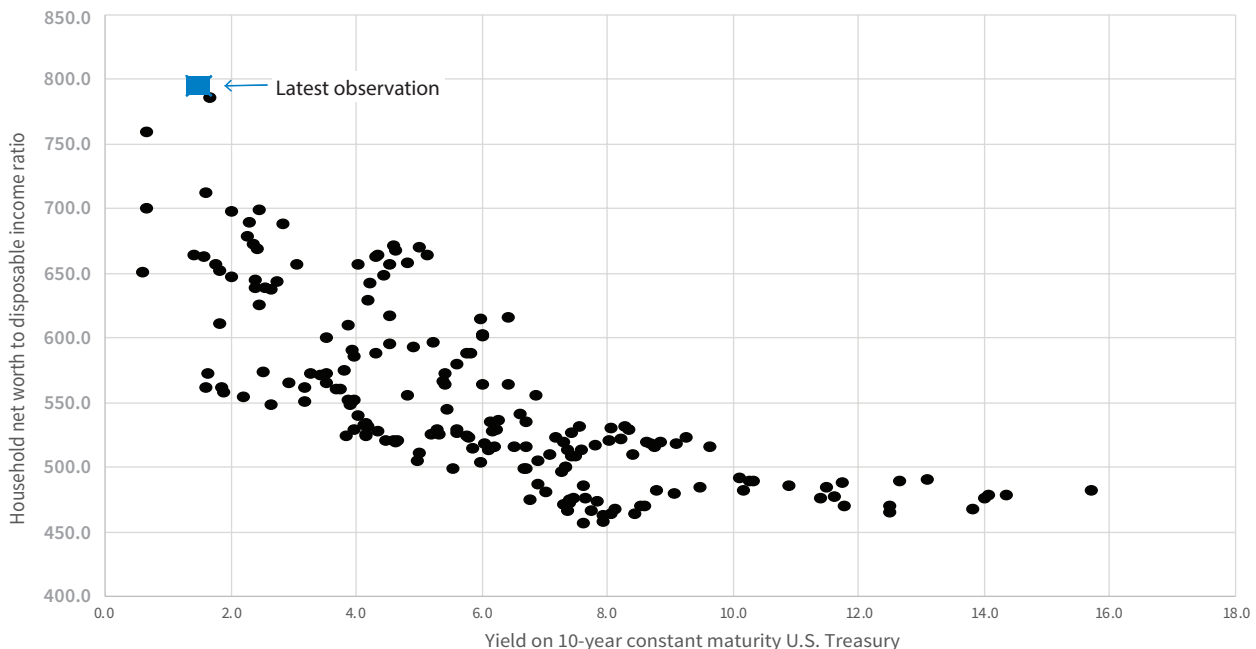
Section 1: Credit markets have come to depend on central banks

In an evolving global economy, central banks have taken a greater role in shaping opportunities to invest in bonds outside of common benchmark indexes. When markets needed liquidity during the GFC and the Covid-19 pandemic, the policy responses were extraordinary. Global central banks are gaining a reputation as risk managers for financial assets — arguably well beyond the scope of their policy mandates.

While unconventional policy aimed at supporting employment and/or incomes benefits all workers regardless of their income status, we have learned that such policies may often exacerbate inequality. However, financial stability and economic growth are entwined via the wealth channel. The owners of capital (the wealthy) benefited from the policy response disproportionately, assuming the assets they own perform well with lower rates.

Wealth owners benefit more than income earners from lower interest rates

Household net worth as share of disposable income
vs. 10-year U.S. Treasury yield, quarterly since 1962



Source: Board of Governors of the Federal Reserve System, as of July 2021.

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Complicating the policy response is the current market structure for capital. A large share of the debt markets consists of maturity transformation vehicles. The daily liquidity provided to investors is a maturity mismatch for the long-term assets supported by their invested capital.

Regulations after the GFC complicated the market structure. It was necessary to create a safer banking system to protect depositors from leveraged and risky bank balance sheets. Policy constrained the size of bank balance sheets and risk profiles, dramatically increasing the banking system’s stability.

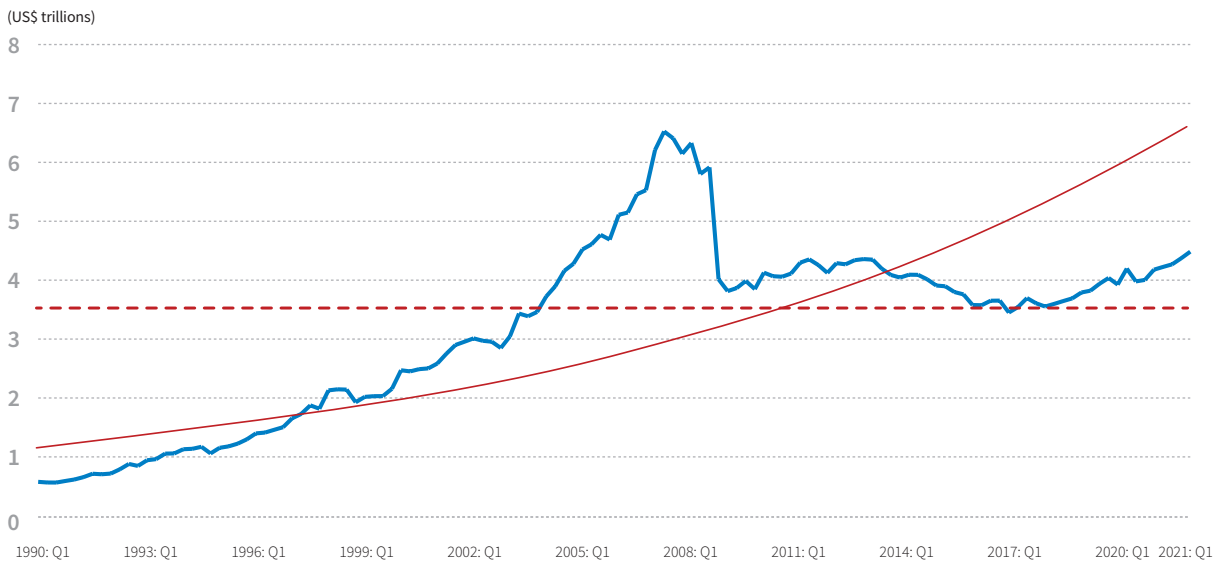
However, banks do more than store deposits. They also mediate risk exchange in the financial markets. During normal market conditions, they act as agents to move risk from one investor to another. During crisis episodes, investors typically shift portions of their portfolios from risky assets to cash — reversing the maturity transformation.

Today, the capital available on dealer balance sheets to handle large capital calls for cash is too small for the risk exchange function, requiring central banks to play a significantly larger role during a crisis, as we saw in 2020 during the outbreak of the pandemic. The investment industry is currently estimated at about \$140 trillion in assets under management (AUM). As industry assets grow, dealer balance sheets are not growing in a manner commensurate with the ability to accommodate the potential need to transfer risk. In fact, since the GFC, aggregate Wall Street dealer balance sheets have fallen dramatically.

As a result, dealer balance sheets can no longer warehouse risk in the same manner as pre-GFC. There simply isn’t a way for the collective dealer balance sheet to meet a large capital call for cash, and central banks must step in to meet that demand.

Current market structure complicates central bank policy response

Dealer assets have stagnated since the crisis



Source: Board of Governors of the Federal Reserve System, Financial Accounts of the United States.

Notes: The chart plots total financial assets of securities brokers and dealers at the subsidiary level. The solid red curve shows the exponential growth trend computed over 1990 through 2021; the red dotted line is set at \$3.5 trillion.

Section 2: Focusing research on capital formation to identify opportunities

The consequence of the market structure explained in section 1 is that policymakers have become the shock absorbers in the market. We saw that happen starting in March 2020 when the Federal Reserve stepped in with its second cycle of QE. It wasn't until the Fed announced unlimited QE that investor capital flight reversed. If QE is going to be regularly deployed, it is important to understand that the policy consequences are not all good. Regulators and policymakers will rightly focus on the need to address liquidity using other measures beyond deploying central bank balance sheets to assuage investor risk aversion. An example is swing pricing, which allows certain funds to adjust their net asset value to pass on the cost of trading during crises. In the future, investors may have to choose between liquidity and return to a greater extent.

Private debt markets

That trade-off has been the focus of private markets: Investor capital is locked up for extended periods to extract maximum return for the limited partner shareholders. Since QE has lowered interest rates and driven asset class valuations to historically high levels, investors have moved capital to private markets at an increasing pace to take advantage of expected higher returns. The private debt market subclass is approaching \$1 trillion in assets under management and includes direct lending, distressed debt, mezzanine debt, and special situations.

Capital formation has also evolved over the past decade, aided in part by post-GFC regulations. We have seen a shift in the creation of enterprise value for firms. As of 2021, there were nearly 1,000 so-called “unicorns,” or start-ups, valued at \$1 billion or more compared with less than 10 in 2011. Firms are raising capital three or more times prior to issuing an IPO compared with just one time prior to 2010. Capital allocated to private debt has also doubled from 10 years ago. [The private equity markets — estimated at \\$7 to \\$8 trillion — drive much of the value creation](#), according to research from iCapital*, a financial technology company.

* Source: iCapital, “Unicorn Growth Blurs the Lines Between Private and Public Markets,” November 4, 2021, <https://www.icapitalnetwork.com/insights/private-equity/unicorn-growth-blurs-the-lines-between-private-and-public-markets/>

Leveraged loans

One of the bridges into the public market with the lowest cost of capital is leveraged loans. This vehicle offers investors a glimpse at a company before it becomes a public debt issuer in the high-yield market. As more private debt lenders and larger loans become available, a growing share of middle-market funding appears to be coming from the private debt market compared with broadly syndicated loans, according to Standard & Poor's in an October 2021 report on private debt. While middle-market private equity transactions have remained relatively stable in recent years, the issuance of broadly syndicated loans in the middle market has fallen.

High yield

In addition to these sectors, we believe high-yield corporate credit also continues to offer compelling opportunities. New firms are issuing more debt, including high-yield bonds. Though 2021 was a big year for rising star opportunities, select pockets of value remain. In addition, companies looking to optimize their cash usage (for example, in high-growth sectors to preserve working capital) are increasingly issuing convertible bonds.

Convertible securities

Convertible securities typically pay a lower coupon than traditional fixed income instruments because of the value of the attached equity option. Instead of reaching for yield in the most speculative areas of the credit markets, we prefer using convertible debt that provides returns on par with the lowest-rated debt, but at a lower volatility. We prefer to bet on growth opportunities as opposed to betting against companies defaulting, given recent valuations.

ESG and sustainable investments

Over the past decade, environmental, social, and governance investing has gained broader adoption by both institutional and retail investors. For active managers, adapting to changing investor priorities often defines success and failure. To succeed, it will be necessary to study, understand, and anticipate the consequences of transitioning toward a more sustainable world.

ESG investments will change the capital formation process. More investors are considering ESG investing, and there is a push from governments and regulators to ensure focus on measurable qualities. Some firms seeking capital will likely adapt to this change, but others may not. Risks and adaptation costs may disproportionately impact countries, corporations, and households, increasing inequality. The shift will be complex to coordinate and could have significant redistributive consequences that need to be adequately handled. This is essential to preserve long-term financial (and price) stability in the age of climate change.

Section 3: The potential of emerging market debt versus developed market debt

Rising government balance sheets, including in the United States, will likely have consequences for growth and investment. For developed market debt, opportunities in active interest-rate strategies are scarce given the size of negative-yielding debt. Still, we believe developed market government debt will continue to offer the benefit of diversification versus other asset classes, like equity and credit. Investors searching for higher returns (and real positive yields) may have to continue to look to the credit markets for the foreseeable future.

Emerging market (EM) debt had a challenging 2021 given inflationary pressures, expectations for global policies to normalize, and the impact of the pandemic on various developing nations. These pressures are not likely to dissipate over the short term, especially given the surge in energy and food prices caused by Russia's invasion of Ukraine. That said, central banks in developing economies have largely shown fiscal discipline in response to the pandemic, and many of these governments have had better balance sheet discipline than the United States or Europe.

So, we see investment opportunities in EM sovereign debt and EM corporate credit. Emerging market government debt has reasonably priced risk premiums and provides potentially higher returns — albeit with higher volatility — over the short term. In EM corporate credit, many out-of-benchmark securities offer attractive and unique potential returns. In our view, EM companies realize that to be global players, they have to be responsible in terms of their use of balance sheet leverage.

Conclusion: Opportunities and challenges ahead for investors

Many forces are exerting downward pressure on potential returns for global safe-haven assets, including inequality, the push toward a sustainable climate policy, and the evolving Covid pandemic. Some of these are endogenous factors that can be addressed with prudent fiscal policy. But this may be difficult given the polarizing views on the definition of prudent. Although technological innovations may ease some of these challenges, it will also create others. Globalization has provided a tailwind for China's emergence, for example, but other developing economies may not be so lucky.

The challenge over the next decade will be to face the transition to a more sustainable and equitable world. Active managers will find opportunities while navigating this transition. We believe the optimal course for finding opportunities in the debt markets will be to continue to invest outside the index and primarily via the credit channel, given that the limited policy space likely will lead to persistently low government bond yields.

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