CAPITAL GROUP™

Investment Insights

A framework for navigating uncertainty

February 2023

FOR PROFESSIONAL / QUALIFIED INVESTORS ONLY
Marketing communication

A framework for navigating uncertainty: high-quality bonds return to traditional role

Flavio Carpenzano
Investment Director

Peter Becker
Investment Director

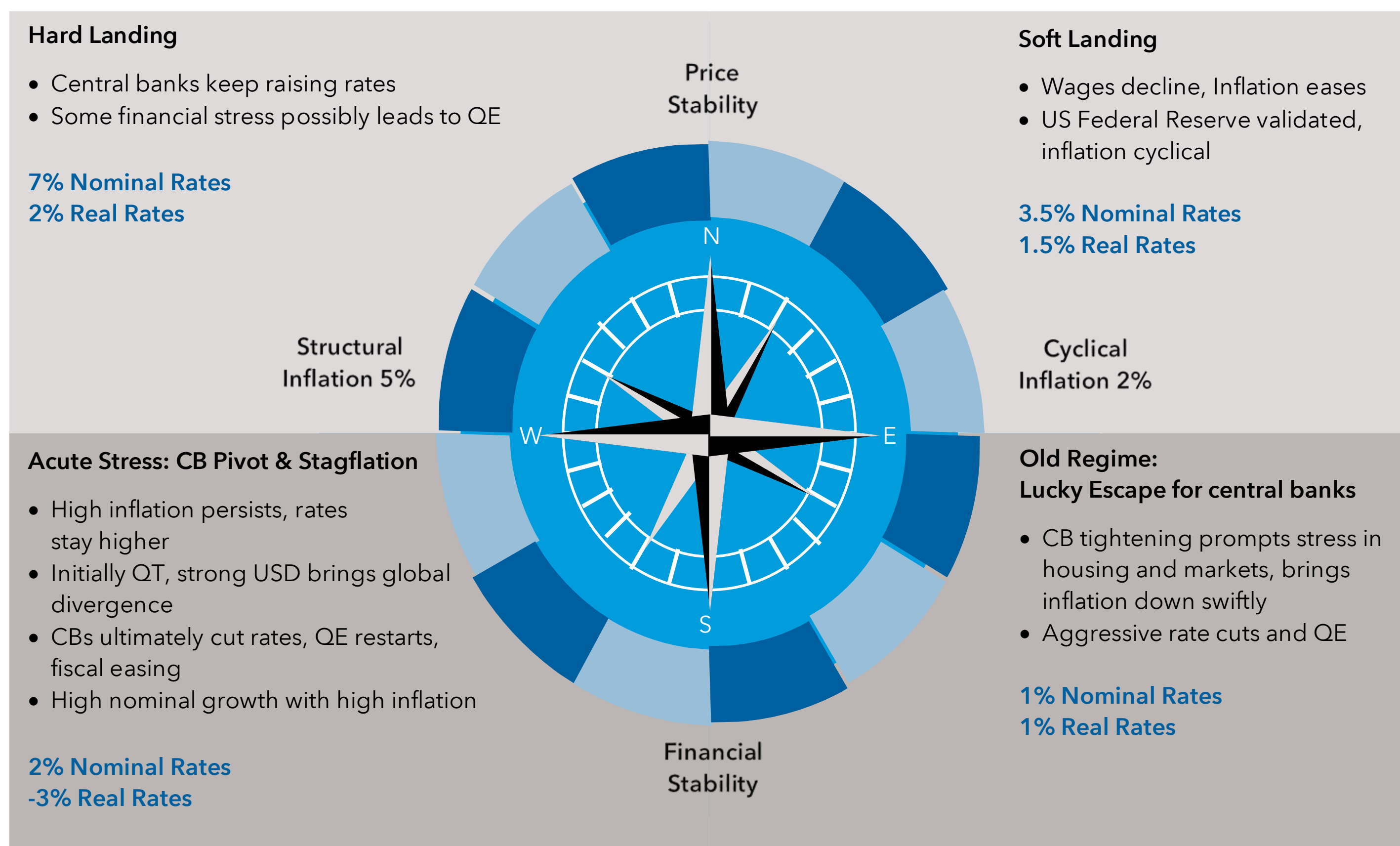
- Uncertainty over inflation and central bank policy is likely to remain high during 2023 with a wide range of possible outcomes for investment returns.
- We have modelled a range of potential scenarios in terms of cyclical versus structural inflation and how the US Federal Reserve would react, plus potential equity and bond returns in these environments.
- Our analysis points to one clear implication: the importance of investing in fixed income.

After a long period of low inflation, many countries around the world have had to contend with the highest increases in prices for decades.

This saw central banks (CBs) adopt an aggressive approach to monetary policy through 2022. Whether policymakers choose to continue to prioritise combating inflation or shift focus to financial stability, and whether current higher prices are structural or cyclical, will be key factors for investment returns in 2023 and beyond.

As a framework to navigate this uncertainty, we have modelled four scenarios for the path of inflation and monetary policy in the US (as a proxy for global developed markets). Among these is scenario 1 (a soft landing), which sits in the top-right quadrant of our compass below. This is essentially what the market is currently pricing in – a view that US inflation is more cyclical than structural, coming back to around 2%, and the US Federal Reserve (Fed), focused on price stability, has been validated in its approach. In this scenario, we would anticipate nominal rates of 3.5% and real rates of 1.5%.

Figure 1. A framework to navigate uncertainty



Source: Capital Group. Fed: US Federal Reserve. CB: Central Banks. QE: Quantitative Easing. QT: Quantitative Tightening

The other three scenarios are where inflation is more structural (the extent varies under each one) and we also adjust the Fed's reaction accordingly in terms of policy response.

- First, we test a dovish approach where the Fed prioritises financial stability.
- Second, we look at a scenario in which price stability is more of a focus, leading the Fed to adopt a hawkish stance.
- Finally, we test an approach in which the Fed is purely focused on price stability and continues to aggressively tighten policy.

Further details of each scenario are provided below.

Scenario 1. Moderating inflation, growth on track. In this scenario, inflation proves to be cyclical and central bank tightening quickly brings it back under control.

Scenario 2. Slowflation, dovish Fed. Inflation is structural. Growth continues to slow but importantly remains positive. In this slowflation environment, the Fed prioritises economic growth and so maintains a dovish approach to monetary policy.

Scenario 3. Slowflation, hawkish Fed. Inflation is structural. Growth continues to slow but importantly remains positive. Unlike in scenario 2, in this slowflation environment, the Fed prioritises price stability and so maintains a hawkish approach to monetary policy.

Scenario 4. Inflationary bust, hawkish Fed. Inflation is structurally higher and central banks not only understand this, but are more determined than in scenario 3 to combat it come what may. Interest rates therefore continue to be hiked aggressively to bring it under control. Under this scenario, the Fed might be forced to buy assets to ease periods of financial stress, but institutions that do not pose systemic risks will be allowed to fail. This is essentially scenario in the upper left quadrant of the compass.

Figure 2. Scenario analysis – A return to form for the role of fixed income

	Spread (bps)			Total return (including 1yr carry)				
				Equity	Fixed Income			
	IG Corp	HY	EMD	S&P 500	US Agg	IG	HY	EMD
1. Moderating inflation, growth on track	100	300	250	**20%**	**13%**	**16%**	**19%**	**20%**
2. Slowflation, dovish Fed	125	350	300	**17%**	**5%**	**5%**	**15%**	**8%**
3. Slowflation, hawkish Fed	200	650	500	**-11%**	**2%**	**-1%**	**0%**	**-6%**
4. Inflationary bust, hawkish Fed	350	1200	800	**-48%**	**-5%**	**-16%**	**-23%**	**-28%**

As at 30 December 2022. Sources: Capital Group, BlackRock Aladdin. Total return includes one-year dividend yield and one-year carry.

Bps: basis points. HY: High Yield: EMD: Emerging Markets Debt. IG Corp: Bloomberg Investment Grade Corporate Bond.
HY: Bloomberg US High Yield 2% Issuer Cap. EMD JPMorgan EMBI Global Diversified Composite. US Agg: Bloomberg US Aggregate Bond:
IG: Bloomberg US Aggregate Corporate

The results of our analysis above show a favourable outcome for fixed income across the scenarios. Significantly, high quality core bonds would return to their traditional role of providing capital preservation and diversification to investors. Even in the worst-case scenario 4, for example, high quality bonds would still suffer but to a much lesser extent than equity markets or compared to the sell-off in 2022.

There are two main takeaways we can take from this simulation:

1. **In contrast with what happened in 2022, core bonds may provide diversification again and offer protection in the case of equities selling off**: In the "risk on" scenarios we tested (1 and 2), bonds and stocks both provide a positive return. However, in the "risk off" environments of scenarios 3 and 4 when equities fall in value, bonds help limit overall portfolio losses. The benefits are particularly notable with the performance of the US Aggregate index. Even in an extreme inflationary bust (scenario 4) where equities can be expected to lose 48% of their value, US Aggregate losses are limited to 5%.

2. **Fixed income, including credit, may also generate positive returns over one year in recessionary conditions:** In a more conventional recessionary environment, as outlined in the additional scenario 5 below (Figure 3), core high quality bonds and riskier high-yielding bonds both deliver positive returns. This reflects two characteristics of the asset class. First, the positive duration impact of falling interest rates and second, the higher level of starting yield that both now offer, which helps cushion periods of price volatility.

   The higher level of carry is particularly noticeable for US high yield. The analysis below shows that even in a moderately negative growth environment where US high yield spreads inevitably needed to widen from current levels, the asset class can generate positive returns. Thus, its higher carry enables high yield to produce equity-like returns in risk-on markets and is likely to deliver stronger returns than equities (where any dividend component is usually lower and discretionary) in risk-off scenarios.

Recession

Many of our clients have raised concerns about the performance of fixed income assets, particularly high yield, under a recessionary environment, so we also tested a relatively mild recession outcome.

Figure 3. Recession – the benefits of diversification become apparent

	Spread (bps)			Total return (including 1yr carry)				
				Equity	Fixed Income			
	IG Corp	HY	EMD	S&P 500	US Agg	IG	HY	EMD
Recession	250	850	600	**-14%**	**14%**	**10%**	**5%**	**1%**

As at 30 December 2022. Sources: Capital Group, BlackRock Aladdin. Total return includes one-year dividend yield and one-year carry.
Bps: basis points. HY: High Yield: EMD: Emerging Markets Debt. IG Corp: Bloomberg Investment Grade Corporate Bond. HY: Bloomberg US High Yield 2% Issuer Cap. EMD JPMorgan EMBI Global Diversified Composite. US Agg: Bloomberg US Aggregate Bond: IG: Bloomberg US Aggregate Corporate

The negative correlation between fixed income and equities comes to the fore under this recession scenario. All four bond sectors are likely to deliver positive returns under the assumed parameters and help offset the negative return in equities. Falling interest rates mean duration is the biggest component of return, and, as a consequence, the more duration-sensitive investment grade and US Aggregate sectors deliver the highest returns.

As high yield returns are more influenced by economic sentiment, the sector might be expected to come under pressure in a recessionary period. However, the strong back up in yields over the past year means high yield offers an attractive level of carry. This provides a good yield cushion, helping mitigate against spread widening and enabling the asset class to deliver a positive return.

Even hard currency emerging market debt, an asset class that undeniably favours a positive growth environment, would generate positive returns in this scenario, albeit moderate in comparison to the other fixed income sectors.

The importance of investing in fixed income

This detailed scenario analysis above points to one clear implication: the importance of investing in fixed income. Given the set of likely outcomes outlined in this paper, we believe fixed income markets have become a much more attractive proposition for investors. Higher-yielding areas of the market now offer sufficient carry to offset periods of potential volatility; at the same time, higher quality bonds once more provide capital preservation and diversification from equities.

Combining fixed income sectors in a balanced way now offers investors levels of yield that we have not seen for decades. Diversifying and allocating flexibly across the major fixed income sectors could therefore help investors build more resilient portfolios with the potential for long-term attractive income and returns.

Flavio Carpenzano *is an investment director at Capital Group. He has 17 years of industry experience and has been with Capital Group for one year. He holds a master's degree in finance and economics from Università Bocconi. Flavio is based in London.*

Peter Becker *is an investment director at Capital Group. He has 26 years of industry experience and has been with Capital Group for four years. Prior to joining Capital, Peter was a managing director in the fixed income product management team at Wellington Management. Before that, he was a portfolio manager at Aberdeen Asset Management. He holds a master's degree from The Ingolstadt School of Management. He also holds the Chartered Financial Analyst® designation. Peter is based in London.*

Past results are not a guarantee of future results. This information has been provided solely for informational purposes and is not an offer, or solicitation of an offer, or a recommendation to buy or sell any security or instrument listed herein.

Statements attributed to an individual represent the opinions of that individual as of the date published and may not necessarily reflect the view of Capital Group or its affiliates.

Risk factors you should consider before investing:

- **This material is not intended to provide investment advice or be considered a personal recommendation.**
- **The value of investments and income from them can go down as well as up and you may lose some or all of your initial investment.**
- **Past results are not a guide to future results.**
- **If the currency in which you invest strengthens against the currency in which the underlying investments of the fund are made, the value of your investment will decrease. Currency hedging seeks to limit this, but there is no guarantee that hedging will be totally successful.**
- **Risks may be associated with investing in fixed income, emerging markets and/or high-yield securities; emerging markets are volatile and may suffer from liquidity problems.**

While Capital Group uses reasonable efforts to obtain information from third-party sources which it believes to be reliable, Capital Group makes no representation or warranty as to the accuracy, reliability or completeness of the information. The material is of a general nature, and not intended to provide investment, tax or other advice, or to be a solicitation to buy or sell any securities. It does not take into account your objectives, financial situation or needs. Before acting on the information you should consider its appropriateness, having regard to your own investment objectives, financial situation and needs.

This communication is issued by Capital International Management Company Sàrl ("CIMC"), 37A avenue J.F. Kennedy, L-1855 Luxembourg, unless otherwise specified, and is distributed for information purposes only. CIMC is regulated by the Commission de Surveillance du Secteur Financier ("CSSF" – Financial Regulator of Luxembourg) and is a subsidiary of the Capital Group Companies, Inc. (Capital Group).

In the UK, this communication is issued by Capital International Limited (authorised and regulated by the UK Financial Conduct Authority), a subsidiary of the Capital Group Companies, Inc. (Capital Group).

In Switzerland, this communication is issued by Capital International Sàrl (authorised and regulated by the Swiss Financial Market Supervisory Authority (FINMA)), a subsidiary of the Capital Group Companies, Inc.

In Hong Kong, this communication has been prepared by Capital International, Inc., a member of Capital Group, a company incorporated in California, United States of America. The liability of members is limited. In Singapore, this communication has been prepared by Capital Group Investment Management Pte. Ltd., a member of Capital Group, a company incorporated in Singapore. This advertisement or publication has not been reviewed by the Monetary Authority of Singapore. Neither has it been reviewed by any other regulator.

In Australia, this communication is issued by Capital Group Investment Management Limited (ACN 164 174 501 AFSL No. 443 118), a member of Capital Group, located at Level 18, 56 Pitt Street, Sydney NSW 2000 Australia.

All Capital Group trademarks are owned by The Capital Group Companies, Inc. or an affiliated company in the US, Australia and other countries. All other company and product names mentioned are the trademarks or registered trademarks of their respective companies.

© 2023 Capital Group. All rights reserved. **WF-3945248**