AEGON INSIGHTS

Duration - Back from the dead

Navigating interest rate volatility in a global investment grade portfolio

Euan McNeil
Investment Manager,
Fixed Income

Kenneth Ward
Investment Manager,
Fixed Income

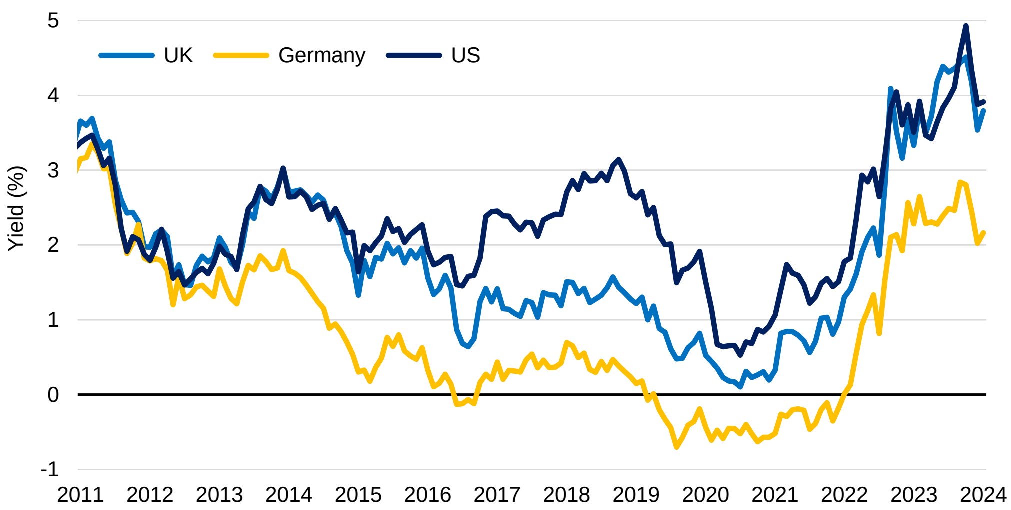
For 10 to 12 years after the Global Financial Crisis ('GFC'), the narrative around interest rates and central banks was almost exclusively concerned with how accommodative monetary policy could be in the face of various existential threats, most notably 2 Eurozone crises, and a global pandemic.

There was also a prevailing narrative amongst many that the forces of globalisation – and an ageing population – would effectively consign inflation to being an historic issue, never to threaten global bond markets again.

The inflationary impact of the monetary stimulus we saw post-Covid was widely underestimated, with the refrain from central bankers (especially the Bank of England) that any pricing pressures were purely a "transitory" phenomenon.

This all changed in late 2021, when central banks belatedly caught up and remembered that interest rate policy is a two-way street. The subsequent tightening of policy we have seen across economies has pushed yields to levels not seen in nearly 15 years. As we reached 2024, Central banks have tended to lean against market pricing (of interest rate cuts), clearly not wishing to be seen to be tolerant of the inflation threat.

Core Government Bonds - 10yr Yields



Source: Bloomberg, as at 31 January 2024

Whilst this is perhaps understandable given their generally slow response to addressing the issue in the first place, we are firmly of the view that market expectations for further rate hikes have become too elevated, not withstanding the most recent global economic data which has generally been above expectations.

Active duration management: Opportunities for a Global Investment Grade portfolio

The first – perhaps obvious – thing to say is that not all Global Investment Grade funds are made the same. There are many who simply refuse to countenance the notion of taking active duration positions in a credit portfolio.

At Aegon Asset Management, we have demonstrated a strong track record of generating outperformance from active duration management in our Global Investment Grade portfolios. For example, our flagship Global Investment Grade Bond Fund has added value from duration in four of the last five calendar year periods *. This has been achieved despite a period of materially higher volatility in interest rate markets.

We actively welcome the return of uncertainty to global interest rate markets – which combined with very attractive starting yields – provide another avenue to generate performance in addition to running a concentrated credit portfolio.

Our preferred approach for 2024 will be to continue to actively manage the portfolio's duration, and to oppose the (undoubted) extremes in market reaction that we will likely see for the remainder of 2024.

*Source: Aegon Asset Management, Attribution record of the representative Aegon Investment Grade Global Bond Fund, last 5 calendar year periods from 1 January 2019 to 31 December 2023

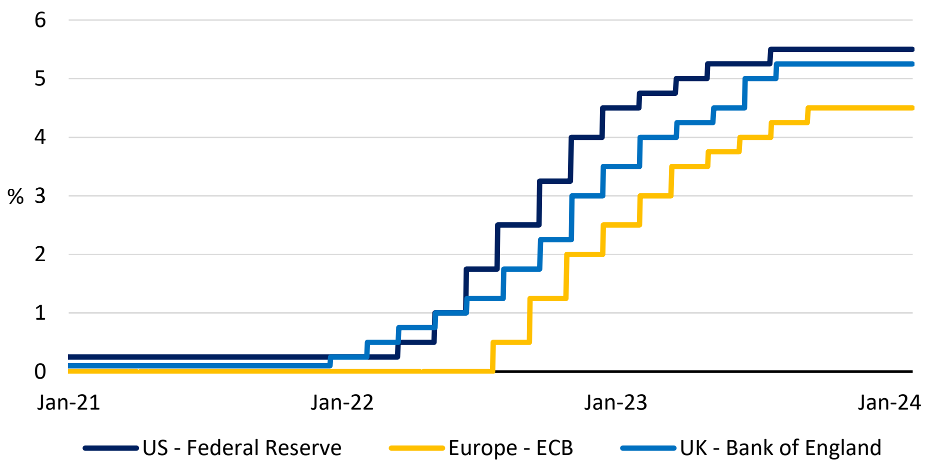
Exploiting the opportunity

There are two key elements of active duration management within a global credit portfolio.

The first is the size and direction of the active duration position at headline portfolio level. The second is the geographic composition of this interest rate risk (i.e., in which markets do you wish to take that active interest rate risk).

Generally, the most significant contribution from duration management to an active portfolio will come from the headline level of interest rate risk. However, as we enter an environment where we will likely see small differences emerge in the pace of the global central bank reaction function, this should allow us to exploit these geographical nuances, and express views across the main 3 interest rate markets depending on the expected risk/return horizon.

Distinct interest rate cycles



Source: Bloomberg, as at 31 January 2024

As a recent case in point, if we think back to 2022 (when the global tightening began in earnest) we saw the Federal Reserve steal a march on its global peers, which undoubtedly created cross-market opportunities within global rates markets.

Conclusion

Aegon Asset Management's Investment Grade portfolios employ a high conviction approach, consisting of c.150 bonds (compared to an investment universe of 16,000 opportunities), therefore credit selection and bottom-up analysis will always be the most dominant long-term driver of outperformance. However, the welcome return of interest rate volatility (after a 15-year hiatus) provides a valuable, additional tool to generate and protect performance for our clients' portfolios.

(Aegon Asset Management as at 31 December 2023)

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