aegon asset management

BondTalk

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AEGON **INSIGHTS**

Strategic Thinking: The three best bond trades right now

Bond markets decided against a traditional "quiet summer" and instead gave us two bouts of volatility to book-end the period – the snap French elections and the "flash crash" in August.

While a crisis in France was ultimately averted by the time of the actual vote in July, bond markets had by then been roiled by a sharp risk-off move pushing credit spreads wider and government bond yields lower.

Meanwhile, amid steadily weaker economic data, US Non-Farm Payrolls surprised meaningfully to the downside, stoking fears of a harder economic landing. Government bond yields fell sharply, and the market swiftly priced in 150bps of interest rate cuts by year-end as well as a chance of an emergency cut.

While these extreme expectations unwound as the month progressed, and markets recovered as it became clear they had overshot (in the short term), it again left bond markets shaken.

With the US Fed's easing cycle now underway and a return to calmer conditions, where should fixed income investors look now for attractive returns until the end of the year?

Below we outline our three current favourite trades.

Real estate

Relative to equity investors, bond investors typically aren't as fixated on identifying companies with high growth rates that provide the most attractive investment ideas. Rather, in the bond market, companies facing challenges tend to have the most mispriced securities, presenting cheap buying opportunities that can offer some upside potential. While lower priced bonds may offer significant price appreciation potential as the bond prices pull to par over time, there is also downside risk, especially for the more challenged companies. As a result, it is essential to balance risk and returns and conduct rigorous bottom-up research.

Alexander Pelteshki, CFA
Investment Manager, Fixed Income

Alexander Pelteshki, portfolio manager, is a member of the multi-sector portfolio management team. He specializes in top-down asset allocation, global bonds, and corporate credit. He is a co-manager for our strategic bond and core plus strategies.

Colin Finlayson, CFA
Investment Manager, Fixed Income

Colin Finlayson, investment manager, is a member of the global rates and multi-sector portfolio management teams. He specialises in global government bonds, relative-value analysis, and asset allocation decision-making across the fixed income market. Colin is the co-manager of our absolute return and strategic bond strategies.

Tier 2 Debt

Another place in credit land that we have favoured this year has been bank Tier 2 debt, the dated subordinated part of the bank capital structure. After a very strong rally in the beginning of the year of the so-called 'CoCos', the perpetual, junior subordinated bank capital debt, we identified an extremely rare and unusual occurrence. The yield on the Tier 2 debt across several parts of the market was flat compared to that of the AT1 debt – a clear mispricing given the latter is inherently riskier and should command a substantial yield pick-up. We successfully exploited that and rotated large parts of our AT1 allocation into Tier 2 debt, de-risking the portfolio along the way, at virtually flat yields.

US interest rate curve steepening

In the US, we have had a strong view that the government bond interest rate curve is too flat. Expecting a steepening as we progress into a rate-cutting cycle, we hold a curve steepening position, overweighting 5-year US Treasuries and underweighting 30-year US Treasuries. The subsequent curve steepening year to date has been a good place for us and we continue to like this position.

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