LOMBARD ODIER
INVESTMENT MANAGERS

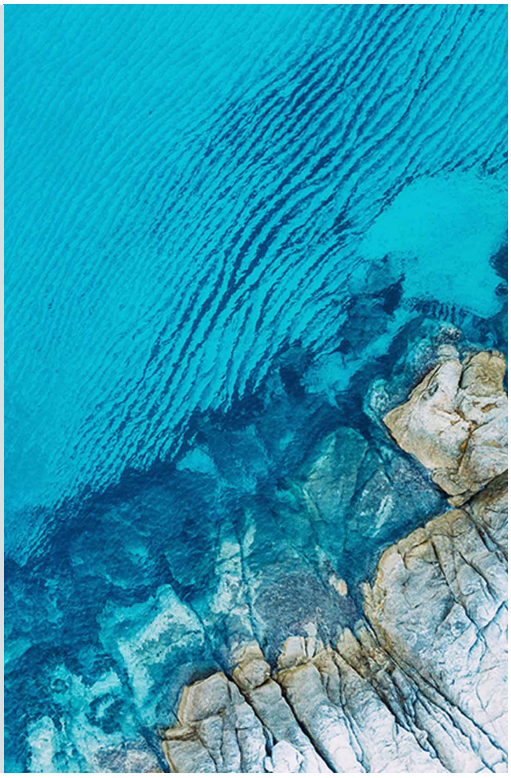
Alphorum

Alpha-seeking perspectives on global fixed income

For professional investor use only • Fixed Income **Q2 2021**

Key points

- We expect rates volatility, which exceeded the historical average in Q2, to remain elevated as investors continue to assess how US fiscal stimulus will impact inflation. Markets anticipate a US interest-rate hike in 2022, but the accuracy of this timing is uncertain given the slack in the labour market and the Federal Reserve's emphasis on accommodating growth. We do see upwards pressure on interest rates but perceive managing the risk of rates volatility as a more immediate concern than judging when the next increase will occur. **See p.2-4**.
- As US economic growth outpaces that of Europe, yields on Treasuries with maturities of 10 years or longer are unlikely to rise further in the near term as the market digests the practicalities of implementing the American Rescue Plan. In emerging markets, rising policy rates, strengthening global trade and commodity prices should soften the headwind of the recent US rates volatility. **See p.5-8 and p.12-14.**
- Corporate earnings are generally strong but show that COVID-immune sectors like ecommerce are still outperforming COVID-sensitive parts of the market, such as transportation. Low investment-grade spreads mean that we are finding the most attractive opportunities in the high-yield market, especially among hybrid instruments. **See p.9-11**.
- Bond indices harbour immense carbon risk, which is not priced in. Seeking to align our portfolios with a net-zero-emissions future, we have begun implementing a robust decarbonisation process aligned with the Paris Agreement, and which champions the net-zero transition across the entire economy – not just low-carbon sectors. **See p.15-16**.



Contents

In our monthly Forum, an internal meeting, LOIM's fixed-income specialists debate market dynamics to clarify their convictions. *Alphorum* reflects this pursuit of diverse alpha sources, which drives our global strategy.

Transition states: the return of growth and the race to net zero

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We may only be in the second quarter of 2021, but already it is shaping up to be a pivotal year. Could it be remembered as the true turning point for the transition to a decarbonised economy? Before we assess the potential implications of this for fixed-income investors, we first consider events that are having a more immediate effect on our universe.

Transatlantic divergence

One of the first macro themes that stands out is the diverging growth trajectories of the Unites States and Europe. The situation has increasing parallels with the period in the wake of the global financial crisis, when the US was able to deal with the consequences more efficiently and quickly pull ahead.

With the US economy showing strong signs of recovery, the Federal Reserve (Fed) is taking a pragmatic, accommodative and patient approach to monetary policy as markets digest President Biden's substantial stimulus measures. While ready to intervene where necessary, the Fed is comfortable with temporary signs of inflation as long as any upward pressure is growth-related. In contrast, the European Central Bank (ECB) is in a position where it needs to be better prepared to intervene monetarily due to the absence of fiscal support.

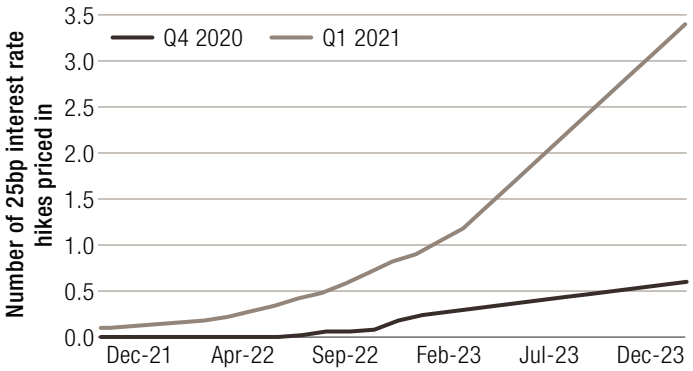
The US is also showing itself to be more bullish than the EU on debt issuance. With a huge amount of fiscal stimulus already approved and more being proposed, the debt burden for the US could be significant. Yet Treasury Secretary Janet Yellen has explicitly stated that the cost of servicing the debt is what matters,[1] and that puts some pressure on the Fed to keep rates low.

In contrast, the more complex political environment in Europe is hampering any agreement on stimulus. To some extent, Europe is still recovering from the last crisis and the austerity which followed. Combined with ongoing lockdowns, which are delaying the start of a proper economic recovery from the pandemic, these circumstances are forcing the ECB to take a more prudent view of public debt levels and hence fiscal stimulus.

Are inflation expectations exaggerated?

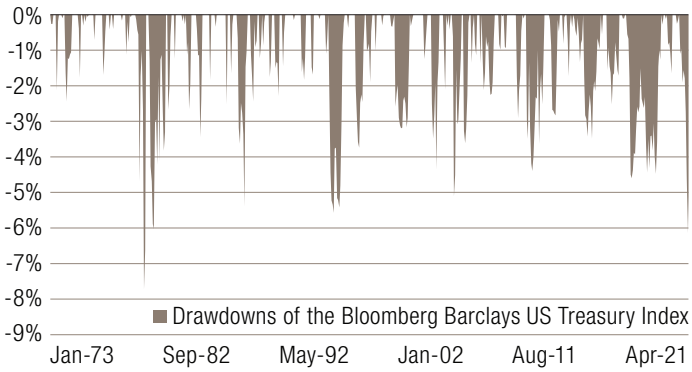
Given the magnitude of fiscal stimulus, Fed dovishness and prospects for economic reopening, inflation risk has staged a comeback. It is uncertain how significant inflationary pressures will be and how soon they will be felt, but many market participants are animated and already moving pricing in the next US interest-rate hike in 2022. However, given the considerable slack in the labour market and the Fed's focus on accommodating growth, the accuracy of this timing is open to debate. We are monitoring the data – especially employment, given its knock-on effects for wages and consumption – for signs of a structural increase in inflation.

FIG. 1 RAMPED UP: MARKET EXPECTATIONS OF FED RATE HIKES



Source: Bloomberg as at March 2021.

FIG. 2 DRAWDOWNS: US TREASURY DEBT



Source: Bloomberg as at March 2021.

[1] Bloomberg News as at March 2021.

One key topic which could have an impact on inflation is how excess savings are used. So far, money given out as stimulus has largely been saved rather than invested and it remains to be seen if consumers will see fit to spend this money as the economy picks up and confidence returns – and if so on what and how quickly. To drive inflation, additional spending would need to be focused on services rather than consumer goods. That is because spending on the latter has been relatively solid through the pandemic, making higher wages in the services sector a more likely driver of inflation. In reality, any surge in consumer spending would likely be a one-off event with short-term implications, rather than a structural increase in consumer spending which provokes sustained inflation.

For now, long-term yields are unlikely to rise further

While increases in long-term yields in the first quarter got a lot of attention, they were largely similar in magnitude with previous episodes. In terms of real-yield increases, the moves have been concentrated at the long end of the curve, in 10-year bonds and beyond. Given that there is unlikely to be any real clarification about structural inflation forces in Q2, we do not currently see any triggers for a further substantial rise in yields in the very short term.

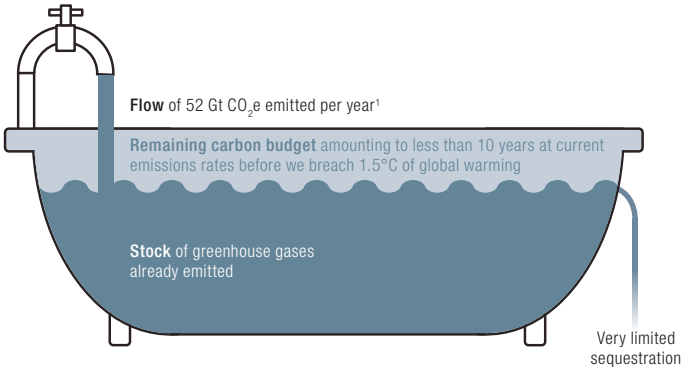
As the market focuses on the political reality of rolling out US fiscal stimulus, there may be an element of "buy the rumour, sell the fact." Biden's plans for infrastructure spending and beyond are ambitious but much of the spending is allocated for future years – and with the Democrats' majority razor-thin and midterms coming up next year, it is not guaranteed that the plans will be fully realised. Growing acceptance of this could actually see yields fall a little.

Sights on net zero

One important aspect of the recovery, which will be common in both the US and Europe, is the shift towards a cleaner economy. Although it is currently receiving less attention than Biden's pivot towards sustainability, the European Green Deal is a plan at least as ambitious given its core intention to create a net-zero-emissions economic bloc by 2050.

To understand what net zero means, Bill Gates uses the analogy of a bathtub that is slowly filling up with water. Because the effect is cumulative, even the slowest trickle of water will cause the tub to overflow. At the current rate of emissions rates, we have less than 10 years before we breach 1.5° C of global warming, a level which the United Nation's Intergovernmental Panel on Climate Change considers pivotal in terms of environmental impact.[2] In the race to net zero, we have 9 years to reduce emissions by 50% if we are to achieve carbon neutrality by 2050.

FIG. 3 EMISSIONS MUST FALL TO ZERO



Source: LOIM. For illustrative purposes only.
[1] Excludes land-use change.

As an environmental challenge for the world, targeting net zero will fundamentally change the global economy and impact every sector – not just those like energy, which are already starting to feel the effects. In essence, what we are confronting is a new industrial revolution, unfolding at the speed of the digital age, and one that will have huge implications for risks and opportunities in fixed-income markets.

[2] Intergovernmental Panel on Climate Change as at 2018.

Understanding carbon risk

Bond indices carry a massive amount of climate risk that is not priced in by the credit curve. For a fixed-income investor, the obvious question is: how should carbon risk be quantified? The answer is not universally clear, but we see a way forward.

Historically, investors have responded by excluding sectors and companies identified as heavy emitters while targeting low-carbon companies. However, this significantly restricts the investible universe and increases concentration risk in portfolios, making it a flawed investment approach, in our view. Since the transition to net zero requires decarbonisation across all sectors of the economy, it does little or nothing to support change in industries were emissions are hard to abate.

Given the necessity of looking forward to anticipate risks and opportunities created by the transition, we believe that analyses of the current carbon footprints of companies is insufficient. Getting sight of viable transition pathways is more important: emissions trajectories tell us whether a company is more likely to be aligned with the net-zero future or not. They are especially important for businesses in high-emission sectors that will remain essential to society and where decarbonisation must be supported.

Targeting net zero in fixed income

The net-zero transition will not be smooth. Instead of managing to a decarbonisation benchmark with step-change reductions in emissions, our analytical tools adapt to changes in emission levels and reduction targets at the industry and company level. At LOIM, our sustainability team has developed an expertise in forward-looking, science-based carbon analysis that underpins our net-zero investment approach. Broadly, it consists of four steps:

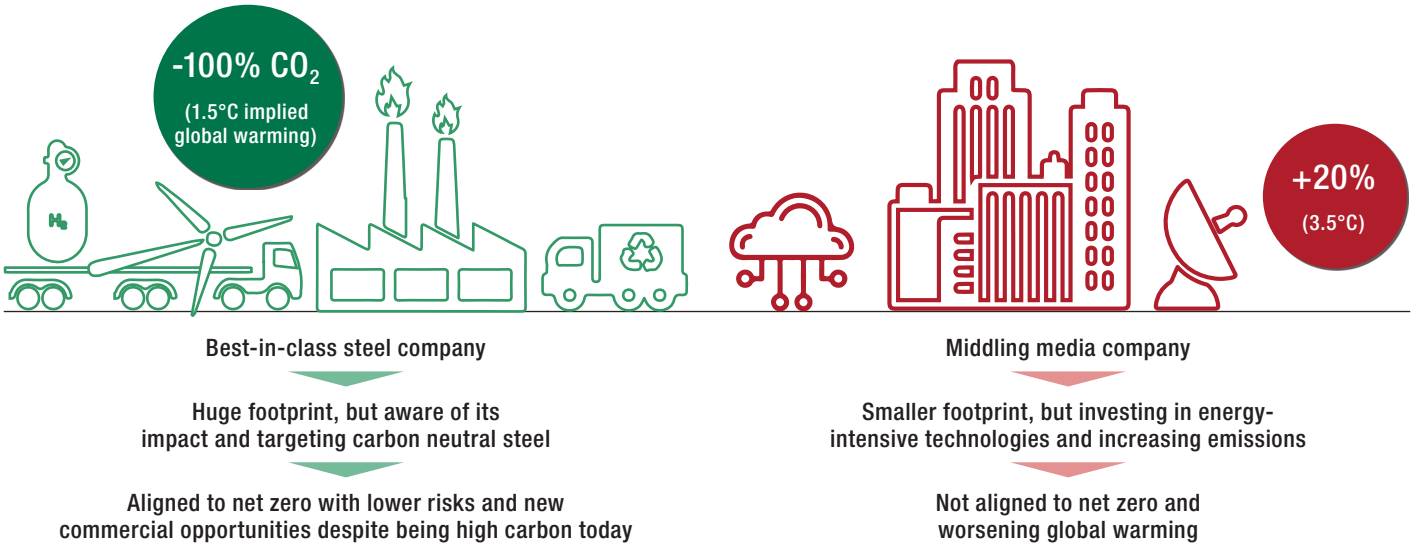
1. We assess the overall CO_2 exposure of a potential investment in terms of scope 1, 2 and 3 emissions. This goes further than most climate-risk models on the market, including the EU's decarbonisation benchmark, which only cover scope 1 and 2 emissions.
2. We assess the company's expected rate of decarbonisation and performance against the level required for its industry to become aligned with a net-zero world.
3. We consider the impact of emissions-curbing regulations and peer pressure created by decarbonising competitors, and identify opportunities to drive change through stewardship.
4. Combining all of this information, we assess how closely a potential investment's emissions trajectory is declining to 100% decarbonisation by 2050, validated by interim targets.

Looking forward, we believe that some of the best net-zero transition opportunities exist among companies that are currently high emitters but are on true low-emission pathways. These companies have the most potential to create impact and thrive in a net-zero world, and their decarbonisation credential might be underpriced by the market. We classify these businesses as "ice cubes," given their contributions to cooling the global economy. In direct contrast are the "burning logs": heavy emitters that seem prepared to continue on high-temperature pathways and therefore do nothing to promote the climate transition.

Currently, the investment universe of net-zero-aligned companies is relatively small. A truly net-zero portfolio of corporate bonds is therefore currently impracticable, although that is something we expect to change with time. Our approach enables us to identify and invest in those companies which are best placed to drive and benefit from the transition.

Sustainability and a pioneering spirit is built into our DNA: half way through the 19th century, we were already allocating capital away from US companies reliant on slave labour and today we are a founding member of the Sustainable Markets Initiative. We will continue to evolve and advance our approach to sustainability to make it ever more central to our fixed-income portfolios. Expect to hear more about our focus on net-zero investing in the coming months.

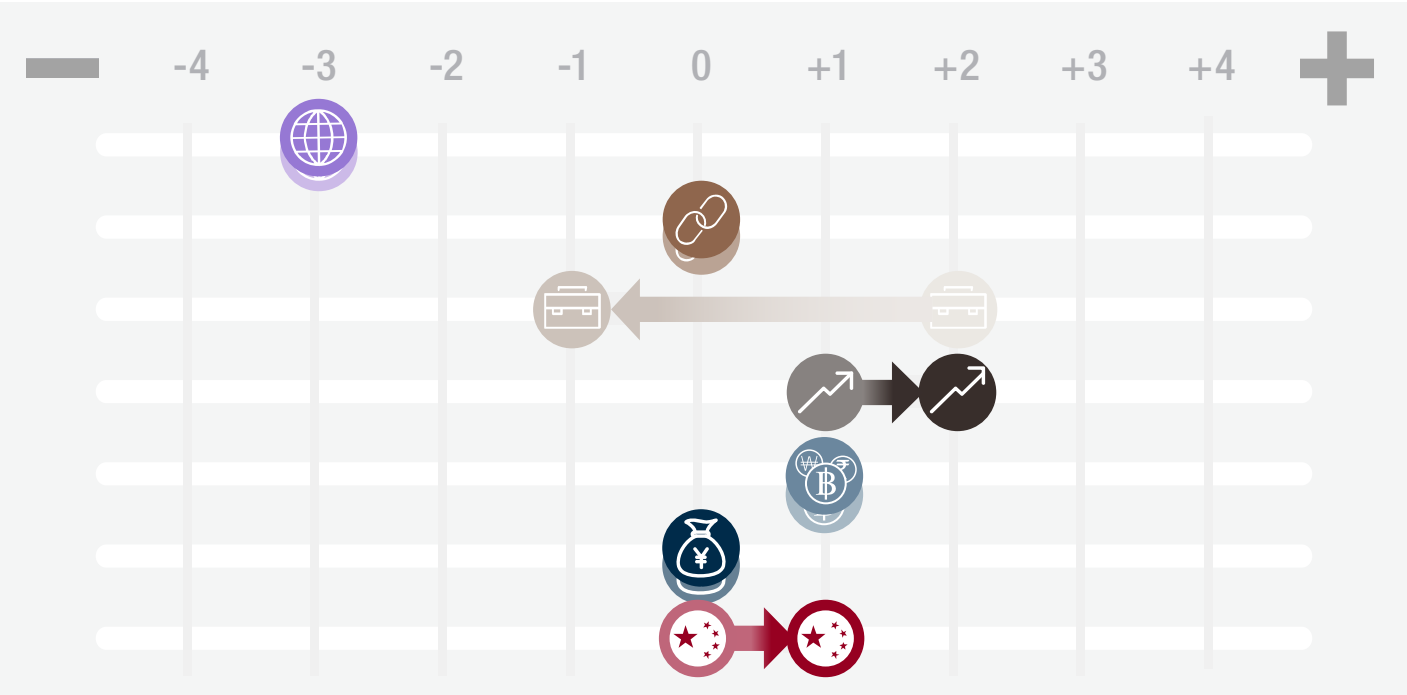
FIG. 4 SOME OF THE TODAY'S HEAVIEST EMITTERS CAN BECOME TRANSITION CHAMPIONS



Source: LOIM. For illustrative purposes only.

[3] The Greenhouse Gas (GHG) protocol identifies Scope 1 emissions as direct emissions from company facilities and vehicles; Scope 2 emissions as indirect emissions from energy supply; and Scope 3 emissions as indirect emissions from a company's overall supply chain. https://ghgprotocol.org.

Convictions scorecard



-3 DM SOVEREIGN

- Despite higher US growth and inflation expectations, the Federal Reserve is unlikely to raise interest rates until at least 2023, in our view.

0 INFLATION-LINKED

- US breakevens remain at multi-year highs, supported by uncertainty about how long the Federal Reserve will allow inflation – when it comes – to overshoot.

-1 CORPORATE IG

- With IG spreads below COVID levels and offering scant dispersion, we favour BB-rated corporate bonds and select B-rated names.

2 CORPORATE HY

- The primary market remains an attractive venue for achieving size and yield further down the capitalisation structure. Hybrids and green bonds offer opportunities.

1 EM HARD CURRENCY

- Low policy rates, stronger global trade and commodity prices should soften US rates volatility, and hard-currency bonds still offer carry despite the rally of recent months.

0 EM LOCAL CURRENCY

- Nominal and real yields remain attractive versus DMs but are below pre-COVID levels.
- FX carry has increased but is low relative to history.

1 CHINA LOCAL CURRENCY

- Foreign ownership of Chinese sovereign bonds is low but should increase given the case for diversification and Bond Connect.

Source: LOIM as at 31 March 2021.

The return of US exceptionalism

Nic Hoogewijs, CFA
Senior Portfolio Manager

1. Fundamentals and macro

The greatly improved growth outlook in the US since the turn of the year is significant for government bonds. A rapidly advancing vaccine rollout is being accompanied by fiscal stimulus from the recently approved USD 1.9 trillion economic relief bill; further proposals for investment in infrastructure, education, workforce development and fighting climate change would potentially more than double that.

In Europe the situation is more complicated, but expectations remain that the impact of the pandemic will peter out in the second half of this year. The stage is thus set for a US-led economic rebound that should be felt globally. The impulse provided by such strong stimulus measures should drive additional growth even beyond the "mechanical rebound" expected as businesses reopen and economies return to something like normality. Data from confidence indicators such as the ISM Reports on Business Manufacturing and Services point to this burgeoning recovery.

The inflation scenario is also changing dramatically from the situation just a few quarters ago. Rising oil and commodity prices, as well as one-off factors like the unwinding of the VAT reduction implemented in the second half of last year, are causing inflationary pressure. At the same time, supply-side mismatches are also pushing up prices in some sectors. An existing example is the chip shortage in the auto industry due to semiconductor makers diverting capacity into in-demand consumer electronics. Meanwhile, reduced capacity caused by business failures in hospitality and leisure may cause similar issues in these sectors as economies reopen and demand surges. However, the US Federal Reserve's view is that these pressures are transitory rather than a persistent source of inflation: the expectation is that consumer price indices will go up over the coming quarters only to see inflation come back down next year. With Fed Chair Jerome Powell viewing any rise in nominal interest rates as a statement of confidence by the markets, the Fed has consciously avoided opposing any such moves. This approach arguably accelerated the sell-off in February but more recently nominal yields are stabilising somewhat, suggesting that the Fed's approach may be working, at least for now.

2. Sentiment

In Europe the European Central Bank is taking a very different stance from the Fed, given the continent's more complicated economic outlook. Verbal interventions from various ECB officials over the past few months have explicitly stated that any rise in nominal yields driven by a rise in real yields (rather than by inflation) would be seen as a tightening of financial conditions. In a press conference on 11 March, ECB President Christine Lagarde reiterated this point and announced that purchases under the central bank's pandemic emergency purchase programme would be increased over the coming months to push back against any significant rise in nominal yields.

However, despite the ECB's concerns, financial conditions haven't tightened in any significant way: while there was some minor volatility in March, equity markets are near record highs, credit spreads are very well behaved and financial conditions generally are extremely accommodative. Despite Lagarde's talk of a "holistic"[4] approach that considers financing conditions for all economic actors – from sovereigns to businesses and households – a modest rise in real yields is not being accompanied by other signs of tightening.

[4] Source: ECB as at 21 January 2021.

3. Technicals

In terms of the technical picture, again there is a sharp contrast between the European and US situations. Technicals are extremely supportive for European sovereign bond markets given that, once redemptions from sovereigns and the ECB's quantitative easing programme are taken into account, there will actually be a negative supply of bonds this year.

In the US the situation is very different. As a consequence of the government's massive stimulus programme, net issuance will be significantly larger than previously expected and result in strong supply; this is part of the explanation for the sharp rise in nominal yields in the US over the first quarter of the year.

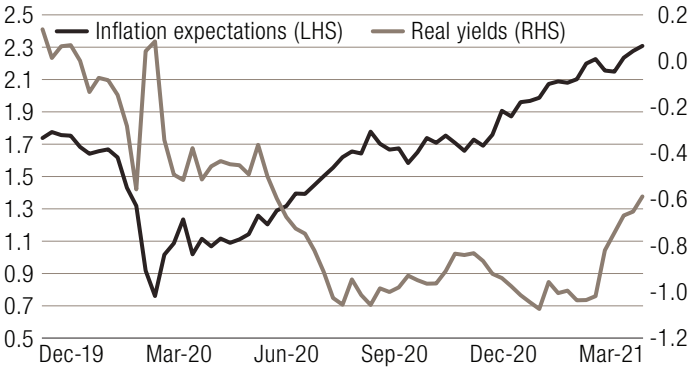
Further afield, the Bank of Japan recently loosened the yield control framework on 10-year Japanese Government Bonds slightly, keeping a target of 0% but broadening the band a little from +/-20 bps to +/-25 bps. Meanwhile, a similar attempt at yield-curve control in Australia has been fought strongly by the market, resulting in the central bank having to significantly step-up its purchases of short-dated bonds with a maturity of up to three years just to keep its yield-curve control target reasonably intact. The market responded by selling off 10-year bonds, resulting in a significant steepening of the yield curve.

4. Valuation

Currently, bond markets are significantly less expensive than at the end of 2020: this is mostly because of breakeven and inflation expectations. In the US, breakevens have climbed steadily over the past year and are at multi-year highs, with the 10-year breakeven rate sitting at 2.33% on 22 April.[5] Investors are unclear regarding the extent to which the Fed is willing to let inflation overshoot (and for how long), and that uncertainty commands a higher risk premium – if inflation remains elevated for some time, that could cause breakevens to drift even higher. However, current inflation expectations are much more reasonable than they were a few months ago, so breakevens have normalised to a large extent.

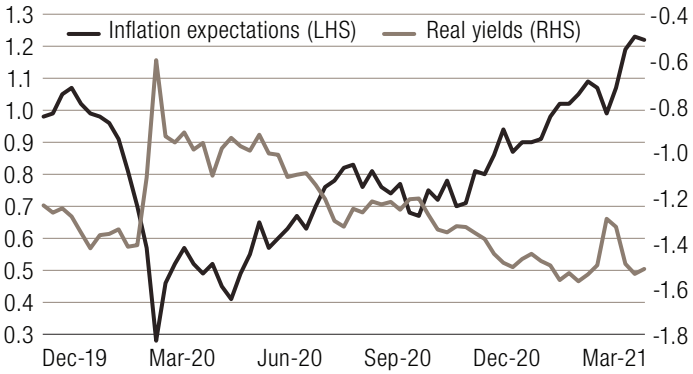
US real yields have picked up since the start of the year due to expectations of rising growth, but remain very low relative to history and expensive after being forced into negative territory by the central bank's actions. Yields could correct from the current levels to some extent but are unlikely to become significantly cheaper in the coming months. With breakevens already high, at some point a rise in nominal yields will be mainly led by real yields, in a similar pattern to that witnessed since the start of the year.

FIG. 5 US INFLATION EXPECTATIONS AND REAL YIELDS (10 YEAR)



Source: Bloomberg as at April 2021.

FIG. 6 GERMAN INFLATION EXPECTATIONS AND REAL YIELDS (10 YEAR)



Source: Bloomberg as at April 2021.

[5] Source: Bloomberg as at 22 April 2021.

5. Outlook

The March Federal Open Market Committee (FOMC) meeting was keenly anticipated and largely confirmed market expectations: growth projections were raised from 4.2% to 6.5% to reflect the higher-than-expected stimulus, while the Personal Consumption Expenditures inflation rate projection went from 1.8% to 2.4%. Market participants were largely focused on the Fed's so-called dot plots, used to signal its outlook for the path of interest rates: these showed that while several FOMC participants had moved up and forward their projections, median views had changed little despite the dramatic shift upwards in growth and inflation forecasts.

Overall, despite these significant revisions in inflation figures and the growth outlook, the Fed remains very reluctant to change its policy path, indicating that the hurdles are extremely high to any tightening of monetary policy at the current juncture: it is likely to announce gradual tapering later this year to be implemented through 2022, with the first interest-rate hike not likely until 2023.

In this context, we expect that the front end of the yield curve – denoting short-term securities – will remain very well anchored. However, at the longer end the upward pressures on interest rates are likely to persist: the current market pricing is only sustainable if the FOMC is correct in its forecast and can deliver on its policy path. However, if the Fed is overly optimistic and inflation is not as transitory as currently expected, then at some point the market could start pricing in higher risk premiums for longer term instruments.

In the eurozone, a very different economic outlook will mean the ECB is likely to remain as accommodative as possible. So, although there is no explicit yield-curve control, yields are likely to remain relatively contained (in fact the already-low yields on German Bunds could fall even lower). That means any rise in yields will continue to be led by the US. As a result, the spread differential between the US and Europe, which has widened significantly over the past quarter, will continue to be in evidence.

Seeking high-yield sweet spots

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David Perez
Portfolio Manager

1. Fundamentals and macro

While some short-term economic uncertainty remains, the macro environment is largely supportive for credit markets.

The USD 1.9 trillion American Rescue Plan signed into law in March includes funding for businesses, while President Biden's recently announced American Jobs Plan would include up to a further USD 3 trillion for infrastructure, manufacturing, R&D and community care. The much-anticipated Federal Open Markets Committee meeting on March 16-17 also provided a constructive scenario for markets, achieving the delicate balance between a stronger economic outlook and reassurance that monetary policy will remain accommodative to support the recovery.

In Europe, fiscal stimulus is less in evidence. However, the European Central Bank's announcement that it will accelerate the pace of its pandemic emergency purchase programme over the next quarter should provide some support to European credit markets. Spreads tightened on this clear signal that the ECB is committed to contain the rise in bond yields.

In a negative development, the advent of a third wave of COVID-19 has seen economies including France and Germany revisiting lockdown measures, which will drag on the eurozone recovery. Despite this, the European Purchasing Manager's Indices for March surprised to the upside, with both services and manufacturing signalling expansion. The final composite came in at 53.2[6] against an expected figure of 49.1, reversing the downwards trend of recent months. However, US figures were noticeably stronger (in line with expectations) with the composite at 59.7, underlining the more accelerated recovery there.

The credit cycle continues to normalise, although unevenly across regions and sectors. We see US companies benefiting from a strong growth outlook driven by fiscal spending, while European firms will lag behind. Some sectors still impacted by lockdown measures such as retail, hospitality and tourism still have some catching up to do. Meanwhile, recent overall earnings are strong, but show COVID-immune sectors such as telecoms and ecommerce outpacing more COVID-sensitive businesses in sectors like transportation and commercial property.

The ratings drift is also normalising. The peak of defaults is behind us, although lockdown measures – particularly in Europe will remain a drag and the effects will materialise slowly. It's worth noting the difference between the US and Europe in this respect: the straightforward US Chapter 11 process for bankruptcy tends to sweep away the dead wood of non-viable businesses more quickly, whereas Europe's more supportive attitude to troubled companies can tend to delay the inevitable.

Sustainability considerations are also impacting fundamentals. In January, S&P revised its assessment of risk for the oil & gas industry from 'Intermediate' to 'Moderately High', reflecting risks relating to the energy transition, weaker profitability and returns, and price volatility. Meanwhile, in March the Bank of England announced it will start greening its corporate bond-buying programme from the end of the year and is working on details of how to account for issuers' climate impacts. In the same month, the ECB outlined its framework for a climate stress test, encompassing about 4 million companies worldwide and covering 30 years into the future. The aim is to assess the exposure of eurozone banks to future climate risks, but the study has the potential to influence the attractiveness to banks of investing in 'dirty' firms.

We believe sustainability is central to the future performance of companies across sectors and that a clear and practicable energy transition strategy is becoming increasingly important as a credit driver.[7] In addition, the increasing adoption of broader environmental, social and governance (ESG) considerations in investment mandates will have a growing impact on the ability of companies to access capital markets. In our view, this vindicates the integration of our CLIC™ sustainability framework and ESG Materiality assessment within our portfolio construction and credit analysis processes.

[6] Source: Markit Economics as March 2021.
[7] For more on this topic, see our lead commentary on p.2 and sustainability commentary on p.15.

2. Sentiment

The risk of rates volatility due to uncertainty about inflation is keeping some investors away. Appetite for duration remains fragile since the real-rates selloff but we expect this to stabilise. Having become rather one-sided in March, positioning has become much more balanced in recent weeks. However, recent rates moves could trigger further outflows from investment grade bonds.

Despite record high-yield issuance, evidence including allocations achieved, upsizing of issues and the tightening of spreads pre-launch, indicates that books typically remain strongly oversubscribed. In the ongoing search for yield, investors are searching further down the capital structure or the ratings spectrum, with the new-issue market the best way to achieve an attractive combination of size and yield. We currently see more opportunities in the high-yield space, as well as through hybrid issues rather than senior debt (hybrid bonds are subordinated debt instruments which, in many cases, offer investment-grade default risk accompanied by high-yield returns.

We are also finding opportunities among high-yield green bonds, including those from:

- A large global auto parts supplier that will use proceeds exclusively to finance the manufacturing of low-carbon technologies for transportation, with a focus on hydrogen storage systems
- A specialist lender focused on mortgages for professional landlords, small businesses and property developers. As well as having sound fundamentals, the company is committed to a net-zero-emissions strategy and will use the bond exclusively to finance green buildings

3. Technicals

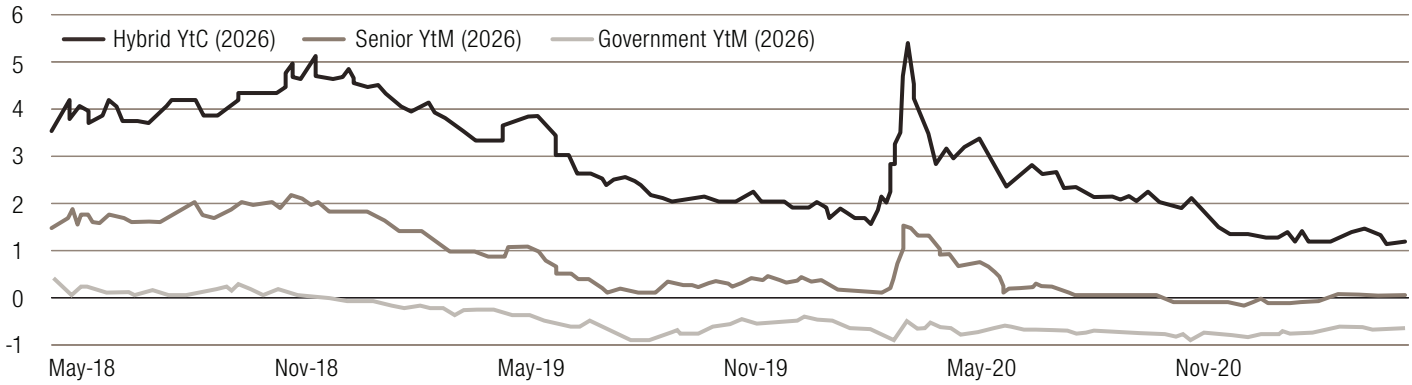
Technicals remain highly supportive as long as strong levels of support from central banks persist. However, the different approaches between the US and Europe are likely to start having more of an impact in the coming months. The aggressive fiscal stimulus and relaxed approach to monetary policy in the US is likely to drive an accelerated economic recovery, which could distance mainland Europe.

4. Valuation

Investment-grade spreads are below pre-COVID levels with little dispersion. Given the limited potential for strong returns, we prefer high-yield instruments for the carry they offer. COVID-impacted sectors have rallied in the current cyclical upswing but we are selective in our approach to capturing carry across industries, as well as for further spread compression. Despite the real-rates selloff, high-yield spreads have been stable amid the financial tightening so far.

Where possible, we choose to invest in hybrids rather than senior bonds for companies for which we see a strong investment case, given the more attractive reward profile. As they are further down the capital structure than senior debt, hybrids have lower credit ratings than senior debt but compensate with a pickup in spread.

FIG. 7 SPREAD DIFFERENTIAL: HYBRIDS IN UTILITY FIRM ENEL OFFER A GREATER SPREAD THAN THE ISSUER'S SENIOR BONDS



Source: Bloomberg as at April 2021.

5. Outlook

While the global economy is showing clear signs of recovery, we do not foresee a return to pre-pandemic conditions in the short term. Volatility is likely to remain elevated given the volume of policy stimulus and the market's reaction: on the one side, fiscal and monetary measures are being employed to stimulate the economy, stoking growth expectations; on the other, some market participants fear that such actions increase the risk of inflation. As explained in our lead commentary, we believe that the spectre of inflation is unlikely to arise anytime soon. However, with many investors uncertain in this regard, volatility is likely to continue at higher levels than in recent years. In the corporate credit space, we are focused on which sectors and companies are emerging from the pandemic with the strongest prospects.

In terms of COVID-damaged sectors, it's important to differentiate between businesses which are equipped to survive in the long term and those which are essentially being kept on life support. We are cautious on issuers in segments that are likely to be impacted longer term such as air travel. However, we see possible opportunities for names with solid liquidity such as cruise operators who have a clear catalyst or pathway to recovery as soon as conditions allow. Above all, we favour those companies with strong fundamentals and sustainable business models that are equipped to thrive in a new, greener world.

We see corporate bonds with a BB rating (along with selected bonds rated B) as the sweet-spot for risk-adjusted returns. BBB-rated bonds remain attractive as well, but look less appealing versus high-yield corporate bonds. We like green and sustainability-linked bonds generally and think these issuance programmes may accelerate in the foreseeable future.

As a final note, in general we expect issuers' financial policy to remain bondholder friendly, however, given the generally buoyant mood, M&A and share-buyback risks are increasing, especially in COVID-immune sectors.

EMs: robust in the face of US rates volatility?

Vincent Megard
Senior Portfolio Manager

1. Fundamentals and macro

In the context of higher US rates volatility, headwinds to the emerging market growth dynamic have risen. However, we believe that many EM countries are well-equipped to withstand some volatility. The starting point for EM policy rates is extremely low, and inflation seems fairly contained so far. EM countries are net beneficiaries of the continued normalisation in global trade, with world trade indices showing a clear rebound. Strong commodities prices are also supportive for a large number of EM countries.

As with developed countries, the balance sheets of EM countries have deteriorated over the last year due to the shock in growth and the need to support populations through social spending. Debt-to-GDP ratios will take time to heal but healthy current account balances and resilient FX reserves reduce the risk of capital flight.

EM countries face heightened downside risk from a potential resurgence in COVID-19, since most are reliant on geopolitical relationships for vaccines and are unlikely to reach herd immunity before the end of 2021. In addition, many EM countries are in the southern hemisphere and are about to head into winter. However, better understanding of how to treat and contain COVID-19 means the impact should be less serious than last year, and the generally younger populations of EM countries are less vulnerable to the disease than those in the developed world.

Of course, it's important to remember that EM is a very broad universe. The most robust countries – including China, Thailand, Malaysia, Russia, Israel, the UAE and most of the Gulf Cooperation Council states – have no strong dependence on external financing and are seeing non-inflationary growth. Others, like Mexico, India, Hungary and Chile are sound but vulnerable with mixed sets of fundamentals, reforms and political dynamics. Finally, there are the weaker economies like Argentina, Brazil and South Africa, where structural reform is needed and the road to economic health is a longer one. In the latter category, the recent reversal of policy in Turkey following the removal of the central bank's third governor in two years caused a strong reaction in the markets. However, the crisis is an idiosyncratic one and seems unlikely to impact the rest of the EM universe.

2. Sentiment

On the positive side, supportive monetary policy in developed markets creates a hunt for yield which inevitably benefits EM. As a result, demand growth has been largely solid for both local and hard currency shorter duration EM bonds.

On the negative side, rising US borrowing costs are bringing back fears of the 2013 taper tantrum and causing some anxiety in the markets: flows in EM bond funds posted a negative week in March after a 20-week uninterrupted positive period. Local currency bonds have been the most affected market segment – a trend we expect to continue to some extent. However, we see this as necessary for a normalisation of rates, which will be a strength for the markets rather than a vulnerability.

That said, in our view the sell-off in emerging markets FX has been unwarranted. Many emerging economies are in better shape than they were in 2013, with stronger current accounts and better reserves. Commodity prices are up, which is positive for many (though not all) EM economies. And while we are entering a period of reflation, the 2013 taper tantrum occurred in a situation where reflation had already happened: in the current scenario EM markets should be more resilient.

With China at the vanguard of the global recovery, the inclusion of Chinese bonds into major global indices and the improved access offered by Bond Connect has been welcomed by foreign investors. The result has been a marked acceleration in foreign inflows into Chinese bonds.

3. Technicals

Extremely dovish monetary policy in developed markets favours the hunt for yield, which is a structural support for EM debt. EM central banks have deployed significant stimulus in the wake of COVID-19, but the increase in bond supply from EM sovereigns seeking to finance their post-pandemic recoveries has mostly been matched by good levels of demand from both domestic and foreign investors. While the easing cycle is now almost over, growing deficits will still require additional funding.

Despite healthy inflows, foreign ownership of Chinese bonds remains low at about 4% of the market: we see room for this to increase to as much as 15% in the long run. China makes a lot of sense as a diversifying asset class in fixed income and with the Bond Connect platform providing much improved access, asset allocators are increasing the weight of Chinese bonds in their allocations. Their current focus is on sovereign bonds and policy banks, which comprise about 55% of the total market. The remaining 45% of the market consists of financial institutions and other corporates (mainly state-owned enterprises), which are too risky for most foreign investors, particularly with the Chinese government in a tightening mood and prepared to allow defaults among the weakest state-owned enterprises.

4. Valuation

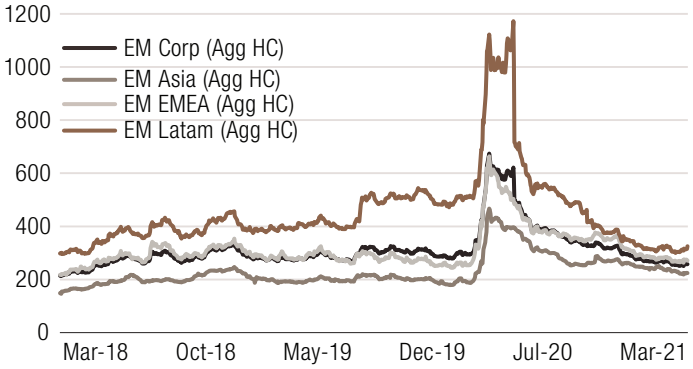
Even after the strong rally of the past few months, in our view EM hard currency bonds still present opportunities for carry in the current near-zero rates environment.

For EM local currency bonds, nominal and real yields remain attractive versus developed market bonds, although below pre-pandemic 2016-2017 levels. However, the favourable real yield differential over the US is diminishing as EM local curves are being replaced in line with US Treasuries, and even increasing versus other developed markets, which are repricing more slowly.

FX carry has increased markedly but remains low in historical terms. EM currencies remain cheap in real effective exchange rate terms, with recent weakness increasing their attractiveness.

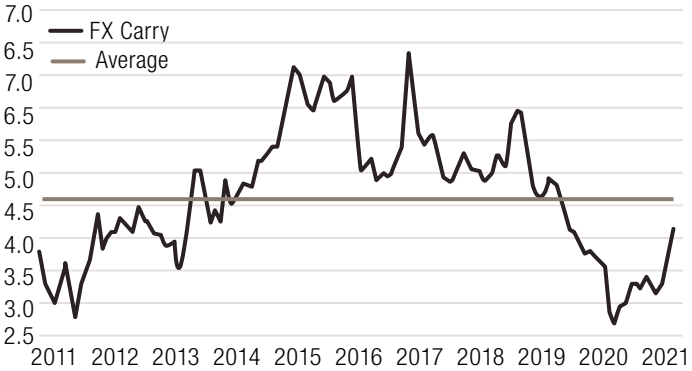
It's worth noting that Chinese rates have a low historical correlation with developed market rates, making them a useful diversification strategy.

FIG. 8 CARRY REMAINS ON OFFER IN EM HARD CURRENCY BONDS



Source: Bloomberg as at March 2021.

FIG. 9 CARRY ON EM LOCAL CURRENCY BONDS HAS RISEN, BUT REMAINS BELOW ITS HISTORICAL AVERAGE



Source: Bloomberg as at March 2021.

5. Outlook

Despite the risks described above, we are entering a largely favourable period for EM. Global trade is increasing and growth is generally recovering in emerging markets. The reflation in developed markets is likely to boost EM, and strong commodity prices are also a support for many EM economies. Meanwhile China, the main importer of EM goods, is back on a strong growth trajectory.

On the downside, significant vaccine rollout is not likely to be in evidence for many EM countries until next year. Recovery from the economic impact of the pandemic is therefore likely to be slower than for their developed market cousins.

Normalisation of monetary policy is much needed to support local markets and is starting to happen: the first rate hikes have come from Brazil and Russia and others will follow. This is supportive of FX and as long as it isn't so brutal that it shocks growth. We see it as a good thing.

For the most part, though, central bank policies in developed markets will stay ultra-accommodative and will keep liquidity in the markets. Some tightening will inevitably come, but it should be gradual enough to maintain broadly accommodative financial conditions from a historical perspective throughout 2021.

However, with debts and deficits having increased due to the impact of the pandemic, fiscal sanity and discipline will be needed. For some countries, fiscal normalisation will be a challenge, and we expect this to be the main source of differentiation between EM countries going forward. Brazil is an example where fiscal reforms are needed, but with elections looming in 2022 the government seems unwilling to act.

Finally, with foreign investors searching for good quality yield in the current low-interest-rate environment, strategic demand for Chinese bonds will remain solid despite more prudent local sentiment towards bond markets.

Towards net zero: powering the energy transition

Ashton Parker
Head of Credit Reseach
and Portfolio Manager

Sustainability is integral to our investment approach at LOIM. We believe the global economy is inevitably transitioning towards a more sustainable model in which growth decouples from its negative social and environmental footprint. We are at a tipping point, and companies with strong, forward-looking management and the vision to understand and act on the growth opportunities generated by this transition will prosper. Our CLIC™ economic model defines the four key elements of this transition as Circular, Lean, Inclusive and Clean.

The shift to an economy with net-zero carbon emissions falls squarely within the Clean pillar of CLIC, and meeting the inherent challenges of achieving zero emissions alongside climate-change adaptation and resilience. Within the energy sector, falling costs are making renewable energy increasingly competitive without the need for subsidies, which is a crucial step towards a net-zero future. In the utilities sector, this means identifying issuers with defined carbon-reduction strategies who are making a clear commitment to renewables while effectively navigating the pitfalls of exposure to potential stranded assets as the energy transition takes hold.

Case study: Enel S.p.A[8]

Enel S.p.A (Enel) is an Italian multinational manufacturer and distributor of electricity and gas. Founded as the Italian state electricity board in 1962, it became a limited company in 1992. Active in more than 30 countries, Enel is ranked 87th in Fortune's Global 500 rankings[9] and is the second largest power company globally by revenue after the State Grid Corporation of China, with estimated revenues of around USD 90 billion in 2020.[10]

Enel's commitment to sustainability can be traced back to 2004, when it joined the United Nations Global Compact,[11] a voluntary initiative based on CEO commitments to implement universal sustainability principles. Over the last decade, the company has transformed itself from a predominantly coal-fired power-generating utility to a business with a future-focused strategy based primarily on renewables. For such a huge company, this pivot towards sustainability has represented an immense investment, both in terms of the capital expenditure required and the research, planning and logistical resource involved.

Enel now describes itself as a platform for 'Open Power': an approach combining sustainability with the best innovations.

An ice cube in a hot sector

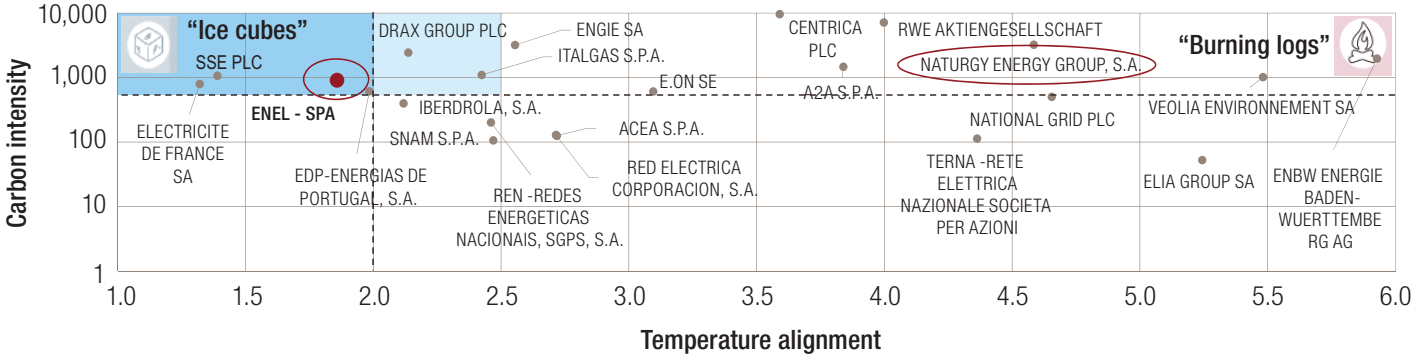
We favour companies with ambitious decarbonisation targets, and which regularly publish their performance against these goals. In our analysis, we seek a full picture of businesses' current and future carbon risk. We categorise companies based on their **direct and indirect emissions intensity** and their **temperature trajectories**: a measure of how any decarbonisation efforts they are undertaking will reduce their emissions in alignment with industry and national-level net-zero targets.

Enel is what we describe as an 'ice cube' – a decarbonising business committed to a low-temperature pathway in its transition from current high emissions. As a multinational utility business, the company's current Scope 1, 2 and 3 emissions[12] are relatively high at 792 but, importantly, the company has clear, ambitious and time-bound targets to reduce its emissions. It compares well to other companies in the energy sector – like Naturgy, a company we categorise as a 'burning log', which has not demonstrated any ambition to reduce its emissions of 3,039. Both companies operate in an industry whose progress on decarbonisation is essential to the climate transition, making Enel's temperature trajectory all the more important.

Having reduced its reliance on coal to 7% of capacity by 2020, Enel is now seeking to cease use of coal for power generation by 2027. At 1.5°C, its targeted temperature trajectory matches the lower end of the 1.5-2°C target specified in the Paris Agreement, while its CO_2 emissions-reduction target is an impressive 80% by 2030 (down to 82 gCO_2 equivalent per kilowatt hour). By the same date, it aims to have a renewable-energy generating capacity of 145 gigawatts. These are significant stepping stones which underline the company's commitment to helping achieve the minimum temperature goal of the Paris Agreement, while pursuing efforts towards 1.5°C. Its actual performance to date is aligning with this target, resulting in a current a trajectory of 1.7°C.[13]

[8] Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.
[9] Source: Fortune Global 500, accessed 26 March 2021.
[10] Source: Power Technology, accessed 26 March 2021.
[11] Source: UN Global Compact, accessed 26 March 2021.
[12] For more information visit https://ghgprotocol.org. The Greenhouse Gas Protocol defines Scope 1 emissions as direct emissions from company facilities and vehicles; Scope 2 emissions as indirect emissions related to purchased electricity, steam, heating and cooling used in company activities; and Scope 3 emissions as indirect emissions resulting from a company's supply chain.
[13] Source: LOIM analysis, Bloomberg PORT and company data as at 29 January 2021. Temperature trajectories are calculated through LOPTA and our methodology is available upon request.

FIG. 10 UTILITIES COMPANIES: CURRENT CARBON INTENSITIES AND TEMPERATURE TRAJECTORIES



Source: LOIM analysis as at March 2021. Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities.

A truly green funding model

Sustainability-focused fixed-income investing continues to evolve. Increasingly structured standards, labelling, verification and certification are contributing to ever-greater integrity and a rapidly maturing market. Principles and guidelines set down by organisations like the Climate Bonds Initiative and the International Capital Market Association are constantly evolving and ensuring more transparent and specific labelling. At the same time, second-party opinion providers such as Sustainalytics, the Carbon Trust and Cicero Shades of Green provide objective verification and make it possible to map bond issues against specific Sustainable Development Goals (SDGs).

Currently the sustainable fixed-income investment landscape comprises a variety of bonds, which fall into two main types:

1. **Labelled use of proceeds:** Some sustainability-themed bonds, such as green bonds, fall into the category of having specifically labelled use of proceeds, so that the money raised can only be used for capital expenditure which will address that usage (in the case of green bonds, these are activities with an environmental goal).
2. **General corporate purposes:** Other bonds in the theme fall into the category of being for general corporate purposes, of which sustainability-linked bonds are an example. They are connected with a sustainability or transition strategy with set material impact metrics: if the company fails to hit target metrics, the coupon steps up.

Enel was among the first utilities companies to issue both green bonds (in September 2017) and sustainability-linked bonds (in October 2019). The latter are particularly interesting from a sustainable investing standpoint as the investment is integrally linked to the strategy of the company as a whole, rather than an individual project. Enel has now committed to only issuing sustainability-linked bonds.

ESG commitment and performance

In appraising companies for a sustainability-focused investment strategy, we seek evidence that management pay structures reward a sustainable approach, along with strong environmental, social and governance (ESG) scores. These indicate the sustainability of the company not just at an environmental level but in terms of its approach to its people, its customers and wider society, along with the manner in which it is run. In a generally high-scoring sector, Enel is a model corporate citizen with a rating of A+.[15]

Credit ratings

Credit ratings are determined by a combination of business risk and financial metrics. Essentially, as an issuer's business profile strengthens, rating agencies permit weaker financial metrics for each rating. In terms of its credit rating, Enel has been able largely to avoid the 'rating taint' inevitably suffered by some Italian companies given the not-infrequent challenges of the sovereign. S&P recently identified Enel among five utility companies it labelled 'energy transition leaders', affirming its rating accordingly. S&P cited these companies' solid asset bases, robust and defensive investment pipelines and strong positioning to benefit from energy transition policies in Europe.

Investment view

We have a similar view to S&P and consider that Enel offers some value for what is a favoured name, particularly through its hybrid bonds, which offer a higher yield than its senior bonds. Indicative spreads of 50bps on its five-year credit-default swap (CDS) are similar to more carbon-intensive competitors with a much higher temperature pathway, such as the aforementioned Naturgy, whose five-year CDS has a spread of 47bps.

[14] Please note that the corporate hybrid bond recently issued by Enel is neither a green bond or a sustainability-linked bond – this is because the structural features of a corporate hybrid bond preclude a target-driven coupon step such as one linked to sustainability goals. Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities.

[15] Ratings may vary without notice.

IMPORTANT INFORMATION