LOMBARD ODIER
INVESTMENT MANAGERS

Alphorum

Alpha-seeking perspectives on global fixed income

For professional investor use only • Fixed Income

Q4 2024

Key points

- **Portfolio positioning.** As the cutting cycle begins and Federal Reserve policy becomes accommodative, we believe investment-grade credit offers the optimal combination of duration and credit risk. Meanwhile, inflation-linked sovereign bonds provide a useful tactical hedge, given the potential for volatility in the wake of the US elections. **See p.02**
- **Sovereigns: constructive but defensive.** Developed market sovereign debt is becoming even more attractive as falling policy rates reduce the appeal of money markets. However, we maintain a neutral stance on emerging market sovereigns, which offer attractive carry but look expensive compared to historically low US yields. **See p.06**
- **Time to get real.** Real estate bond prices fell significantly as rates rose, with investors spooked by weakening financial metrics, widening spreads, liquidity concerns and ratings downgrades. Interest cover remains a concern for weaker names, but the bonds of quality firms have recovered strongly – and should now tighten further. **See p.08**
- **Cuts, credit, correlation and curves.** Our analysis of 13 past cutting cycles shows a consistent negative rate-credit correlation that favours the balance of credit and duration at the upper end of high yield. Meanwhile, despite consistent curve steepening across past cycles, current market pricing limits the value of rate-curve 'steepener' trades. **See p.12**
- **Investors and the 'finance COP'.** COP29 is expected to focus strongly on the key issue of how to effectively finance the climate transition through scaling up all funding sources, including public, private, development and concessional finance. We believe greater policy certainty is essential to facilitate the private sector's contribution. **See p.10**

Contents

In our monthly Forum, 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.

LEAD COMMENTARY
Ease-y does it: positioning for the rate-cutting cycle

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Key takeaways

- We believe the Federal Reserve's decisive September rate cut reduces the risk of the bank appearing to be behind the curve later and accelerates the possibility of a soft landing – an outcome supported by analysis of past cycles
- However, the 'quality' of the US economy's slowdown remains unclear, and the normalisation process is rarely linear; we think investors should be pragmatic and entertain the possibility of some pullbacks along the way
- At this point in the cycle, we believe investment grade credit offers the optimal combination of duration risk and credit risk, while inflation-linked sovereign bonds provide a useful tactical hedge ahead of upcoming US elections

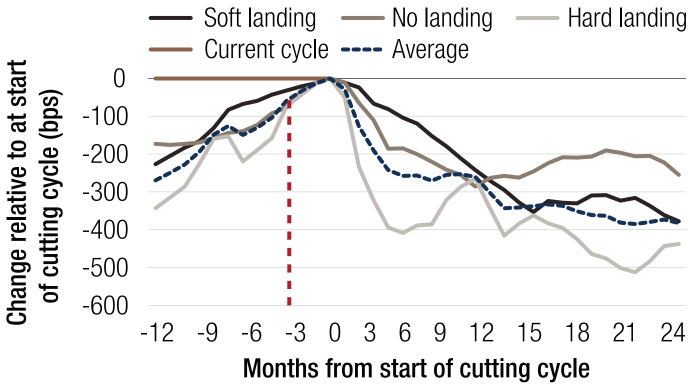
With the US Federal Reserve (Fed) fulfilling widely held expectations of an end to tightening by announcing a decisive 0.5% rate cut at its September meeting, all the major developed market central banks (ex-Japan) have now started their easing cycles. The Fed has been quite aggressive in its efforts to change the narrative towards a dovish view over the course of 2024, a strategy that should effectively reduce the tail risk of a hard landing. But will the much hoped for soft landing materialise, and how should fixed income investors position themselves through the rate cutting cycle?

Learning from the past

While there are of course no guarantees that past patterns will repeat, looking at how markets behaved in previous cycles provides a useful framework within which to seek insights regarding where markets may be headed. We conducted some research into changes in the Fed policy rate around past cutting cycles, along with the behaviour of a range of key indicators, to gain some insight into what to expect in the current cycle.

Our analysis shows that easing cycles have led to the Fed cutting rates by approximately 350 bps on average over the first 12 months (see Figure 1). Over the same period, 10-year Treasury bonds have fallen by 70 bps on average, and the one-year-10-year (1y10y) yield curve has steepened by an average of 180 bps. We think it likely that, as has generally happened in the past, as rates move lower, long-term yields will come down and the yield curve will steepen. The extent of the move, however, will depend on the type of landing that plays out: the harder the landing, the lower rates will go and the steeper the curve will get.

FIG 1. CHANGES IN THE US EFFECTIVE FED FUNDS RATE (EFFR) AROUND CURRENT AND PAST CUTTING CYCLES, BY OUTCOME

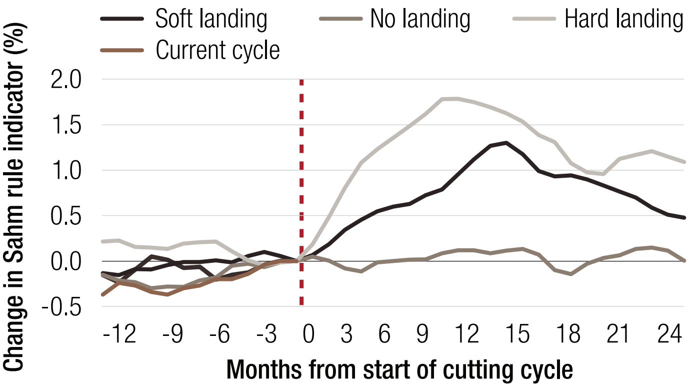


Source: Bloomberg, Lombard Odier IM Calculations. As at 19 September 2024. For illustrative purposes only. For the current cycle, cuts are assumed to begin in September with metrics at levels as at 20 August 2024. "Landing type" is allocated based on severity of recession as follows – No landing: 1967, 1986; Soft landing: 1960, 1971, 1992, 2003; Hard landing: 1954, 1958, 1976, 1980, 1982, 2008. 2022 cutting cycle excluded due to Covid interruption.

Other key metrics, from activity indicators to labour market figures, are also tracking a soft landing. One example is the Sahm Rule recession indicator, a heuristic Federal Reserve Economic Data (FRED) measure that, rather than being a lagging indicator, aims to determine whether an economy has entered a recession in real time. It does this by comparing the three-month moving average of the national unemployment rate relative to its low during the previous 12 months – when this measure rises above 0.5%, it is seen as signalling the start of a recession. Figure 2 shows the percentage change in the Sahm Rule indicator around past cutting cycles, making it possible to immediately distinguish the difference in trajectory between hard-, soft- and no-landing scenarios, with the sharp deterioration under both hard and soft landings clearly visible (as you can see, up to the start of the September rate cut, in this cycle the Sahm Rule indicator has actually been tracking closely with the same metric during past 'no landing' events). However, we should be careful not to extrapolate from the past; the future evolution of such metrics needs to be monitored closely to understand the situation as it develops.

Of course, another lesson from the past is that the normalisation process is never linear. The extent and nature of the deterioration taking place in the labour market could determine the type of

FIG 2. CHANGES IN THE SAHM RULE INDICATOR AROUND CURRENT AND PAST CUTTING CYCLES, BY OUTCOME



Source: Bloomberg, Lombard Odier IM Calculations. As at 19 September 2024. For illustrative purposes only. For the current cycle, cuts are assumed to begin in September with metrics at levels as at 20 August 2024. “Landing type” is allocated based on severity of recession as follows – No landing: 1967, 1986; Soft landing: 1960, 1971, 1992, 2003; Hard landing: 1954, 1958, 1976, 1980, 1982, 2008. 2022 cutting cycle excluded due to Covid interruption.

landing that transpires, as well as the associated policy response. This may well create cycles within the general downward shift in rates, with markets pricing in bigger cuts than the Fed chooses to make. As active bond investors we welcome this sort of volatility, since it gives us the opportunity to make calls that generate returns.

Sleight of hand from the Fed?

In our view the Fed’s decision to start easing with a 50 bps move showed sound judgement. While 25 bps steps may have been more usual in the past, we are in a different environment today; with policy the furthest away from neutral in a long time, a big step is appropriate. Furthermore, with the market already pricing a 50-bps cut, the Fed’s decisive move reduces the risk of appearing to be behind the curve later and accelerates the possibility of a soft landing.

The Fed is now attempting to manage the full-employment aspect of its dual mandate; with wages starting to come down, the move from tightening to easing was a natural one. At the same time, with most market participants putting a neutral rate in the 3-3.5% range (which broadly aligns with our view), starting with a decisive move lower delivers a clear message. It also gives the Fed some flexibility, making 25 bps or 50 bps cuts, or even no cut, viable options at the next meeting. In contrast, increasing the pace at the next meeting in November, just days after a presidential election result, is not a message the central bank would want to convey to markets.

Meanwhile, sometimes things in the background left unmentioned can be just as important as official actions and guidance. Over the past nine months, the median of Fed officials’ long-run projections for rates (which while not official bank policy, are widely interpreted by the market as its expected neutral rate) have gradually edged upwards from 2.5% to 2.9% – the highest projection in six years. In theory, if the Fed succeeds in engineering a soft landing, rates will need to be brought to neutral. However, it’s important to remember that what constitutes a neutral rate is unobservable and so open to debate – note the difference between the Fed’s projections and the neutral rate of 3-3.5% estimated by the market.

A slowdown, but how fast?

With the slowing of the US economy no longer reasonably in doubt, markets are pricing in a relatively smooth and rapid normalisation of interest rates. However, we would qualify expectations by noting that there are still some question marks concerning the ‘quality’ of the slowdown.

August saw a relatively weak labour market report, with non-farm payroll figures coming down quite substantially. However, it’s worth noting that the increase in the unemployment rate was largely driven by temporary layoffs, making it a less decisive signal of a weakening economy, and these figures were possibly distorted by the weather. In fact, stronger market data published in October, both in terms of non-farm payrolls and the unemployment rate, suggests that weakening is not as marked as the data published in early August suggested.

Meanwhile, positive net immigration is another mitigating factor, as it means that more jobs need to be created to keep the unemployment rate from increasing. It’s worth bearing in mind that non-farm payroll figures show the US economy is still creating a significant number of jobs every month, with 254,000 added in September compared to a three-month average of 186,000 and a 12-month average of 203,000. That suggests that the labour market remains pretty resilient, pointing towards a soft-landing scenario. Ultimately, however, as in past cycles, whether there is a hard or soft landing (or no landing at all) may depend on how fast and how sharply the labour market deteriorates.

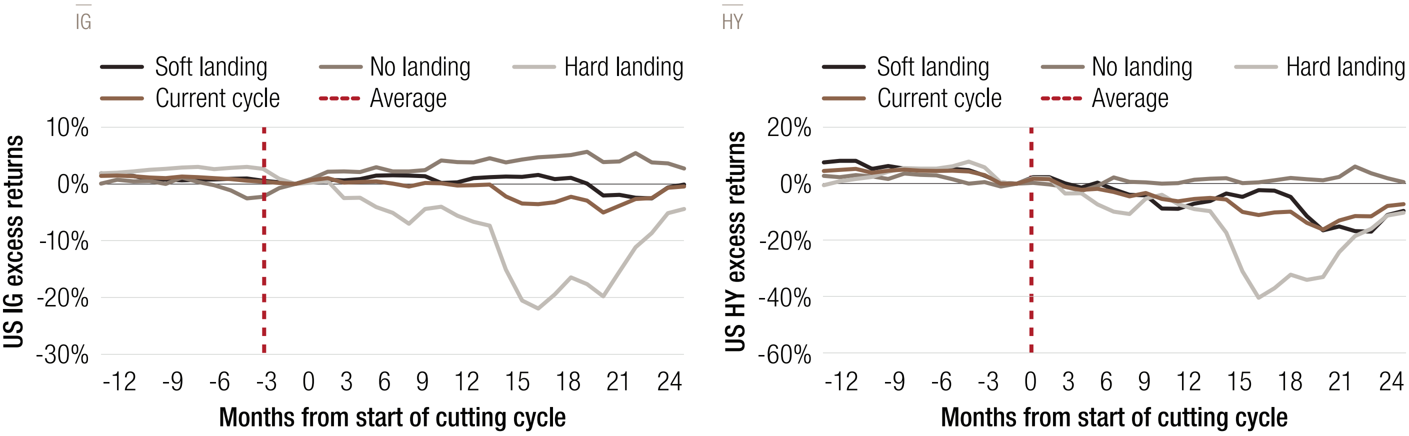
Positioning for the rate-cutting cycle

For those with a relatively short-term investment horizon, cash has been hard to beat in recent years. However, as policy rates come down and curves ‘dis-invert’, investors need to put their money to work. As curves normalise, a high-quality bond portfolio – encompassing sovereign debt, investment grade credit and potentially even some good quality high yield credit – offers a strong alternative to cash.

Overall, we are very positive regarding the road ahead for fixed income, particularly in light of the expectation of a soft-landing scenario. But with a lot already priced into the market, we believe investors should be pragmatic and entertain the possibility of some pullbacks along the way. Any fixed income asset essentially offers a mix of credit risk and duration risk; at this point in the cycle, we believe investment grade credit offers the optimal combination of these two components, offering a little more duration risk and less credit risk than high yield.

As you can see from Figure 3 below, investment grade credit has delivered positive excess returns in soft-landing and no-landing scenarios (but negative excess returns in the case of hard landings). In contrast, high yield underperforms on average, only outperforming when there is no landing.

FIG 3. EXCESS RETURNS FOR FIXED INCOME ASSETS AROUND CURRENT AND PAST CUTTING CYCLES, BY OUTCOME



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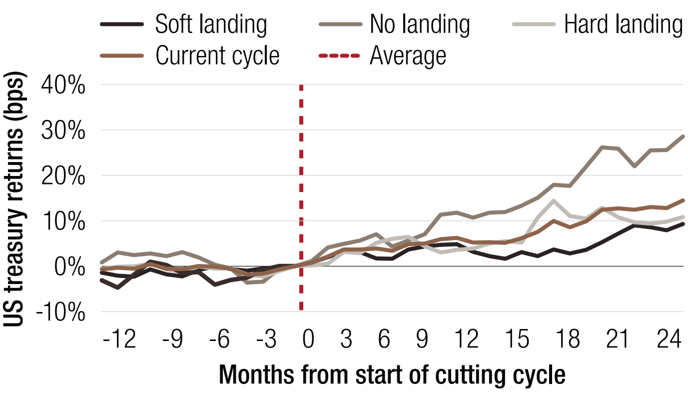
In sovereign bond markets, expected returns can be split into two components: the yield in terms of the income return or carry, and the move in terms of mark-to-market adjustments to the bond curve. Curves tend to move lower as central banks cut rates; however, the long end of the curve can be less sensitive. A proactive Fed increases the chance of a soft landing, lowering the chance of a recession that would reduce both economic activity and inflation. This would benefit the front-to-middle of the curve, as the yield curve steepens.

FIG 4. TOTAL US RETURNS ABOVE CASH FOR US TREASURIES AROUND CURRENT AND PAST CUTTING CYCLES, BY OUTCOME



Source: Bloomberg, Lombard Odier IM Calculations. As at 19 September 2024. For illustrative purposes only. For the current cycle, cuts are assumed to begin in September with metrics at levels as at 20 August 2024. “Landing type” is allocated based on severity of recession as follows – No landing: 1967, 1986; Soft landing: 1960, 1971, 1992, 2003; Hard landing: 1954, 1958, 1976, 1980, 1982, 2008. 2022 cutting cycle excluded due to Covid interruption. Past performance is not a reliable guarantee of future results.

As you can see in Figure 4, in the past US Treasury bonds have delivered average outperformance of around 5% over cash in the 12 months from the start of past cutting cycles, as lower yields boost their return through the duration effect.

Hedge your bets

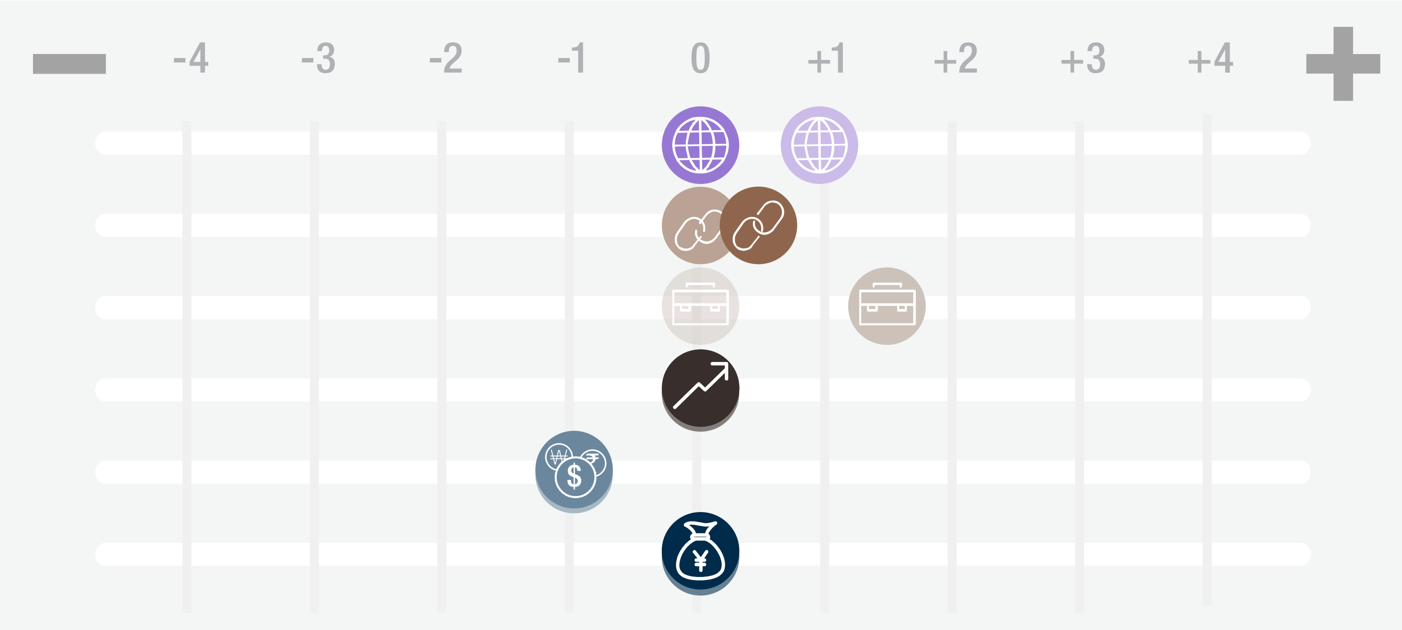
With the Fed increasingly focused on emerging signs of weakening in labour markets to address the full-employment aspect of its dual mandate, there is a risk it may lower its guard on inflation, tending towards being more accommodative than restrictive. This increases the chances of a repricing on an inflation risk premium ahead of the US elections if the economy continues to be resilient.

Aside from potential volatility in the event of a disputed result, both presidential candidates have announced policies that would be likely to prove inflationary – particularly Trump with his more confrontational stance on global trade. On the other hand, either candidate may see their scope for action limited once in office if they cannot count on a majority in Congress to support the adoption of their policies.

At a tactical level, we have therefore increased our exposure to inflation-linked bonds as a portfolio hedge ahead of November. As this move has been financed through a reduction in cash, it ultimately results in an increase in duration through real yields, which still offer value in the US.

Meanwhile, on the credit side, being overweight investment grade rather than high yield credit reduces risk in the event that a soft landing fails to materialise, while at the same time preserving carry and benefiting from a balanced diversification between rates and credit risks.

CONVICTIONS SCORECARD



1 DM SOVEREIGN

As central banks embark on rate cutting cycles, duration remains appealing. But with macroeconomic data strong, especially in the US, we see scope for volatility ahead.

0.5 INFLATION-LINKED

Hedges against residual inflationary pressures and the potential for higher US tariffs have been available at attractive valuations recently.

0 CORPORATE IG

An attractively balanced mix of credit and rate risk, combined with elevated all-in yields and improved sentiment, are particularly supportive of IG.

0 CORPORATE HY

All-in yields remain attractive ahead as the rate-cutting cycle gets underway, particularly among higher quality issues. These are countered by tight spreads and idiosyncratic financing pressures.

-1 EM HARD CURRENCY

We favour corporates over sovereigns, given the better diversification, quality and yields on offer.

0 EM LOCAL CURRENCY

Yields are high, but the yield premium relative to US debt appears tight. We have a neutral outlook for EM currencies.

Source: LOIM at 30 September 2024.

SOVEREIGN & INFLATION-LINKED BONDS
Positioned for easing and residual inflation risk

Nic Hoogewijs, CFA
Senior Portfolio Manager

Key takeaways

- Renewed vigour in the Democrats' US election campaign improved bond market sentiment in July, before a Japanese rate hike and an unexpected rise in the US unemployment rate triggered volatility in early August
- By the end of Q3, however, the Fed's decisive 50bps rate cut in the wake of tame inflation reports had set the scene for a soft landing, and the US yield curve reacted accordingly by coming out of its inverted state and steepening
- We remain constructive on sovereign fixed income, particularly as falling policy rates reduce the appeal of money markets, but we prefer to hedge residual inflation risk with exposure to interest-linked sovereign bonds

Fundamentals and macro

The third quarter of 2024 was another eventful period for sovereign bond markets. As the summer began, Donald Trump looked like the clear favourite to win the US presidential race – an eventuality that, based on announced policies, would be inflationary and not constructive for fixed income. At the same time, the latest Congressional Budget Office outlook raised US deficit projections for the coming years.

Taken together, these factors gave us the tactical opportunity to tweak our constructive stance on duration. We moved to a moderate overweight exposure on inflation-linked bonds alongside nominal bonds (which we usually prefer for their higher beta), as a portfolio diversifier for inflation risk. Subsequently, the entrance of Kamala Harris into the race in July was supportive for bonds, and yields started to come off.

Two main factors caused market volatility to spike at the beginning of August. First, the somewhat unexpected timing of the Bank of Japan's rate hike on 31 July triggered an unwind of carry trades, with the yen extending its dramatic rally versus the US dollar that had started in early July. Second, July's US labour market report showed an unexpected rise in the unemployment rate, lifting its three-month average more than 0.5% above the prior 12-month low of 3.5% – an indicator widely seen as a precursor to recession. Short-term interest rates tumbled on the news, as investors speculated the Fed might be behind the curve.

At the Jackson Hole Economic Symposium in August, Chair Jerome Powell signalled a shift in focus by the Federal Open Market Committee (FOMC) to the labour-market aspect of its dual mandate. Surprisingly persistent price pressures at the beginning of the year had given way to a series of tame monthly inflation reports, supported by a deceleration in increases in prices for services. Considering the Taylor Rule,[1] the path to easing was clear and Powell all but confirmed a rate cut in September. By the end of the month, the nervousness in risk assets had largely ebbed away, but expectations of a reduction in Fed rates was very much priced into the market, with the debate turning to whether the cut would be 25 bps or 50 bps. The final decision to cut by 50 bps underscored the central bank's commitment to its maximum employment objective.

As discussed in our lead article, we view the Fed's move through a risk management prism. This is because the September projections showed the FOMC continues to expect a soft landing, with the economy to expand at approximately trend pace in the coming quarters. In the wake of the announcement, we took the opportunity to close some of our tactical positions.

For emerging markets (EMs), the global normalisation of economic cycles has improved the scenario for sovereign debt. Having begun tightening sooner, most emerging economies have inflation under control and commodity prices are supportive.

Sentiment

With investors keen to lock in still-attractive yields, sovereign fixed income markets recovered from a lacklustre H1 to post solid performance in Q3. With data indicating moderating activity in most regions, central banks undertook easing. Notably, the Bank of England (BoE) started to recalibrate policy with its first rate cut in August, while the European Central Bank delivered a second 25 bps rate cut in September (and a third in October, as *Alphorum* went to press).

In H1 2024, elevated carry was still outweighed by yields edging higher. However, as declining policy rates start to weigh on the appeal of money market instruments, fixed income is set to reap the benefit. In Q3, the sharp move lower in yields led by the front end of the US curve lifted the year-to-date performance of the Bloomberg Global Treasury Index (EUR Hedged) out of the red to the tune of 2.5%. In EMs, however, investor sentiment has remained weak, with the significant outflows since 2022 not yet showing strong signs of reversing.

[1] The Taylor Rule is an interest rate formula; it implies the Fed should lower rates either when inflation is below target or when output growth is below potential.

Technicals

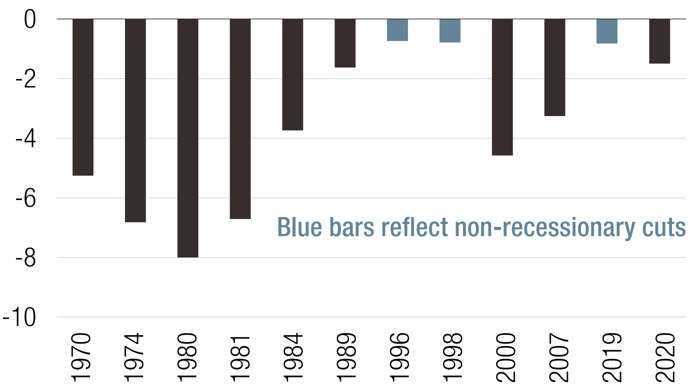
With the attractiveness of money market rates set to diminish, investors have piled into fixed income. At the end of August, J.P. Morgan estimated robust year-to-date global bond fund inflows of USD 868 billion.[2] However, the dramatic steepening of yield curves during Q3 2024 points to a preference for shorter duration assets.

Fundamental factors, including the Fed's decisive rate decision and the likelihood of ongoing elevated net bond supply net of quantitative tightening (QT) – given the lack of political appetite in the US to address fiscal largesse – support the case for steep yield curves to persist. We would caveat, however, that QT is likely to become less of a headwind for fixed income investors going forward. The BoE announced QT will be kept at GBP100 bn over the coming 12 months, implying a sharp fall in active bond purchasing, and we expect the Fed may also start to slow its balance-sheet drawdown once bank reserves start to fall – possibly as soon as early next year. In EMs, meanwhile, bond supply has returned to normal levels after very low issuance in the past few years.

Valuations

Since the summer rally, valuations have been less compelling. As we write this, the front end of the US yield curve prices in a drop in the effective federal funds rate (EFFR) from its peak of 5.25-5.5% down to 3% by the end of 2025. Looking back over past market events, Fed rate cuts in excess of 200 bps in the first 12 months of an easing cycle typically only occur during recessions (see Figure 5). In the context of a resilient growth outlook, current front-end pricing appears somewhat rich (the Atlanta Fed's GDPNow forecasting model puts GDP growth at around a healthy 3.2%).

FIG 5. HISTORICAL 12-MONTH CHANGE IN THE EFFECTIVE FED FUNDS RATE (EFFR) FROM THE START OF PAST CUTTING CYCLES



Source: LOIM, Bloomberg at 30 September 2024. For illustrative purposes only.

Long-end rates rallied less, with the yield curve even steepening in a bearish fashion following the Fed's September rate cut – in sharp contrast to the bullish flattening that was dominant during the summer. Indeed, the proactive stance of the FOMC could prolong the expansion and support higher yields further out on the curve, as well as higher inflation expectations. Still, for investors with a longer investment horizon, interest rates remain attractive from a historical perspective – and it could be argued that the long end of the US curve is somewhat cheap.

The Fed's decisive start to the easing cycle is supportive of and opens up room for additional easing for some EM central banks. Their sovereigns offer attractive carry, but spread premiums look expensive compared to historically low US yields. Meanwhile, EM FX has been underperforming the major G10 currencies this year.

Outlook

Looking ahead, major developed-market central banks should have room to deliver a series of rate cuts over the coming quarters. However, while almost all central banks are now easing, monetary policy remains highly data dependent and regionally specific. In the US, inflation has started to normalise quite suddenly, and its path will need to be confirmed to validate current front-end market pricing. For other regions, the inflation story is less clear cut. In Europe, services inflation remains elevated and is likely to keep central banks on a gradual easing path to maintain policy flexibility. Meanwhile, the existence of tight financial conditions (stemming from monetary policy) but easy conditions (reflected in equity pricing and credit spreads) are something of an anomaly.

Despite these reservations, with real yields for 10-year Treasury Inflation-Protected Securities (TIPS) trading above 1.5% at the time of writing, we continue to see merit for medium-to-long-term investors in locking in current yields with longer durations – particularly as money market rates are set to fall over the coming quarters.

Investors should, however, keep in mind that the US elections in November will be significant for inflation prospects and thus for bond markets, with a Republican 'red sweep' of the presidency and Congress the most bearish outcome due to Trump's proposed tariff increases and tax cuts. In a close contest, mixed polling in battleground states such as Georgia indicates the presidential race remains an extremely close call.

In this context we maintain a constructive stance for developed market debt, albeit with a slightly more defensive approach that incorporates inflation-linked bonds as a hedge against inflation risk. Meanwhile, for the reasons stated in the valuations section, we remain neutral on EM local and hard-currency debt.

[2] Panitgirtzoglou, N., et al. " Flows & Liquidity: What do markets expect ahead of the US jobs report?" Published by J.P. Morgan on 5 September 2024.

CORPORATE CREDIT
Time to get real

Ashton Parker
Head of Credit Research and
Senior Portfolio Manager

Key takeaways

- As rates rose, real estate bond prices fell, driven by weakening financial metrics, widening spreads, liquidity concerns and ratings downgrades, and exacerbated by a sense of panic from investors
- Fortunately, most companies have survived, having hopefully learned a valuable lesson; with interest rates starting to come down, investors are now seeing value in the sector, and we expect spreads to normalise
- Quality firms have valuable assets and enjoy healthy liquidity, while high occupancy and secure rental income provides operational resilience; with rates falling, we see no reason why property bonds can't tighten again

Regular readers of *Alphorum* will know that we've been flagging the relative cheapness of bonds from quality companies in the real estate sector for some time now. With credit quality in the sector linked closely to property valuations, which in turn are essentially a function of interest rates, it's easy to understand why rising rates had a negative impact on the sector. This impact was exacerbated by the issuers lack of planning for when interest rates inevitably increased.

A further factor was perhaps the fact that many investors were not familiar with a rising rate environment. The resulting negative spiral of weakening financial metrics, increasing spreads, liquidity concerns and rating downgrades – despite a generally solid operational performance across residential, retail, commercial and even (non-US) office sectors – therefore caused them to panic. The good news is that with interest rates expected to fall, most companies have survived, but have hopefully learned a valuable lesson. Meanwhile, investors are now seeing value in the sector, and we expect spreads to normalise.

A short history of the real estate bond market

Until the late 2000s, property firms had a limited presence in fixed income, with deals mainly financed through bank loans. However, in the wake of the financial crisis, Banks were generally less willing (and able) to continue to provide long-term funding. With interest rates falling and bond investors desperate for carry, the fixed income market proved an attractive alternative source of finance. Fixed income bonds provided convenient access to funds relatively cheaply, and as debt was unsecured it reduced administrative costs while offering flexibility in terms of being able to buy and sell assets as required.

Many real estate companies started their bond issuance careers with a BB rating, mainly because they had large quantities of secured debt. Over time many have improved their rating to BBB, with two keys factors driving upgrades. Firstly, they have reduced their reliance on secured debt; and secondly, they have become bigger. In the latter respect, property companies share a similarity with banks, in that getting larger through takeovers, mergers or acquisitions is often ratings-positive for them because it enables diversification and creates a bigger asset base.

It's true to say that there has been an element of the 'magical balance sheet' involved in real estate over the past decade. With interest rates around zero, property valuations increased, which meant companies could borrow more while maintaining investment grade metrics based on loan to value (LTV) and interest cover. Many property companies took full advantage of this peculiarity in the rating agencies' approach. Of course, when rates began to rise, valuations fell, and therefore LTV declined. It became clear that many property firms had not planned strategically for this eventuality, and as a consequence many firms were downgraded, some to BB and below. However, while this was of concern, the market overreacted, with many real estate firms' bonds pricing in default-with-minimal-recovery scenarios – a somewhat unlikely eventuality given the solid asset base of the sector. In reality, relatively few firms have failed, and they have generally been smaller, lower-rated players with less attractive assets – and often some form of governance or accounting issue.

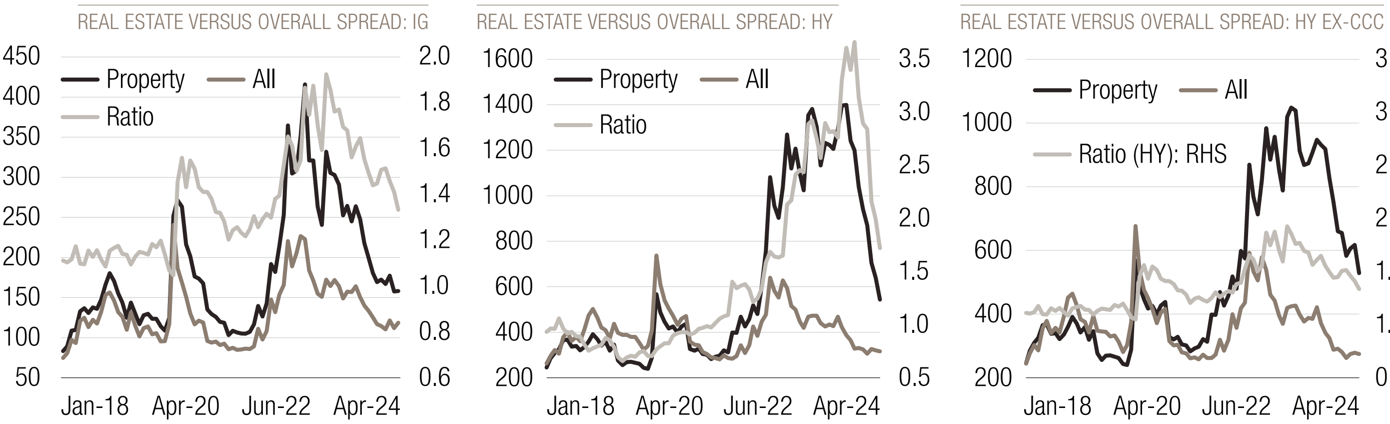
Constructive on property

With real estate bonds seen as risky in a rising rate environment, spreads relative to similarly rated bonds from issuers in other sectors widened considerably from the end of 2022 through 2023, particularly in high yield (see Figure 6). Our confidence in the sector and active research into individual names meant we were able to take advantage of this relative cheapness. This has paid off handsomely in 2024, with many bonds up over 20 points year to date, and we have taken some profit to crystallise returns.[3]

There are good reasons for the sector's strong recovery. Quality property companies have strong fundamentals. While high interest rates have affected valuations and credit ratings (leading to downgrades in some cases), firms have been able to sell assets,

[3] For illustrative purposes only. Past performance is not a guarantee of future returns.

FIG 6. SPREAD COMPARISONS: REAL ESTATE VERSUS IG, HY AND HY EX-CCC, JANUARY 2018 TO AUGUST 2024



Source: Bloomberg, LOIM calculation. As at 31 August 2024. We exclude spreads below 10bps and above 5000bsp. Past performance is not a guarantee of future results. Ratings may vary without notice. For illustrative purposes only.

raise equity or refinance in the bank secured debt market to maintain liquidity. Operations have remained robust, with occupancy generally above 90% (and often much higher), and rents have tended to rise with inflation. Despite this, their bonds have been delivering two-to-three times the returns of issuances by similarly rated companies in other sectors. In the fourth quarter of 2023, when it became clear interest rates had peaked, sentiment became more supportive, and some property companies were able to refinance in the bond market. This led to a strong recovery in pricing in Q4 2023 through to today.

As macroeconomic conditions start to ease, we are still constructive on the sector, as we see no reason why property bonds can't tighten again. With valuations having stabilised and now begun to improve as interest rates fall, asset managers are looking at the sector as a source of additional returns.

Interest cover is still a thing

In last quarter's *Alphorum*, we pointed to interest cover as a possible issue for credit markets, and this remains an ongoing theme. While policy rates for nearly every developed economy are starting to fall, firms are still having to refinance at far higher rates than they enjoyed when issuing the debt they are replacing. The need to cover this additional interest and the cost it entails means that companies are not yet out of the woods. More disposals may be in order, and further ratings downgrades are possible.

As we explained previously, real estate names tend to have a higher debt burden than companies in other sectors with a similar level of income, which makes them particularly susceptible to interest-cover-driven rating downgrades. However, they also have strong, high-quality assets and reliable income streams, making them operationally sound as well as resilient in a recovery situation (compare this to an IT services company that has very limited tangible assets and liquidity in a similar scenario). As a result, we see scope for further negative rating action within the sector driven by rating agency methodology around interest cover metrics; however, this is likely to be limited to a notch or two, which could move some issuers from investment grade to high yield and provide an opportunity for active investors to take advantage of any price overreaction.

Improving liquidity

As market sentiment improves, liquidity is becoming less of an issue for real estate firms. Good businesses have been able to access secured bank debt and issue bonds, often domestically, and there have been some buyers such as sovereign wealth funds, large property funds and even municipalities interested in buying property. Disposals are still progressing, but as valuations stabilise with interest rates, there is more confidence in the market. Finally in this respect, the pricing of assets, which has been an issue, should become less contentious.

Sustainability

A final point to note is that regulatory imperatives and market forces may mean sustainability becomes more important for the sector going forward. When tenants change buildings, they are more likely to opt for 'green' properties with a smaller carbon footprint to comply with their own corporate sustainability goals. That's likely to lead to property firms reviewing their portfolios to assess what assets are green enough, what can be made green and what is uneconomic to make sustainable. This could result in a potentially materially green building valuation premium, which analysts may need to consider. It could also be a driver of new green bond issuance across the sector.

Having said all that, real estate firms tend to have a high implied temperature rise score but a very low carbon investment ratio (essentially, the firm's emissions divided by its asset base). This means that currently, holding real estate has very little impact on the overall temperature of a portfolio. As a result, we are able to include property firms across our range of funds, including our TargetNetZero strategies.

SUSTAINABLE FIXED INCOME
Finance to take centre stage at COP29

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Key takeaways

- USD 1.8 trillion was invested into the clean energy sector in 2023. Despite this, financing enabling the climate transition is falling well short of the estimated USD 4.5 trillion needed annually by 2030
- COP29 is being billed as the 'finance COP'. In addition to the need to fund climate change adaptation, a key focus will be how to deliver the huge overall sums needed via public, private, development and concessional finance mechanisms
- To help align capital to the transition, policymakers need to forge strong public policy, sectoral transition plans, biodiversity strategies, climate disclosures and support for emerging markets and developing economies

The 29th Conference of the Parties of the United Nations Framework Convention on Climate Change, more commonly referred to as COP29, will take place in Baku, Azerbaijan from 11 to 22 November. Already dubbed the 'Finance COP' by many, negotiations at this year's summit will be critical to ensuring effective sources of finance are in place to address perennial adaptation and mitigation climate challenges.

Progress made since COP28

Progress since last year's event in Dubai has been mixed, with some positive developments alongside growing recognition that far more needs to be done to meet agreed global climate goals. A key commitment was the tripling of global renewable energy capacity by 2030. Last year, BloombergNEF found that a record USD 1.8 trillion of total investment was made to in clean energy. This demonstrated significant progress but fell well short of the estimated USD 4.5 trillion annually that the International Energy Agency reckons is needed by 2030 to stay on track for net-zero emissions by 2050.

By mid-century, our projections see electricity meeting half of total global energy demand – and 62% of that electricity will come from solar and wind. Solar generation demonstrating strong growth, with installations booming thanks to falling costs, policy ambition, supply-chain resilience, deployability, and the paired attributes of modularity and scalability. As a result, we expect a four-times increase in total global capacity between 2023 and 2030, to around 7,000 gigawatts.

Climate Week NYC 2024: key takeaways

Two key themes emerged from Climate Week 2024 in New York in late September, a gathering of senior figures from international business, government, civil society and the climate sector that is the largest of its kind globally.

1. **The increasing role of the private sector.** Organisations of all sizes acknowledged sustainability not just as desirable but as a business imperative. Firms showcased how they are turning corporate sustainability commitments into effective core strategies by reducing carbon emissions and addressing supply chain resilience, ahead of the introduction of carbon pricing and tariffs
2. **Bridging the finance gap.** The need to address the multi-trillion-dollar annual investment gap for clean energy was a recurring theme. Solutions like blended finance and public-private partnerships are urgently needed, especially in developing regions that face the greatest challenges. However, they will need to be supported by more robust public funding and policy

There was also plenty of interest in the potential of emerging technologies, such as green hydrogen. But experts across the transport, energy and industrial sectors emphasised the need to maintain a focus on solar and wind as affordable, scalable solutions.

Prioritising adaptation, securing finance

Adaptation was a focus of COP28, resulting in the launch of the 'loss and damage' fund. So far, developed countries have contributed USD 700 million to the compensation vehicle – a fraction of the estimated USD 160 billion to USD 340 billion needed each year for developing countries to cope with floods, droughts and other adverse impacts of climate change, according to the United Nations Environment Programme. As evidence of the impact of climate change grows, adaptation efforts will again be in the spotlight this year as stakeholders increasingly recognise the need to build resilience.

This is especially important given that the United Nations' global stocktake report, compiled ahead of COP28, saw broad agreement that action on climate change so far has been insufficient, with little evidence of an aggregate reductions in emissions. The Independent

High-Level Expert Group on Climate Finance has identified investment as the key issue to drive down emissions, recommending that financing is scaled up via four main sources:

1. **Public finance.** Delivering and expanding on domestic public financing commitments, with developed countries leading the way
2. **Private sector finance.** Providing transition financing via capital markets to help high-emitting and hard-to-abate sectors decarbonise; and removing regulatory uncertainty and making parameters for transition financing more flexible to facilitate this and address accusations of greenwashing
3. **Development finance.** Discounted lending from multilateral development banks (MDBs) to help vulnerable countries build climate resilience; reforms to international financing to enable developing countries to increase borrowing in the wake of severe climate events without risking a debt crisis; and a new mechanism to fund post-disaster reconstruction
4. **Concessional finance.** Recognising and addressing the need for non-debt financing via mechanisms including the International Development Association, as well as hybrid capital, policy-based guarantees, portfolio guarantees of MDB loans, global philanthropy, rechanneling of inefficient subsidies, and emissions pricing and taxation

It is clear that diverse sources of financing will need to be scaled and coordinated to combat climate challenges. As more capital is mobilised through the private sector, forward-looking investors will need to identify where these flows are going and align portfolios accordingly.

The imperative for long-term investors to align with the transition compelled us to launch our TargetNetZero investment-grade credit strategies in 2021. Through these strategies, we aim to manage diversified portfolios that fulfil investment objectives while investing in companies making material emissions reductions and therefore supporting the Paris Agreement. Rather than exclude hard-to-abate sectors, we take a long-term, forward-looking view, seeking decarbonisation leaders across all economic sectors making credible progress towards a world limiting global heating to less than 2˚C. Our transition approach combines investment analysis, to confirm these companies are fundamentally robust, with our proprietary implied temperature rise methodology to qualify them as 'ice cubes': businesses that might be high carbon today but are transitioning credibility and are therefore effectively cooling the economy.

Wanted: granular policy

We believe efforts to invest in the transition could strongly benefit from stronger, more granular policies for aligning finance with net zero. Lombard Odier Investment Managers is a signatory to the 2024 Global Investor Statement to Governments on the Climate Crisis, which calls for decisive action in five areas:

1. **Economy-wide public policies.** Nationally Determined Contributions (NDCs) for 2030 and 2050 should be aligned with the 1.5˚C objective. To facilitate this, countries should establish incentives to develop and deploy enabling technologies; robust, evolving carbon pricing; climate-resilient, net-zero government procurement to support economies of scale; and inclusive national adaptation planning and financing
2. **Sectoral transition plans, especially for high-emission sectors.** Governments should scale up the deployment of low-carbon energy systems, electrification, storage and infrastructure. Power sector reforms should encourage competition and facilitate renewable deployment; fossil-fuel subsidies should be replaced with incentives for clean energy and low-emission fuels; unabated fossil fuel use should be phased out; and non-CO_2 emissions, including methane should be reduced
3. **Nature, water and biodiversity.** Ambitious National Biodiversity Strategies and Action Plans should support countries' NDC targets. This is warranted as nature-based solutions – conservation and land management programmes that sequester carbon and cut emissions – can achieve 30% of the reductions needed by 2030. Governments should establish and deliver commitments to address water scarcity and pollution, and halt degradation of other ecosystems including forests; climate finance for nature-based and water solutions should be scaled up; and nature-related disclosures should be strengthened across the financial system
4. **Climate disclosures.** Public disclosure of science-based, independently verifiable climate transition plans aligned with 1.5˚C should be mandatory for listed and large non-listed companies, asset managers and asset owners. Climate risk disclosure in financial reporting should also be mandated
5. **Climate mitigation, adaptation and resilience.** Further investment should be mobilised to help emerging markets and developing economies (EMDEs) through credit enhancement programmes such as insurance, guarantees and other blended finance approaches, as well as via concessional finance. EMDEs should be offered technical assistance and capacity building support for project development and implementation

Transition lever

Private-sector finance, including investor capital, is one of many sources of funding that needs to be mobilised effectively for a successful net-zero transition. As decarbonisation becomes embedded in the business models of more firms across the global economy, investors have the opportunity to align their portfolios with this shift. Simultaneously, they will be helping to finance transitioning firms – complementing the public, development and concessional finance initiatives in focus at COP29 and beyond.

SYSTEMATIC RESEARCH
Cuts, credit, correlation and curves

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Key takeaways

- Analysis of 13 past cutting cycles shows that on average, periods of falling rates favour duration over credit; however, the range of outcomes suggests a macro dependency on credit performance needs to be explained
- A persistent relationship through cutting cycles is that of negative rate-credit correlation; this favours the higher end of high yield, which offers the best balance of both credit and duration exposure
- Analysis of past performance would suggest rate-curve ‘steepener’ trades are a clear winner as cuts begin; however, current market pricing means they are best deployed tactically, given high carry and rolldown costs

“History doesn’t repeat, but it does rhyme.” This adage is often referenced at the point of perceived regime shifts in financial markets – perhaps never more so than during the shift in direction of monetary policy regimes. With the Fed having joined other developed-market central banks in commencing their cutting cycle, in this quarter’s insight we will try to identify and decipher trends in fixed income data through cutting cycles. We will then assess whether such trades can again perform in the current environment.

Backward-looking analyses in fixed income markets often focus on more recent history due to the lack of readily accessible longer-term data regarding returns. In the case of cutting cycles, there are only four relevant examples to analyse from the past 30 years,[3] reducing potential confidence in conclusions. To counter this, we have used a set of return data that extends beyond the traditional index returns by combining multiple series and proxies to analyse 13 cutting cycles covering 60 years of fixed income market performance. Our analysis focuses on the US market to maximise data availability.

Duration and credit reaction

Figure 7 sets out the results of our analysis of US rates and high-yield performance for each of the 13 cutting cycles, showing average returns and ranges of returns at six months and 12 months, as well as hit rates, i.e., the number of periods posting positive returns.

As you can see, cutting cycles clearly favour duration over credit on average, with mean and median high yield returns both six months and 12 months after first rate cut sitting in negative territory. However, the hit rate of around 40% is not a complete dismissal of credit in these scenarios, instead implying a range of outcomes. Indeed, as shown in the bottom line of the chart, credit has actually outperformed rates during the first six months in four of the 13 cycles. Clearly, then, there is a macro dependency on credit performance to explain rather than a straightforward buy or sell decision to be made.

Rate-credit correlation

The macro dependency we have identified suggests that rather than a pure duration or credit allocation, a more systematic exploitation of the situation requires a different approach manifesting through the correlation channel. A persistent relationship through cutting cycles is that of negative rate-credit correlation, as shown in Figure 8.

In fixed-income markets, this correlation favours the higher end of high yield, which offers the best balance of both credit and duration exposure (see Figure 9). As it stands, high-quality names are heavily tilted in favour of duration exposure, whilst issuers rated

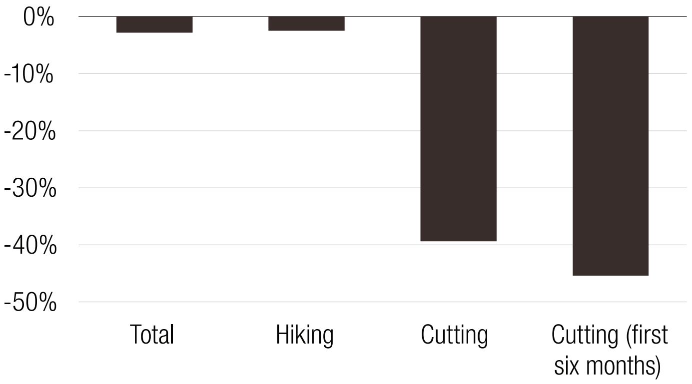
FIG 7. RATES AND CREDIT PERFORMANCE FOLLOWING FIRST RATE CUT OF US CUTTING CYCLES, 1953-2020

	SIX MONTHS AFTER FIRST CUT				12 MONTHS AFTER FIRST CUT			
	Mean return	Median return	Volatility	Hit rate	Mean return	Median return	Volatility	Hit rate
Rates	3%	2%	3%	11/13	4%	4%	5%	11/13
Credit	-1%	-1%	5%	5/13	-2%	-1%	4%	6/13
Rates-credit	4%	3%	6%	9/13	7%	6%	6%	10/13

Source: Bloomberg, Moody’s, LOIM Calculations. Analysis covers 13 cutting cycles from 1953-2020. For illustrative purposes only.
Past performance is not a reliable guide to future results.

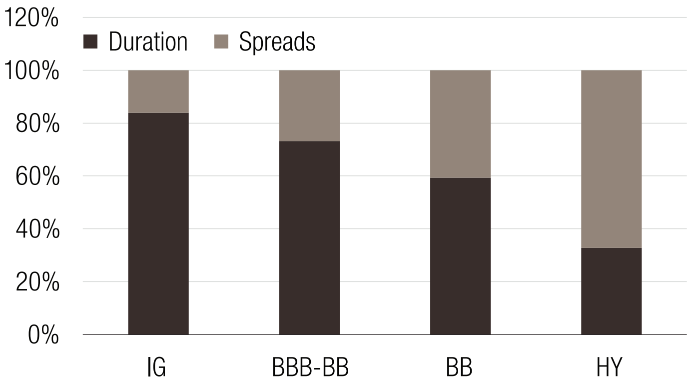
[3] We only consider cutting cycles that include a minimum of 100 bps of cuts, hence we omit the cuts of 1995/96 and 1998/99.

FIG 8. RATE-CREDIT CORRELATION DURING HIKING AND CUTTING REGIMES BY CENTRAL BANKS, 1953-2020



Source: Bloomberg, Moody's, LOIM Calculations. Calculated using monthly data 1953-2020. For illustrative purposes only. Past performance is not a reliable guide to future results.

FIG 9. CONTRIBUTION OF DURATION AND SPREAD TO OVERALL RISK FOR US CORPORATE BONDS



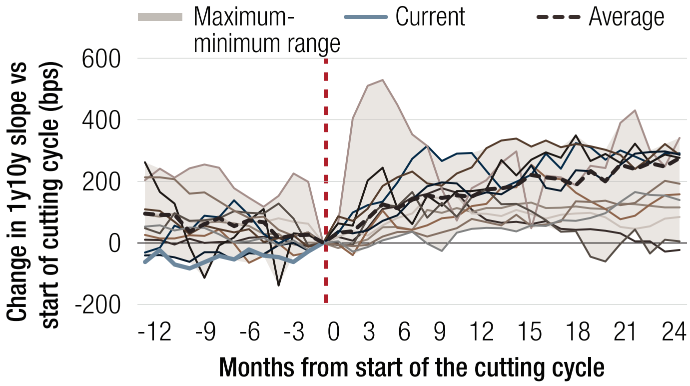
Source: Bloomberg, LOIM calculations. Calculated using monthly return data from September 2019 to September 2024. For illustrative purposes only. Past performance is not a reliable guide to future results.

'B' or lower are always a more credit-heavy proposition. This leaves higher-rated high yield best positioned to benefit from a persistent return of negative credit-duration correlation, further supporting our preference for the segment.

Is the curve all it seems?

Duration has more often than not been a safe bet through cutting cycles, although there have been rare instances where cuts have failed to translate into positive performance. However, one area of greater success is that of steepening curves. Within the period studied, US one-year-10-year (1y10y) curves have steepened both six months and 12 months into all instances of cutting cycles.[4]

FIG 10. CHANGE IN 1Y10Y BOND CURVE BEFORE AND AFTER THE START OF CUTTING CYCLES, 1950-PRESENT



Source: Bloomberg, LOIM calculations. For illustrative purposes only.

This would suggest that a 'steepener' trade is a clear winner in the midst of rate cuts. In reality, however, the translation of a steepening curve into positive performance for a steepener is not quite that straightforward. This is because curve steepenings are often priced into markets ahead of their occurrence.

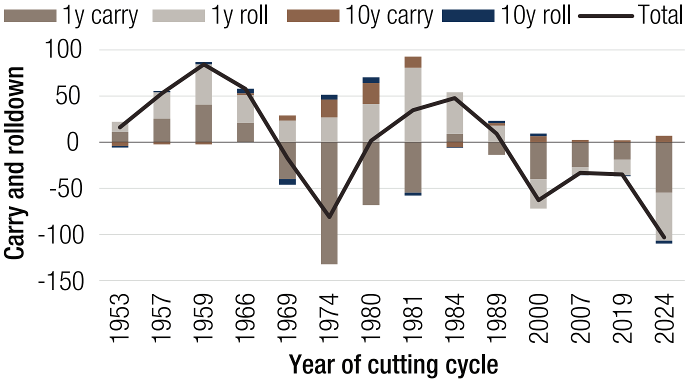
With all else held constant, treasury curves steepen mechanically as cuts proceed. This is because the change in short-term rates has a greater weight in the shorter end of the curve than in the longer end. The expectation of rate cuts is already within the price of the curve, so the very front end of the curve is heavily inverted. As a result, a long position in the front end of the curve is exposed to negative impact from rolldown, that is, the yield increases rather than falls as a position 'rolls down' the curve.

In addition to negative rolldown, there is a second negative drag from the inverted front end of the curve. This is because the funding 'leg' or element of any derivative position used to express the steepening trade pays the short rate but receives the one-year rate, a negative carry position in inverted conditions. Ultimately, both carry and roll play against a steepener position at the start of cutting cycles, meaning that a curve has to steepen sufficiently to overcome the negative carry/rolldown to result in positive returns. Put another way, for a steepener to generate positive performance, the curve must steepen more than is currently priced in markets.

Our calculations indicate that current conditions are extremely challenging for steepener trades in the 1y10y space. Figure 11 uses historical yield figures to produce an estimate for the carry and roll implied by implementing a steepener trade with a six-month horizon at the onset of all previous cutting cycles; this has been further broken down into the impact of carry and roll in the 10-year and one-year elements of the curve. We calculate the current headwinds to a steepener to be larger than in any previous cutting period, with

[4] We have shown the 1y10y curve because there is more historical data available than for the more commonly used 2y10y curve. Historically, 1y10y and 2y10y curves exhibit very similar behaviours, so the conclusions discussed also hold for the 2y10y curve in all cutting cycles with available data (i.e., since 1970).

FIG 11. CARRY AND ROLLDOWN PROPERTIES OF 1Y10Y STEEPENER TRADE AT THE START OF PRIOR CUTTING CYCLES



Source: Bloomberg, US Treasury, Lombard Odier IM Calculations. Calculations are an estimate, using the nearest available yield tenors to calculate rolldown. Steepener trades are calculated as being duration neutral.

almost 1% of combined negative carry and roll impact. In other words, the 1y10y curve would need to steepen by more than 100 bps in the next six months to generate positive performance. Whilst this is possible, a steepening of this size has only occurred in six of the past 13 cutting cycles.

On the other hand, it's also worth noting that all cycles have produced a steepening of sufficient size to generate positive performance over the initial six months (the exception is the 2019 cycle, when the impact of the Covid pandemic was a mitigating factor). Nevertheless, with 100 bps of steepening required just to generate positive performance, the efficacy of systematic buying of steepeners as an effective trade at the onset of a cutting cycle is less clear than it may at first appear.

Conclusion

In summary, analysis of historical data demonstrates that positioning in a world of falling central bank rates is perhaps not as clear cut as might be hoped. Within fixed income, the performance of credit is very mixed – and even duration, whilst often a winner, has not shown a 100% hit rate. Rate-curve 'steepener' trades are being widely touted as policy rates begin to fall; however, while historically a good position to hold in cutting cycles, current market pricing means they are likely best deployed very tactically, given high carry and rolldown costs.

The most reliable play historically through cutting cycles has been to take advantage of a return to negative rate-credit correlation. In the current environment, this would tend to favour crossover or high-quality high yield, which offer a balanced exposure to both sources of returns, thereby providing the potential to smooth performance through uncertain times.

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