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WESTERN ASSET

TOPIC OF FOCUS: **STRATEGY**

Global Bonds—Ripe for the Picking

As global central banks continue to hike rates in their efforts to fight inflation, valuations across fixed-income strategies have materially reset this year. Additional volatility due to ongoing geopolitical tensions make the investment landscape even more uncertain. However, we believe fixed-income investors can help mitigate risk of global rates volatility by working with an active investment manager whose approach helps diversify duration in those markets where the interest-rate cycle is stabilizing or poised to ease. Here we explain why we feel that actively managed global bond strategies have an inherent advantage over passive strategies.

Robert Abad
Product Specialist

KEY TAKEAWAYS

- With markets pricing in additional rate hikes this year by the major central banks, we believe active duration and yield-curve management will continue to be the key drivers of alpha generation in global bond strategies going forward.
- Following a material reset in valuations this year, global bonds provide strong diversification benefits to domestic and global equities as well as other fixed-income asset classes.
- For investors looking to make a global bond allocation, we suggest using a hedged benchmark as a starting point and then allowing currency latitude to capture additional diversification benefits.
- Given the pitfalls associated with a passive investing approach, we encourage investors to look for an asset manager with an active management philosophy, a global scale, robust research capabilities and a proven track record in successfully managing global bond portfolios.

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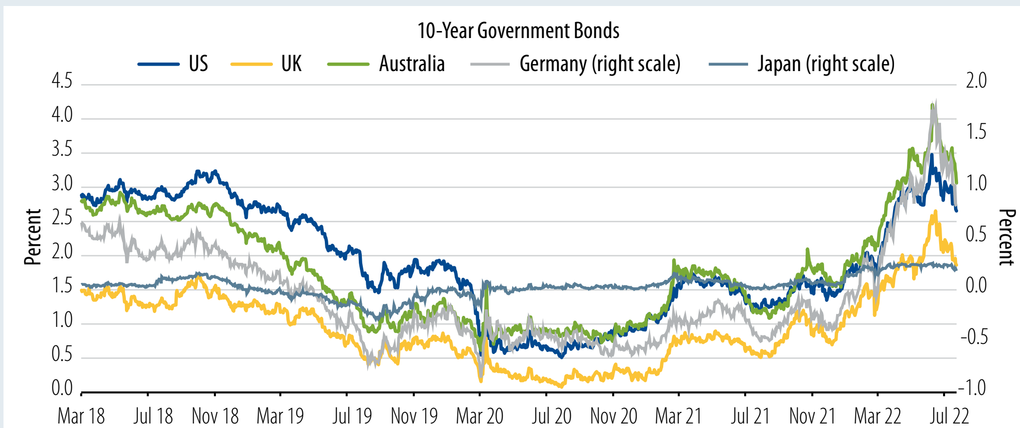
Global Bonds—Ripe for the Picking

By Robert Abad

"… heightened rate volatility over the past months has not only impacted risk assets, but also the entirety of the investment-grade-rated global government bond market."

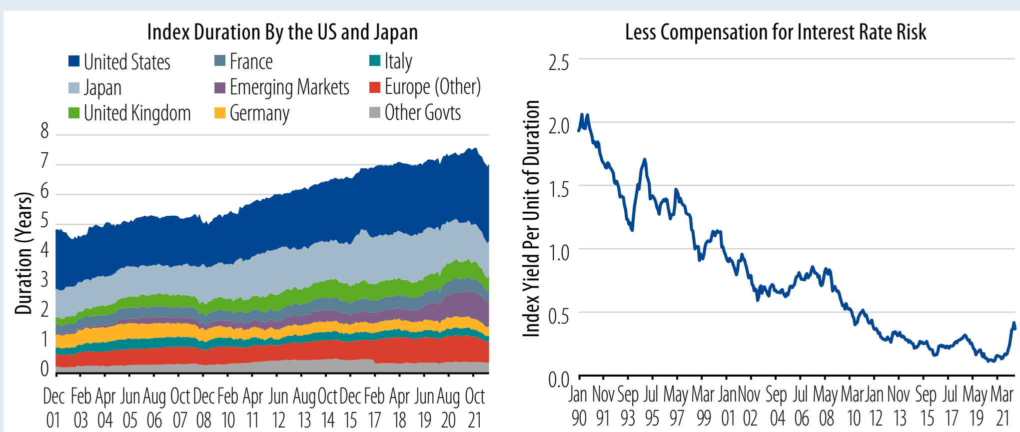
Valuations across fixed-income strategies have materially reset this year on the back of a sudden and sharp pivot by developed market (DM) central banks aimed at curbing rising inflation pressure. Indeed, heightened rate volatility over the past months has not only impacted risk assets, but also the entirety of the investment-grade-rated global government bond market. In hindsight, this result is not surprising as the global fixed-income market—as proxied by the Bloomberg Global Aggregate Index's (Global Aggregate)[1] risk-return profile—became increasingly vulnerable over time to a spike in interest rates given its longer duration (as both sovereign and corporate issuers refinanced and extended at longer maturities) and lower yield level (as extended bouts of quantitative easing further suppressed global bond yields).

Exhibit 1: Global Government Bonds Have Materially Repriced This Year



Source: Bloomberg. As of 29 Jul 22

Exhibit 2: The Evolving Risk-Return Profile of the Global Aggregate Index



Source: Bloomberg. As of 31 Jul 22

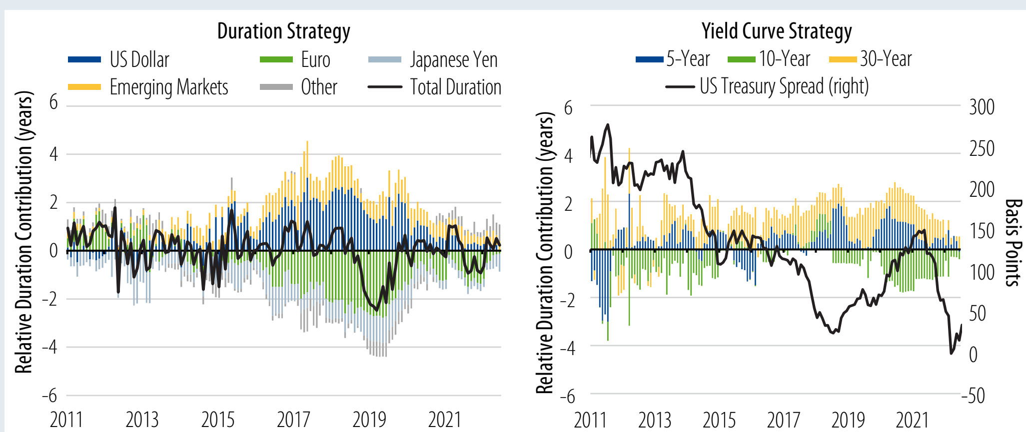
"… we believe active duration and yield-curve management will continue to be the key drivers of alpha generation in global bond strategies going forward."

In our 2017 paper, [Global Investing: The Price You Might Pay for Going Passive](), we cautioned against the allure and efficacy of passively managed global bond strategies; specifically, their tendency to expose investors to the underlying benchmarks' declining yield buffer (or compensation) against rising rates. Moreover, we highlighted the inherent inflexibility of the passive approach to this area of the market, including, for example, the inability of a passive manager to replicate a global benchmark, calibrate currency risk, invest in off-benchmark securities or go overweight or underweight sectors based on changes in relative value.

We would note that the asymmetric duration risk that comes with global fixed-income benchmarks still persists as the bulk of their duration comprises the US and Japan, where yields of the former are off their lows (but low relative to history) and yields of the latter remain near the zero bound. With markets pricing in additional rate hikes this year by the major central banks—all against the backdrop of slowing global growth, the ongoing Russia-Ukraine conflict, key election cycles across DM and emerging market (EM) countries and simmering Taiwan-related tension between the US and China—we believe active duration and yield-curve management will continue to be the key drivers of alpha generation in global bond strategies going forward.

In our view, the most effective way to accomplish this while mitigating the risk of global rates volatility is to diversify duration in those markets where the interest-rate cycle is stabilizing or poised to ease. This means being thoughtful about which countries to own and where duration is held along the yield curve. Given the substantial variance among the change and movement of absolute yield levels, slopes and shapes of government bond curves, both within and across countries, an active manager such as Western Asset seeks to add value for investors by anticipating and capitalizing on these differences (Exhibit 3). For a summary of the key drivers behind our global outlook and a description of where we currently see value across global fixed-income markets, please refer to our [Global Outlook]().

Exhibit 3: Western Asset's Active Approach



Source: Bloomberg, Western Asset. As of 30 Jun 22

The potential diversification power of global bonds can be seen in the varying degrees of correlations across a select number of government bonds (Exhibit 4), all of which are a function of the differences in economic cycles, fiscal policies and central bank policies across countries.[2] These findings should encourage investors to reevaluate continually the potential for home-country bias when considering their fixed-income allocations.

"… global bonds can provide strong diversification benefits to domestic and global equities as well as other fixed-income asset classes."

Exhibit 4: Yield Correlations Across Global Bond Markets Continue to Ebb and Flow

7/31/17-7/31/22	Australia	Belgium	Canada	France	Germany	Italy	Japan	Mexico	New Zealand	Russia	United Kingdom	United States
Australia		0.94	0.94	0.95	0.97	0.74	0.63	0.72	0.96	0.63	0.95	0.88
Belgium	0.94		0.92	0.99	0.98	0.82	0.61	0.79	0.91	0.72	0.95	0.83
Canada	0.94	0.92		0.92	0.92	0.76	0.49	0.84	0.94	0.67	0.97	0.94
France	0.95	0.99	0.92		0.99	0.79	0.64	0.77	0.93	0.71	0.95	0.82
Germany	0.97	0.98	0.92	0.99		0.77	0.63	0.72	0.93	0.65	0.95	0.85
Italy	0.74	0.82	0.76	0.79	0.77		0.30	0.81	0.66	0.54	0.76	0.83
Japan	0.63	0.61	0.49	0.64	0.63	0.30		0.32	0.62	0.58	0.59	0.29
Mexico	0.72	0.79	0.84	0.77	0.72	0.81	0.32		0.75	0.72	0.84	0.82
New Zealand	0.96	0.91	0.94	0.93	0.93	0.66	0.62	0.75		0.70	0.95	0.83
Russia	0.63	0.72	0.67	0.71	0.65	0.54	0.58	0.72	0.70		0.75	0.51
United Kingdom	0.95	0.95	0.97	0.95	0.95	0.76	0.59	0.84	0.95	0.75		0.90
United States	0.88	0.83	0.94	0.82	0.85	0.83	0.29	0.82	0.83	0.51	0.90	

Source: Bloomberg. As of 31 Jul 22

For investors with broad asset allocations, "going global" in fixed-income has historically provided the strongest portfolio offset when growth assets (e.g., equities) have disappointed. As Exhibit 5 highlights, global bonds can provide strong diversification benefits to domestic and global equities as well as other fixed-income asset classes.

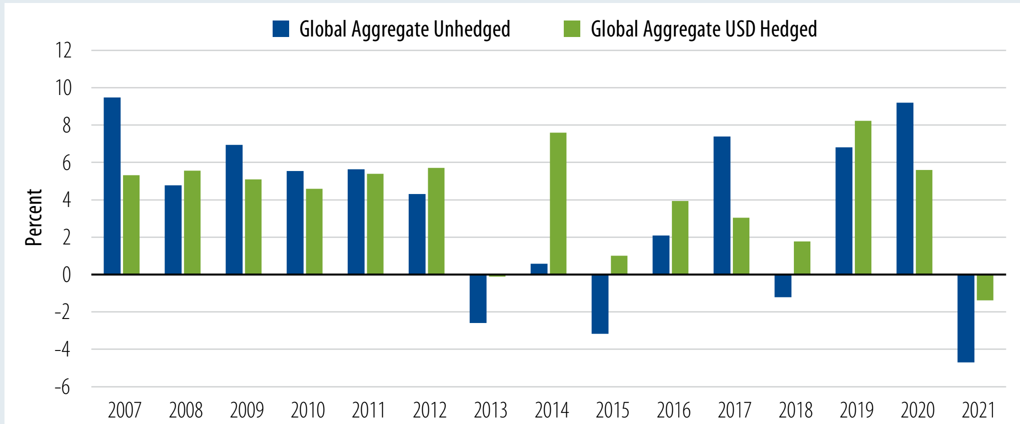
Exhibit 5: Global Bonds Have Offered Strong Diversification Benefits

1/31/2007 - 7/31/2022	Global Aggregate Unhedged	Global Aggregate (USD Hedged)	US Aggregate	US HY	US Credit	S&P 500	MSCI World Index
Global Aggregate Unhedged		0.72	0.77	0.43	0.75	0.34	0.43
Global Aggregate (USD Hedged)	0.72		0.94	0.24	0.82	0.09	0.11
US Aggregate	0.77	0.94		0.30	0.85	0.11	0.15
US HY	0.43	0.24	0.30		0.64	0.74	0.79
US Credit	0.75	0.82	0.85	0.64		0.41	0.48
S&P 500	0.34	0.09	0.11	0.74	0.41		0.96
MSCI World Index	0.43	0.11	0.15	0.79	0.48	0.96	

Source: Bloomberg. As of 31 Jul 22

A major source of appeal for global bonds, in addition to coupon income and capital appreciation, is the incremental return that can be obtained from currency exposure. However, unlike income, which is a fixed component of a bond's total return, currency moves are unpredictable with the potential of negatively impacting the value of income payments and amplifying bond price volatility. We are always mindful of the risk/reward tradeoff of investing in global bonds on an unhedged basis, where one assumes currency risk, or on a hedged basis, where one avoids currency risk.

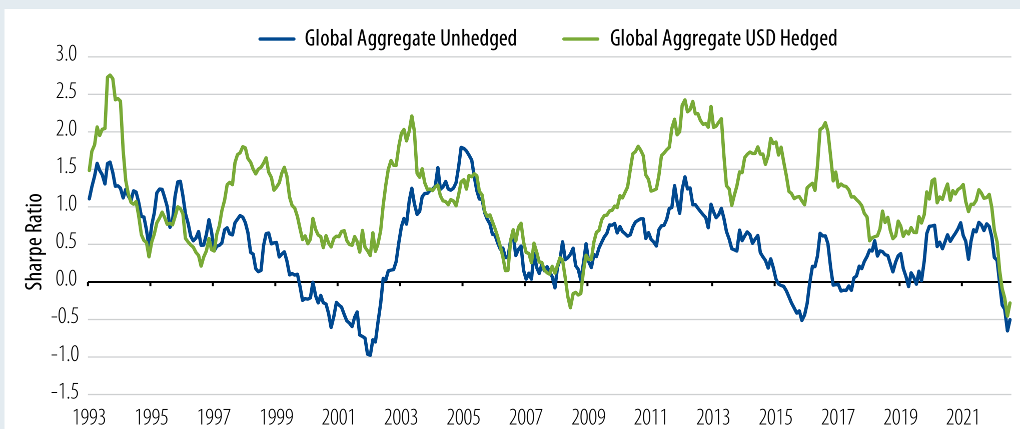
Exhibit 6: What Is the Better Choice – Unhedged or Hedged? Comparative Annual Returns



Source: Bloomberg. As of 31 Jul 22

A comparison of annual returns over the last 15 years between the unhedged and hedged versions of the Global Aggregate Index suggests that the latter may be the best option (Exhibit 6). The volatility of the unhedged series also has been consistently higher than the hedged series when looking back over a longer time frame. As a result, the risk-adjusted return of the hedged series (as measured by the Sharpe ratio[3]) is much more attractive (Exhibit 7).

Exhibit 7: Hedged Bonds Produce Better Risk-Adjusted Returns Over Time (3-Year Rolling Sharpe Ratio)



Source: Bloomberg. As of 31 Jul 22

> *"For investors looking to make a global bond allocation, we suggest using a hedged benchmark as a starting point and then allowing some currency latitude …"*

This finding underscores two important points:

- The outlook for major global currencies plays a key role in the choice of a hedged or unhedged global bond benchmark. For example, the US dollar rallied significantly during 1995-2001, experienced a period of sustained weakness during 2002-2013 and is now back at a multi-year high. The choice of the wrong benchmark, particularly at the start of a key inflection point, could result in a significant difference in portfolio return.

- The benefit of hedging away currency risk does outweigh its cost (which is low given the breadth and depth of the forward currency market).

For investors looking to make a global bond allocation, we suggest using a hedged benchmark as a starting point and then allowing some currency latitude (i.e., the ability to go both long and short select currencies). A more

"… we believe actively managed global bond strategies have an inherent advantage over passive strategies in five key areas …"

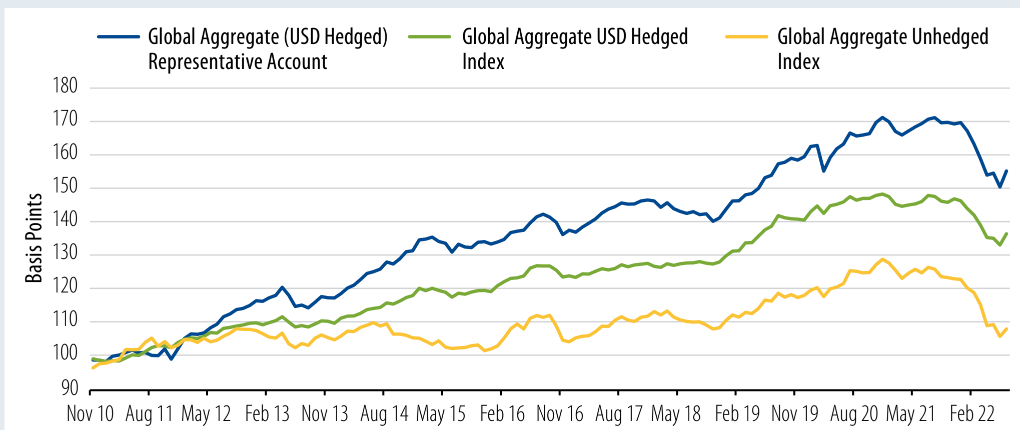
active approach to currencies may moderately increase portfolio volatility, but will—over a market cycle—lower the correlation (and therefore improve diversification benefits) of the portfolio with other asset classes.[4]

To summarize, we believe actively managed global bond strategies have an inherent advantage over passive strategies in five key areas:

1. The latitude to invest across the full spectrum of global interest rates and credit markets, including those that are off-benchmark
2. The ability to rotate across sectors (i.e., overweight sectors that offer value or underweight sectors that are expected to lag)
3. The flexibility to tactically manage duration and yield-curve positioning to mitigate interest-rate sensitivity
4. The ability to manage (and seek to exploit) currency volatility over different market cycles
5. The flexibility to enhance diversification and complementary strategies within a portfolio

Given the complexity of global bonds and the pitfalls associated with taking a passive approach toward this market, we encourage investors to look for an asset manager with: a) an active management philosophy, b) a global scale and robust research capabilities and c) a proven track record in successfully managing global portfolios (Exhibit 8). For more information, please refer to our May 2022 paper, Going Global: The Western Asset Approach to Global Bond Investing.

Exhibit 8: Global Aggregate (USD Hedged) Representative Account Performance Since Inception



Source: Bloomberg, Western Asset. As of 31 Jul 22
Past investment results are not indicative of future investment results. *Please refer to the Performance and Risk Disclosure for more information.*

ENDNOTES

1 The Bloomberg Global Aggregate Index is a multi-currency benchmark that comprises global investment-grade debt.

2 Note that correlations are not necessarily stable and might change over time; manager judgment might be necessary.

3 The Sharpe ratio is a measure that indicates the average return minus the risk-free rate divided by the standard deviation of return on an investment. Generally, the greater the value of the Sharpe ratio, the more attractive the risk-adjusted return.

4 Interestingly, when passive managers tie a strategy to an unhedged or hedged benchmark, they are essentially making an "active" decision.

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Global Aggregate (USD Hedged) Composite*

Composite Inception Date: 04/01/2001 | Composite Creation Date: 04/01/2001

	No. of Accts	Gross Total Return	Net Total Return	Benchmark Total Return	Gross Total 3-Yr St Dev	Benchmark Total 3-Yr St Dev	Internal Dispersion	Mkt. Value USD Mil	Percentage of Firm Assets	Firm Assets USD Mil
2012	5	12.39%	11.95%	5.72%	3.76%	2.16%	-na-	1,878	0.41%	461,891
2013	5	0.28%	-0.12%	-0.14%	4.10%	2.42%	-na-	2,174	0.48%	451,632
2014	5	9.60%	9.16%	7.59%	3.53%	2.29%	-na-	2,347	0.50%	466,036
2015	5	0.59%	0.19%	1.02%	3.76%	2.66%	-na-	1,655	0.38%	433,747
2016	5	4.38%	3.96%	3.95%	3.67%	2.73%	-na-	1,591	0.38%	419,207
2017	8	6.74%	6.32%	3.04%	3.59%	2.63%	-na-	2,109	0.48%	436,309
2018	7	-1.18%	-1.57%	1.76%	3.43%	2.37%	0.46%	1,657	0.39%	424,136
2019	9	10.84%	10.40%	8.22%	2.93%	2.40%	0.70%	2,146	0.47%	455,276
2020	9	7.87%	7.45%	5.58%	4.66%	2.86%	0.39%	2,575	0.54%	479,810
2021	9	-0.95%	-1.35%	-1.39%	4.56%	3.12%	0.29%	3,218	0.66%	488,490

Description: The Western Asset Global Aggregate (USD Hedged) strategy is an aggregate fixed-income strategy that aims to maximize total return and add value through duration and curve positioning, sector, country and currency allocation, and security selection, while approximating benchmark risk. The strategy invests in a diversified portfolio using all major global fixed-income sectors and currencies. The strategy allows for opportunistic investments in high-yield securities.
Benchmark Description: The current benchmark is the Bloomberg Global Aggregate USD Hedged Index.

Base Currency: USD | **Composite Minimum:** No minimum asset size requirement as of 1/1/21 (previously $5 million as of 6/1/14 and prior $25 million).

Current Fee Schedule: .40 of 1% on the first $100 million, .20 of 1% on amounts over $100 million.

**Effective 1 January 2021, the Global Aggregate (USD Hedged) Composite has been redefined to broaden the inclusion of accounts by removing quality constrains. Previously referenced as Global Core Full Discretion (USD Hedged) Composite.*

Western Asset claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Western Asset has been independently verified for the periods from January 1, 1993 to December 31, 2021.

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Gross-of-fees returns are presented before management fees, but after all trading expenses. Net-of-fees results are calculated using a model approach whereby the current highest tier of the appropriate strategy's fee schedule is used. Effective January 1, 2020, for annual periods where the actual account weighted fees are higher than the composite model fee, the actual account weighted fees will be used for the net-of-fee composite return calculations. Net-of-fee composite return calculations using actual account weighted fees may include fund returns that incur higher fees than those applied to separately managed accounts. The portfolios in the Composite are all actual, fee-paying and performance fee-paying, fully discretionary accounts managed by the Firm for at least one full month. Investment results shown are for taxable and tax-exempt accounts and include the reinvestment of all earnings. Any possible tax liabilities incurred by the taxable accounts have not been reflected in the net performance. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request.

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Internal dispersion is calculated using the asset-weighted standard deviation of annual gross returns of those portfolios that were included in the Composite for the entire year. Periods with five or fewer accounts are not statistically representative and are not presented. The three-year annualized ex-post standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period.

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Western Asset's list of composite descriptions, limited distribution pooled fund descriptions, and broad distribution pooled funds are available upon request. Please contact Derek Fan at 626-844-9465 or derek.fan@westernasset.com. All returns for strategies with inception prior to January 1, 2012 are available upon request.

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