BRANDES INSIGHTS:
Novel Idea – Fixed Income Markets Now Offer Income

Boxing great Mike Tyson once said: “Everyone has a plan until they get punched in the mouth.” The swift repricing of fixed income markets thus far in 2022, the likes which we have not seen since the 1970s, appeared to knock many investors on their heels.

By some accounts, the first half of 2022 was the worst bond market performance since ’88 – that is 1788.[1] Interest rates continued to march higher, equity markets continued to move lower, and inflation readings hit levels not seen for decades.

Many market participants that have been able to *ride the wave* of implicit Federal Reserve (Fed) support for the past several years by favoring long duration and lower quality assets have experienced a painful year as persistently high inflation has effectively forced the Fed to abandon its 15-year *dovish* stance.

Complacency and relaxed risk tolerance appeared to be the main drivers of declining yields and historically low credit spreads. With the Fed keeping rates near zero and buying increasing amounts of U.S. Treasuries, agency mortgaged-backed securities, and even high-yield corporate bonds – who could blame those that believed part of the Fed’s mission was to stamp out market volatility?

Markets now appear to be exiting a period where valuations were largely artificially propped up by huge injections of liquidity and easy policy by the Fed - not to mention extraordinary stimulus from the federal government. This transition has been painful for virtually *every* financial asset class, including equities, over the short term. Over the longer term, however, *income* is the most important determinant of fixed income returns, and we are approaching levels in the market that we have not seen in over a decade.

So where do we go from here?

In our view, fundamentals like cash flow generation, margins, balance sheet positioning have taken a back seat to technical factors like momentum, yield and investor enthusiasm.

Post the Global Financial Crisis (GFC) many hungry investors, perhaps unknowingly, extended their risk profile searching for yield during the low-rate years. Some resorted to purchasing unfamiliar products like bank loans or even using complex derivatives. In today’s environment, some of these holdings may be less liquid and harder to unwind. And many, with high duration, have simply fallen flat, delivering painful negative short-term return.

We believe the bond market has begun to return to a longer term-focused landscape where fundamentals again drive valuations. In our view, this is not only a healthier market, but one where managers focused on finding value through individual security selection have the potential to positively impact portfolio performance.

At Brandes, we have been managing fixed income portfolios in the same long-term, Graham & Dodd bottom-up style for nearly a quarter century. We build concentrated portfolios of cash-pay bonds, one security at a time. We don't use leverage or derivatives – nothing exotic. We search for strong, tangible asset coverage and are willing to be extremely patient as we hunt for potentially mispriced opportunities. Further, we believe being small and nimble can be beneficial.

As with any investment, and in particular fixed income, time horizon is important. In the short term, interest rate increases can cause negative total returns. However, over a longer time horizon, higher yields should allow a diversified portfolio to generate a higher level of income, cushioning the impact.

At Brandes, we look at the current market as one filled with potential to add meaningful value through thoughtful research and careful credit issue selection. The structural changes in Fed policy and to the market have the potential to create opportunities over the longer term for smaller more nimble managers like us that are focused on underlying credit fundamentals.

[1]*Financial Times*, July 7, 2022, Datawatch

Agency mortgage-backed securities (MBS): An MBS issued by one of three quasi-governmental agencies: The Government National Mortgage Association (GNMA or Ginnie Mae), the Federal National Mortgage Association (FNMA or Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac). A MBS is an investment similar to a bond that is made up of a bundle of home loans bought from the banks that issued them.

Asset Coverage: Measures how well a company can repay its debts by selling or liquidating its assets.

Basis Point (BPS): 1/100 of 1%.

Cash Flow: The amount of cash generated minus the amount of cash used by a company in a given period.

Cash-Pay Bond: Debt security that pays a cash coupon.

Credit Spread: The difference in yield between two bonds of similar maturity but different credit quality.

Duration: The weighted maturity of a fixed-income investment's cash flows, used in the estimation of the price sensitivity of fixed-income securities for a given change in interest rates.

Yield: Annual income from the investment (dividend, interest, etc.) divided by the current market price of the investment.

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