Diversified fixed income Portfolios

5%[1]

Average initial yield of investment grade Corporate bonds, in terms of yield to worst

+80%[2]

Historical correlation between the bond's initial yield and the return over the next 5 years

5-6%[3]

Potential opportunity cost of being in cash throughout a cutting rates cycle

1 Source: Bloomberg, as of 29/04/2024. YTW Bloomberg Global Corporate Index.
2 Source: Morningstar Direct and Santander.
3 Source: Calculations by Santander (see example inside).

Yield levels of most fixed income asset classes remain attractive from a historical point of view despite the good performance of 2023

Attractive yields in historical terms

Eleven months ago we published a note where we discussed about the opportunity of increasing duration in fixed income portfolios as interest rate hikes were coming to an end and existing yield levels were mitigating possible further hikes. **During 2023**, the **central banks** of the main developed countries ended their hiking cycles (the Fed in July, the BoE in August, and the ECB in September) and entered a period of pause. Performance was uneven during the year and the rally that started in mid-October **made it a good year overall for fixed income**, particularly assets with greater credit risk, such as high yield and emerging debt.

Few months later, the **monetary policy debate has now shifted to when to initiate any cuts and at what intensity they should be made so as not to provoke a rebound in inflation** that is proving to be particularly sticky. Since the beginning of the year, rate cut expectations have been moderating and delaying (in January, the market was expecting up to seven rate cuts in 2024), to the point that the Fed is now expected to cut rates only once or twice, starting in September, and the ECB, three times, starting in June.

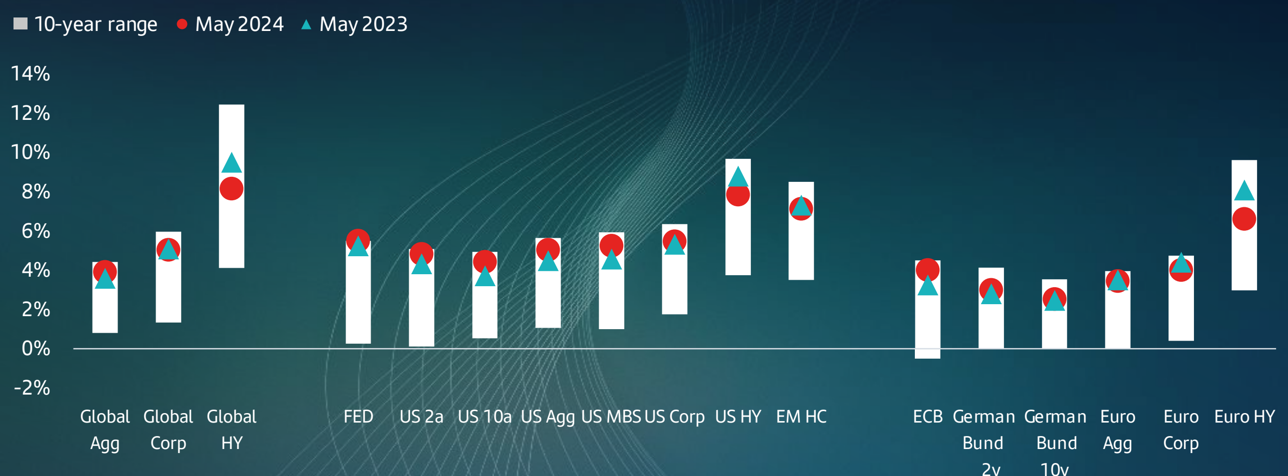
As we discussed in our Quarterly Market Outlook: Q2 2024, "Softer landing moderates rate cuts", **rates will be reduced, but only moderately**. This moderation in rate cuts is putting pressure on government debt in particular, with the result that several indices entered negative territory in April.

Despite all the volatility caused by the monetary policy debate, the fact is that, **at current levels, most fixed income asset classes have attractive yields in historical terms**. The chart below shows that almost all indices offer yields similar to or higher than a year ago and they are in the upper range of the last 10 years. We have only seen better opportunities in high-yield and emerging debt, but that was only during a very short period of time (pandemic).

The key issue is: **how likely is an investor to receive this return** when constructing a diversified portfolio. In the following section we will try to answer this question.

Historical yields of the different Fixed Income asset classes

Source: Bloomberg, Data as of 20/05/2024.



The initial level is important

As we have seen, **yields** on the various fixed income asset classes are close to their **10-year highs**.

History shows that, in fixed income, **initial yields** (in terms of Yield to Worst) are a **reasonable estimate** of expected returns for the **next 5 years**.

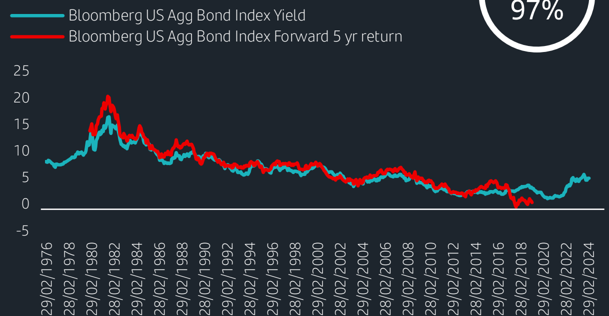
By analysing historical data on initial yields of the various indices and how they performed over the following 5 years, we **find correlations of over 80% in most asset classes**.

In those cases where the correlation falls below 80%, it is because the asset suffered especially during the rate hikes of 2022 and 2023, as is the case with emerging debt.

Yield vs. Returns in the following five years

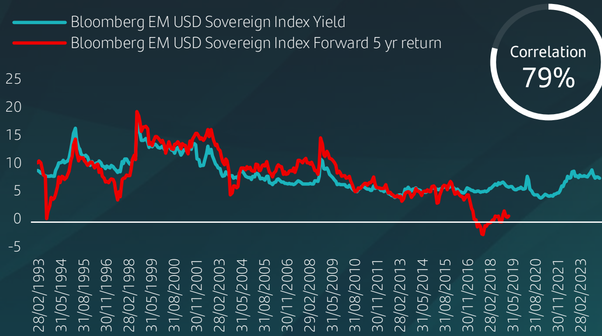
US Investment Grade Corporates

Source: Morningstar Direct. Data as of 31/03/2024.



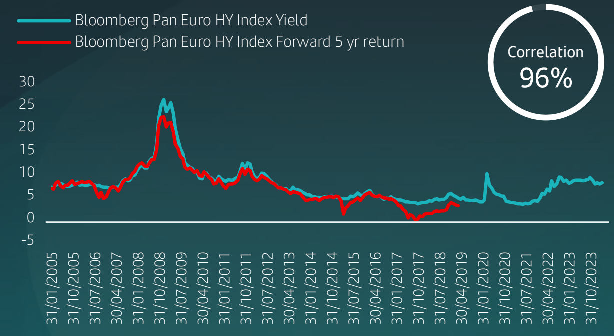
Emerging sovereign debt in USD

Source: Morningstar Direct and Santander.



European High Yield Debt

Source: Morningstar Direct. Data as of 31/03/2024.

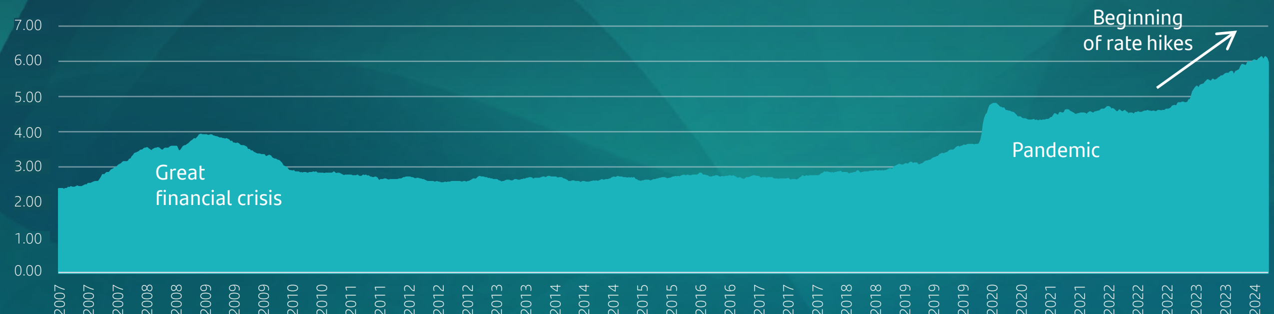


Money market assets at record highs

The conventional tendency to accumulate cash in periods of uncertainty has **been reinforced in the last two years** as **rising** interest rates **have increased the attractiveness of investing in cash compared to other fixed income options.** In fact, at the end of March 2024, positions in U.S. money market assets exceeded USD 6 trn, an **all-time high**. This trend was also in evidence in other geographies such as the euro area.

Evolution of US Money Market Assets

Source: Bloomberg, figures in USD trillion.

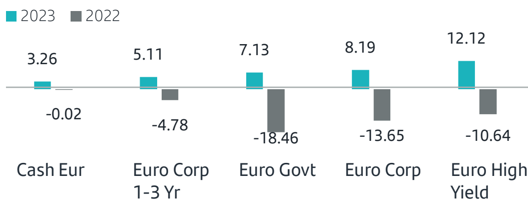


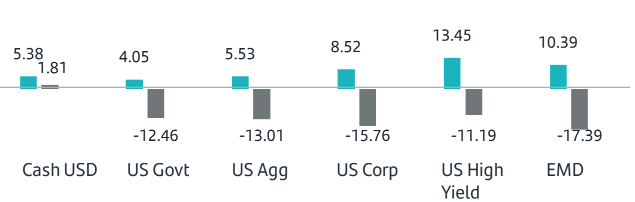
Opportunity cost of remaining invested in the money market

From an investment standpoint, **this rotation to cash has proved successful over the last two years** as it has produced very attractive returns without assuming the risk caused by the interest rate hikes, as shown in the following chart.

Returns in 2022 and 2023

Source: Morningstar Direct and Santander.



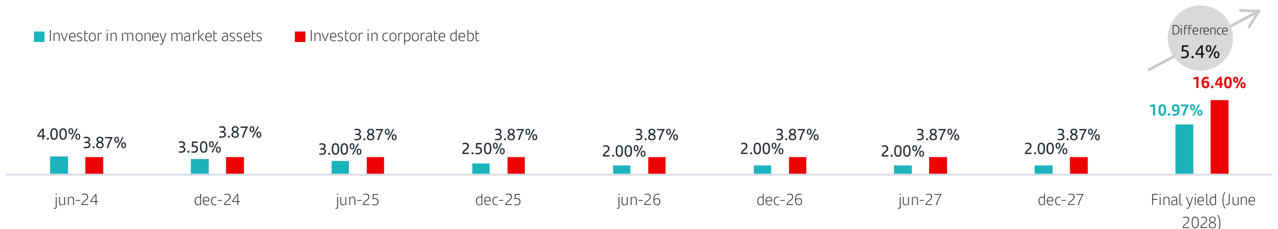


However, having reached a point where it seems that interest rates will no longer rise and, in a central scenario, they **may start to fall in the very near future** in some geographies, such as the euro area, it is time to **assess the opportunity cost of remaining invested in money market assets** as compared with other options that may be more volatile.

To do so, we propose a **simple example** in which we compare two investments. On the one hand, a cash investor who reinvests in 6-month instruments at the prevailing rates through 2 years of interest rate cuts and for two years at the terminal rate. On the other hand, an investment grade corporate bond investor who invests in the same instrument for the entire period.

As the curves are inverted, the starting point is more favourable in cash (4% vs. 3.87%). However, **as rates get cut, the reinvestment rates become steadily lower**, with the following outcome:

Source: Bloomberg and Santander. Data as of 30/04/2024. The initial yield for an investor in corporate debt is the Yield to Worst of the Bloomberg Euro Corporate index.



So, **after investing in money market assets for four years**, the estimated cumulative return would be 10.97%, while an investment in high-grade corporate debt could achieve a cumulative return of 16.40% over the same period. Therefore, it could be said that the **5.4% difference in the estimated returns represents an opportunity cost of 49.50% in relative terms over the 4-year period in question.**

How to take advantage of this interest rate scenario?

We believe that **the best option is always to build a diversified portfolio** that can give us access to all asset classes while controlling exposure and the risk assumed.

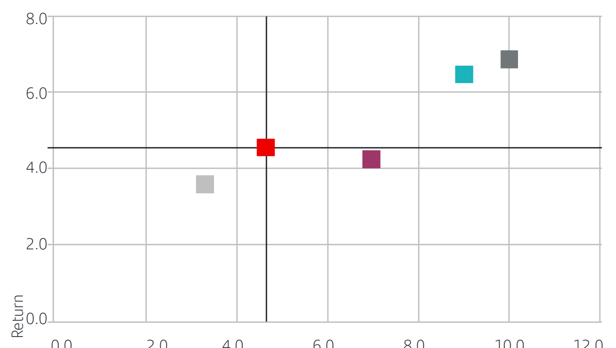
To do so, **we recommend that you contact your financial advisor and** select a portfolio with several **flexible, global strategies that use complementary** approaches in a way that **suits your risk profile**.

A **good solution** may be to mix a **global** fund that is flexible in terms of asset classes and geographies with another that is more specialized in the **US and securitized debt**, plus another focused on **Europe**. This is a way to **cover all asset classes** with a specialised asset manager.

As an example, the chart on the right shows the **historical performance (over 20 years) of a diversified global portfolio (in red)** consisting of 50% government debt, 25% investment-grade corporate debt, 12.5% high-yield corporate debt and 12.5% emerging debt.

Risk vs Return

Time Period: Since Common Inception (01/10/2000) to 30/04/2024.
Currency: US Dollar Source Data: Monthly Return.
Source: Morningstar Direct and Santander.



Private Banking

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