RBC BlueBay Asset Management

The Case for Going Global

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> "Investors should consider the additional value of diversification offered by investing in global bonds."

Global diversification can help smooth overall volatility and offer higher risk-adjusted returns.

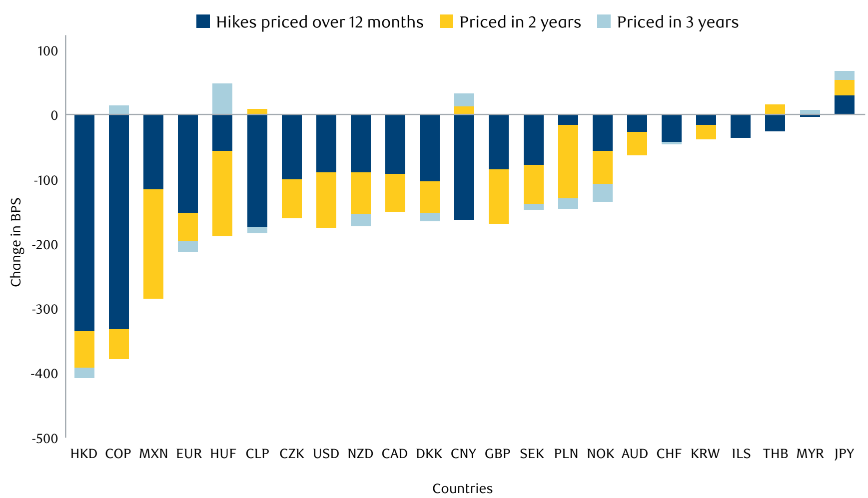
Under the post-covid regime of higher interest rates, volatility is set to remain elevated as new higher equilibriums are discovered. Amid unprecedented disruptions from quantitative tightening, record high supply, and prominent geopolitical risks, investors should consider the additional value of diversification offered by investing in global bonds.

Rate cutting cycles will not be uniform as markets find new higher equilibrium rates.

Fixed income is set to benefit from falling rates as many central banks finish tightening with both the Fed and ECB on the precipice of embarking on easing cycles. Yet, unlike what we witnessed with the shock of the pandemic, the path to cutting will not be quite as synchronized and we will see larger differentiation globally as policymakers recalibrate to the new regime of higher interest rates.

Therefore, opportunities exist across markets and curves within the global bond universe to deliver alpha while diversifying away from domestic risks as evidenced below.

Chart 1: Easing cycles will not be uniform globally



Source: Bloomberg, June 2024

Inflation and inflation volatility is to remain high, but with increasing variance between economies.

New higher equilibriums will be increasingly determined by domestic structural dynamics. This includes demographics (both population growth, immigration trends), debt levels, fiscal policy, green transition strategy and investment needs.

For instance, countries with high population growth driven by immigration have thus far seen inflation driven higher because of the respective boost to demand. However, studies suggest this phenomenon's inflationary impact is short-term and over the medium-term the resulting boost to productivity leads to lower inflation[1].

As such, countries such as Australia and New Zealand may find the productivity benefits of less restrictive migration policies enable more space to ease policy than peers. Alternatively in Canada, where heavy immigration inflows have been politicized with the approaching 2025 general election and led to a tightening of migration policy, there is a risk that high inflation volatility is locked-in as increased restrictions prevent productivity benefits to materialize in full.

Elsewhere, in Poland the green transition strategy is key for inflation outcomes. The green transition is the centerpiece of the new government's economic strategy and is critical to the government's success and ability to maintain power with an eye on the 2027 parliamentary election. The transition is key to bringing down energy prices, improving Poland's competitiveness, and keeping cost of living measures contained over the medium-term. Thus, while heavy investments and fiscal spending boost inflation in the near-term, they are pivotal to lower inflation outcomes over the medium-term.

The new high inflation regime should see term premiums added back into longer-maturity bonds to account for higher uncertainty on inflation outcomes. As a result, higher inflation volatility implies higher nominal yields, higher rates volatility, and steeper yield curves - with increasing variation between economies.

This provides ideal conditions to take advantage of the larger opportunity set of global bonds with plenty of scope to deliver alpha playing cross markets and curve strategies. *In this environment the diversification benefits of global bonds can be particularly helpful in offsetting potentially higher overall volatility of investments and diversifying returns away from domestic market challenges/dynamics*.

Geopolitics will additionally add to volatility and lend to differentiation across markets.

Escalating China-US tensions will remain a dominant theme over the year as the US heads to polls come November. The direction of travel is clearly towards deglobalization under either candidate. However, increased trade protectionism marred by a slew of trade tariffs under Trump could add considerably more pressure on US inflation.

Meanwhile China's counter tactic has been to allow Renminbi depreciation via stockpiling US treasuries and thus looking increase its competitiveness across manufacturing industries. Not only will this have the US making coupon payments large enough to cover most China's military spending needs in the future, but it has enabled China to increase the market share of its manufacturing exports. In effect those economies with higher imports from China will benefit from further imported disinflation adding to differentiation across global markets.

The ongoing war in Ukraine and Palestine is also adding to global market volatility. Costs are around 0.4pp of world GDP and the drone war, for example, is increasing demand for chips.

After the European election we expect that the current set-up where Europe continues to pay, and the US produces, will change along an increase in fiscal expenditure in Europe. Notably, this will have repercussions on yields and inflation as well as on spreads.

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[1] Inflation and migration: Theory, evidence and implications for the Monetary Policy Committee, New Zealand Institute of Economic Research, March 2024

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