Fixed Income | US Investment Grade Bonds
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Credit remains attractive in this heightened risk environment

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> **We expect credit selection to remain a key alpha generator**

Buying into a better bond regime, quality counts…

Following the relentless tightening of monetary policy in 2022 and into 2023, all-in yields for investment grade credit have risen materially, on higher government yields and wider credit spreads, placing credit in a positive spotlight. However, the degree and the pace of interest rate hikes was bound to place stress on the financial system adjusted to a low-rate environment. This quarters' U.S and European bank weakness is one of the signs that higher real and nominal rates are posing financial risks.

Concerns over banking stress contagion have raised renewed questions on forward policy rate, credits and growth. The rally in front-end rates was significant – however, with relatively sticky core inflation, amid strong labour market conditions, the path for policy rates and economic activity is staying uncertain, despite market hopes of monetary relief. As investors wait for the Federal Reserve (Fed) to pause its hiking, bonds offer an opportunity to potentially generate high single-digit returns from high-quality assets – an opportunity that hasn't presented itself for a long time.

Importantly, the trade-off between risk and reward has improved, with spreads now wider, investors are well placed to benefit from, and harness this higher 'carry'.

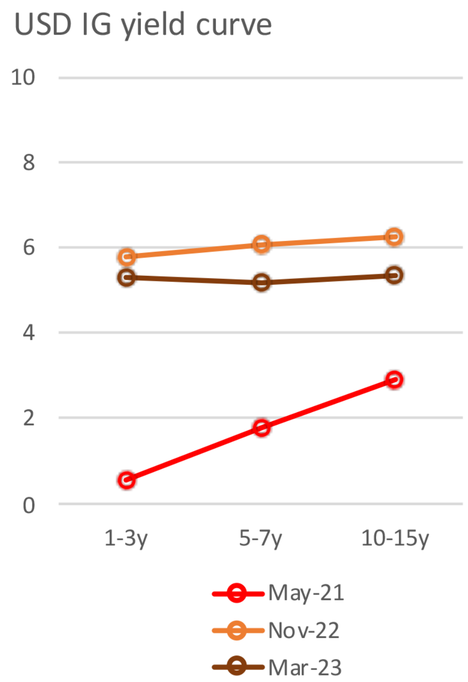
Generally, US corporate fundamentals remain resilient and US investment grade companies have managed balance sheets well. Importantly, with economic growth stronger than originally expected, headline inflation easing, and interest rates closer to peak, the pressure on corporate profit margins might not deteriorate significantly from here. Even so, margins are certainly starting from healthy levels.

Some spread volatility is expected due to the slower growth cycle and elevated funding costs, with highly levered issuers likely to find it harder to adjust, particularly companies starting with low interest coverage, and those with unhedged floating rate liabilities. This bodes well with our preference for higher quality credits, with focus on security selection for companies which are more resilient to the slowdown growth cycle. We expect credit selection to remain a key alpha generator, as active managers look for companies with stable earnings, agile operations, and strong liquidity.

...and so, does duration

Investors also need to consider the yield term structure of investment grade credit, which is flat, given the inverted shape of the US government bond curve (Illustration 1). As a result, with comparable yields achievable without adding incremental interest rate and credit risks, short-to-intermediate duration strategies offer the possibility of superior risk reward.

Illustration 1: Inverted US treasury favors short to intermediate bonds



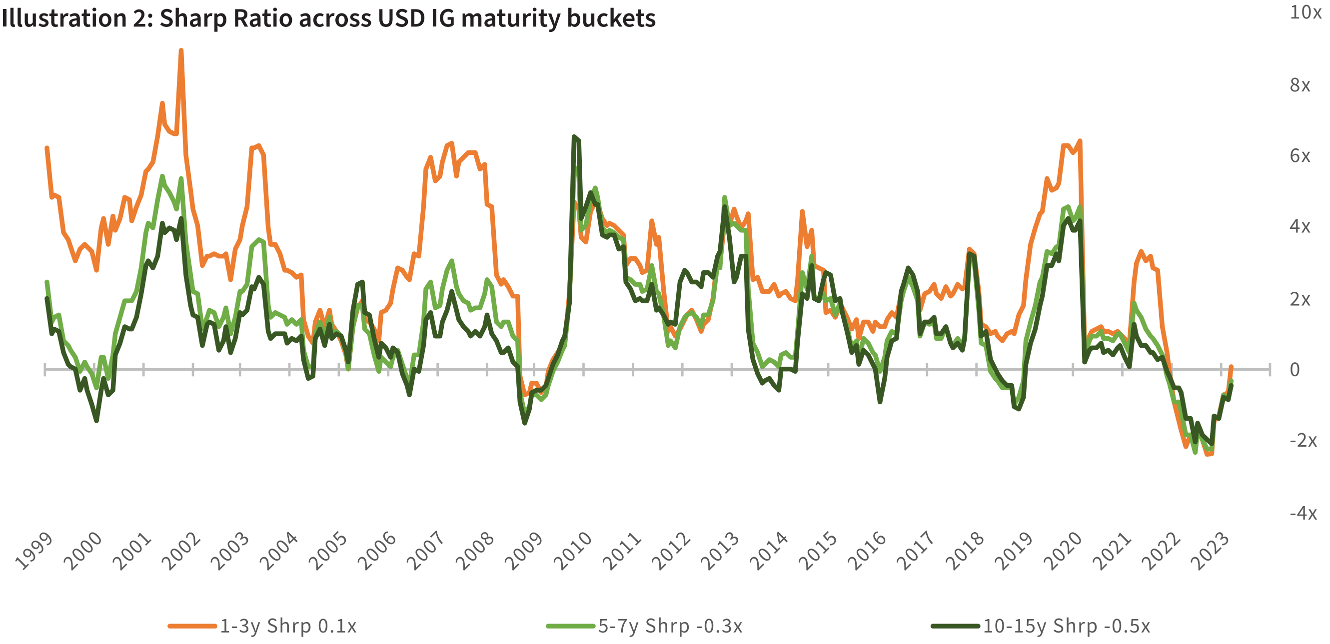
Source: Bloomberg, AXA IM Research calculations, March 2023

These bonds exhibit lower volatility and have typically generated superior risk-adjusted returns over time (Illustration 2). Specifically, short duration bonds are, in general, less sensitive to rate and credit spread movements compared with debt that has a longer duration. They also offer an ability to boost liquidity – having a larger percentage of an overall portfolio in bonds that mature frequently, creates potential for getting regular cashflows to the portfolio. This might enable investors to avoid forced selling, especially during a stressed economic environment. It should also create a higher reinvestment rate, with the potential to seize investment opportunities in a rising rate environment.

Equally, the price of bonds near its maturity tends to be closer to par than for longer duration bonds. This is due to an ability to estimate coupon and capital payments from short duration bonds with greater certainty than bonds with longer durations – implying lower volatility in returns compared with the broader market. This combination helps eradicate much of the inevitable uncertainty about how markets will move and how central banks will respond.

To harness this opportunity, we advocate staying invested in actively selected, high-quality, shorter maturity bond strategies. For investors with a slightly longer time horizon, intermediate duration bonds can also make a differentiated contribution in a portfolio. In addition to the positive carry available today as coupons have reset at higher levels, intermediate duration bonds will benefit from capital appreciation when the Fed ultimately pivots, and we return to more normal levels of inflation.

Illustration 2: Sharp Ratio across USD IG maturity buckets



Source: Bloomberg, AXA IM Research calculations, as of March 2023

Credit selection and contributors to alpha generation

A credit-intensive strategy leads to alpha generation primarily from security selection and sector rotation

In all market environments, a successful US investment grade corporate credit allocation that captures return potential and mitigates risk, relies on a rigorous bottom-up security selection, complemented by sector rotation (Illustration 3). This enables differentiation between credits and avoids credit deterioration, downgrades, and default risks.

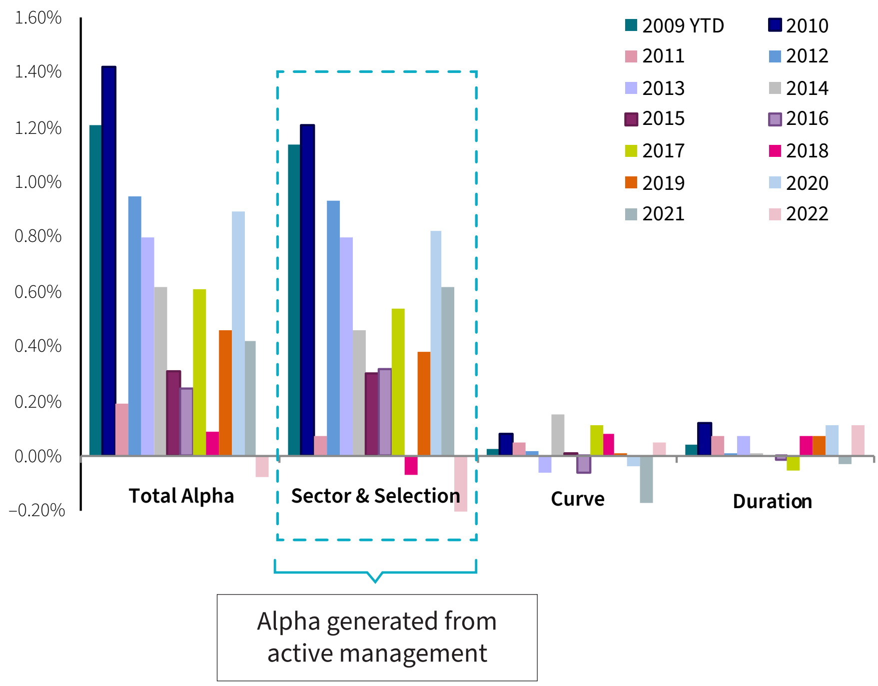
Based on rating agency estimates, both the US high-grade and high-yield corporate indices could carry marginally lower average ratings at the end of 2023, indicating potentially more volatile spreads. We are likely entering a period of greater dispersion of credit ratings between issuers. In this environment, an active security selection, we believe, is paramount for identifying issuers with robust fundamentals and capturing the most interesting opportunities.

Sector rotation is an important secondary consideration as the economic and credit cycles evolve. This supports portfolio risk positioning as we can, dynamically alter weights throughout a market cycle. Equally, altering the weights in credit quality, depending on the cycle is an important alpha consideration. For example, early in the credit cycle we would increase the weight of lower credit quality BBBs and are then able to capitalise on the outperformance of BBBs throughout the rest of the cycle.

Illustration 3: Creating the right sector and security mix delivers outcomes

PERFORMANCE DRIVERS

	Target	13 Year Avg
Security Selection	65 - 80%	72%
Sector	10 - 25%	14%
Yield Curve	0 - 10%	7%
Duration	0 - 10%	7%



Source: AXA IM Jan 2009 through Dec 2022. Performance attribution % breakdowns from FactSet have been applied to the official performance sourced from State Street. The performance shown is gross of applicable management fees. The deduction of fees reduces the level of returns. Past performance is not indicative of future results. For illustrative purposes only.

> **The credit analysis and the investment best practices we've implemented have helped to add alpha in a consistent way**

A rigorous investment process built on teamwork

In selecting individual securities, there are three pillars that underpin our philosophy:

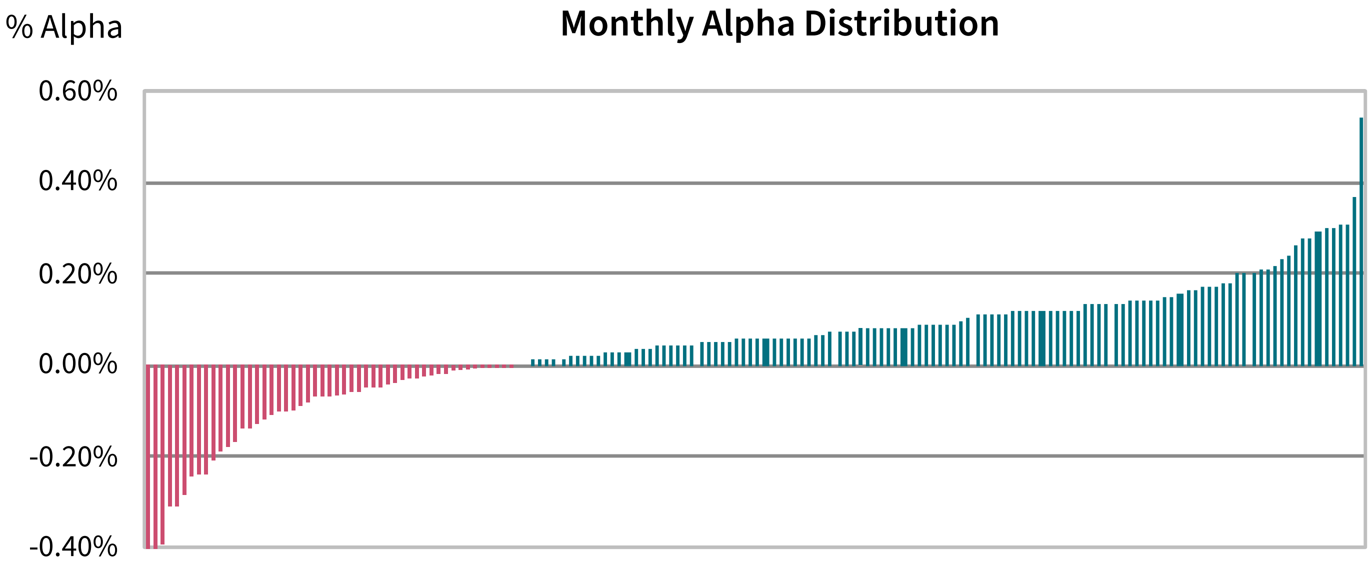
- **Be active** – to effectively differentiate between credits, separating winners from laggers.
- **Avoid downgrades** – rigorous credit selection is an important step in reducing this asymmetrical risk, preventing potentially greater portfolio underperformance that can occur from downgrades, compared with positive performance gained from spread tightening.
- **Prevent credit deterioration** – working with analysts to closely monitor valuations and fundamentals, providing insights that may help tackle periods when cycles are more challenging.

Working with analysts across our fixed income investment teams, we believe, enhances the process. In this way, credit selection forms part of a cross-over strategy, given that many of our investment grade analysts have prior experience covering high yield credits.

We coordinate with our high yield team on credit migrations to capture names considered likely to be upgraded to investment grade. Since the inception of our strategy in March 2009, we have seen 37 "rising star" picks from high yield analysts – four of which were in 2022 alone.

Overall, we have observed that the credit analysis and investment best practices we've implemented, particularly within the short and intermediate duration strategies, have helped to add alpha in a consistent way (Illustration 4).

Illustration 4: Alpha generation consistency (gross of fees)



Source: AXA IM from Feb 2009 through Jan 2023. The composite shown is the AXA IM US Corporate Bonds-Intermediate GIPS Composite. Benchmark is the Bloomberg US Corporate Intermediate Index. The performance shown is gross of applicable management fees. The deduction of fees reduces the level of returns. Past performance is not indicative of future results. For illustrative purposes only.

> **We believe ESG focus should benefit performance longer term**

Making ESG part of the mix

Environmental, social and governance (ESG) factors have become essential to our credit selection as part of our commitment to responsible investing. This aligns portfolio allocations with global megatrends that are changing the investment landscape – including issues such as increasing regulation, the growing need for risk mitigation and a heightened social conscience.

The integration of ESG factors enhances traditional financial analysis by identifying potential risks and opportunities beyond fundamental valuations. The end-goal is to enhance financial performance, alongside having a positive impact on the environment and on the society.

ESG implementation throughout our portfolios is backed by 20 years of experience, and supported by over 30 dedicated analysts. The process is well integrated within the overall investment strategy. We blend a top-down and bottom-up approach to ESG standards, and exclusionary sectors.

Alongside this, we undertake long-term investor dialogue to drive change within the companies we invest in (Illustration 5).

Illustration 5: ESG Integration based on common foundations

Source: AXA IM. For illustrative purposes only. AXA IM reserves the right to modify any of the procedures, process and controls described herein at its discretion.

*The ESG data used in the investment process are based on ESG methodologies which rely in part on third party data, and in some cases are internally developed. They are subjective and may change over time. Despite several initiatives, the lack of harmonised definitions can make ESG criteria heterogeneous. As such, the different investment strategies that use ESG criteria and ESG reporting are difficult to compare with each other. Strategies

Preparing high-quality portfolios

With bonds now once again delivering higher yields, investors can tap into potentially greater income streams – and we presently prefer up in quality, shorter-duration bonds. This dynamic will remain the case while a flat credit yield term structure continues to allow investors to capture most of the yield with exposure at the front end of the curve. Extending duration along the curve, to intermediate, offers comparable yield and provides optionality to recognise capital gains once markets start to anticipate central banks easing. Yet our base case is that this is unlikely to occur until 2024.

For now, investors' mindsets should focus towards harnessing the income from higher yields, without the rates volatility that comes when taking on longer duration risk. And with spread volatility expected, implementing allocations effectively, rely on an active process where there is a dual approach of bottom-up security selection and sector rotation, to help investors avoid risks of downgrades while allowing them to enjoy the 'carry' without significant erosion.