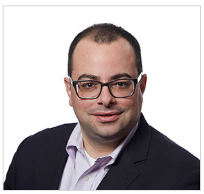
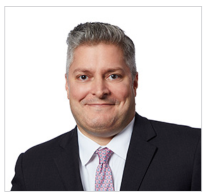
Multisector Investing: Key Themes for Today's Market

Lord Abbett experts discuss the current uncertainty around rates and inflation—and the potential appeal of a multisector fixed income strategy in such an environment

Featured Contributors



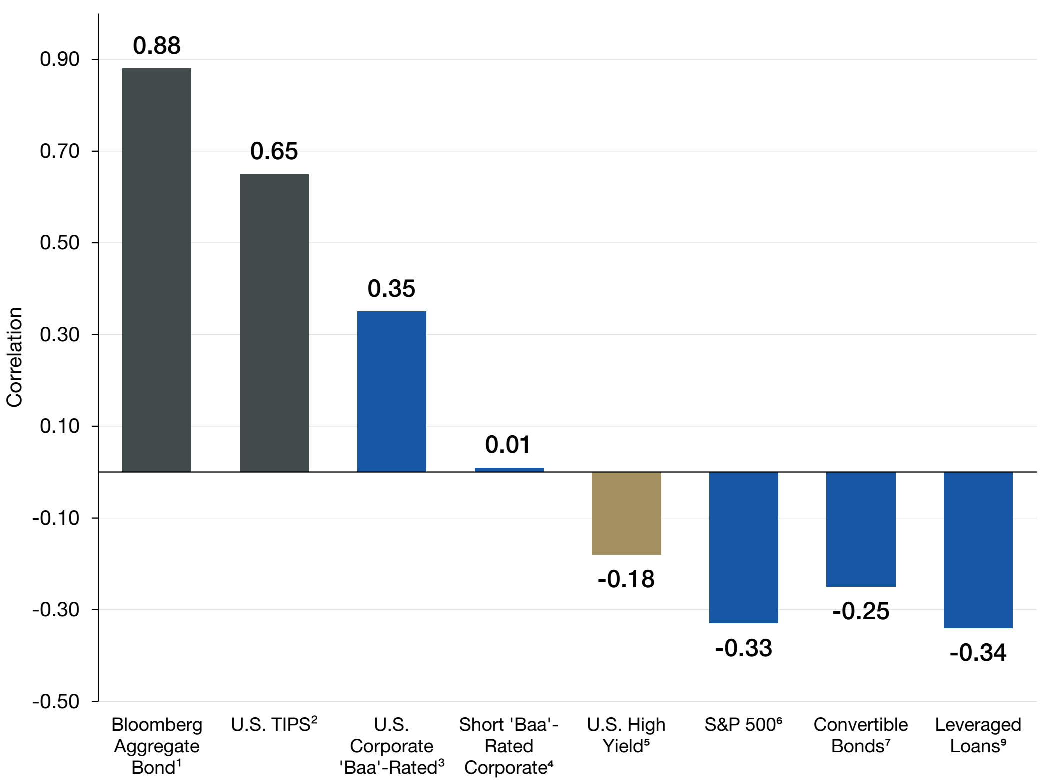
Steven Rocco
Partner and Co-Head of Taxable Fixed Income



Andrew Fox
Investment Strategist

Figure 1. Credit Sectors Offer Potential Diversification Benefits

Correlation with Bloomberg U.S. Government Index, October 1, 2011–September 30, 2021



Source: Morningstar. Data as of 9/30/2021. [1]Bloomberg U.S. Aggregate Bond Index. [2]Bloomberg U.S. TIPS Index. [3]Bloomberg U.S. Corporate Baa-Rated Index. [4]ICE BofA Corporate BBB 1-3 Year Index. [5]ICE BofA U.S. High Yield Constrained Index. [6]S&P 500 Index. [7]ICE BofA U.S. Convertibles Index. [8]Credit Suisse Leveraged Loan Index.

Correlation is a statistical measure that describes the strength of relationship between two variables. It can vary from 1.0 to -1.0.

Past performance is not a reliable indicator or guarantee of future results. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

Recently, Lord Abbett Partner and Co-Head of Taxable Fixed Income Steven Rocco and Investment Strategist Andrew Fox participated in a discussion of the challenges and opportunities investors currently are encountering in the fixed-income market. Here, we present edited excerpts from their remarks, focusing on three important themes for investors who might be considering multisector, fixed-income strategies:

1. Inflation: Trending, Not Transitory

Andrew Fox: There's a debate in the marketplace right now: Is inflation going to be transitory? What does "transitory" mean? And what are the things that might bring inflation down or goose it higher?

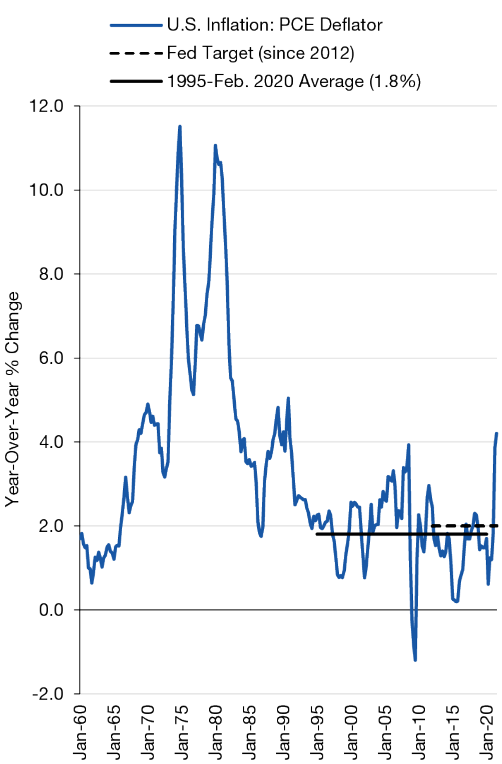
Steven Rocco: Our belief is that inflation is trending, it's not transitory. (See Figure 2.) That doesn't mean we are "inflationistas" who think it will hit extreme levels. We do believe that it's going to stabilize at a higher level.

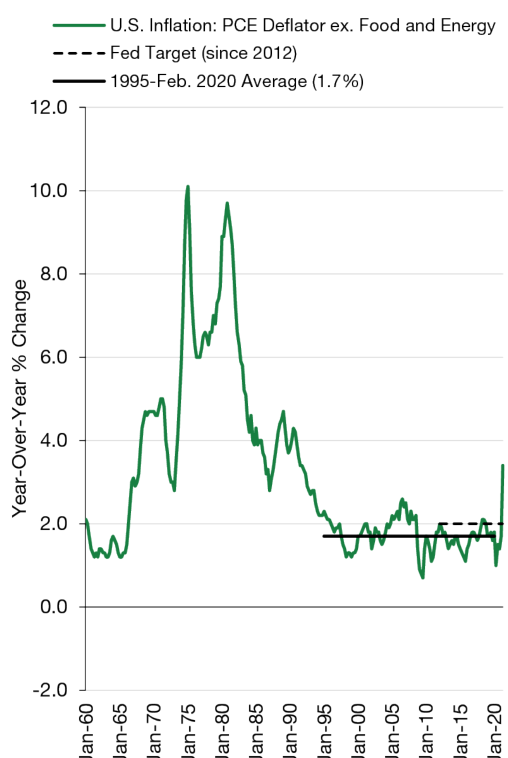
So why do we believe that? First, the big part of the increase has been the base effect coming out of the pandemic and the strain on supply chains. In fact, I would say we're close to the peak of the supply-chain difficulties, and we're starting to see shipping costs come down.

Certainly, if you want to ascertain whether inflation is trending, we think you need to focus on three things. One is owners' equivalent rent,[1] which is a big component of the U.S. consumer price index. And that's a more stable and trending data series: Once it turns up, it usually stays up. And that is ticking higher, reflecting the ongoing strength in the U.S. housing market, which looks to be getting stronger, assuming we can solve some of the labor and material challenges that have impacted the sector.

Figure 2. Is Inflation "Transitory" or Will It Stick Around?

Monthly data for the period January 1960–July 2021





Source: U.S. Bureau of Economic Analysis, Bloomberg Index Services Limited and Lord Abbett. Data as of 08/01/2021. PCE = Personal Consumption Expenditures. The PCE Deflator tracks overall price changes for goods and services purchased by U.S. consumers. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. **Past performance is no guarantee of future results.**

The second factor to watch is wages. Wages for the lowest-paid employees are starting to rise. And current data from the Bureau of Labor Statistics suggest that we're closer to full employment in the United States. Third, medical costs are something to monitor. During the pandemic, they have been particularly depressed. We expect those costs to rise as well as we come out of the pandemic, with more elective procedures being performed, among other things. So those three things suggest to me that inflation will be trending.

Now, is that all negative for the markets? Not necessarily. Because we also think economic growth is very strong. While the first and second quarters of 2021 were quite strong in terms of U.S. GDP, things appear to have slowed down in the third quarter. But we are starting to see signs that we're picking up here in the fourth quarter. COVID-19 cases counts are dropping, and you're starting to see some of that pent-up demand get unleashed again. The consumer is particularly flush.

Companies are certainly responding to some of these challenges. We see that through the third-quarter earnings season. You see companies can raise prices and hold their margin. And so we think growth will be stronger and inflation will be higher.

What does this mean for corporate credit? The high-yield market loves the regime of strong growth with a little bit of inflation. We've had four months without any issuer defaults, according to JP Morgan data. We acknowledge that's a lagging indicator. But, in my view, this is probably the best liquidity and default environment that we've been invested in in quite some time.

2. Rising Rates Underscore the Case for Diversification

Fox: When rates move up, people typically may think about adding a little bit of credit exposure. They might use something like the Bloomberg Agg [Bloomberg U.S. Aggregate Bond Index], or some sort of a core or core-plus type of product. But right now, there's not a lot of yield to provide cover at current levels if prices decline, should rates move higher.

So we might suggest that if you find yourself with heavy exposure to rate-sensitive bonds, it might be a good idea to look for a little bit of diversification. And you don't have to look too far to get it done. Figure 1 on the first page, shows correlations of various fixed-income assets with U.S. government bonds. You can see that the Bloomberg Agg and TIPS [U.S. Treasury Inflation-Protected Securities] are very highly correlated with the government bond index, as well as each other.

But as we move toward investment-grade (IG) corporates and the other side of the risk spectrum, things are different. IG corporate bonds have far lower correlation, while U.S. high yield, convertible bonds, leveraged loans, and equities are negatively correlated. All these asset classes represent a part of the potential solution to diversifying versus a core investment-grade portfolio.

And so far this year, this diversification strategy has been a pretty good idea. Remaining too close to the Agg and government bonds has not helped you very much, while deploying some of the higher-risk asset classes mentioned has continued to add value.

3. A "Nimble" Approach Is Key

Fox: Steve, what are your views on the overall value in the marketplace, and how investors should be thinking about it?

Rocco: So first, let me say: By no means am I going to suggest that there are bargains galore in credit markets. Clearly, the time when you want to be aggressive and ramp up risk was the middle of last year, the type of environment when high yield spreads are wide of the historical average level of 500 bps.

And so now you're through that. But we know that markets can live with these levels for quite some time. You just need to calibrate your risk appropriately. And so that's what we're doing. We're not at our maximum risk level, and that's a reflection of how tight spreads are.

So, long story short, we think you want to have a little bit of high yield risk. We do. You don't want to be at your maximum risk position. We think spreads can go tighter; we think it's possible. But you also take these other factors into account.

What does that mean for our multisector bond strategy? We do take our high yield exposure lower when conditions warrant, which we have done recently. So we can be nimble around these allocations. If we do get to the period where we see lending standards deteriorating and other warning signs, we'll make some adjustments.

Fox: With all the uncertainty around rates and inflation and the other crosscurrents that Steve and I have discussed, we think a multisector, fixed-income strategy—one that can move across multiple asset classes and the credit-quality spectrum—is a compelling approach in today's market. We think it represents an attractive way to diversify portfolios, given its inherent flexibility and ability to participate in various areas of the fixed-income market.

[1]Owners' equivalent rent of primary residence (OER), a component of the U.S. consumer price index, is a measure of the change in the shelter cost consumers receive from their primary residences, based on the following survey question: "If someone were to rent your home today, how much do you think it would rent for monthly, unfurnished and without utilities?"

Unless otherwise noted, all discussions are based on U.S. markets and U.S. monetary and fiscal policies.

Asset allocation or diversification does not guarantee a profit or protect against loss in declining markets.

No investing strategy can overcome all market volatility or guarantee future results.

The value of investments and any income from them is not guaranteed and may fall as well as rise, and an investor may not get back the amount originally invested. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon, and risk tolerance.

Market forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

Fixed-Income Investing Risks

The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price.

The credit quality of fixed-income securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

This material may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described here.

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Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

TIPS (Treasury Inflation-Protected Securities) are U.S. Treasury securities indexed to inflation in order to protect investors from the negative effects of inflation. The principal of a TIP is adjusted according to the CPI-U. With a rise in the index, or inflation, the principal increases. With a fall in the index, or deflation, the principal decreases. Though the rate is fixed and paid semi-annually, interest payments vary because the rate is applied to the adjusted principal. Specifically, the amount of each interest payment is determined by multiplying the adjusted principal by one-half the interest rate. Upon maturity, TIPS pay the original or adjusted principal amount, whichever is greater. Because TIPS are adjusted for inflation, a change in real interest rates (but not nominal interest rates) will affect the value of TIPS. When real interest rates rise, the value of TIPS will decline, and when real interest rates fall, the value of TIPS will rise.

A basis point is one one-hundredth of a percentage point.

A bond yield is the amount of return an investor will realize on a bond. Though several types of bond yields can be calculated, nominal yield is the most common. This is calculated by dividing the amount of interest paid by the face value.

The **Consumer Price Index (CPI)** measures the price changes f or each item in a predetermined basket of goods and services, and the inputs are weighted according to their importance to consumers.

Core bond portfolios invest primarily in investment-grade U.S. fixed-income issues including government, corporate, and securitized debt. Core plus is an investment management style that permits managers to add instruments with greater risk and greater potential return to a core bond strategy.

A **real interest rate** is the rate of interest excluding the effect of expected inflation.

The **Bloomberg Corporates Baa Index** is the Baa-rated component of the Bloomberg U.S. Corporate Investment Grade Index. The U.S. Corporate Investment Grade index includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements.

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The **Bloomberg U.S. Government Index** includes U.S. Treasury and agency securities.

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The **ICE BofA 1-3 Year U.S. Corporate Index** is an unmanaged index comprised of U.S. dollar denominated investment grade corporate debt securities publicly issued in the U.S. domestic market with between one and three year remaining to final maturity.

The **ICE BofA U.S. Convertible Index** contains issues that have a greater than $50 million aggregate market value. The issues are U.S. dollar-denominated, sold into the U.S. market and publicly traded in the United States.

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