THE SCOOP-MAY 2021

NOMURA ASSET MANAGEMENT

MAY 2021-NOMURA GLOBAL DYNAMIC BOND FUND

The Case of Rising Inflation

Key Takeaways

- We expect inflation to rise during Q2 2021 and remain elevated throughout the remainder of the year, but not to accelerate far away from the Fed's target.
- Interest rates are, in our view, on hold for the remainder of this year and beyond, despite an improving economic situation.
- Whilst rates are on hold for now, if inflation does embed and the markets start to anticipate multiple rate hikes by the Fed, this will cause risk assets to fall in value, just as they did in 2018.
- We have a meaningful allocation to longer-dated EM hard currency and local currency bonds where we believe there is sufficient yield cushion to more-than-offset the losses that we expect through the inherent duration exposure.
- However, with spreads so narrow, we continue to hold almost 30% of the Fund in short-dated US Treasuries.

Strategy and Positioning-Looking Forward

Almost all our conversations with Fund investors over the last few weeks and months have focussed on the topics of inflation and the future path of yield curves, particularly in the US. This makes sense – the future path of the yield curve will have tremendous implications for all asset prices in future. So far this year we have seen yield curves steepen as the prospects for economic recovery have improved. Although the trend paused in April, we believe it can resume – as economies continue to reopen the possibility of moves higher still in long end yields remains real. Part of our belief that yields can rise further is that we see inflation starting to come through. We expect inflation to rise during Q2 2021 and remain elevated throughout the remainder of the year, but not to accelerate away. There are temporary supply side constraints that are forcing the prices of some goods higher, but this is far from the sustainable inflation that the Fed wants to see before it thinks of raising interest rates. For that, we need to see sustained wage inflation, and there is considerable slack in the labour market that needs to be absorbed before wage inflation becomes embedded.Some inflation would be perceived as good news – if prices start to rise, more of the recently-arrived stimulus cheques may be spent, rather than languishing in the banking system. As a result, interest rates are, in our view, on hold for the remainder of this year and beyond, despite an improving economic situation. This adds up to a supportive environment for risk assets, which goes some way to justify the very low levels of credit spreads and near all-time-high equity market valuations that we see today. As we have repeatedly stated, we do not believe that higher long end yields are problematic for risk markets. Risk assets will be far more sensitive to changes in short term yields – expectations for interest rates. Whilst rates are on hold for now, if inflation does embed and the markets start to anticipate multiple rate hikes by the Fed (no earlier than late 2022), this will cause risk assets to fall in value, just as they did in 2018, the last time the Fed hiked rates. For now, we believe that risk assets have further to run, and we have allocations to higher-yielding sectors, including High Yield debt itself (although much of this exposure is via subordinated issues of otherwise investment grade companies) and contingent convertible bonds of European financials. We also have a meaningful allocation to longer-dated EM hard currency and local currency bonds where we believe there is sufficient yield cushion (and the potential for capital appreciation through spread narrowing) to more-than-offset the losses that we expect through the inherent duration exposure. However, with spreads so narrow, we do not believe it is the right time to be maximising risk, so continue to hold almost 30% of the Fund in short-dated US Treasuries. This stabilises the Fund and offers liquidity to help us take advantage of future opportunities from volatility. We also continue to have a measure of protection in place in the form of investment grade CDS exposures, and we hedge a substantial portion of the Fund's duration exposure through US Treasury futures at the 2 year and 5-year points of the curve.