ABSOLUTE RETURN IS AN ABSOLUTE MUST

APRIL 2021

BNP PARIBAS ASSET MANAGEMENT

The asset manager for a changing world

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01 | EXECUTIVE SUMMARY

1. Classical fixed income is already a source of "return-free risk" in this post-pandemic economy awash with central bank stimulus

2. Reflationary expectations have expedited the rise in interest rates and aggravated the challenges faced by traditional fixed-income strategies and indices

3. Absolute Return strategies are instead better positioned to deliver fixed income's core premises of income, diversification and stability

4. Absolute Return strategies are therefore an absolute must in portfolios aiming to tackle post-pandemic financial markets

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02 | INTRODUCTION

The coordinated central bank response to the COVID-19 crisis has pushed real yields in the developed world into firmly negative territory. While this policy action prevented a prolonged recession, it has left fixed-income investors grappling with an asset class where coupon has shrunk, while duration risk is higher than it has ever been. In other words, there remains no income in fixed income, and the asset class has become a source of "return-free risk."

Simultaneously, the expectation that this sustained monetary and fiscal stimulus will be the impetus behind a vaccine-led recovery has led to a consensus view that a reflationary environment will be pervasive in 2021.

In this paper, we highlight the challenges that these reflationary forces pose for classical fixed-income strategies in the near-to-medium term, with rising inflation potentially aggravating the challenges.

At the same time, we underscore the fact that Absolute Return Fixed Income strategies are particularly well positioned to not just defend against these reflationary pressures but exploit them to generate returns in the portfolio.

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GLOBAL ECONOMY POISED FOR REFLATION (AND INFLATION?)

Just one year ago, COVID-19 cases began making their way into the developed world and lockdowns rapidly began taking effect. The exogenous shock that followed in March 2020 caused an extraordinary collapse in the global economy. However, the speed and magnitude of the rebound has been equally extraordinary. In most segments, prices are at or above pre-COVID levels and markets have central banks to thank for the price action. The accommodative monetary policy coordinated across major central banks did much of the heavy lifting in 2020.

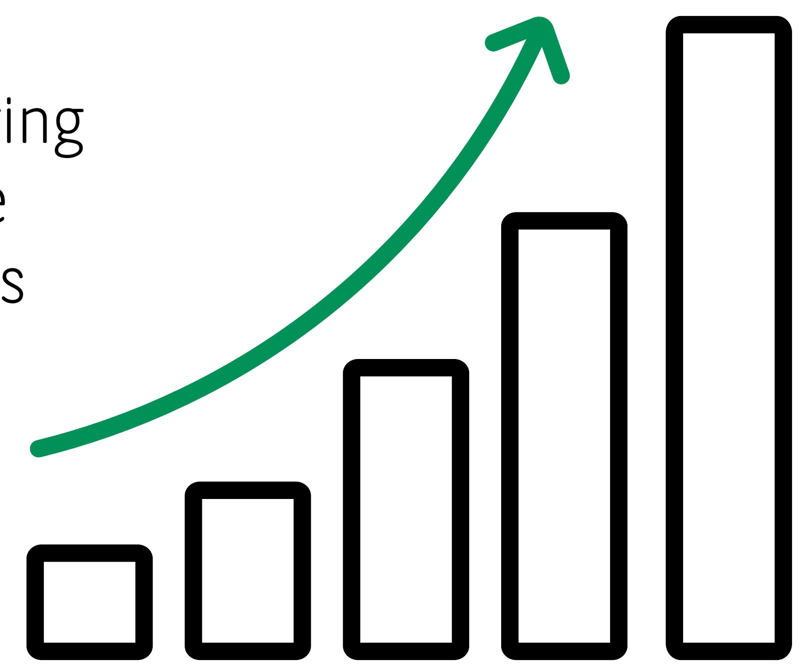
Looking ahead

Central banks will likely seek to keep front-end real yields as low and as negative as possible to help governments and businesses work off their debt burden.

Fiscal stimulus in developed nations, coupled with the pent-up demand from excess savings, particularly in mid-to-high income households, should boost consumer spending, thereby delivering a massive boost to the economy. Simultaneously, high-efficacy vaccines are game changers and together they paint a reflationary outlook for the global economy. Indeed, market consensus estimates point to GDP growth topping 5% in 2021.

The corporate sector, too, coped with the downturn far better than many had expected. In sharp contrast to the significant increases after the Global Financial Crisis, bankruptcies are in fact down on the year across the major economies. Here too, the efforts of central banks and policymakers must be lauded as they have helped keep credit flowing. Businesses are working under the assumption that the vaccine rollout will allow lockdowns to end, or at least be less pervasive, by as early as June. Unless that expectation proves wrong, bankruptcies should remain below 2008 recession levels and that should ensure a well-supported corporate bond market.

However, **inflation fears** are emerging as an important investment theme for 2021 and beyond. COVID-19 has remapped global supply chains, as corporations are increasingly emphasising resilience against future shocks.



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GLOBAL ECONOMY POISED FOR REFLATION (AND INFLATION?)

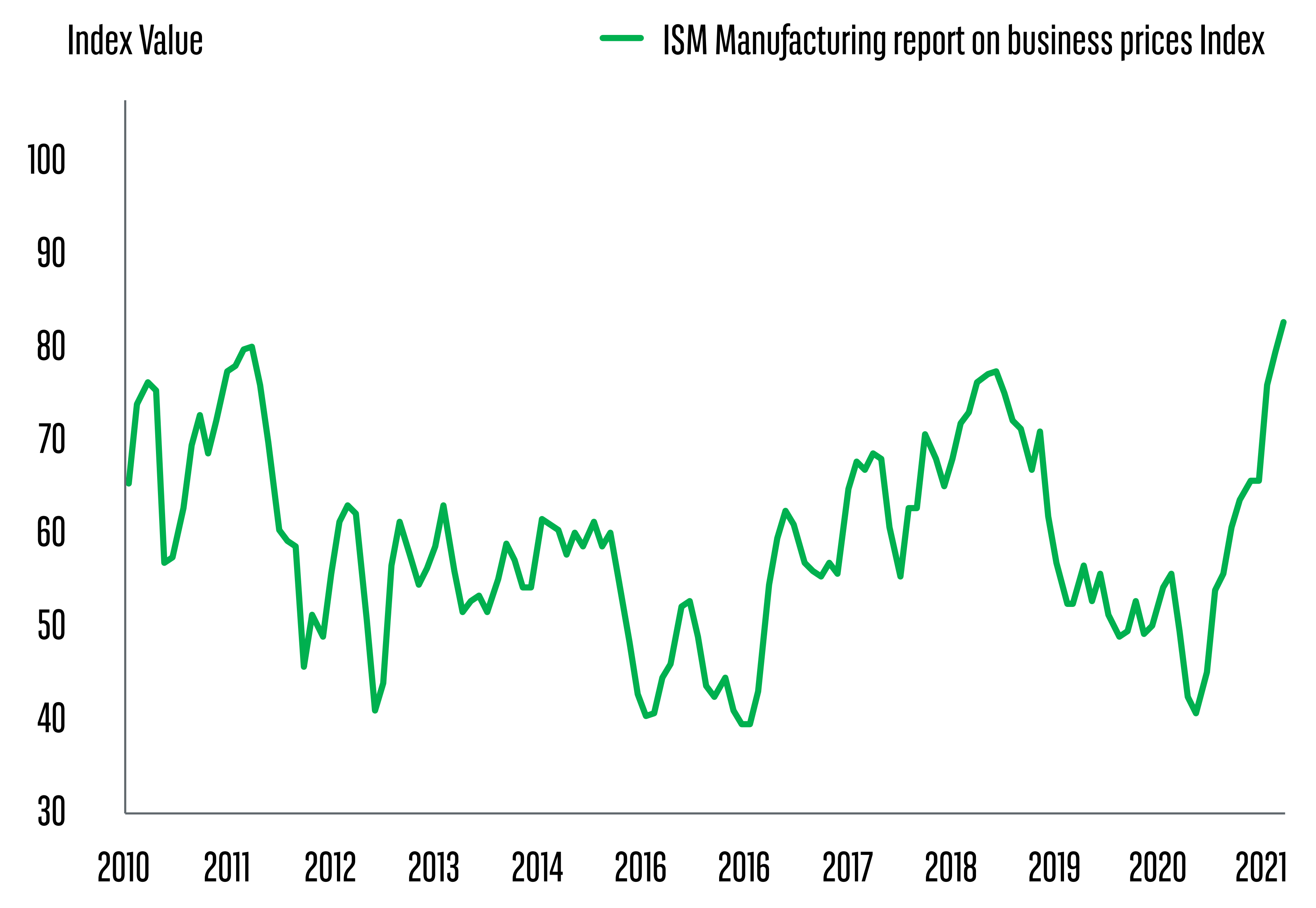
This diversification of production facilities comes at higher costs. At the same time, after experiencing a bear market for years, **commodities have been in a bull market**, which does not look likely to ease. Oil in particular may continue to rise as production cuts, in shale oil extraction as an example, are difficult to reverse rapidly. There has been some anecdotal evidence to support higher production costs as well.

Shipping capacity constraints, and consequently higher freight costs, have been garnering attention, as have the emerging semiconductor availability pressures in the automobile industry. On the demand side, **money supply** (M2) growth is at historic highs, particularly in the US, propped up by this combination of quantitative easing and aggressive fiscal stimulus.

This has been somewhat offset by the fall in the velocity of money, but this can be expected to reaccelerate once the vaccine roll-out takes effect and restrictions are eased.

Inflation risk is rising, and it is neatly illustrated by January's ISM Manufacturing report, where every firm included in the survey reported higher prices – something that has not happened since 1978.

ISM MANUFACTURING REPORT ON BUSINESS PRICES INDEX



Source: BNP Paribas Asset Management, Bloomberg as of 26 February 2021

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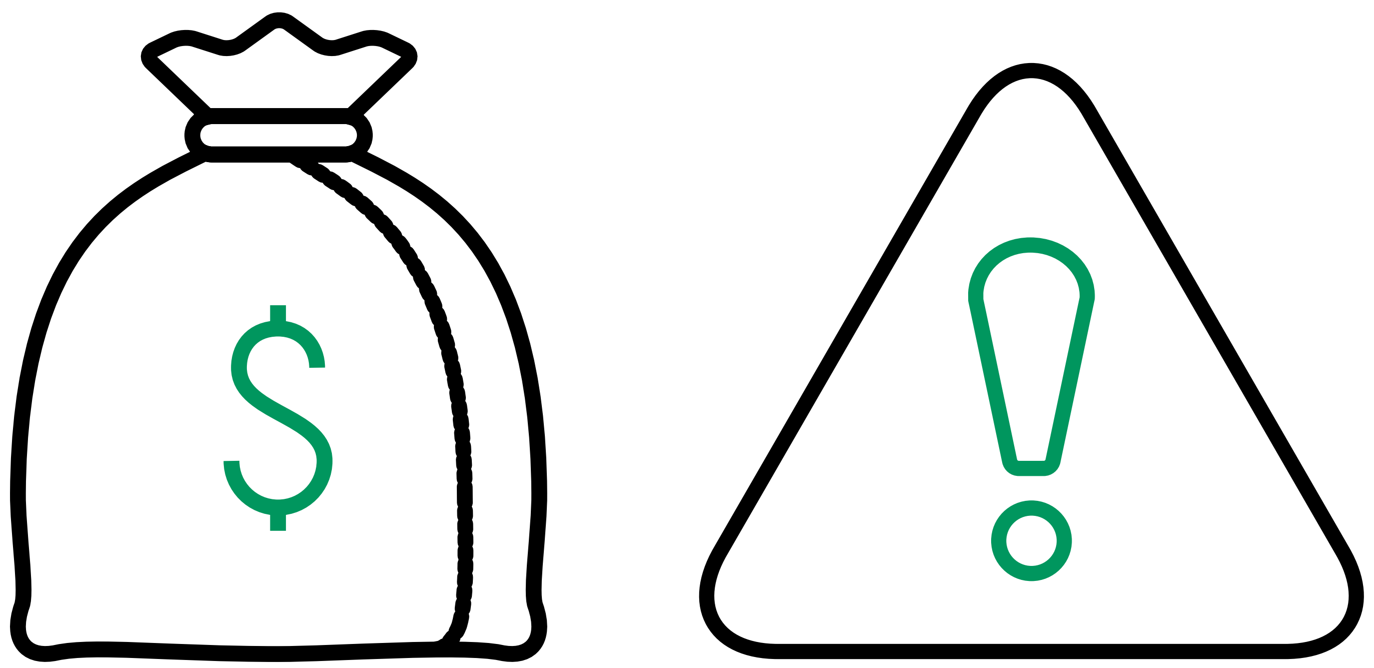
TRADITIONAL FIXED INCOME MAY GENERATE RETURN-FREE RISK

In a classic deflationary environment, equities are likely to suffer while government bonds, even at very low yields, are likely to perform well. But, with reflation, economic activity accelerates and equity risk premium shrinks, and that shrinkage comes at the expense of rising bond yields: If growth is accelerating, why would interest rates remain at recessionary levels? Indeed, **reflationary markets** are marked by rising bond yields, and the pullback in 10-year Treasury yields since the US election points to such an unwind.

Central banks, however, have pledged to hold front-end yield low, so the thrust towards increasingly high bond yields will likely manifest itself via steep yield curves.

Traditional fixed-income products, both passive and active, are not well-positioned to tackle this projected rise in interest rates. Indeed, as things stand today, fixed income has rarely been riskier, yet yielded less. A 30-year bull run in bond markets has meant that the duration, that is, interest-rate risk, of the Bloomberg Barclays Global Aggregate Bond index is the highest it has even been. In fact, in the 12 years since the Global Financial Crisis, the duration of the index has risen by around 50%, from five years to 7.5 years. What this means is that if bond yields were to rise by 100bp, bond investors would stand to lose 7.5% of the principal.



The US 10-year Treasury yield had already backed up to 1.44% as at the end of February 2021 from a low of just 0.515% in August. It follows that a 100bp rise is not just possible but that such a rise would be wholly unexceptional.

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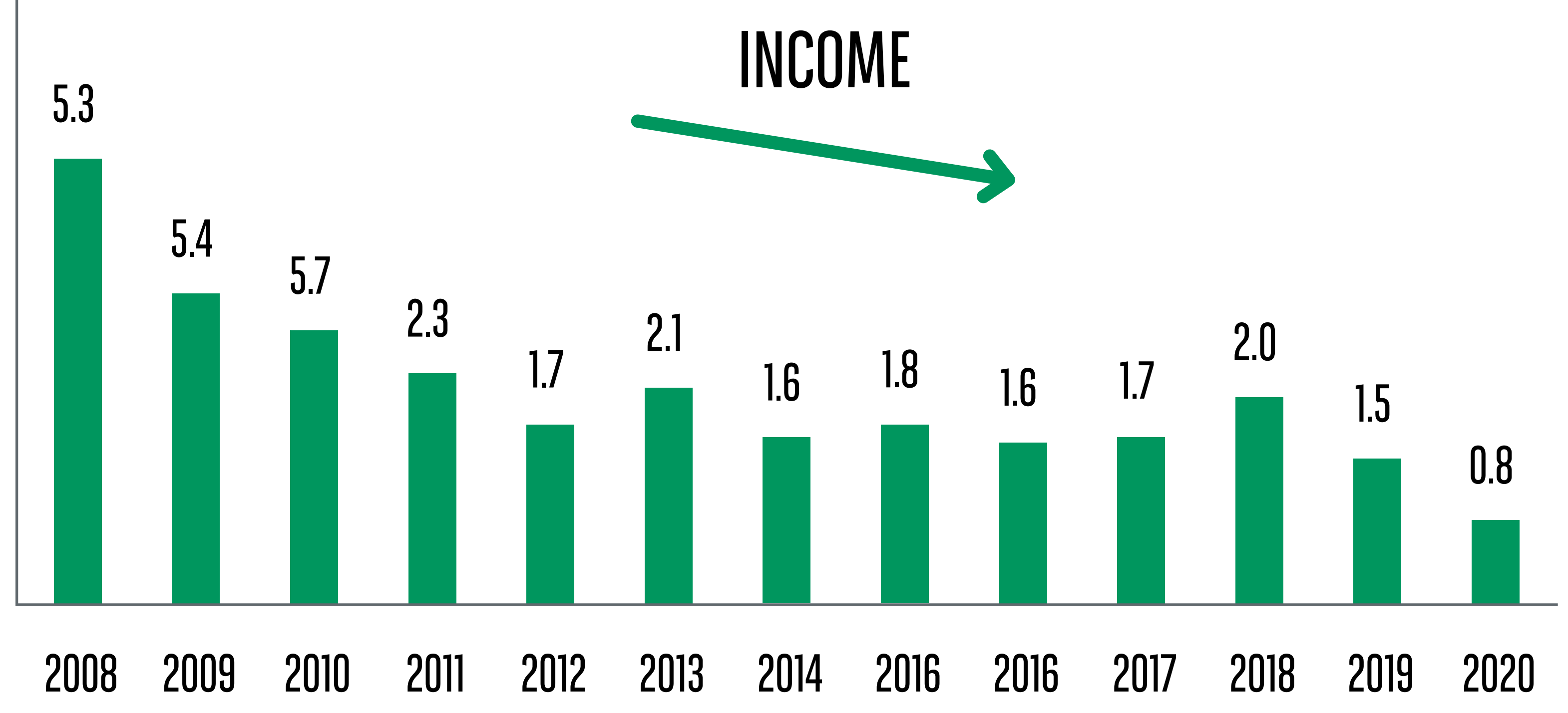
TRADITIONAL FIXED INCOME MAY GENERATE RETURN-FREE RISK

BLOOMBERG BARCLAYS GLOBAL AGGREGATE BOND INDEX DURATION (YEARS)

Source: BNP Paribas Asset Management, Bloomberg as of 31 December 2020

BLOOMBERG BARCLAYS GLOBAL AGGREGATE BOND INDEX YIELD (%)



Source: BNP Paribas Asset Management, Bloomberg as of 31 December 2020

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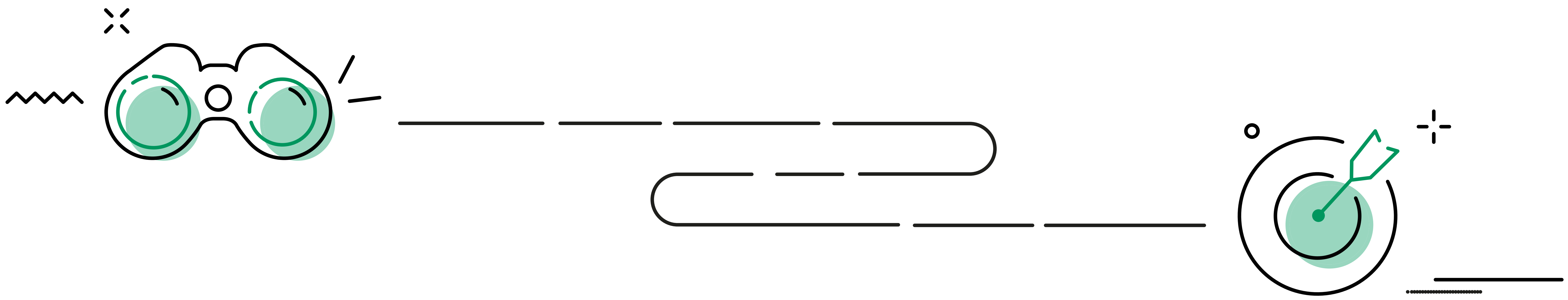
TRADITIONAL FIXED INCOME MAY GENERATE RETURN-FREE RISK

Typically, the income from the spread components of fixed income would counterbalance losses from rising rates. However, low or negative rates, coupled with spreads at historical tights, mean that **income from fixed income is also extremely low**, and indeed has been negative in real terms (that is, after inflation).

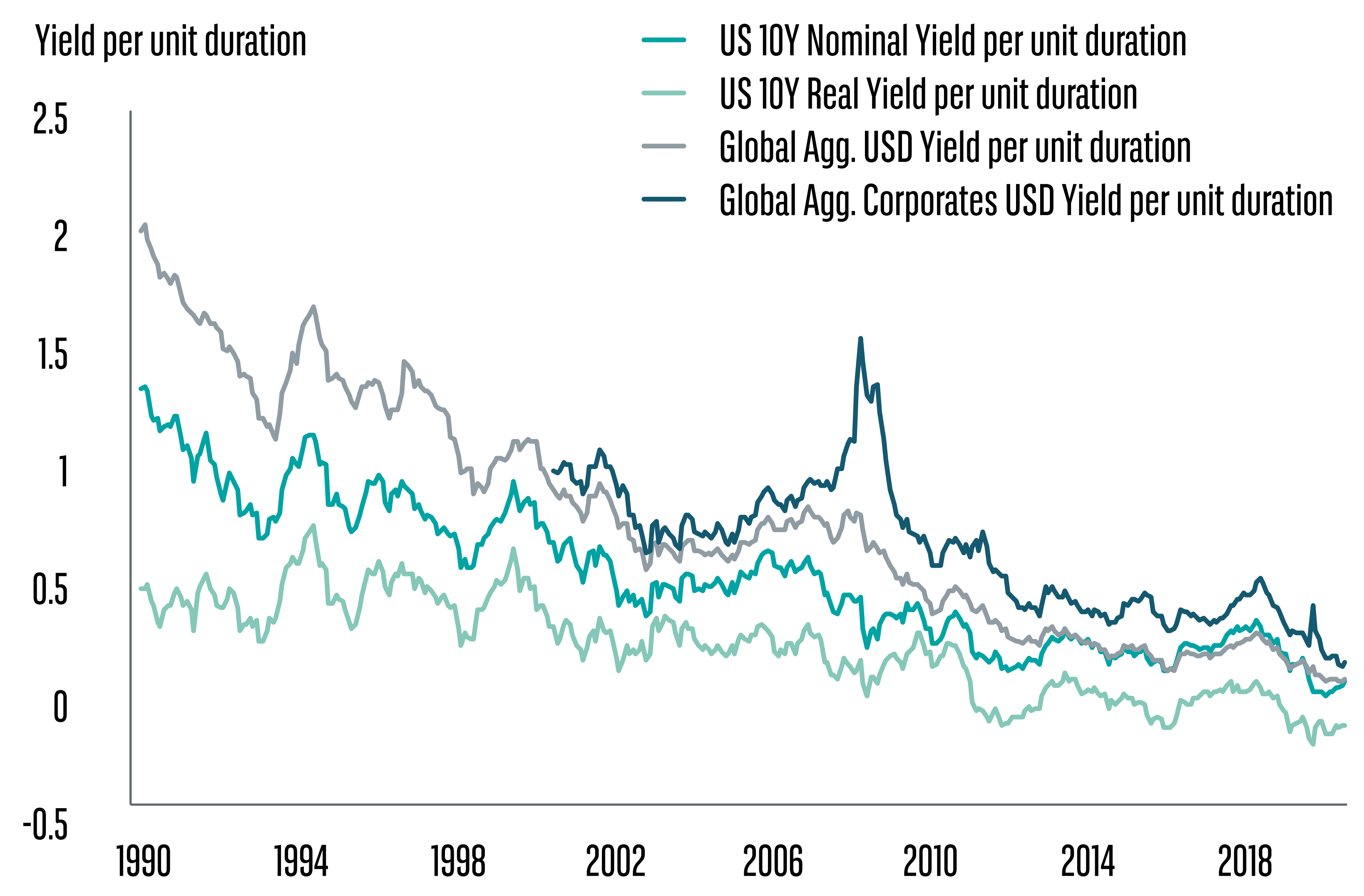
Indeed, the yield to maturity of the Bloomberg Barclays Global Aggregate Bond Index is now below 1%. Compare that to US inflation running at around 1.4%. So, at current levels, it is increasingly difficult to make "buy and hold" investments in fixed income with the expectation of returns above inflation over the medium term. This fact may have been partially obscured because the increase in capital values – prices – has flattered fixed-income total returns. 2020 was a striking example, with the Bloomberg Barclays Global Aggregate Bond index (unhedged in USD), a proxy for fixed income, returning over 9%.

In many cases, investors have also benefited from large secular foreign exchange moves contributing significantly to fixed-income portfolios. But both of these effects are transient. Fixed income as an asset class is delivering very little in the way of income, and with interest rates so low, there is little room for further price appreciation.



TRADITIONAL FIXED INCOME MAY GENERATE RETURN-FREE RISK

RETURNS PER UNIT OF RISK IN FIXED INCOME HAVE NEVER BEEN LOWER



Source: BNP Paribas Asset Management, Bloomberg as of 31 December 2020

This is not a great start. But it gets worse if inflation is added to the equation. The current environment remains akin to a “Goldilocks” scenario – economic growth is expected to be strong, yet inflation remains well below central banks’ stated targets.

Yet, as noted earlier, rising inflation remains a risk to market forecasts in 2021. Add to that the US Federal Reserve’s (the Fed’s) new average inflation targeting framework and apparent commitment to focus on what some are calling the “lower leg” of the K, alluding to the “K-shaped recovery” of a very differently experienced 2020 between those able to work from home, and those furloughed or rendered unemployed, and we could well be headed into a secular bear market for bonds.

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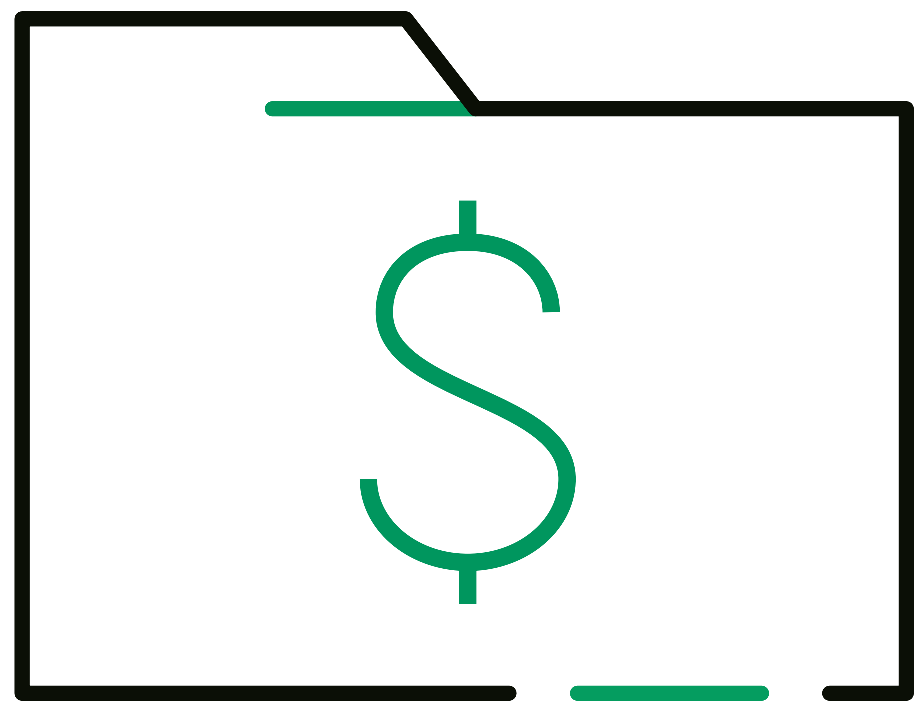
DOES FIXED INCOME STILL FIT IN A MULTI-ASSET PORTFOLIO?

All investment portfolios still need ballast. If one were to return to first principles, fixed income has a three-pronged role in most portfolios: It is a source of stability, a source of returns and a source of diversification. The pertinent question is whether traditional fixed income, as we know it, is still able to perform this role.

The marked rise in duration in fixed income, as articulated in the earlier section, implies that fixed income no longer remains the stable part of the portfolio where investors can sleep well knowing that they will not lose their capital. Further compounding the problem is the growing exposure to lower-grade credit. Increasing balance sheet leverage, and with it, lower credit ratings, were trends in place long before today. But, record corporate issuance – at lower ratings, but now tighter spreads – embeds a level of risk in these allocations which is structurally higher than it was.

Likewise, as noted earlier, with **real yields close to zero or negative**, there is not much traditional fixed income can offer by way of returns. It took an exogenous shock of the magnitude of the COVID-19 pandemic for fixed-income betas to generate the returns they did in 2020. But, from this point on, nominal yields will have to turn negative in the US, and significantly more negative in the eurozone, for fixed income to be able to replicate anything remotely close to the returns generated last year. And it could well take another black swan event to get there, because economic underpinnings point firmly in the opposite direction.



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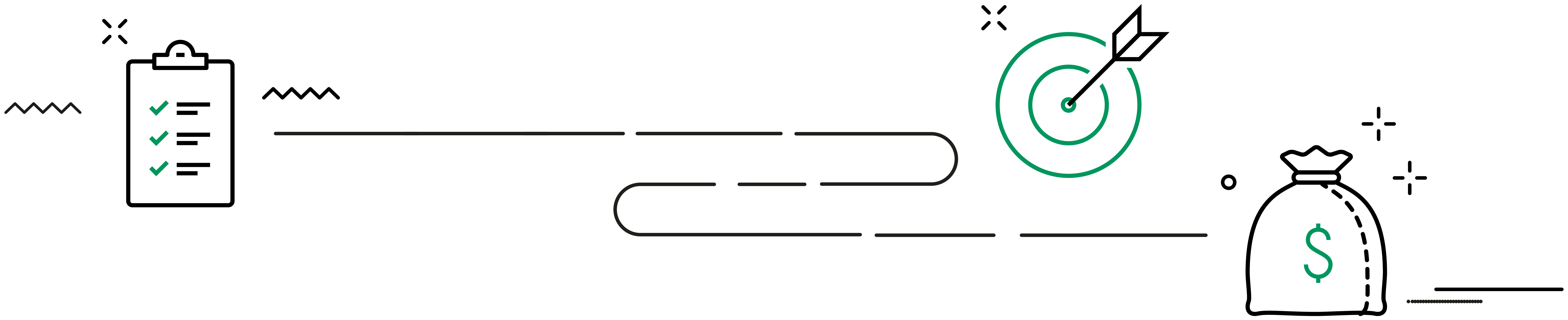

Challenge to traditional 60-40 portfolio allocation

Finally, not only have fixed-income returns and stability withered in recent years, the asset class clearly no longer functions as an efficient diversifier against risk assets. Increased correlation with equities seems to challenge the traditional 60-40 asset allocation. Through much of the bull market of the 1990s, the asset classes expressed strong negative correlation, but since the turn of the century, and with both equities and fixed income benefiting from the secular decline in rates, they have acquired a strong positive long-term correlation.

So even as the case for using fixed income as a portfolio diversifier was gaining traction, its economic groundwork was already starting to weaken. This positive correlation has increased in recent years, never more so than in 2020, when bonds moved in lockstep with equities. It worked out quite well because the direction of travel was higher, but a move in the opposite direction could inflict pain on the traditional 60-40 portfolio.

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THE CASE FOR ABSOLUTE RETURN FIXED INCOME

CLASSIC FIXED INCOME IS FAILING TO LIVE UP TO ITS THREE FUNDAMENTAL TENETS

Classic Fixed Income	Absolute Return
Secular decline in yields means that fixed income has not been generating a stable income	Flexible approach designed to generate positive returns in all rate environments
Fixed income has become increasingly correlated with equities, calling into question its role as a diversifier	Return stream derived from fixed income and yet completely uncorrelated with fixed income and other market betas
Returns per unit of risk have never been lower	Drawdown management at the core of the investment process

There can be no assurance that the investment objectives of any portfolio will be achieved. Please see additional disclosures for further information.

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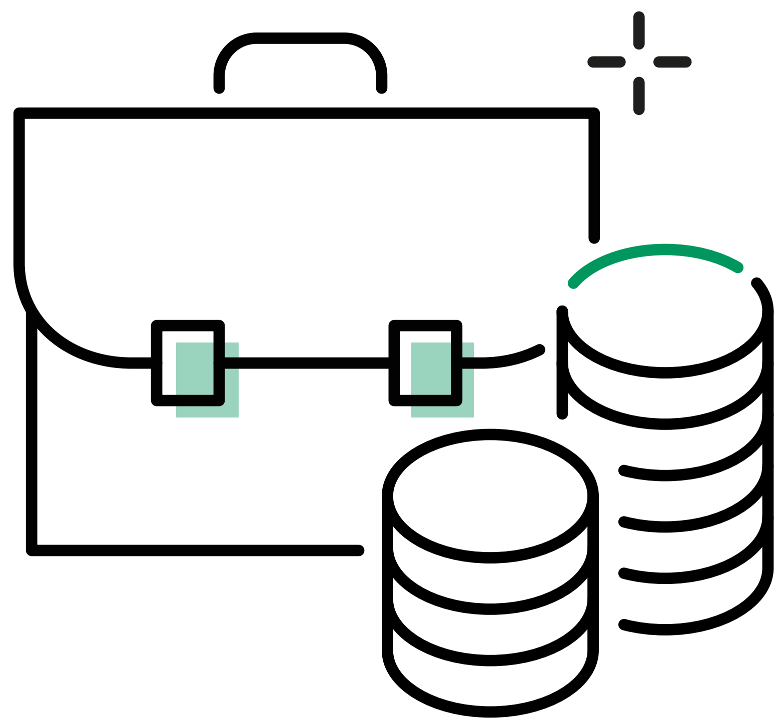
IS CREDIT THE STAND-IN DEFENSIVE ALLOCATION?

Direct intervention by the Fed and the European Central Bank (ECB) in corporate credit markets helped unlock the sector in 2020, and their extension of credit facilities will likely keep a lid on volatility and tail risk, particularly in the investment grade section of the market.Segments of the credit markets, such as floating rate notes and senior secured loans, can help mitigate the duration risk from rising rates.

With a vaccine-led recovery generally priced into the market, **corporate bond spreads** are pretty much at pre-pandemic levels, so while tight valuations might dictate that returns in 2021 may not be as stellar as 2020, they are nonetheless expected to deliver stability in the medium term. Returns from the asset class in 2021 will likely be **coupon income driven**, but there remains some room for spread compression on the basis of a strong economic recovery materialising, coupled with investors clamouring for yield pickup. This potential for generating returns with stability, at least in the near term, has garnered attention from investors looking for a defensive allocation that can substitute for classic fixed income.



Zombification

That being said, one of the legacies of this pandemic is the rising "zombification" risk in the corporate sector. Investors have been willing to look past near-term challenges on the premise that the medium-term growth outlook will iron out the kinks. While zombie corporations were typically associated with Japan's "lost decade", the recent erosion in risk premia has led

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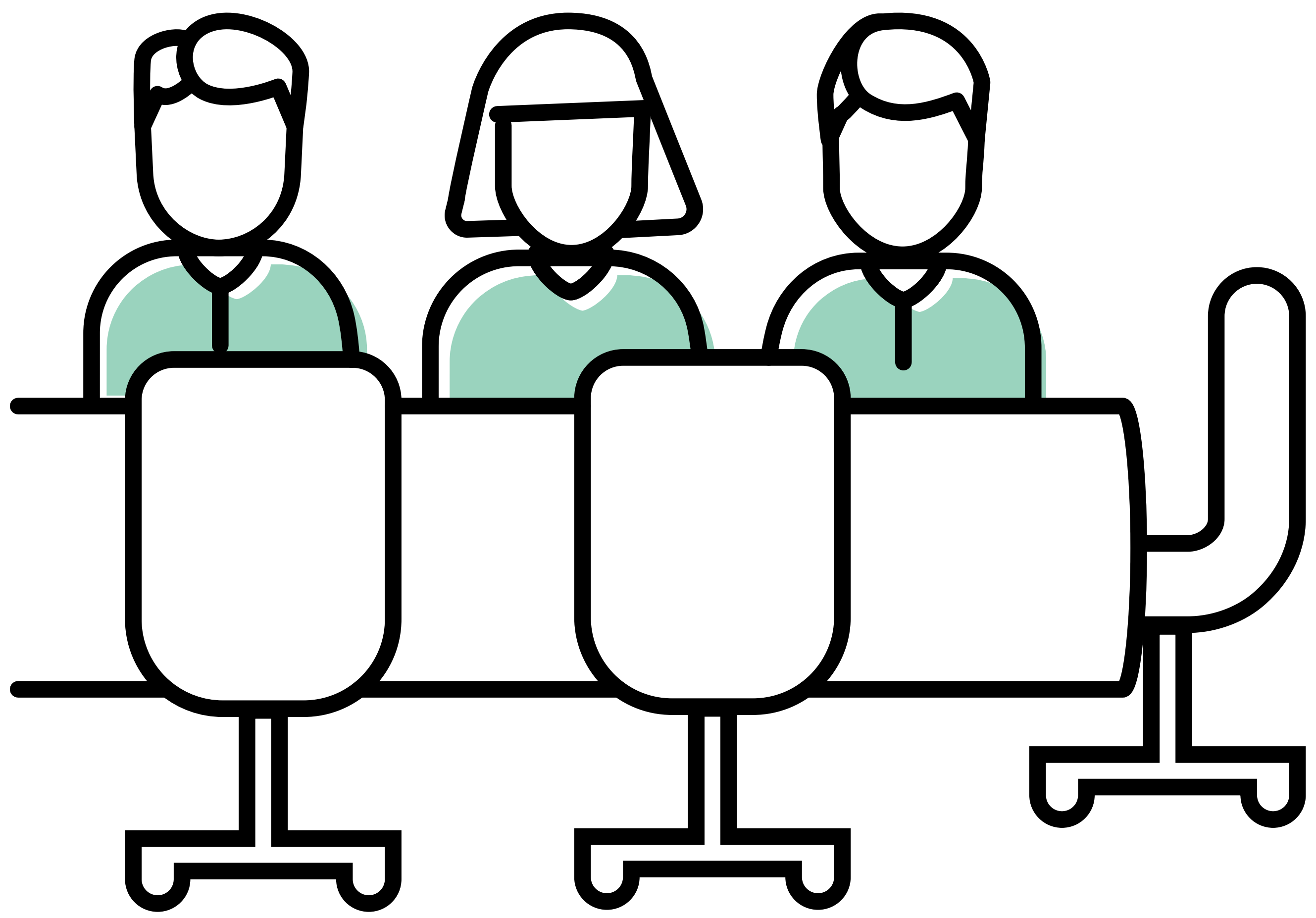
IS CREDIT THE STAND-IN DEFENSIVE ALLOCATION?

to asymmetries in credit markets, and government help has prolonged the life of many businesses that might otherwise have fallen to the forces of creative destruction.

While many of these corporations are not generating enough revenue to cover their interest expenses, most of them were able tap into credit markets in 2020 to shore up their balance sheets ahead of upcoming maturities. If, however, this recovery is derailed, many of these corporations are indebted to a point where even strong organic growth may not be sufficient to bail them out. The unrelenting central bank support might kick the default can down the road, but the historically tight valuations that are pervasive in the corporate sector are materially undercompensating investors for the risks they are amassing.

In short, while stability and income are available in the near term, they come at the expense of meaningful long-term capital risks.



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07 | ABSOLUTE RETURN FIXED INCOME: A GOOD PRODUCT-MARKET FIT

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ABSOLUTE RETURN FIXED INCOME: A GOOD PRODUCT-MARKET FIT

In Silicon Valley speak, product-market fit refers to building a product whose value proposition satisfies the need of a market and its potential customers. The road to product-market fit is often driven by identifying the key challenges faced by customers at that point in time. For current fixed-income investors, that challenge squarely lies in finding a reliable, income-generating counterbalance for their portfolio in a reflationary environment. **Absolute Return Fixed Income** is a natural fit for this specific investor need because its architecture continues to support the ability to perform the three-pronged role that one would expect from classic fixed income.

When we define Absolute Return, the first thing we are talking about is something that has no benchmark. This is an approach using fixed-income constituents but is purely managed versus cash. And because there is no benchmark, returns are derived solely from the skill of the manager. Returns coming from the manager's skill will tend to exhibit a low correlation to market direction. That means that, ideally, no matter what the underlying market, or more specifically what fixed-income market beta is doing, Absolute Return Fixed Income should have no bearing on that.

Now, life may not always be so kind: As we saw in March 2020, extreme situations can develop where all assets become correlated, and to ask that skill should deliver negative correlation in such circumstances is to ask not for diversification, but for perfect foresight. It will be appreciated that this is not realistic.

But we should not fall into the trap of allowing perfection to be the enemy of the good: Unpredicted events are a risk in any investment strategy, but Absolute Return aims to protect asset allocations from quite foreseeable developments, and to recognise when pricing prices in wildly asymmetric risks. Indeed, an ideal Absolute Return implementation focuses on ample diversification with robust risk controls, which help maximise risk-adjusted returns.

In this reflationary environment, Absolute Return fixed-income strategies are positioned to perform for the following reasons:

1 **Stability**

2 **Income**

3 **Diversification**

ABSOLUTE RETURN FIXED INCOME: A GOOD PRODUCT-MARKET FIT

1. STABILITY

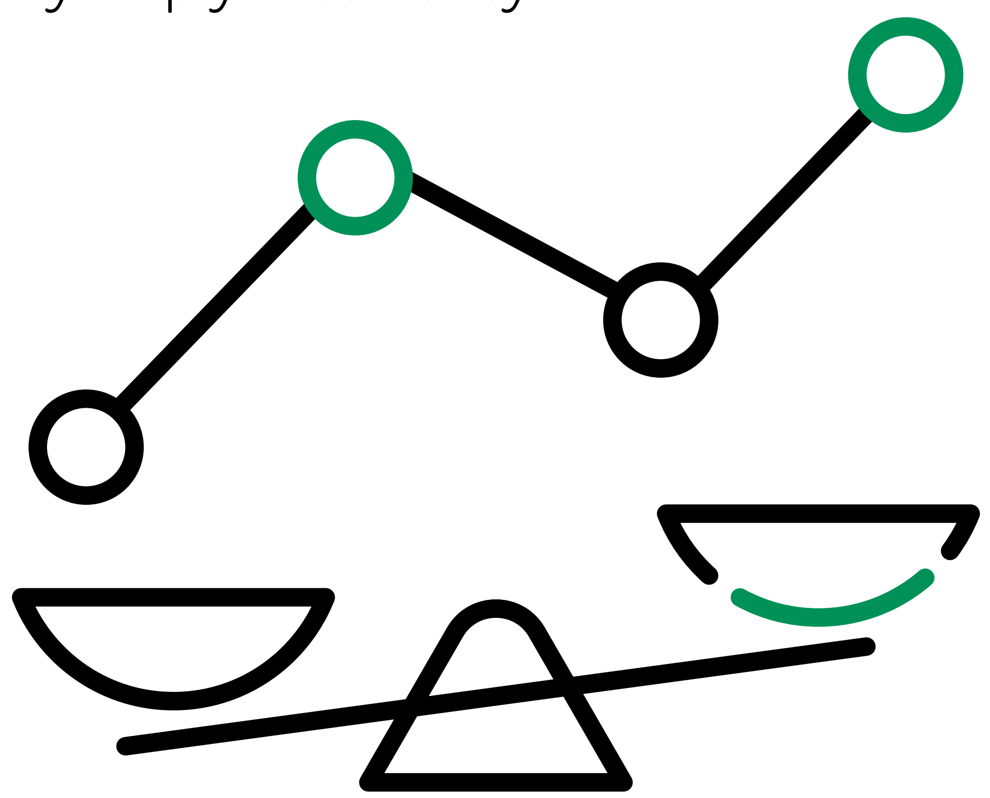
Absolute Return strategies employ a long-short approach to portfolio management. So, of course if there are positive opportunities in given markets then one would be long, most likely like every other manager. If we are neutral in exposure, we would not hold what is within a given market, we would not hold it at all. But where it gets the most interesting is where we hold a short. If we dislike a particular security or sector, we can go short.

So, if reflationary forces push US Treasury yields higher, we would not merely remain underweight duration against some index and consume the losses, we would short Treasuries and capitalise on the opportunity, as we have done over the past couple months. In other words, the same duration risk that is the bane of fixed-income beta at the moment, is an opportunity to generate returns for Absolute Return managers.

Likewise, in the event of a significant risk wobble, the sector likely to experience amplified impact would be high-yield credit, so we are able to use derivatives to short the sector and hedge our portfolio.

The stability offered by Absolute Return strategies was tested through the COVID crisis when correlations converged to one across the board. However, when the performance of these strategies is viewed on a full-year basis, it would be fair to say that they performed as one would expect them to under the circumstances.

There were segments of markets that were paralysed in March 2020 and that amplified market-to-market performance, US residential mortgages being the notable one, but the experience of the subsequent months has proven that correlation episodes do not necessarily imply insolvency.



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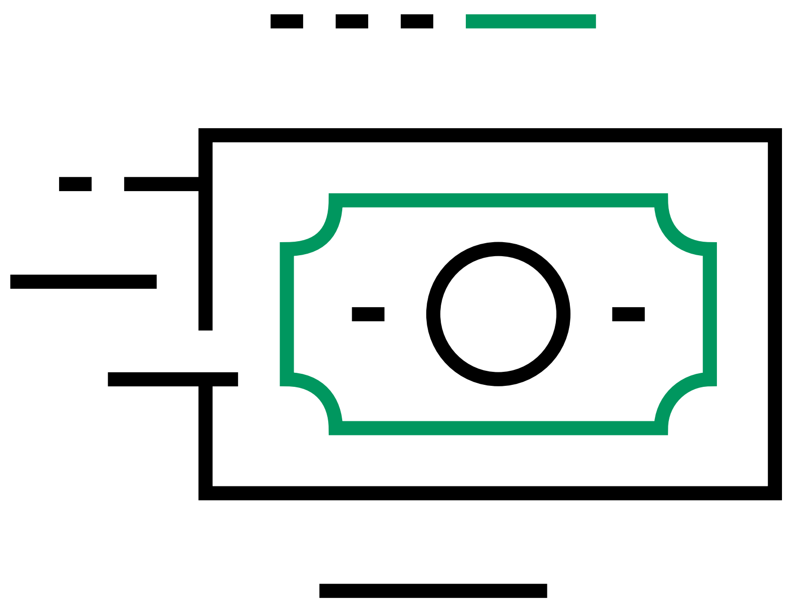
ABSOLUTE RETURN FIXED INCOME: A GOOD PRODUCT-MARKET FIT

2. INCOME



This long-short approach, coupled with a global opportunity set, also opens up opportunities to generate pure alpha-based returns in portfolios for Absolute Return managers. In current markets, we observe that US consumer credit fundamentals are much stronger than corporate credit. Indeed, households have done a good job repairing their balance sheets since the Global Financial Crisis and debt-to-income ratios have steadily declined during the past decade.

Without a benchmark dictating the limit to our exposure to these sectors, we have looked to gain exposure to the American consumer through multiple avenues: US residential mortgages being one where the housing market posted strong returns in 2020 and is poised for another strong year on the back of limited housing stock coupled with structurally rising consumer demand; we have sizeable allocations to agency Commercial Mortgage-Backed Securities (CMBS) deals that are collateralized by rent collection from consumers renting apartments; and finally a small exposure to subprime vehicle loans.

As economic activity gathers steam, generic Commercial Mortgages, the one sector that has lagged others through this recovery, should finally start catching up and we are poised to exploit some of the higher beta segments of that market, for example, idiosyncratic travel and leisure names. Likewise, despite some challenges in the corporate credit markets, some travel and leisure names present sizeable alpha opportunities, and we are positioned to exploit them. Many such pockets of idiosyncratic opportunity present themselves in markets ranging from emerging markets through 'peripheral' eurozone countries and currencies.

Our Absolute Return strategy is able to assemble these opportunities and the result is a portfolio constructed from the same ingredients as classic fixed income, yet one with higher income-generating potential.

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ABSOLUTE RETURN FIXED INCOME: A GOOD PRODUCT-MARKET FIT

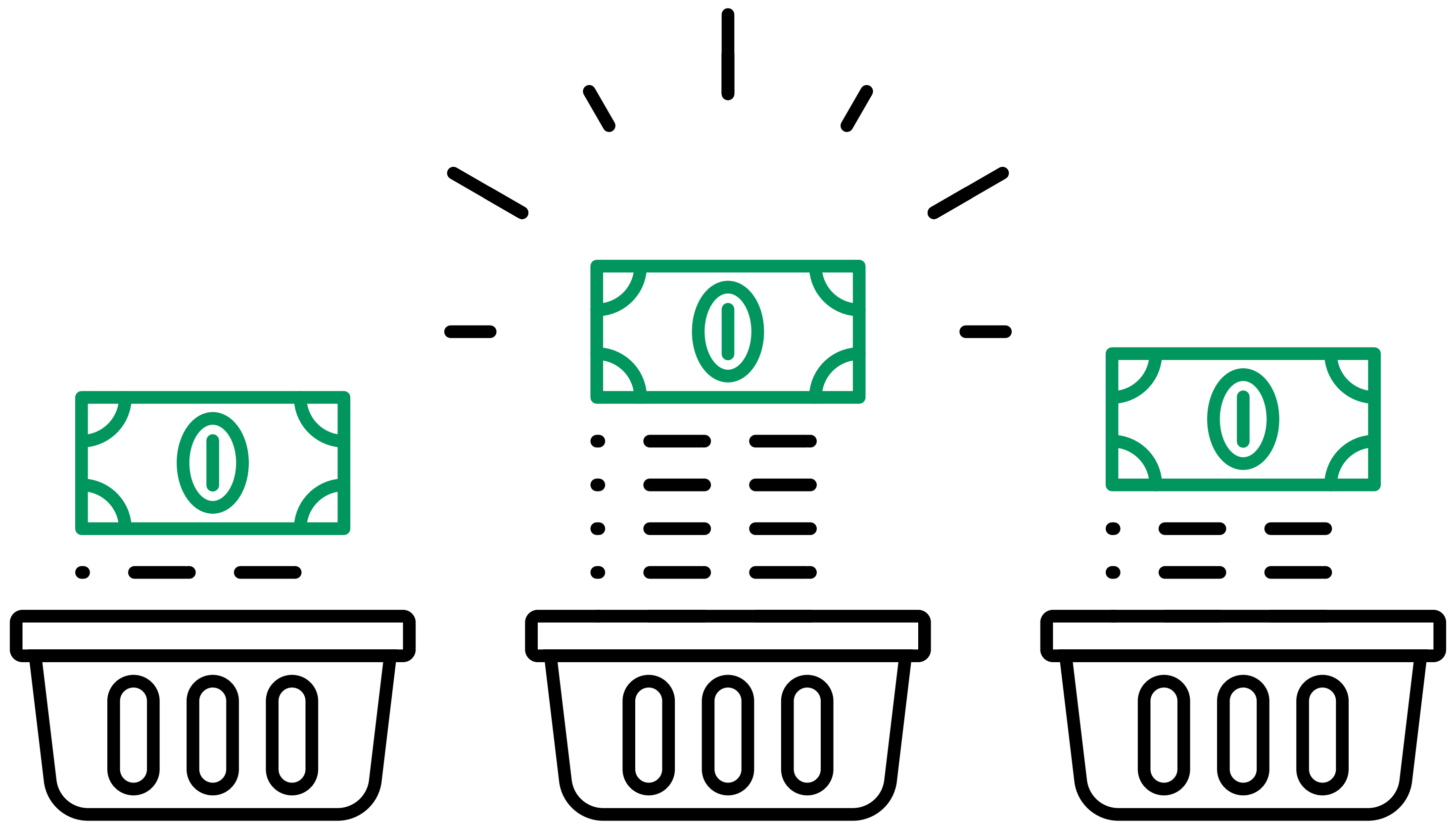
3. DIVERSIFICATION

Diversification is perhaps not universal across all Absolute Return managers, but it is an important concept for investors and means spreading capital not only across different asset classes but also across different geographies. Ample diversification in the portfolio helped counter many of the shocks brought about by the pandemic.

The pandemic, because it spread through different parts of the world at different times and with varying intensities, meant that even in the midst of the selloff, there were pockets in bond markets that were less impacted than others.

Moreover, as we emerge from the pandemic, the pace of recovery has diverged across countries. While regional portfolios were limited in their sector allocations to benefit from these trends, diversified global portfolios had the tools at their disposal to navigate the crisis, and now, on the other side of it, are well positioned to exploit the opportunities it presents. Another trend observed during the pandemic was the resilience of corporations with diversified supply chains and global operations.

These corporations withstood local lockdowns and economic disruptions far better and generally emerged unscathed from the crisis. So, the strength of diversification was witnessed not just in portfolio asset allocation, but also in security selection. We think risk diversification in every layer of the portfolio will continue to play a pivotal role in differentiating performance.



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CONCLUSION

ABSOLUTE RETURN IS AN ABSOLUTE MUST

Traditional fixed-income strategies and indices today are already sources of "return-free" risk

Reflationary expectations and risk of inflation upside may have expedited the bear market for bonds and aggravated the challenges facing traditional fixed-income strategies

In this environment, the case for Absolute Return strategies seems stronger than ever before.

Absolute Return strategies are doing what traditional fixed income was meant to do, that is:

- **Generating income:** The flexible, long/short approach is designed to generate returns in a rising rate environment
- **Increasing diversification:** These strategies are derived from fixed income and yet are completely uncorrelated to fixed income and other market betas
- **Providing stability:** Robust risk management practices coupled with portfolio construction practices where no one theme, sector, style or strategy dominates
- **Absolute Return** strategies are therefore an absolute must in the portfolio designed to tackle the post-COVID economy.

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BIOGRAPHIES

SATYA CHAKRAVARTY

Investment Specialist, Absolute Return

15 years of investment experience.

Satya is an Investment Specialist for the Absolute Return team at BNP Paribas Asset Management. He is responsible for the commercialization of the firm's Absolute Return product offerings. Satya joined BNPP AM in 2017. He is based in New York.

Prior to joining us, Satya was a Fixed Income Portfolio Manager at BlackRock Inc., where he specialized in fixed-income structured products within multi-sector fixed-income long/short duration portfolios. Previously, Satya was a Portfolio Manager within BlackRock's Financial Markets Advisory Group where he focused on managing Non-Agency Mortgage portfolios for official institutions such as the New York Federal Reserve.

Satya received his his bachelor's degree in Mechanical Engineering from the University of Mumbai, and his master's degree in Financial Economics from Ohio University.

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BIOGRAPHIES

ALEX JOHNSON

Head of Absolute Return Multi-Sector Fixed Income

24 years of investment experience.

Alex is the Head of Absolute Return Multi-Sector Fixed Income at BNP Paribas Asset Management. He is responsible for the management, growth and development of global absolute return strategies, and he is the portfolio manager for multi-strategy absolute return portfolios. Alex joined FFTW, a predecessor of BNP Paribas Asset Management, in 2008 and is based in New York.

Prior to his current role, Alex served as Co-Head of Global Fixed Income for FFTW having previously been Head of Portfolio Management. Before joining the firm in 2008, Alex was on the Global Fixed Income team at BlackRock having spent the previous four years at FFTW in London and New York where he was the Market Specialist responsible for short duration interest-rate strategies across the major currency blocs. Alex came to FFTW from Paribas Asset Management, where he worked as a Portfolio Manager for UK and European funds.

Alex has worked for over 16 years within the BNP Paribas organisation, and has over 24 years of global fixed income portfolio management experience. He received an MA in Law from Balliol College, University of Oxford and an LLM in Law from the University of Virginia.

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