CORE DATA research

Fixed Income Investing in the USA

How US institutional investors plan to handle higher interest rates

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Contents

Five key takeaways

1

Bears outnumber bulls by almost two to one

US institutional investors are almost twice as likely to be bears, believing that the US economy will go into a deep recession, with inflation persisting, as they are to be bulls, expecting a mild recession and strong recovery. Over a quarter (27%) have a bearish outlook, compared to only 14% who take a bullish view of the US economy.

2

Smaller investors and endowments are more likely to be bulls

Investor views on the macroeconomic outlook vary considerably by fund type and size. Endowments (24%) are much more likely to be bulls than public defined benefit pension funds (7%). This difference is even greater between smaller investors with less than $1bn AUM (30% are bulls) and larger investors with at least $10bn AUM (only 4% are bulls).

3

Nearly half will up allocations to fixed income as rates rise

Nearly half (47%) of US institutional investors plan to increase their allocation to fixed income if, as expected, the Fed increases interest rates to around 5%. Investment grade corporate bonds are the biggest recipient of higher allocations, with 29% of investors overall planning to add to their allocation.

4

Investors plan to hold more cash due to liquidity fears

Nearly a fifth of investors (18%) will increase their allocation to cash as rates rise. Half agree that higher rates could spark a liquidity crisis if investors exit crowded trades. And a similar proportion think higher rates could expose hidden fault lines in US financial markets, as happened recently in the UK with liability-driven investing strategies.

5

Emerging markets are seen as losers when US rates rise

Two of the asset classes most likely to see allocation cuts when US rates rise are emerging market debt and equities. A key reason for this is that most investors (69%) agree that higher US rates will cause more problems in emerging markets than they will do in the US itself.

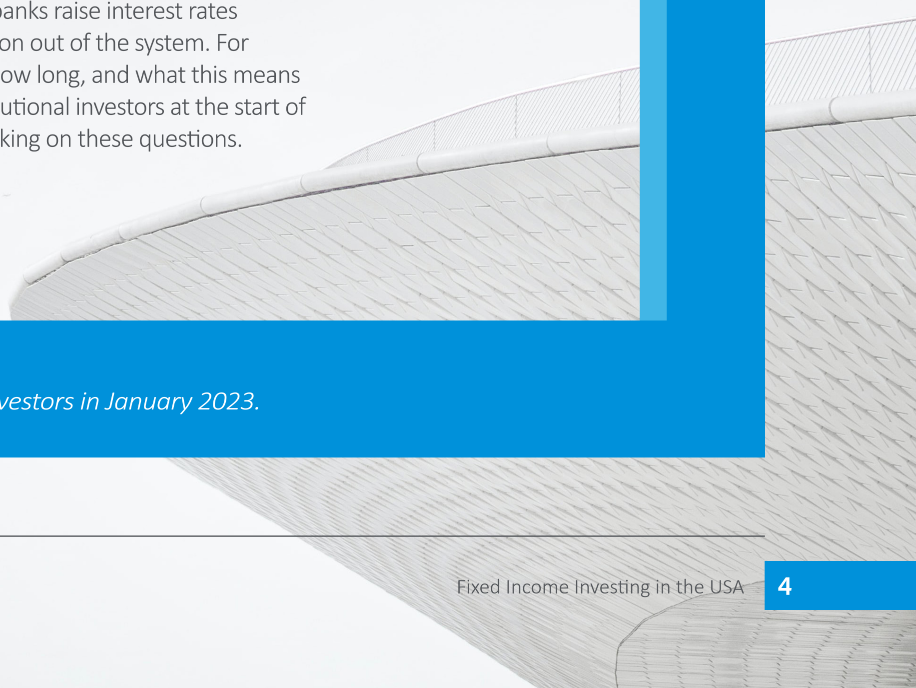
Introduction

After seeing both their equity and bond asset values fall in 2022, investors will be hoping for a change in 2023. This depends on a wide range of factors, but the ability of central banks, particularly the US Federal Reserve, to control inflation will strongly influence investment returns in 2023. If inflation persists, then it is likely that the Fed will be forced to keep interest rates high until it sees inflation come down. If this happens, any recession could be deeper and longer than the current market consensus. In turn, this is likely to affect investment decision-making, as investors adapt to an environment of higher interest rates, a possible economic slowdown and other disruptions.

In order to take the pulse of US institutional investors, CoreData asked a representative sample of 120 investors at pension funds and endowments for their views on the macro-economic outlook, the possible impact of higher US interest rates and how they plan to change their allocations to fixed income and selected other asset classes. From this we can see that the majority of investors now have a fairly cautious view on the state of the US economy, expecting to see a recession of some form. But this does not preclude them making asset allocation changes. In fact, rising interest rates are leading to a reappraisal of fixed income assets, as investors take advantage of higher yields after a long era of very low interest rates.

There are other repercussions from the shifting plate tectonics of the investment landscape. One is that US investors see rising interest rates as a disincentive to hold emerging market assets. A likely reason for this is that higher US interest rates will strengthen the US dollar against emerging market currencies, making it harder for emerging market countries to service US dollar-denominated debts. Another consequence is that investors want liquidity as an insurance policy and source of dry powder. Many think that the law of unintended consequences could strike when rates rise. This was seen in the UK in September 2022 in dramatic fashion when the announcement of unfunded tax cuts sent UK bond markets into a spin, leading to a liquidity crisis for some pension funds using a volatile mix of liability-driven investing and derivatives. This incident will have reminded many institutional investors of the need for good risk management during times of change.

As we go through 2023, the US economy may show its characteristic resilience and shrug off fears of recession. On the other hand, central banks raise interest rates knowing this will slow growth, in order to squeeze inflation out of the system. For investors, the big questions are how high rates rise, for how long, and what this means for their investment portfolios. This snapshot of US institutional investors at the start of the year should provide useful guidance on investor thinking on these questions.



Methodology:
CoreData Research surveyed 120 US institutional investors in January 2023.

Conclusion

If US interest rates rise to around 5%, there will be a shake-up in many of the portfolios of US institutional investors, according to the results here.

Firstly, many, if not most, investors expect to see a recession in some form, as rates are elevated to combat inflation. Inflation may be showing signs of coming down, but the Fed is likely to be ‘once bitten, twice shy’; it will be wary of now easing off too soon, given it was seen as doing too little, too late when inflation started to pick up.

So, assuming rate rises are in line with the current consensus, what will investors do? From the findings here, investors intend to add to core fixed income and some other forms of fixed income. Investors are also aware of the risks of not having sufficient liquidity, with allocations to cash on the rise. This shows that they think rate rises could precipitate ‘black swan’ events, or trigger a liquidity crunch of some kind.

The negative prognosis for emerging market assets is another interesting finding. This could offer opportunities to contrarians and there is a view that as China re-opens from the pandemic, its growth will surge. Against this, it could be argued we have seen ‘peak globalization’ and countries such as the US want to bring more industry back home, in order to have more resilient supply chains. The Inflation Reduction Act could also be a force for investing in the US in the future.

Overall, investors will fervently hope that 2023 brings better investment returns than its predecessor. Even if there is a recession, this may be the case. As Warren Buffett is quoted as saying: "Be fearful when others are greedy, and be greedy when others are fearful". Just as long as the light at the end of the tunnel is not that of an oncoming train.

CoreData

About Us

CoreData Research is a global specialist financial services research and strategy consultancy. CoreData Research understands the boundaries of research are limitless and with a thirst for new research capabilities and driven by client demand; the group has expanded over the past few years into the Americas, Africa, Asia, and Europe.

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With a primary focus on financial services CoreData Research provides clients with both bespoke and syndicated research services through a variety of data collection strategies and methodologies, along with consulting and research database hosting and outsourcing services.

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CoreData Research has developed a number of syndicated benchmark proprietary indexes across a broad range of business areas within the financial services industry.

- Experts in financial services research
- Deep understanding of industry issues and business trends
- In-house proprietary industry benchmark data
- Industry leading research methodologies
- Rolling benchmarks

The team understands the demand and service aspects of the financial services market. It is continuously in the market through a mixture of constant researching, polling and mystery shopping and provides in-depth research at low cost and rapid execution. The group builds a picture of a client's market from hard data which allows them to make efficient decisions which will have the biggest impact for the least spend.

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