Uncertainty: The new certainty

by Matthew Rees, Head of Global Bond Strategies

Financial markets have experienced considerable turbulence in recent years, reflecting developments such as the COVID-19 pandemic and the Ukraine war, both of which had dramatic impacts on the global economy. That turbulence is continuing in 2025, as the old geopolitical and economic certainties come under strain.

Various underlying and often interconnected issues are currently unfolding. These include:

- The polarisation of domestic politics across the globe
- Rising geopolitical tensions
- The far-reaching consequences of technological change, including artificial intelligence, which could lead to short-term economic dislocation and job losses
- The impact of climate change on economies and societies
- Concerns about government fiscal sustainability

While every era is marked by unexpected developments that can cause short-term dislocation or even market shocks – such as the events of 9/11 and the global financial crisis in the 2000s, or the rise of computing and the opening up of China in the 1970s – the kind of disruption we are currently seeing, with so many dynamic and pressing factors colliding, is very rare. Moreover, the unpredictability of the impact of factors such as climate change, artificial intelligence and rising geopolitical tensions makes it extremely difficult to forecast the direction of the global economy.

However, we do believe most of the current trends, whether geopolitical or economic, could prompt upward pressure on prices and are thus associated with the risk of higher interest rates. That has clear consequences for the fixed income sector.

In our view, these factors are also likely to deliver shorter – and possibly sharper – economic and market cycles. That would create a very different backdrop for investors – particularly those in fixed income – than has been seen in the recent past. Inevitably, it will lead to greater volatility and make it harder for investors to predict the direction of interest rates and asset prices.

The benefits of an unconstrained bond strategy in this environment

Given this fluid outlook, we believe strategies that are nimble and can quickly adapt to changing circumstances can outperform their constrained, benchmarked counterparts. And rather than focusing on one region or sector, given all the idiosyncratic risks facing markets, we think it is best to adopt a truly agnostic and pragmatic approach, seeking out the best opportunities in fixed income markets globally.

We believe our unconstrained approach, which is benchmark-agnostic, can help investors navigate this environment and capture a wider opportunity set. An unconstrained bond strategy, with the flexibility to invest in a wide range of fixed income securities, both within and outside of traditional benchmarks, can help investors navigate the uncertain outlook for global markets. Such a strategy takes a highly diversified approach to generating income, aiming to produce returns from credit selection, duration management and overall risk management. The strategy, for example, provides the managers with the flexibility to target good, profitable companies in whichever sector or part of the world they may be located.

Dynamic approach to managing duration

Interest-rate risk is one of the main risks facing fixed income investors, and in an uncertain and volatile world, that risk is likely to be heightened. An unconstrained approach, however, can lower the risk significantly. That's because unconstrained strategies do not have a benchmark level of interest-rate risk they are expected to take.

We also believe the duration of fixed income portfolios should be managed in a more dynamic fashion in 2025, and an unconstrained approach certainly allows for this. Over the 40 years to 2021, duration was something to 'buy and hold'. However, a more volatile, shorter-cycle backdrop will require a sharper focus not only on duration management for the entire portfolio, but also on its interaction with risk assets.

Our team includes interest-rate experts who look at the dynamics between interest rates and credit spreads to actively manage duration. We actively position duration with a view to the correlation of returns between government bonds and credit spreads. Without this, investors could face large capital losses.

The challenges facing investors include how to achieve global diversification. It can be tempting to simply buy the bonds with the highest yields, but that can result in dangerously high concentrations of risk.

Lessons from the past

The year 2022 proved extremely difficult for all investors, with interest rates rising sharply from the near-zero levels seen during the pandemic and causing sharp reversals in global bond markets. Both equities and bonds fell in value, with the Global Aggregate Bond index losing around 12%, making 2022 one of the worst years on record for bond investors. However, investors in unconstrained strategies that had the ability to entirely avoid or even negate duration risk were able to successfully navigate this period. Unconstrained bond strategies, for example, were able to exploit their flexible mandate to deliver positive returns in 2022.

Current opportunities

We continue to maintain a broad range of exposures across investment grade debt, with a preference for shorter-dated debt where we benefit from good yields and more defensive behaviour in any potential sell-off.

We also currently prefer subordinated debt within the higher yielding asset allocation, particularly AT1s, given banks remain well capitalised and more insulated to the direct impact of tariffs than other sectors.

We've been increasing exposure to 10s30s flattener trades globally. While we acknowledge that demand for long-term government bond debt has decreased and will likely continue to do so, we think it is illogical for governments to persist in issuing long-term debt and paying a premium.

Risks that investors should be aware of

We believe it is very difficult to predict the outlook for variables such as economic growth, inflation and interest rates, particularly in the current uncertain environment. So, we prefer to consider what the market is concerned about. We use that to position our duration accordingly, thinking about duration as a hedge against our credit positions rather than as a source of returns. That's because, over the long term, interest-rate risk management does not generate significant returns.

Navigating the new uncertainties

The levels of volatility experienced by financial markets this year have taken most analysts by surprise. We expect this turbulence to continue at least into next year. In this new age of uncertainty, fresh thinking is required, including the use of an unconstrained approach that searches for the best opportunities in fixed income worldwide. An unconstrained strategy can guide investors through this challenging environment, helping them protect and growth their wealth, as well as generate an attractive income.

The key to success lies in the ability to cut through the headlines and focus on what matters most over the longer term. A thoughtful but nimble approach, we believe, is required to balance opportunity-seeking and risk-taking in this newly unpredictable world.

Key Risks