Are real returns beyond the passport gates?

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Truffle's SCI Income Plus Fund won a 4th award for being the Best South African Interest-Bearing Short-Term Fund at this year's Raging Bull Awards. Fixed Income portfolio manager at Truffle Asset Management, Raihan Allie, shares his thoughts.

After more than a decade of artificially low rates across the US and other developed markets, prospective real returns beyond Emerging Market (EM) shores are looking more attractive to bond investors. An end to Quantitative Easing (QE) and two years of an aggressive rate hiking cycle means global risk-free rates are now in line with longer-term levels.

Strategically, the 10-year return assumptions across major Developed and Emerging Markets provide a good foundation for prospective returns and indicate that DM bonds compare well with EM counterparts over the long term, building the case for a globally diverse bond portfolio. Historically low to zero rates across DM regions meant EM compared more favourably from a long-term return perspective. However, given the long-term and non-linear nature of these assumptions, short-term and tactical opportunities can be found to earn excess returns above these strategic expectations.

The promised lands

We believe the current rate hiking cycle has reached its peak, and that EMs are set to benefit when rates are eventually cut. Emerging Markets in this environment provide:

- attractive starting yields that protect against downside
- moderating inflation – eroding less of your returns
- good growth prospects
- cheap currency valuations versus an expensive US dollar.

Tactically, it makes sense to include EM bonds in a fixed income portfolio.

While Emerging Market players share similar characteristics and in aggregate should benefit from the cutting cycle, we acknowledge the case for diversification.

2024 and beyond brings many challenges and uncertainties, including global elections. Half the world is heading to the polls amidst a more polarised environment lifting the risk of extremist views that could drive significant change. Due to the extent of globalisation, outcomes of elections will have far-reaching effects.

South Africa is a case in point. Our ruling party is aiming to extend their term; however, current data indicates a real possibility that a coalition will be required for the ANC to hold the reigns. This is unchartered territory and the tail risks for investors are increasing. We need to mitigate risk and protect downside.

The only free lunch is diversification

It is difficult to predict the timing of a rate cut, especially as the market is already guilty of raising expectations, only to be disappointed. As fixed income investors, we're taking a measured approach to incrementally increase exposure to the assets we believe will benefit from peak rates or a cutting cycle.

The significant idiosyncratic uncertainty in each region worldwide warrants introspection into any concentration risk. South African bonds offer compelling real returns over the long term, while familiarity with and a deep understanding of the local risks and economic environment provides local investor comfort. However, being mindful of 'home bias,' we believe it is currently prudent to take the 'free lunch' in the form of diversifying our Emerging Market exposure beyond local shores. Fortunately, rising global rates provide a reasonable entry point into diversified global income. EM bonds are also typically perceived as riskier than reality given their geographic categorisation. It's therefore important to consider the specific characteristics of each EM bond.

As local elections draw nearer and the sustainable health of our fiscus hangs in balance, it can only make sense to diversify our bond and fixed income holdings into other Emerging Markets, ensuring we increase the probability of participating positively when rates are eventually cut.

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