Fund report, December 2022
Global Investment Grade
Fixed Income

Sparinvest

ARE HIGHER INTEREST RATES A GODSEND?

Christmas and 2022 brought higher interest rates

Markets. The global economies and the financial markets are still paying a high price for the major central banks' collective misinterpretation of the economic situation after the corona crisis, which meant that monetary policies were far too accommodative in 2021 and parts of 2022. Attempts are now being made to address the economic imbalances via a synchronised tightening cycle, resulting in the largest interest rate shock for decades.

In the middle of the month, the ECB's Governing Council adjusted its inflation expectations upwards and assessed that interest rates will have to rise considerably and steadily before reaching a level that is sufficiently restrictive to ensure a timely return of inflation to the target level of 2% in the medium term. It is assessed that keeping interest rates at a restrictive level will ensure that inflation gradually subsides because demand is dampened, while also providing a safeguard against the risk of a sustained upward shift in inflation expectations. Hence, the ECB did not see inflation fall back until after 2024 and indicated that monetary policy would be tightened more than expected by the market.

The credit market response to the ECB's announcement was positive and credit spreads narrowed, thereby adding to the positive sentiment we have seen in Q4. The ECB confirmed that it will do what it takes to get inflation under control. With higher nominal interest rates and marginally declining inflation expectations in the market, positive real rates on Investment Grade rose further. This may prove to be a major supporting factor for demand in 2023.

There is no doubt that it will be a balancing act, with the economic downturn as the counterbalance. There is a risk that the ECB will tighten its monetary policy so much that the economy ends up in a severe recession. In that case, the credit market's focus will shift from interest rate volatility to the credit risk of individual companies.

Traditionally, December is a month with low issuance activity, and 2022 was no exception. A few issues were made in the first week of the month, and then activity stopped. Historical patterns indicate that the market will re-open in January.

Higher interest rates led to negative returns

The portfolio yielded a negative return in December, as narrower credit spreads in the market could not offset the negative contributions from the higher interest rates.
The decomposition of returns shows that the entire yield curve contributed to the negative return. The strongest contributions came from long-dated bonds with maturities of more than seven years. This is a repetition of the pattern seen in both 2021 and 2022, when interest rates also rose. Viewed over the full year, A and AA rated companies generated higher returns than BBB companies did. Capital securities benefited from reduced interest rate sensitivity and outperformed the general credit market.

Given the weak business environment, we expect that companies will still take a conservative view of their capital in 2023 and have less appetite for bolt-on acquisitions, new investment projects or higher dividends/share buybacks. In addition, central banks' massive quantitative easing is ending and hence also the strong growth in corporate bond markets. It is possible that companies will, once again, turn to banks for funding. Overall, this points to another year with a low net supply. On the demand side, the new level of nominal and real rates means that it has again become attractive for insurance and pension companies to invest in corporate bonds. In 2023, central banks will still be a major source of demand, but not to the same extent as previously. So we see favourable supply and demand dynamics.

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Strategy
Global Investment Grade invests in global corporate bonds, cf. the fund's prospectus. Bond selection is based on the value approach, meaning that the team focuses on bonds issued by companies with healthy long-term earnings power and strong balance sheets as well as an expected ability to service outstanding debt. The portfolio is diversified across sectors, regions and credit ratings. At least 2/3 of the portfolio are invested in Investment Grade bonds.

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