Active Fixed Income Macro Analysis for Effective Portfolio Management

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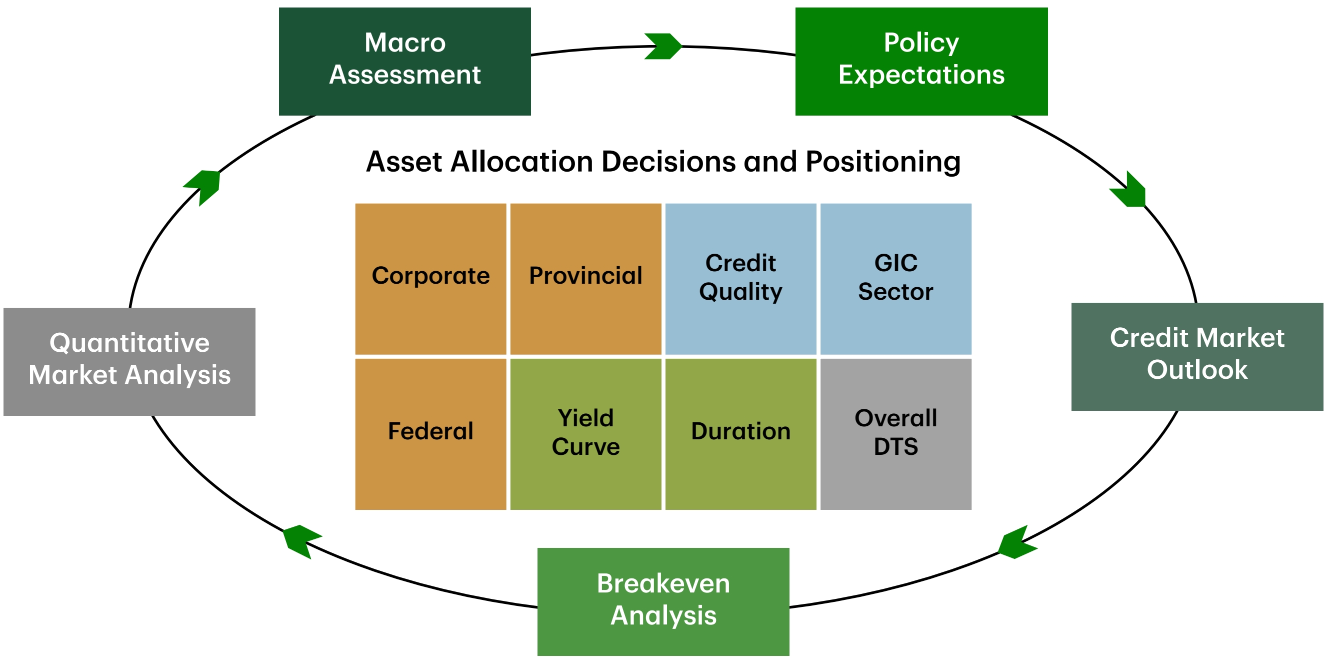
After two years of interest rate increases, central banks in developed markets are hitting the breaks on hikes, pivoting from a rate hiking cycle to a rate cutting cycle. However, the precise moves will depend on inflation and economic data as it rolls in.

Navigating the ever-changing rate landscape requires a robust approach to active fixed income, which should include both expertise in macroeconomic analysis and credit research. This is precisely the approach that TD Asset Management Inc. (TDAM) takes. While TDAM is an integrated shop with both top-down and bottom-up approaches to market analysis, this paper focuses on the firm's top-down approach, detailing each step of process.

Figure 1: TDAM's Active Fixed Income Top-down Macroeconomic Framework



Quantitative Market Analysis

Our process for conducting fixed income macroeconomic analysis features a feedback loop with no fixed starting or ending point. We begin with quantitative market analysis.

The way we approach market analysis involves a blend of top-down and bottom-up strategies. Each step of our process incorporates elements of both approaches to varying degrees. We focus on:

- **Volatility:** We analyze historical volatility (ex-post) to understand past market behaviour across various asset classes, including interest rates, credit, equities and foreign exchange (FX). We also assess forward-looking (ex-ante) volatility that helps to identify skew in market pricing and contextualize subsequent market moves.
- **Correlation:** We assess correlations between low-risk assets (e.g., government bonds) and various risky assets (e.g., corporate bonds and equities), which helps us diversify portfolios and manage risk. For instance, changes in yield curve components (expected real rate, real rate term premia, expected inflation rate and inflation term premia) provide insights into market expectations and how they influence correlations between different asset classes.
- **Sentiment Indicators:** We track various established risk sentiment indicators. These indicators help better evaluate investors' credit risk appetite and its implications for excess return performance.
- **Liquidity and Financial Conditions:** We consider interest rates, credit spreads and FX movements as primary factors influencing market behaviour. Understanding how changes in rates and FX impact different asset classes helps in developing robust investment strategies.

In summary, our process integrates numerous quantitative and qualitative factors, which aims to inform a robust portfolio construction. We continuously refine our approach to account for changing market dynamics and investor behaviour, ensuring that our strategies remain effective.

Macro Assessment

At TDAM, we strive to be proactive in our portfolio positioning. To achieve this goal, we utilize a proprietary internal model that helps us to understand the current market environment and make informed decisions.

Our model takes into consideration several key indicators, such as the labour market, Purchasing Managers Index, term structure, valuations, inflation and credit conditions. The weight of each indicator varies based on the stage of the economic cycle, and the inputs are transformed into an indicator that points to the likelihood of a bull or bear market. If the indicator falls below a certain threshold, it signals an increased likelihood of a potential bear market.

Our experience has shown this to be a reliable tool that advises us on the level of risk we should take in the portfolio when it comes to credit versus government bonds. Our ultimate goal is to identify opportunities that will provide the best return for a given level of risk.

In addition, we incorporate indicators that are updated more frequently (e.g., weekly or biweekly). These indicators provide more immediate insights and help us with more tactical decisions.

These leading indicators help predict future components of the inflation basket and broader macroeconomic conditions. We do not rely solely on our Asset Allocation regime model, a proprietary model developed by TDAM's asset allocation team. We use additional factors and assess broader macro conditions, such as critical market indicators from emerging markets. These insights help us forecast outcomes for real rates, inflation and credit conditions.

We use various higher frequency indicators to enhance our understanding and forecasting capabilities. For instance, we have developed internal models thatoffer us guidance on when to take certain trade positions, based on jobless claims, which are updated frequently. This data helps us decide whether to go long or short and over what timeframe, providing a basis for more frequent rebalancing.

We don't just track data; we back-test it to generate actionable signals. This includes sentiment indicators, high-frequency economic data points and models designed to predict market conditions, such as the probability of a bull or bear market over the next 12 months.

By leveraging a variety of indicators and continuously refining our models, we capture a nuanced view of market dynamics, enabling both strategic and tactical views to emerge. This approach allows us to generate more frequent and reliable signals, ensuring our strategies remain robust and responsive to changing conditions.

Policy Expectations

Our policy expectations analysis is crucial for understanding monetary and fiscal policy impacts on the markets. This involves a comprehensive examination of various indicators and their implications for real and nominal yields.

Components of our rates analysis include analysis of the actions of central banks and examination of inflation expectations versus real rates.

Central Banks' Actions

The role of central banks in shaping monetary policy is pivotal in both Developed Markets (DM) and Emerging Markets (EM). Our analysis involves examining the current policy settings across these markets to understand the broader economic implications. Central banks in DM, such as the U.S. Federal Reserve, the European Central Bank and the Bank of Japan, typically follow more predictable and transparent monetary policy frameworks. We track key economic indicators like Gross Domestic Product growth, unemployment rates and inflation to gauge the central banks' likely policy moves.

For instance, when the Federal Reserve gradually reduces its accommodative stance, moving towards a more neutral position as economic conditions improve, this impacts real yields, inflation expectations and their term premia, which we monitor closely.

EM central banks, such as those in Brazil, India and South Africa, often face more volatile economic conditions and political pressures, leading to less predictable policy settings. EM economies are more sensitive to global economic conditions and capital flows. In those markets, we analyze inflation trends, currency stability and external debt levels.

Inflation Expectations vs. Real Rates

Inflation expectations and real rates are crucial components of nominal rates. Our analysis focuses on what the market prices in versus our expectations. The term premium reflects the extra yield that investors require for holding longer-term bonds versus short-term securities, accounting for uncertainty. We examine current real rates and identify how much term premium is priced in. We analyze quarter-on-quarter changes in 10-year break-even spreads and real yields. This helps us understand the market's inflation expectations and real yield trajectories.

By comparing market pricing with our internal models, we identify discrepancies and potential market inefficiencies. We develop scenarios based on potential economic outcomes (e.g., soft landing, hard landing or no landing) and simulate future rate paths. Using tools to modify expected paths, we create probability-weighted forecasts, integrating macro and quantitative assessments to predict the most likely market behaviours.

Understanding the relationship between policy expectations and market pricing helps us assess financial conditions, particularly through the rate channel, and adjust our strategies accordingly.

Economy

Credit Market Outlook

By carefully studying the global macroeconomic trends, we gain a deeper understanding of the current economic landscape, market sentiment and potential for unexpected events. Once we've understood the valuation of the markets, we develop a credit market outlook based on real-time market events. These events include:

- **Market Breadth of Recent Performance and Stress Indicators:** Our analysis includes monitoring recent market performance and stress indicators to gauge the health and stability of the credit markets. We use a variety of metrics, such as spread changes, volatility indices, credit quality trends, and liquidity measures, to assess market depth and identify potential stress points.

- **Demand/Supply Dynamics:** We closely examine the demand and supply of new debt issuances across different sectors. This includes tracking new issue supply, new issue concessions, fund flows and investor positioning to understand the balance between demand and supply. Specific focus is given to identifying how new supply impacts credit spreads and overall market sentiment.

- **Earnings Expectations Across Sectors:** Earnings expectations are a critical component of our sector analysis. We monitor quarterly earnings reports and forward guidance to identify emerging trends and potential risks or opportunities within each sector. This helps us anticipate market reactions and adjust our investment strategies accordingly.

- **Sector Themes:** Our sector analysis includes identifying and analyzing key themes that could impact performance. These themes may include wage growth, supply chain disruptions, environmental factors and regulatory changes. We integrate these themes into our broader market outlook to better understand sector-specific and issuer-specific risks and opportunities.

- **Ex-Ante Sector and Company Leverage Dynamics:** We evaluate leverage dynamics at both the sector and company levels, focusing on expectations of credit rating upgrades and downgrades. This involves analyzing financial ratios, debt maturity profiles, capital allocation policies and refinancing risks as well as engaging with company management. Our proprietary models help us predict potential changes in credit ratings, which are crucial for managing portfolio risk.

- **Proprietary Credit Risk Assessment for Each Issuer:** We conduct proprietary credit risk assessments for each issuer in our portfolio, which includes evaluating financial health and business model resilience. Our assessments are supplemented by external credit ratings and market-based indicators to provide a comprehensive view of credit risk. Regular updates and discussions with our credit research team ensure that our risk assessments are current and reflective of any new developments.

Break-even Analysis

Our valuation approach includes analyzing break-even spreads and their percentiles over different time frames, such as the last five years or 15 years. We begin with a high-level view, examining different asset classes, but also delve into more detailed analyses that consider recent developments.

- **By Asset Class:** We assess break-even spreads for different asset classes, providing a comprehensive view of valuation across the market. This involves looking at historical data and current market conditions to understand the overall risk and return profile of each asset class.
- **By Credit Quality:** Within each asset class, we further segment by credit quality. This helps us identify how spreads and volatilities differ between high-yield and investment-grade securities. We also consider leveraged loans and the specific dynamics of high-yield bonds.
- **By Sector:** We break down break-even analysis by sector to capture sector-specific risks and opportunities. This includes analyzing spread volatilities, Z-scores and other relevant metrics for each sector, which helps us understand how different economic conditions and industry trends impact credit spreads.
- **By Issuer:** At the most granular level, we analyze break-even spreads for individual issuers. This involves a detailed assessment of each issuer's financial health, credit risk and market positioning.

Our break-even analysis supports portfolio constructions by identifying undervalued or overvalued sectors, issuers and securities. It also allows us to balance risk and return, ensuring that the portfolio is aligned with our investment goals and risk tolerance.

Conclusion

All these layers of analysis are crucial for effective portfolio construction. By breaking down the data in this manner, we can turn our guiding principles into actionable insights. This structured approach ensures that we are well-informed about market conditions and can make strategic and tactical investment decisions.

Our investment framework integrates various quantitative and qualitative factors with the goal of forming a comprehensive view of the market and thus enhancing our portfolio construction and risk management. By analyzing historical and forward-looking volatility, correlations, sentiment indicators, positioning and liquidity conditions, we build a robust understanding of market dynamics.

Collectively, all the above components impact our risk budgeting process. They help us to determine the optimal sizing of each factor and effectively implement both strategic views through bond allocation and tactical views by using derivatives. This ensures that our strategies are aligned with evolving market conditions and therefore positioned to achieve our value-add target. ■

Analysis