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The Case for Going Global, in Pictures

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We've made the case - here, here, and here - that it's generally a good time for fixed income given bonds' revaluation to yields well above the secular stagnation levels that existed prior to the 2022 bear market. These higher yields, combined with the shift by most developed market central banks from rate hikes to cuts, suggest that this sleeper bull market is set to continue. But where or how does global fixed income fit within this context?

This report makes the case for hedged global fixed income in nine figures.

Spoiler Alert: While the returns from hedged global bonds are not always higher than domestic bonds, they are typically less volatile. Additionally, the global bond market offers an expanded opportunity set for adding value through active management. If history is any guide, this combination of lower volatility and greater alpha potential positions active, global hedged portfolios to achieve compelling risk-adjusted returns going forward.

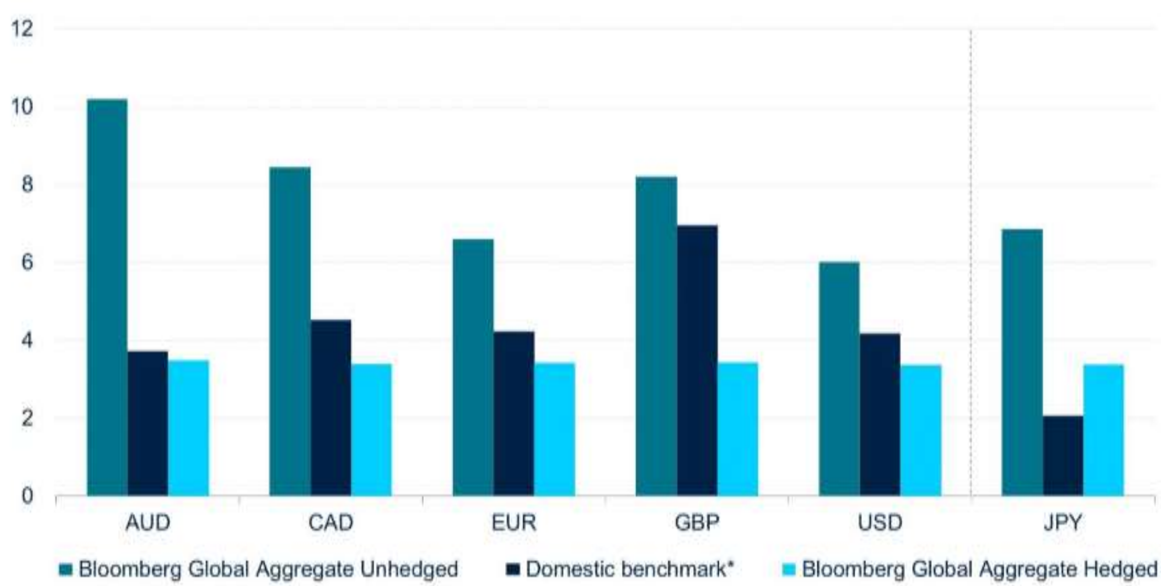
First, let's look at the starting point of the average investor: how big are international allocations to stocks and bonds vs. domestic allocations? Depending on the country, international equity exposure ranges from 15-80%, with **most allocating 50% or more to international equities**. By contrast, allocations to international fixed income range from 5-50%, with **most allocating well under 20% to international/global bonds**.

FIGURE 1: Global and international bond allocations are less common than allocations to international equities (share, %).

Source: Thinking Ahead Institute/Willis Towers Watson (reproduced with permission); Morningstar

The higher volatility of unhedged global bonds is the result of their inherent foreign exchange risk, which ends up overwhelming the benefits of the diversification across countries. Absent currency risk, however, **hedged global bonds benefit from their diversified exposure to imperfectly correlated bond markets, resulting in less volatility than domestic bonds.**

FIGURE 2: Global unhedged bonds exhibit volatility that can be multiples of the volatility on a domestic bond index. However, hedged global bonds exhibit volatility that is comparable to, or less than, domestic benchmarks, highlighting the importance of currency hedging (annualized standard deviation of total returns, August 2004-July 2024, %).



Source: Bloomberg, PGIM Fixed Income as of July 2024. * Domestic benchmarks are as follows: AUD: Bloomberg AusBond Composite 0+ Year; CAD: Bloomberg Canadian Aggregate; EUR: Bloomberg European Aggregate; GBP: FTSE UK Domestic Investment-Grade; JPY: Nomura BPI; USD: Bloomberg U.S. Aggregate.

Why are global hedged bonds less volatile than domestic benchmarks? In general, the world's interest-rate markets are highly - but not perfectly - correlated. This diversification of exposure across dozens of markets results in volatility on hedged global benchmarks that is generally lower relative to domestic bonds.

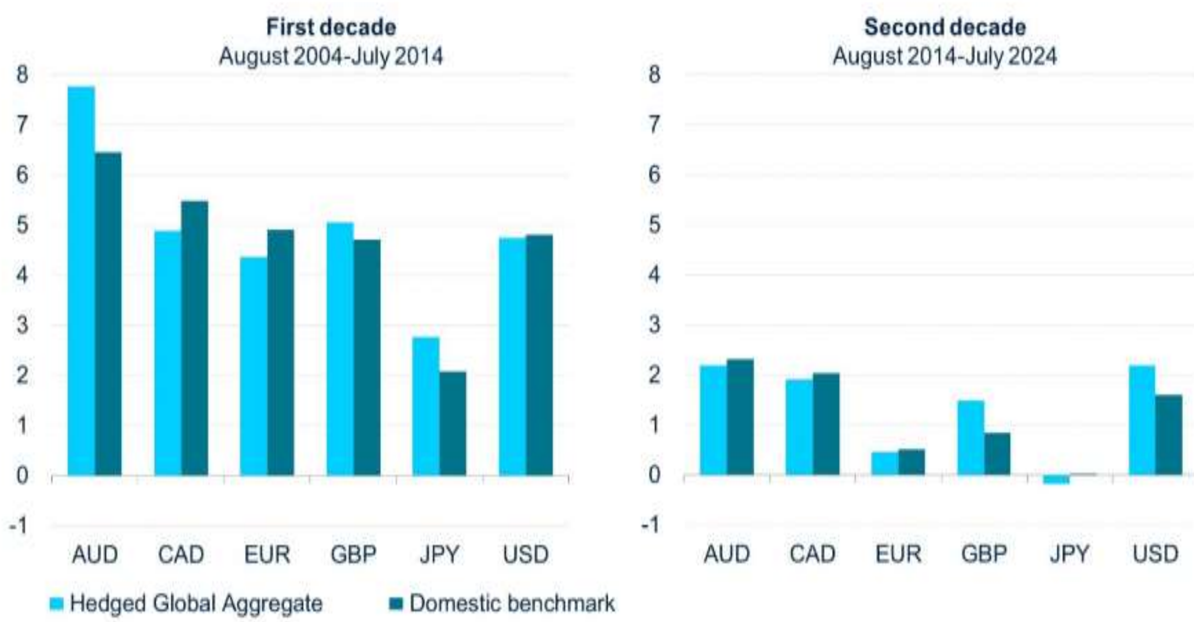
FIGURE 3: The imperfect correlation across markets drives the relatively low volatility on hedged global indices (correlation of 10-year government yields across currencies).

	AUD	CAD	EUR	GBP	JPY	USD
AUD	1.00	0.79	0.75	0.72	0.51	0.77
CAD		1.00	0.76	0.75	0.52	0.87
EUR			1.00	0.83	0.53	0.79
GBP				1.00	0.48	0.79
JPY					1.00	0.55
USD						1.00

Source: Bloomberg, PGIM Fixed Income. Note: Correlation of monthly yield changes of 10-year government bonds from August 2004 to July 2024. German bunds are used for the euro.

The relative performance of hedged global versus domestic bonds is quite period specific. This is observed in the two panels of Figure 4, which show domestic and hedged global bond market returns over the most recent 10 years (right panel) and the preceding 10 years (left panel). **While domestic and global hedged bonds have generally posted comparable levels of return, the relative performance varies across the two timeframes.**

FIGURE 4: Hedged global bonds may not post higher total returns than domestic…(annualized total returns by investor currency, %).



Source: Bloomberg, PGIM Fixed Income

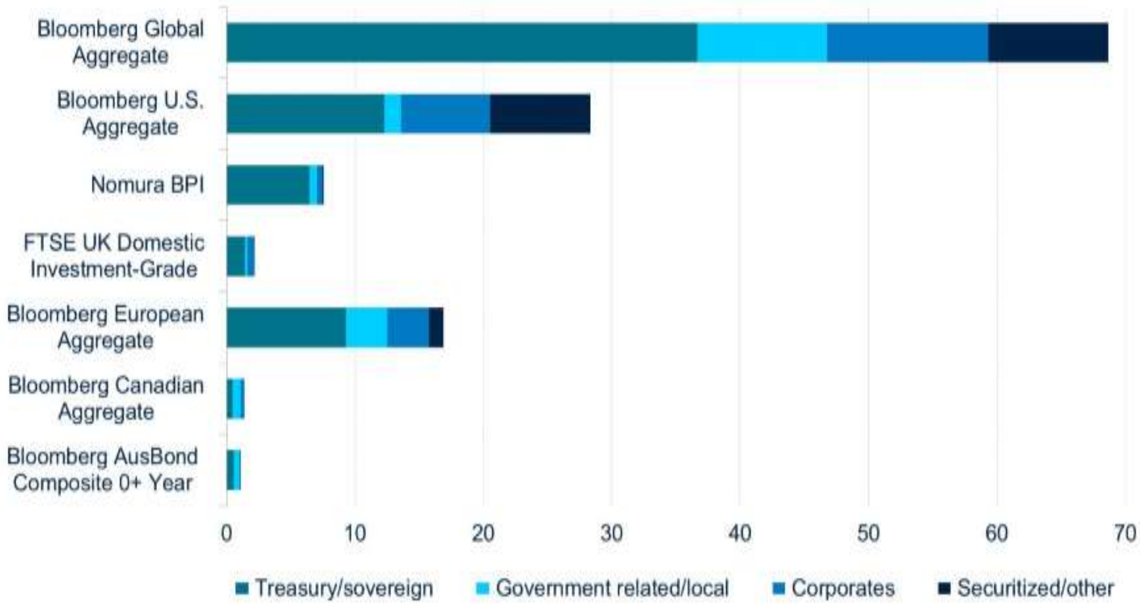
Yet, when looking at the relative risk-adjusted performance, we see that hedged global bonds posted superior risk-adjusted returns over the last 20 years compared with most domestic benchmarks. A quick study of the timeframes below also shows that the risk-adjusted performance was stronger in the first decade from 2004-2014, but less consistently so in the second decade.

FIGURE 5: …but they generally provide superior risk-adjusted returns relative to domestic indices (total return/volatility by investor currency).

Source: Bloomberg, PGIM Fixed Income

The global bond markets dwarf the size of many popular domestic benchmarks. In addition to providing diversification, this greater range of securities across the government, quasi-government, corporate, and securitized product sectors offer a much wider investment universe. **Hence, it also expands the set of opportunities to add value through sector allocation, issuer/issue selection, and duration positioning.**

FIGURE 6: Expanding the opportunity set to global not only offers diversification, but it also broadens the field for adding value through active management (USD trillion).



Source: Bloomberg, Nomura, FTSE Russell as of August 2024.

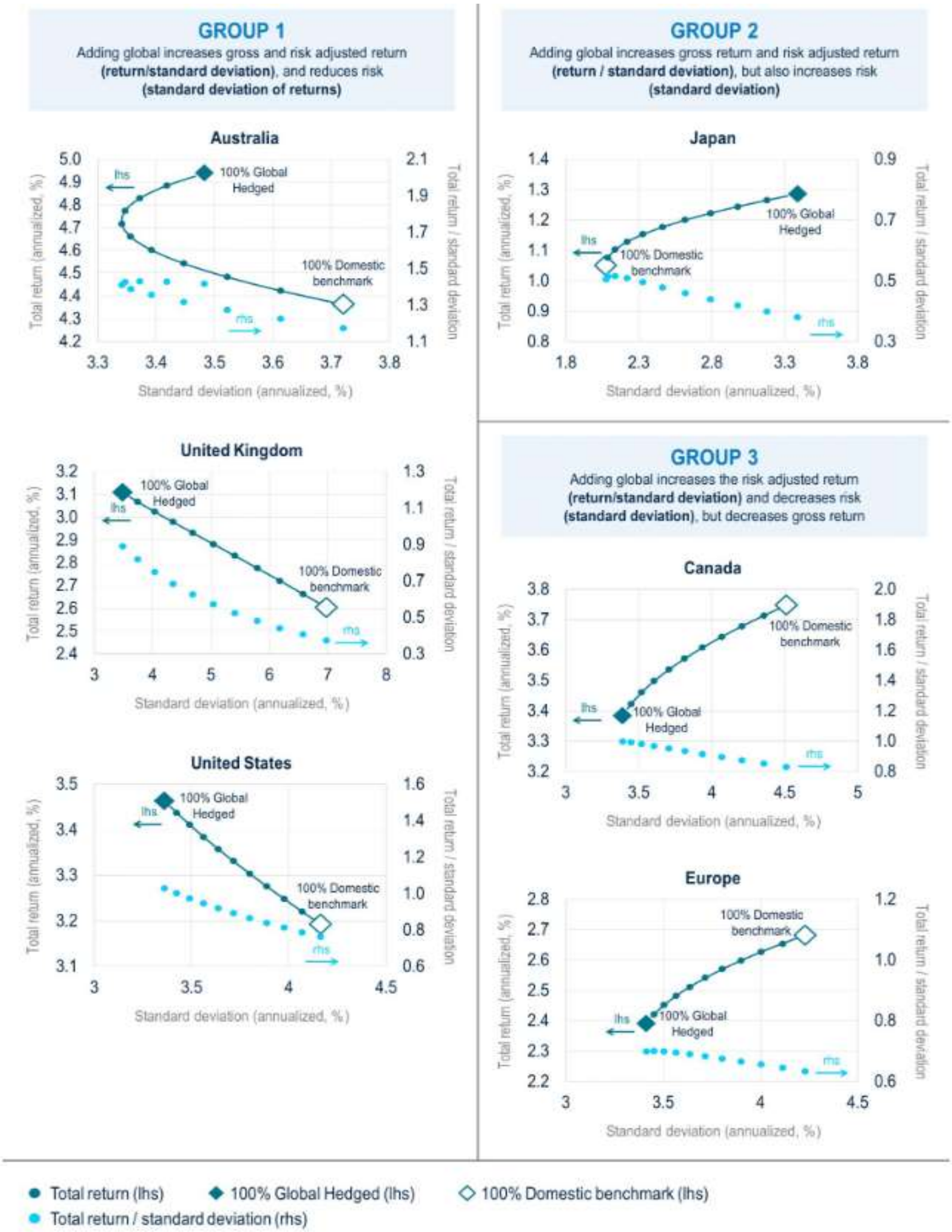
FIGURE 7: A global approach provides the opportunity to seek alpha opportunities and diversify credit risk across a range of markets offering comparable spreads in many cases (option-adjusted spread of sectors within each benchmark, bps).

	Local government /domestic	Corporates	Securitized/ other
Bloomberg AusBond Composite 0+ Yr	55	113	70
Bloomberg Canadian Aggregate	60	123	--
Bloomberg European Aggregate	64	116	60
FTSE UK Domestic Investment-Grade	39	121	101
Nomura BPI	13	38	23
Bloomberg U.S. Aggregate	47	92	43
Bloomberg Global Aggregate	42	102	44

Source: Bloomberg, Nomura, FTSE Russell as of August 2024.

Moving to the application of global hedged to portfolios, Figure 8 highlights the diversification potential of adding the asset class to a domestic bond portfolio by showing combinations varying from 100% hedged global to 100% domestic. Looking at the last 20 years of bond market returns, we can segment the impact of adding global hedged into the three groups observed in the following panel.

FIGURE 8: Adding a hedged global bond (Global Agg. Hedged) allocation to a domestic benchmark improves overall portfolio risk-adjusted performance, i.e. boosting the efficient frontier (x-axis: standard deviation, annualized, %; lhs: total return, annualized, %; rhs: total return / standard deviation).



Source: PGIM Fixed Income analysis of Bloomberg data.

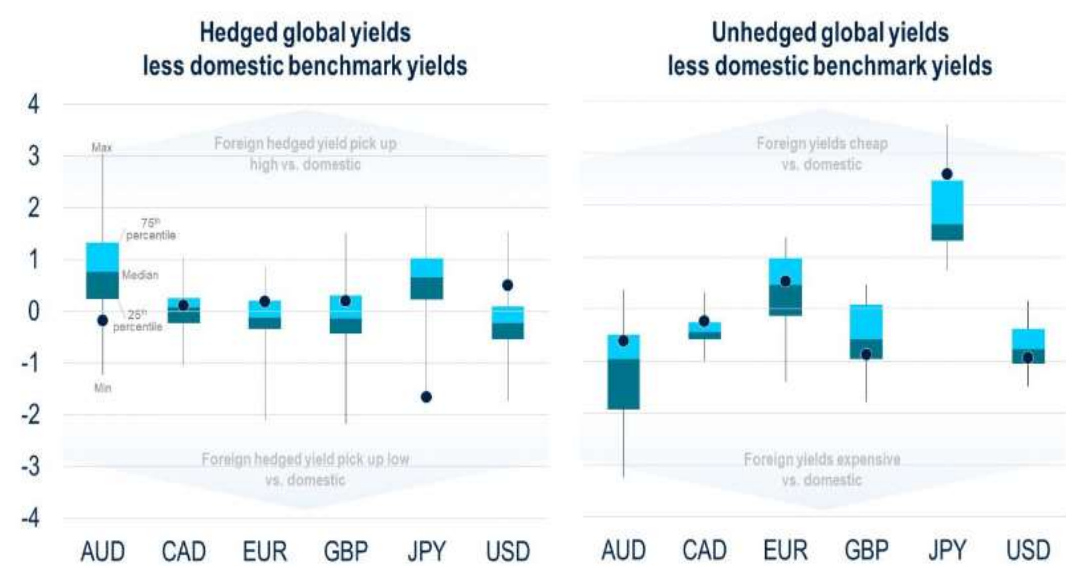
We mentioned that the relative performance of hedged global bonds was highly period specific over our two-decade sample, which begs the question: how does the timing for adding global hedged look now? First, we look at the standstill carry impact of moving from domestic bonds into global hedged bonds - which is equal to the yield on the global market less the cost of a short-term FX hedge relative to the yield on domestic bonds.

From this perspective (Figure 9), **the carry advantage appears average or favorable for Canada, Europe, UK, and the U.S.** In other words, for investors in these markets, adding global hedged would increase their carry, or yield, at least initially based the on current yield curve shape. **Conversely, investors in Australia and Japan would currently give up carry when buying global bonds - and by a wide margin in the case of Japan.**

In addition to the hedged-yield and short-term carry impact of shifting to global, **it is equally important to look at the relationship at the back of the curves.** Indeed, relative shifts between domestic and global long-term yields will be a significant driver of relative returns.

Japan provides an interesting case where the carry of going international - which is very negative - may be offset by the raw yield differential, which is very positive and more so than usual. This might suggest that while Japanese investors may have lower carry, they may benefit from a narrowing of long-term yield differentials, which would boost the return on global bonds relative to yen-denominated assets (more on this below). Similarly, global yields look a bit higher than average for European investors. In the cases of Australia and Canada, yields on a relative basis are higher than normal, while the yield differential for UK and U.S. investors is less favorable than average with yield reductions below median levels.

FIGURE 9: How is the timing for a shift to global? (August 2004-August 2024, percentage points. See Appendix for a table representation of the data below.)



	AUD	CAD	EUR	GBP	JPY	USD	AUD	CAD	EUR	GBP	JPY	USD
Current percentile	13	52	72	70	0	98	69	76	53	32	77	35
Current - median	-0.94	0.03	0.31	0.34	-2.33	0.72	0.35	0.20	0.07	-0.29	0.97	-0.18

Source: Bloomberg, PGIM Fixed Income as of August 2024.

Long-term yields versus hedged yields… the Japan case…

As shown in Figure 8, when looking at the carry impact of going global, Japanese investors by far face the biggest hedged yield give-up of roughly 1.5% on incremental allocations to hedged global bonds. This is a function of the fact that Japan's yield curve is positively sloped - which creates a positive hedged yield - whereas most other DM country yield curves are inverted, rendering their hedged yields negative. To the extent that interest rates do not change, this would prove a substantial performance headwind for hedged global bonds relative to yen bonds.

However, there are three mitigating factors that may yet make a plausible case for hedged global bonds. First, the Bank of Japan is set to continue raising rates in the quarters ahead, while most foreign central banks are likely to cut rates. This should narrow short-term rate differentials and narrow the hedged yield gap between domestic yen fixed income and international bonds by a significant margin.

Second, long-term global yields are higher than average relative to Japan (Figure 9). Should this relationship normalize - i.e., foreign yields fall relative to Japanese yields - hedged global bonds would experience favorable price performance relative to Japan.

Lastly, investors diversifying out of the yen market will vastly broaden their investment universe, which should significantly improve the potential to add value through active management.

In short, while on the face of it, hedged global bonds appear to be a poor option for Japanese investors, the main hurdle - the carry give-up as a result of yield curve slope differences - may be wiped out as short-term rate differentials narrow. Furthermore, the risk of Japanese bonds continuing their bear market stands in a 180-degree contrast to Western markets where rates appear to be biased for stability, or even further declines, likely extending the current bull market. Lastly, global bond returns will benefit from the much broader opportunity set for active management and alpha generation.

Conclusion

While the notion of global fixed income may sound exotic, in fact global hedged fixed income may offer the opportunity to reduce risk and improve risk-adjusted returns while offering a broader opportunity set for adding value via active management.

Appendix

	Hedged global yields less domestic benchmark yields						Unhedged global yields less domestic benchmark yields					
	AUD	CAD	EUR	GBP	JPY	USD	AUD	CAD	EUR	GBP	JPY	USD
Maximum	3.05	1.05	0.85	1.52	2.05	1.54	0.37	0.32	1.38	0.46	3.55	0.16
75th Percentile	1.33	0.26	0.20	0.31	1.02	0.10	-0.50	-0.25	0.98	0.08	2.48	-0.38
Median	0.76	0.07	-0.12	-0.14	0.66	-0.22	-0.97	-0.44	0.46	-0.58	1.63	-0.77
25th Percentile	0.24	-0.23	-0.34	-0.43	0.22	-0.54	-1.93	-0.59	-0.13	-0.97	1.31	-1.04
Minimum	-1.22	-1.05	-2.10	-2.16	-1.67	-1.73	-3.24	-1.00	-1.40	-1.79	0.74	-1.49
Current	-0.18	0.11	0.18	0.20	-1.67	0.50	-0.61	-0.24	0.52	-0.88	2.60	-0.95
Current percentile	13	52	72	70	0	98	69	76	53	32	77	35
Current - median	-0.94	0.03	0.31	0.34	-2.33	0.72	0.35	0.20	0.07	-0.29	0.97	-0.18

Source: Bloomberg, PGIM Fixed Income as of August 2024.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of October 2024
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