

Talking Heads with James McAlevey

Andrew Craig: Hello and welcome to this week's BNP Paribas Asset Management Talking Heads podcast. Every week, Talking Heads will bring you in-depth insights and analysis on the topics that really matter to investors. In this episode, we'll be discussing absolute return fixed income investing. I'm Andy Craig, Co-Head of the Investment Insights Centre, and I'm joined today by James McAlevey, who is Head of Global Aggregates and Absolute Return in our global fixed income team.

James has managed the team for over four years now, and last year, he and his team celebrated their global absolute return strategy passing the milestone of one billion euro in assets under management. Welcome, James, and thank you for joining me today.

James McAlevey: Pleasure to be here. Thanks for having me.

AC: Let's start with the interest rate outlook. Since the Iran conflict started at the beginning of March, markets have become concerned about inflation and are pricing in rate hikes from the ECB and the Bank of England. And recent inflation data has also cast doubt on the ability of the US Federal Reserve to cut rates this year. We're talking on the 16th of April. What's your view on what happens now with central bank policy rates, and how is this manifesting itself in market pricing?

JM: The first point to note is that this is yet another negative supply shock that we're experiencing. We saw one back in 2022 with Russia's invasion of Ukraine. We saw one last year with the initiation of tariffs from the US on global trading partners, and this is just the latest iteration.

Consequently, interest rate markets have sold off. Central banks do look like they might hike rates into the face of this shock, in much the same way they did in 2022. We take issue with the market response. There's a number of different reasons. First of all, we have to remember that back in 2022, we were coming out of COVID. Consumers, businesses had a lot of cash. They were willing and happy to spend. We were emerging from lockdown and labour markets were particularly tight. That's not the case today. Labour markets globally look a lot softer.

Policy rates then were on the floor. Policy was effectively stimulatory. Today, that's not the case either. Central bank policy is at best neutral, possibly a bit tight in markets like the US and the UK. And then thirdly, consumers look stretched today, certainly compared to 2022, and almost certainly compared to last year. Savings are run down and depleted. Wage growth is what it was last year or the year before. And as such, consumers don't really have the ability perhaps to withstand this shock in the way they have previously.

Long story short, we think central banks will want to try and look through this and not hike at the first opportunity. However, if second-round effects occur, interest rate hikes will be necessary. But we think that's a story for multiple months out.

AC: This energy crisis is clearly a global event. It's hitting all fixed income markets. Given what's happened, where are you seeing opportunities today?

JM: The UK certainly. The underperformance of the UK market has been substantial, certainly versus many of its peers. Policy still looks tight. The labour market's been a lot softer, and there is a slightly more pragmatic approach, perhaps, to policy setting.

Some of the more interesting opportunities exist in markets beyond people's natural focus, and here I refer to markets like Australia and New Zealand. These are markets, obviously in Asia. Asia is at the forefront of potential demand destruction. Their access to refined energy products is particularly curtailed. If this crisis rumbles on, if there are growth consequences, it's plausible that we start to get more dovish responses from central banks.

AC: At the moment, the initial reaction has been to view the energy crisis as an inflation shock. Do you think we're now tipping into the energy shock being viewed also as a growth shock, or is that further down the road?

JM: We're not quite there yet. As I've alluded to, the consumer is looking stretched. The employment market is not what it used to be. Gas at the pump in the US is all we hear about. It's gone from just over two dollars to over four dollars. That's costing the US consumer and that's going to wipe out all the additional gains the consumer got as a consequence of the Big, Beautiful Bill tax repayment that they're currently receiving.

But at the moment, it's premature for the markets to embrace this. The markets are celebrating the fact that this looks like it's coming to a close, and that's the only thing within the markets' attention span at the moment.

AC: You referred to the fact that your absolute return strategy gives you licence to roam across global fixed income markets. What about emerging markets? Asia is potentially negatively impacted, being dependent on energy from the Gulf. Are the emerging markets where you see opportunities?

JM: Yes, that is one of the single best opportunities to have emerged. It's not all emerging markets that we like; we prefer those in Latin America because real rates are particularly high. Inflation has been coming back down more recently, which is allowing central banks to cut interest rates. EM currencies, particularly those in Latin America, have been particularly strong. That is supporting the idea that central banks can and will continue to cut interest rates. We saw Mexico and Brazil cut interest rates after the conflict started. Long story short, we like emerging markets, prefer them in Latin America significantly, and rate cuts we think will continue.

AC: Given the environment at the moment, what's your core view on how the global macroeconomic outlook will evolve for the rest of 2026, and how will you be looking to exploit that in your strategies?

JM: In essence, interest rates are probably still going to come down globally. We think the opportunity for long duration is now greater than it was before this conflict emerged. We like it more now. We also like the idea of curve steepening.

The consequence of this conflict has been to underpin the motivations of seeing what we call term premium rise. We're going to get a lot more fiscal issuance out of the US because they need to fund this war. That's also happening in Europe. Europe now knows that it's going to have to bolster even further its defence expenditure. So, lots of reasons here to think that curve should be steeper.

AC: You've mentioned the advantages of an absolute return bond strategy. Can you just expand on that and remind our audience just the basic principles of an absolute return bond strategy and the return objectives?

JM: The objectives are cash plus two and a half percent, almost regardless of environment. What that effectively means is that we don't invest in anything unless we think it has a role to play in helping us deliver against those objectives. We can generate pure alpha from long-short strategies rather than just long-only investments. To that end, it's quite different to a traditional long-only fund.

The other thing that often appeals to individuals is that we have a significant capital preservation objective. Because we don't have an attachment to the benchmark, we can be quite flexible in terms of the markets that we invest in and the bonds that we own, and that's a big advantage. Of course, it's not a guarantee.

AC: We talked about yield curves steepening requiring an investor to be overweight short-dated bonds, underweight long-dated bonds. Can you talk to us about how you use derivatives and the advantage does they give you?

JM: It's a good point because it is a big distinguishing feature of absolute return funds, and it does enable them to access many more investment opportunities. When we use derivatives in a product like this, it's important to highlight a couple of things. If you can't borrow money or use derivatives in your portfolio, you cannot implement a curve steepening strategy. You're going to need access to derivatives. The other way we can use derivatives is to adopt short positions. Having the ability to benefit from declining markets opens your alpha opportunity set.

AC: James, let's talk about the outlook. Today yields are more attractive. You talked about the fact that there's scope for them to fall. Where does an absolute return approach sit relative to traditional fixed income strategies in this context?

JM: I'm always looking at the opportunity cost of this strategy versus owning cash. In a world where cash is positive, the ability to deliver something like cash plus two and a half [percent] is greater because volatility is higher. Volatility being high is generally a good thing for active managers; it creates more dislocations, and particularly when you have such a wide opportunity set like we do, there's always something interesting happening. There's a much greater chance of delivering good risk adjusted returns on top of a cash benchmark, not just alongside a cash benchmark.

AC: And what about in relation to a multi-sector fixed income portfolio? Does this strategy provide diversification to equities or more risky credit-based strategies?

JM: I've always looked at the strategy through the lens of giving investors what they want, almost irrespective and independent of the macro backdrop. To that end, it's flexible enough to put it in different places in your portfolio. There's a greater opportunity to deliver those excess returns versus cash investors so desperately need.

AC: James, thank you. Certainly, flexibility in this environment would seem to be a very significant advantage. That's it for this week's episode of Talking Heads. If you'd like to learn more about our investment insights, please reach out to your BNP Paribas Asset Management contact or check out Viewpoint's website for investment insights at [viewpoint dot BNP Paribas am dot com](http://viewpoint.dot.BNPParibas.am.com). We recommend subscribing to Talking Heads on your favourite podcast channel such as YouTube or Spotify. You'll receive your podcast episodes every week. And if you like Talking Heads, do please leave us a positive review and a nice rating. You've been listening to the BNP Paribas Asset Management Talking Heads podcast with me, Andy Craig, and James McAlevey, Head of Global Aggregates and Absolute Return. Please do join us again next week. Until then, take care.