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Fixed income

Adapting to the withdrawal of monetary stimulus

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Bond markets have been in a sweet spot in recent years. Economic growth has been positive, inflation has been relatively benign, volatility and default rates have been low, central bank policy has been accommodative and the demand for income has been high. One of the biggest challenges we as fixed interest investors now face is what happens when one of the central pillars of this supportive environment – the still huge amount of central bank stimulus – is reduced.

Private investors will need to absorb a lot more supply in the US and Europe going forward. Since it is difficult to see strong demand at current yield levels, one would expect to see higher yields as the process unfolds.

The macro view – Stuart Edwards
When thinking about the bond market implications of central bank tightening, it is worth taking a step back to understand why central banks now want to withdraw liquidity. Since the global financial crisis, global economic growth has been relatively low but synchronised across developed markets. Recently, this has been helped by a pickup in global trade as a result of a resurgence in Asian trade flows and a recovery in North American imports. Meanwhile, labour markets have continued to tighten, but thus far the historically low unemployment rate has not fed through to wage growth, which remains muted. This does not, in my view, mean that the Phillips curve (the inverse relationship between unemployment and inflation) is dead – it has just flattened. For structural (as well as short-term) reasons, I believe labour markets need to tighten further before we see a pickup in wages. I am starting to see some signs that this is happening, albeit slowly. Although it is not my central view, I think the risk is that inflation turns out to be stronger (not weaker) than expected. Against this backdrop, central banks are seeking to normalise monetary policy.

How this plays out for markets will, in my view, depend on the pace of any tightening. So far, central banks have been very careful to communicate their strategies well in advance, and this should help to smooth the process of monetary policy normalisation. I expect (and markets are currently pricing in) the Bank of England to stop at 0.50% or possibly 0.75%, and both the European Central Bank (ECB) and the US Federal Reserve (Fed) to taper quantitative easing over a long period at a slow pace. If that view holds, then fixed income markets should remain well-supported. However, there remain risks. The ECB now owns nearly a quarter of the eurozone's outstanding debt, and the tapering of asset purchases comes at the same time that the US deficit is predicted to increase to over US$1 trillion. This means that private investors will need to absorb a lot more supply in the US and Europe. It is difficult to see strong demand for government bonds at current yield levels, and so one would expect to see higher yields as the process unfolds.

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Credit markets – Paul Read and Julien Eberhardt
2017 has been good for many of our portfolios, with our exposure to corporate hybrids, subordinated financial bonds, and high yield and US dollar-denominated bonds all delivering outsized returns. However, as a consequence of this strong performance, we now start 2018 with many areas of the European bond market looking expensive.

That said, a number of the factors that helped drive returns in 2017 remain in place. The demand for income remains very high, and the ECB is still a dominant force in European credit markets. Although it is tapering its asset purchases, it is doing so very gradually, and any actual hike in European interest rates still looks some way off. Amid improving economic data, "animal spirits" are also high. Meanwhile, companies have been able to take advantage of low yields by refinancing debt at more attractive terms, so there is currently little pressure on default rates. This mixed backdrop of positive fundamentals but expensive valuations leads us toward a more balanced investment outlook. It is difficult to see a scenario in which yields move meaningfully lower, and so income is likely to be the main component of return in 2018.

Key takeaways

- Bond markets have performed well for years primarily due to strong demand, low inflation, positive economic growth and accommodative monetary policies.
- With major central banks now normalising policies, there is a risk that investors will not absorb the extra supply until rates rise.
- Due to this and other factors, we believe it is unlikely that recent outsized bond market returns will be repeated in 2018.

Our strategy is to seek out relatively "safe" sources of income while staying defensive overall. Periods of market strength provide the opportunity to reduce exposure and wait for better levels at which to add. That said, there are still some parts of the market where we are finding opportunities, and others we avoid. Generally, we stay away from those parts of the market that are being manipulated, such as peripheral European sovereigns and bonds purchased through the ECB's Corporate Sector Purchase Programme. Outside of these areas, the price of bonds often better reflects the underlying risk of the investment. Some of these areas include subordinated financials, corporate hybrids and selective parts of the high yield market.

From a fundamental perspective, banks remain in a strong position. The bailout and rescues of the past year have removed weaker banks, leaving a stronger financial sector overall. Tighter monetary policy and steeper yield curves should, all else being equal, also be supportive of the sector. However, from a valuation perspective, the outlook for the sector, like much of the corporate bond market, has become more balanced. Additional tier one and contingent capital yields have fallen significantly in 2017, and so the standout valuation opportunity versus the high yield sector has, in our view, diminished. That said, there are still some opportunities, but we need to ensure that we are being rewarded for taking the risk.

US corporate bonds are another market where we are still finding opportunity. The expectation that the Fed will continue hiking in 2018 is, to some extent, already priced into the US Treasury market. Compared to German Bunds, US Treasuries also offer between 160 and 240 basis points of extra yield across the curve. Nonetheless, the two markets are interdependent. The 10-year Treasury tends to pull the 10-year Bund higher, while the Bund anchors the Treasury. As this tussle plays out in 2018, we think the likelihood is for higher Bund yields. Higher rates feed straight through to banks' bottom lines, so this should be supportive of our exposure to European subordinated financials.

Overall, it is difficult to see bond markets repeating the kind of performance we have seen in 2017. Our focus is therefore defensive, and we are taking relatively "safe" income where we can while waiting for better opportunities to add exposure.

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