INVESTORS FACE UNCERTAIN OUTLOOK IN THE GLOBAL CREDIT MARKETS

While many fixed-income investors are still chasing yield, others are focused on managing risk exposures, reducing volatility, and preserving capital.

“While the financial market is undergoing a cyclical uptick, there are serious structural headwinds — slow economic growth, high debt levels, geopolitical tensions and the long-running bull market,” says William J. Adams, CIO — Global Fixed Income, MFS Investment Management. “We believe valuations in the fixed-income market may not reflect these risk factors.”

Noting that fixed income traditionally plays a balancing role in a diversified portfolio, Adams adds, “In an environment where spreads appear particularly tight, it is important to keep this key function in mind and manage fixed income with the appropriate prudence. Rather than pursuing their quest for higher yields, institutional investors should focus on preserving capital through active risk management — a strategy that is well-suited for today’s uncertain market environment.”

Those uncertainties include global central banks retreating from quantitative easing (QE), economic stagnation, high debt levels, adverse demographic trends, political dysfunction, geopolitical tensions and technology dislocations, says Adams. “The focus of fixed income should be on prudent capital preservation, given the host of factors weighing on the global economy and the aging business cycle.”
WHAT IS PIMCO’S OUTLOOK FOR INTEREST RATES AND THE ECONOMY?
Mather: Our near-term outlook for the U.S. economy is fairly benign: A continuation of the low growth environment of the past few years. We don’t foresee a recession soon, even though this U.S. expansion is now in its ninth year.

However, the Federal Reserve is on a path to policy normalization, and global central banks appear to be shifting toward less accommodative policy stances. This is important because central bank support has contributed to low economic and financial market volatility — and rewarded broad risk-taking — for several years. Given low growth, there is precious little room for shocks to be absorbed, including geopolitical or trade frictions. So, while moderate growth is our baseline view, risks are meaningful.

We think interest rates are likely to be range-bound in the near future, with two or three gradual rate hikes from the Federal Reserve between now and the end of 2018. However, the ultimate destination of interest rates is likely much lower than in previous cycles because of low trend growth (driven by modest labor force and productivity growth), benign inflation and debt overhangs. In addition, low interest rates globally and the potential for volatility and flight-to-quality episodes will likely weigh on U.S. yields.

WHAT ROLE CAN CORE BONDS PLAY IN THIS ENVIRONMENT?
Mather: This environment — low but synchronized growth, easy financial conditions, supportive policies, and eerily low volatility — has created complacency in the markets. With equities near record highs and risk assets generally reflecting high valuations, we think this is a good time to consider lowering overall portfolio risk exposure and emphasizing more defensive strategies. A high quality, diversified core bond strategy aims to provide attractive returns through a combination of income (yield) and capital appreciation, but with a focus on capital preservation. This may be especially prudent as central bank support declines.

SECKING ALPHA IN A LOW RETURN WORLD

Scott Mather, PIMCO’s CIO for U.S. core strategies, explains the role core bonds can play amid the uncertain outlook for both bonds and equities, and discusses PIMCO’s Total Return Strategy, which has been navigating changing environments for 30 years.

HOW IS PIMCO’S TOTAL RETURN STRATEGY POSITIONED FOR THE CHANGE AHEAD?
Mather: The conservative and diversified approach we employ in the Total Return Strategy has proven beneficial recently, as fundamentals have started to reassert themselves and policy-supported valuations have begun to look less attractive. We are focused on bottom-up, relative value opportunities where we see appropriate compensation for risk and on diverse sources of yield. Our aim is to maintain a yield above that of the benchmark but with a defensive posture suited to the changing landscape.

Specifically, in U.S. Treasuries, we are focused on medium-term maturities, mainly because we find the long and short ends of the yield curve to be less attractive. We think inflation may rise and TIPS (Treasury Inflation-Protected Securities) holdings offer value.

To enhance yield potential, we like mortgage-backed securities from the U.S. housing agencies, and in credit, we prefer diversified exposures, such as non-agency mortgage securities. In corporate bonds, where we think valuations are stretched, we favor the financial sector as bank balance sheets have become healthier.

Because we think diversification is a key to managing core bonds, we draw on many sources of potential return. The ability to construct a more diversified portfolio, which can help mitigate downside risk, is crucial in our effort to achieve both higher-than-benchmark returns and better risk-adjusted returns for investors. It is a major reason why we feel confident in the strategy as we look ahead.

Past performance is not a guarantee or a reliable indicator of future results.

Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. Inflation-linked bonds (ILBs), issued by a government are fixed income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. Treasury Inflation-Protected Securities (TIPS) are ILBs issued by the U.S. government. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market’s perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. High-yield, lower-rated, securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. Diversification does not ensure against loss.

There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.

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A CHANGING WORLD
Since the financial crisis, central banks have provided a relatively stable, low-rate environment for fixed-income investors. “This unprecedented support has helped maintain generally low market volatility and rewarded broad risk-taking,” says Scott Mather, CIO, U.S. Core Strategies, PIMCO.

With conditions favorable, investors have poured far more into fixed-income than equities, says Emily Roland, Head of Capital Markets Research, John Hancock Investments. “The flow into the fixed-income market in recent years has been extraordinary,” she says. “In fact, more than $300 billion has been invested in fixed income funds and exchange-traded funds (ETFs) this year. It remains to be seen if this seemingly insatiable demand for fixed income can continue as central banks around the world march down the path of rate normalization.”

With the re-emergence of global growth, Roland expects the Fed to continue its slow and steady rate increases. “That will be a challenge to the interest-rate sensitive parts of the fixed-income market,” she adds. “However, the move should be an orderly one, and we don’t expect a significant drawdown in fixed income.”

In the investment-grade sector, investors can benefit from a reasonable balance between potential returns and diversification benefits, says Roland. Other areas of the credit markets may offer higher yield, but their correlations to equities are higher, she adds.

Mather suggests considering high-quality Treasury exposure, although only in intermediate maturities since front-end maturities are less attractive with the Fed increasing rates. He adds, “With global central banks adopting less accommodative stances, we prefer interest rate exposure within the U.S., relative to interest rate exposure outside the U.S.”

Looking at durations, Adams says investors may not find many alpha opportunities in the rate structure. “While there is no immediate need for investors to adjust their current duration profiles, we would not suggest increasing those allocations and placing a big bet on going long,” he adds.

A FOCUS ON QUALITY
Strong interest in corporate debt has driven up the price of corporate bonds — and led to spreads tightening in both investment grade (IG) and high-yield (HY) debt, according to a recent white paper, “Live to Fight Another Day: Capital Preservation Is Key in Fixed Income Today,” by Adams and James Swanson, Chief Investment Strategist, MFS.

In the pursuit of yield, investors have also rushed to buy equities that serve as bond proxies — utilities, telecommunication stocks, and real estate investment trusts (REITs), for instance — leading to high prices and low dividend yields for these securities. “Investors would be well placed to focus on broadening the opportunity set, actively selecting securities, allowing for flexible allocations where appropriate, and constructing portfolios with prudent risk management controls to ensure adequate compensation for risk,” say Adams and Swanson.

In a market with tight spreads, there is less dispersion between lower-quality and higher-quality assets in the various fixed-income sectors. Therefore, Adams suggests that institutional investors look for opportunities to improve the quality of their fixed-income holdings, whether in the investment grade or high-yield sectors.

For instance, one active strategy in the high-yield sector would be to shift money from CCC-rated bonds into the Bs and BBs, Adams says. Those higher-rated credits are less likely to have drawdowns in a more challenging market environment, he adds.

“The same strategy can be applied to the investment grade portion of a fixed-income portfolio,” Adams says. “Moving up the quality spectrum may reduce the number of yield opportunities, but if the markets weaken, investors are less likely to be faced with a sell-off situation. If there is a market decline, they can then decide to reengage and pick up lower-rated securities at significantly lower prices.”

Adams adds, “The greatest determinant of future returns in fixed income is the price you pay today. Since the risk premiums are being squeezed out of market, those future returns look stretched as well. We suggest a cautious approach, and reducing your exposure to the more volatile fixed-income asset classes.”

SEEKING YIELD OPPORTUNITIES
Fixed-income investors seeking higher yields may need to take a tactical approach to the credit market and perhaps broaden their opportunity sets.

“Valuations on emerging market debt are relatively attractive compared with high-yield bonds,” says Roland. “HY has held a spread premium over emerging market debt for an extended period, but that premium has declined and is very small today. When the spread differential between the two is so narrow, historically emerging market debt has outperformed HY in subsequent periods.”

Mather believes there are still
DELIVERING FIXED INCOME STRATEGIES IN TUNE WITH INVESTMENT GOALS TAKES DEDICATION

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relative value opportunities throughout the market. In corporate bonds, for instance, investors might consider the financial sector because balance sheets and spread levels are attractive.

“...We also favor other diversified sources of yield, including non-agency mortgage-backed securities, which offer attractive fundamentals and compelling yields,” says Mather, adding that the underlying borrower profile for these legacy securities is improving with lower loan-to-value ratios.

“Given the later stage of the corporate credit cycle, we are focusing on bottom-up credit opportunities and emphasizing portfolio liquidity,” Mather adds. “This includes sector and credit assessments for better fundamentals, stronger asset coverage, and potential for organic de-leveraging.”

Roland notes that the unwinding of the Fed’s balance sheet will also affect the mortgage-backed securities (MBS) market. The Fed holds nearly $2 trillion in MBS, and no one knows if there is enough pent-up demand in the market to pick up the slack, she says.

Adams says there are still some opportunities in structured credits, such as commercial mortgage-backed securities (CMBS) and collateralized loan obligations (CLOs). “But investors need to do their research and be very selective,” he says. “Every security should be vetted and understood before adding it to a fixed-income portfolio.”

In the municipal bond market, Adams does not expect Puerto Rico’s debt problems to carry over to other issuers. “If the tax advantages of munis make sense to an investor, we see no reason to exit this asset class,” he says. “We do, however, suggest looking at the quality of your current holdings and remaining prudent with your risk exposures.”

Outside the U.S., dislocations in the markets may create opportunities. “We view Japanese interest rates as a great vehicle for hedging exposure to U.S. interest rates,” says Mather. “The likelihood of bond yields falling in Japan is quite low, while there are several scenarios in which yields could move higher.”

In emerging markets, sovereign and corporate debt can provide compelling value at times. But investors should be clear about which risk factors, such as local interest rates, currency or credit, may be attractive at any particular point. “We focus on healthier balance sheets and solid fundamentals, while remaining mindful of any potential shifts in the broader macro landscape that could affect emerging markets,” Mather says.

ACTIVE OR PASSIVE STRATEGIES?

Whether seeking yield or managing risk, fixed-income investors may benefit from active strategies tailored to their objectives.

“Investors would be wise to focus on risk management by engaging in active security selection,” Adams says. “While we are not proponents of tactically trading asset classes, we do believe that active risk management is vital in today’s market. Specific security selections by your asset manager can make a difference in your risk-adjusted returns.”

Drilling into the issue of active versus passive strategies, Mather says there are significant differences between managerial performance in the equity and fixed-income sectors.

“If you examine some of the largest equity categories over the past 10 years, the median active manager has underperformed both its benchmark and the median passive provider,” Mather says. “However, the same is not true for fixed income, where the median active manager has outperformed the median passive peer in the largest fixed income category by more than 0.5 percent per year for the past 10 years after fees. If you look at the top quartile managers, you can see consistent excess returns of about 1 percent per year.”

Why the difference? Mather says active managers can exploit structural inefficiencies in the bond markets. One reason is that a large portion of the $100+ trillion fixed income-market is held by central banks, insurers, and other financial institutions that may not prioritize maximizing returns.

“That allows active managers to take advantage of dislocations and mispricings,” Mather says.

AVOIDING COMPLACENCY

Looking toward the new year, Mather says investors should review their fixed-income strategies with a goal of reducing correlations to risk assets.

“A period of low volatility helped by years of unprecedented central bank support has lulled investors into only focusing on return and yield at the expense of diversification and balance in portfolios,” he says. “We think this is an environment where institutional investors should truly focus on diversification and capital preservation, since return of capital may prove more important than return on capital.”

As Mather says, a strong diversifier for risk assets such as equities is a true core bond strategy — a high-quality, diversified portfolio that can provide resilient return streams when adverse market conditions affect riskier assets.

— Richard Westlund
Today’s uncertain bond markets call for a nimble approach

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