Quiet Flows the Bond

Opportunity in fixed income nine years after the global credit meltdown

After a surprise victory in the 2016 U.S. presidential election kicked off a spate of optimism about U.S. growth, the bond markets have settled back into a lower-risk—but lower-than-average—return cycle. Rates look likely to rise in the U.S., while the Fed is looking to reduce its holdings of mortgage-backed securities. Central banks in Europe and Japan are backing away from the extraordinary accommodative measures put in place after the global credit crisis. Optimism about the stimulating effects of tax reform, deregulation and infrastructure

investment in the U.S. are fading as market observers begin to doubt that the Trump administration will be able to push through its aggressive agenda.

In short, everything is returning to normal, and most bond managers see a quiet year of muted risks and modestly positive returns ahead. That's the kind of environment that should make institutional investors consider a reset of their default positioning—whatever it is—based on the outcomes they seek from fixed income: stability, income, additional yield or some combination of the three.

"Asset allocation strategists are taking a look at fixed-income portfolio allocation now that the Fed has started raising rates again," says Andrew McCormick, a Vice President and Fixed Income Portfolio Manager at T. Rowe Price Group. "Now that longer rates have reached some type of equilibrium for now, investors who want to stabilize their portfolios against volatility in the stock market have had an opportunity to extend duration at better yields than they could have last year. For investors who are nervous about ongoing increases in rates and think the economy is going to pick up, the opportunity set is more in floating rate and shorter duration."

"The main message for fixed-income investors is that even with spreads and nominal yields at relatively low points in their historical experience, fixed income can play the role you want it to play," says Tom Coleman, North America Senior Investment Specialist at Standard Life Investments. "It can play the role of being a great diversifier, in particular relative to equities. It can play the role of liquidity provider. It can generate coupon, and you can go in and out at the margins with some degree of efficiency to produce extra return. I think what investors need to do is to look beyond the conventional role of fixed income to different ways of approaching it to do the job they want it to do."

Long recovery, no end in sight

Slow growth is the trend that has been in place, more or less continuously, since the U.S. economy emerged from recession in 2009, and Coleman doesn't see it ending anytime soon. "Credit cycles last, on average, right around six or seven years. We're in the late stages of this credit cycle. But economic policies have evolved and credit has evolved—both things that can allow the recovery, slow that it might be, to continue almost indefinitely. There's also no reason to believe that it's going to get some type of jump-start," he says.

In the U.S., the Fed started tightening last year and raised rates another quarter point in March, and has indicated it expects at least two more increases before 2017 ends. That move has, so far, not had a pronounced negative effect.

Monetary policy in other developed countries hasn't yet made as definitive a turn, but the trend worldwide is clear. "Without question, the developed markets have seen the peak of monetary authorities being accommodative for the current cycle," says Ashish Shah, Chief Investment Officer of Global Credit and Head of Fixed Income at AB. "In Japan, in Europe and in the U.S., we've seen different versions of either tapering or pulling back from engaging in heavy QE, or actually raising rates, in the case of the U.S."

Fading political optimism

The Trump stock rally, which saw the S&P 500 rise by 12.41 points between Nov. 7, 2016 and a peak on March 1, may have grabbed all the headlines, but the bond market felt the impact, too. The 10-year Treasury bond yield moved from 1.83 percent on Nov. 7 to 2.62 percent by mid-March (about when the healthcare bill started unraveling), while the 30-year Treasury bond yield rose from 2.60 percent to 3.20 percent over the same period. High-yield bonds rallied sharply, with spreads contracting from around 500 basis points over Treasuries to a low of 350.

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But fast-forward to early 2017: Healthcare is back-burnered on Capitol Hill, tax reform and infrastructure spending are on ice and markets have gone back to normal. "At this point, markets have reached an equilibrium where we'll need to see some follow-through on policy shifts to ratify these levels," says McCormick. "If that doesn't take place, there's a chance that we could move lower on yields at the long end, at least temporarily."

The U.S. may have its problems, but it's doing well compared to other developed regions, according to Jeff Moore, a Portfolio Manager at Fidelity Investments who oversees diversified bond portfolios for both institutional and retail investors. "With global developed rates negative, you have to be cautious. There's not a lot there to do," he says. He's encouraged about an uptick in Japan's producer prices, indicating the possibility of slightly stronger growth and inflation, and he sees signs of growth in German GDP. "Even with immigration, population decline is another speed limit on the German economy," he cautions. "But having said that, I think they're in early cycle or mid-cycle in Europe. It's probably positive once you get the negative return out of the way."

Emerging markets look a bit more promising, though a late 2016 rally compressed spreads to Treasuries to about half their levels of a year ago. "A mix of factors make emerging-markets debt attractive," says AB's Shah. "We think that emerging-markets inflation rates will continue to converge with developed markets; that's a multi-year theme."

Still, despite broad supportive trends, Shah says it's important to take a tactical approach. "You have to be willing to buy countries on dislocations," he explains. "Three months ago, if you were buying Brazilian assets, people thought that you were crazy, particularly if it was in local currency—and today they've been a very strong-performing asset. Being contrarian to headline risk is important when it comes to emerging markets." —*Jennifer Kelly*

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