Fixed Income Focus.

It's all about the debt

You won't be surprised to hear that LGIM's Fixed Income Team is passionate about debt. And we really are. Indeed, one of our four 'D's that drive the team's strategic portfolio construction is the world's enormous debt overhang, which is suppressing growth and represents a significant vulnerability in the world economy.

Contribution by Ben Bennett – Credit Strategist

Ben focuses on allocation within the credit funds as well as providing the credit input to macro strategies.

Fixed Income Focus represents the viewpoint of the Global Fixed Income team at LGIM.

This is why we did not believe that the collapse in commodity prices was a good thing for global growth, despite what economic models told us. Instead, our view was that it undermined the solvency of commodity companies and countries that had been borrowing heavily in recent years. We are well aware of the systemically disruptive nature of debt defaults. In other words, as debtors go bad, questions start to be asked about whether creditors are able to withstand the losses.

This stage of the debt squeeze has been one of the key stories of 2016 so far – when defaults increase, it's generally the banks that are most exposed. And the additional tier 1 (AT1) bank market has been particularly badly hit, as such instruments can lose interest, be converted to equity or be written down as issuing banks face difficulties. For us, these investments are more equity-like than debt and we have been very wary of adding them to our bond funds. However, from the recent price action, it seems that other investors are only just waking up to the potential downside **(Figure 1)**.

Of course, market weakness has not been confined to the AT1 market, with many true debt instruments trading at spread levels not seen for a number of years. Given our structural concerns, we hold a significant proportion of cash across our portfolios, and the question is whether now is the opportunity to start deploying it.

The problem is that there is a further stage to a default cycle, when banks facing losses from a specific sector start to restrict credit availability to healthier parts of the global economy. This is already playing out in the capital markets where bonds issued by companies outside of the commodity sector have seen their

Figure 1: The collapse in banks' additional tier 1 capital prices

Source: Barclays Capital European Banks CoCo Tier 1 Index

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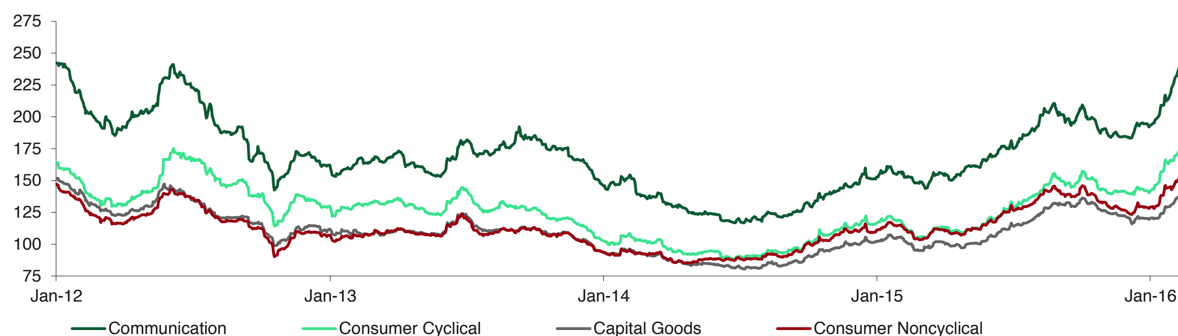
Figure 2: Non-commodity related sectors are also trading poorly (credit spreads, bp)



Source: Barclays Capital US Corporate Bond Index

credit spreads rapidly increase towards stressed levels **(Figure 2)**. So far, significant credit tightening among banks has only been seen in emerging markets, but it appears to be spreading.

This then becomes a self-fulfilling spiral towards an economic slowdown as businesses faced with difficult borrowing conditions slow their investment and job creation. Again, I would argue that this is already happening and explains the disappointing global growth of the last few quarters. For this reason, we assigned a 70% chance of a global recession in 2016 in our Fixed Income year-ahead outlook (i.e. global GDP growth below 2% to adjust for population growth) with an associated 8% high yield default rate.

At the time, this was very far from consensus, but it is fair to say that this scenario is gaining a lot more traction with the chattering classes. But I don't think it has yet been accurately reflected in asset valuations. Global credit spreads are back to levels last seen during the 2011/12 European crisis, when tightening credit conditions led to Europe sliding back into recession. At the time, emerging markets were firing on all cylinders and, importantly, market volatility compelled central banks to unleash a new wave of monetary easing in the form of Draghi's sovereign bond buying and the Federal Reserve's (Fed) third round of quantitative easing (QE).

This time, it's hard to pinpoint an engine of global growth and central banks are either constrained (the Fed needs to admit their error in hiking rates in December before they can contemplate more QE) or are hitting their limits (the ECB and Bank of Japan are already undertaking QE and have applied negative interest rates). So it's hard to see what might break this negative spiral in the next few months.

For that reason, and despite the significant widening of credit spreads in recent weeks, we are maintaining our cautious portfolio positioning and retaining our cash war chest. We are braced for a further negative economic impulse from tightening credit conditions, and we do not think central banks will be able to provide a circuit breaker for a little while yet. Of course, we are carefully considering the potential for Mario Draghi to directly intervene by buying more European corporate bonds or even start to buy bank debt, but such a desperate act would require a dire macro backdrop in our view. More importantly, we are waiting for the Fed to first reverse their rate hike and then restart QE. Such an easing of dollar funding conditions could, at least temporarily, allow borrowers some breathing room. After all, it's all about the debt.

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