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Targeting Global Fixed Income Opportunities

Preparing for rising interest rates

As the Federal Reserve (Fed) begins to wean fixed income markets off of its bond purchase stimulus programme, interest rates are expected to rise, albeit slowly. The great realignment, which reflects a growing consensus that we are at the end of the secular decline in interest rates, has an increasing number of investors concerned about how they should restructure their fixed income portfolios. At a recent Schroders conference held in New York, several of Schroders' portfolio managers engaged in a roundtable panel discussion on navigating the global fixed income waters in a rising interest rate environment.

The panel discussion, which was moderated by **Karl Dasher**, CEO North America & Co-head of Fixed Income, included: **Wes Sparks**, Head of US Taxable Fixed Income; **Andy Chorlton**, Portfolio Manager – US Fixed Income Value; and **Jim Barrineau**, Co-Head Emerging Markets Debt Relative Return. The following article is an abridged summary of the panel discussion.

Now that the Fed is mid-way through tapering its bond purchase programme, investors have started to focus on a potential change in Fed forward guidance, which means keeping the Fed funds near zero for a prolong period. How are bond markets being impacted? Has tapering already been priced into the markets at this point?

Andy Chorlton: Clearly the taper had an impact on the bond markets in 2013, but I think far too many commentators extrapolated that move into 2014, almost assuming bond prices would go up forever. At the beginning of the year, virtually every investment bank outlook for 2014 was positive on equities and negative on bonds.

I also think that the impact of the taper is being looked at too simplistically. For instance, what happens with two-year Treasury bonds isn't the same as what is happening at the long end of the market with 30-year Treasuries. The relative influence of the tapering of quantitative easing (QE) compared to other demand/supply factors will differ at different durations. We can

Karl Dasher

CEO North America and Co-head of Fixed Income

point to significant natural demand for the long end of the yield curve, namely pension plans looking to de-risk, which we believe will offset any impact of tapering. The impact in the 5- to 10-year part of the yield curve could, however, be greater where the natural buyer is harder to define. As a result, tapering is not going to have a uniform impact on the fixed income market. For us as value investors, the Fed taper is just one of the many factors we look at on the demand/supply side. We also need to incorporate relative value between sectors and securities, fundamentals and risk appetite.

Wes Sparks: There are a couple of structural issues as to why there is strong demand for investment grade corporate credit from insurance companies and pension companies. Slightly higher yields or wider spreads will lead to more demand from insurance companies because they need yield to match the liabilities around their business. For pension funds, it's an asset liability management issue where they are selling equities to buy fixed income—primarily 30-year corporate bonds—as a risk reducing trade. Given the rally of 30% in the S&P 500 last year, it actually reduces risk for a pension fund to allocate to 30-year corporates. Overall there is demand that exceeds supply and that is what's driving the strong technicals in the investment grade market. A lot of the new issues continue to be for refinancing or general corporate purposes.

I also think that the weak economic data that we have seen in January and February was largely weather related and we are just starting to see an improvement in economic data. If that happens, the market could start to price in earlier hikes in the Fed fund rate than late 2015, which will result in an intermediary Treasury sell-off. We continue to be more concerned about interest rate risk than credit risk as being the primary threat to high yield returns in 2014, and we carry a slight short duration posture in our portfolio as we expect that the next major move in US Treasury yields will be to higher levels, not lower.

Jim Barrineau: For emerging markets the "pricing in" of bond tapering began in May 2013 with the very sharp fall in emerging market currencies, and sovereign and corporate dollar debt. For the rest of the year, emerging market bonds traded very poorly. We continue to price in bond tapering over a long period in emerging markets and that puts the asset class in front of the rest of fixed income sectors. For example, US high yield continues to rally at this point.

For decades we have experienced a falling rates environment, bringing us down to the lows we saw last summer. What are your thoughts on how clients should be shifting fixed income strategies now?

Andy Chorlton: We believe that fixed income offers much more than a total return investment. It provides a stream of cash flows, which can help

Wes Sparks

Head of US Taxable Fixed Income

Andy Chorlton

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US Fixed Income Value

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solve other client problems alongside the investment returns, primarily as a risk mitigator. The obvious example is Liability Driven Investments (LDI), which are gaining real traction. Secondly, we strongly believe in active management of the whole portfolio, rather than a benchmark-driven overweight/underweight allocation. The more freedom a manager has to invest in areas where he has expertise will add more value for investors.

One final comment is that investors often talk about having a long-term view of three to five years, but in the face of volatility that quickly turns to a horizon of three to five months or even three to five weeks. With curves as steep as they are today, institutional investors are being paid to think long term.

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Jim Barrineau: One of the key points about emerging markets is people don't fully understand that most of the risk is actually interest rate risk rather than emerging market risk, as most of the indices are investment grade securities that trade with high correlation to US Treasuries. Clients should be thinking about emerging markets with a very sharp focus on duration. The way to manage duration is to access the entire opportunity set, and not just with focus on the most liquid part of emerging markets, which is sovereign debt as that has the highest correlation to Treasuries.

In what areas do you see value? What areas do you feel have more interest rate risk?

Andy Chorlton: From a value perspective, we are positioning portfolios to take advantage of two major themes. The first is the demand for long duration bonds from pension plans, which have been substantially underfunded relative to liabilities in recent years, and are much closer to 100% funded today. Their funding level, coupled with reasonable yields at the long end, provides an opportunity to reduce interest rate risk and volatility through increasing long duration bond holdings. This is evident from client flows, market moves and studies that we have seen from investment banks, fellow investment managers and pension consultants. There is potentially a wall of money that is going to be invested in the long end of the market and there are not enough bonds outstanding to satiate the demand. To put some numbers around it, the outstanding supply of investment grade corporate bonds with maturities over 10 years is approximately $1 trillion. The defined benefit private sector pension market is around $2.5 trillion. So, a marginal increase of just 10% to long corporates would require buying around 25% of the entire market.

The second theme is the value opportunity in traditional tax-exempt municipal bonds, principally long duration bonds. The taper was much more of a factor for retail investors, especially in the municipal market. In the second half of last year, municipal bonds fell out of favour with sustained mutual fund redemptions triggering forced selling by fund managers. This created a compelling relative value opportunity in the fixed income market, regardless of a client's tax status. Despite the headlines,

the municipal sector is not as volatile as you might think. Puerto Rico and Detroit do not represent the wider market. We have a significant allocation to tax-exempt municipals across strategies even where there is no tax advantage to the end investor.

Jim Barrineau: In the emerging market asset class, local rates are very attractive. Most emerging market countries have aggressively raised interest rates. We have begun to see foreign reserves grow instead of fall and this has been coupled with stability in currencies. The areas within emerging markets with the most interest rate risk are sovereigns and high-grade corporate risk.

Is now a good time to buy high yield?

Wes Sparks: No, I would say that the US high yield sector is fair value at best and with valuations at 5.3% yield and +370 spread to Treasuries there is probably limited price appreciation potential from here. At the same time, there are several reasons why high yield spreads might not widen materially and we might not see a big correction because there continues to be solid demand as investors search for yield. We saw evidence of that already this year where the correction in late January proved to be both mild and brief as investors began buying credit on only a minor backup in yields. So while the overall high yield market is fully valued right now, we believe that any upcoming market downdraft will not lead to a prolonged bear market, but rather, it should be seen as a buying opportunity. I believe that it is crucial for investors to distinguish between an environment that would lead to a bear market, and a mere short-term correction that resets valuations to attractive levels.

The fundamental backdrop is very supportive of valuations. I would also like to point out that overall profitability remains solid, credit metrics are strong, defaults remain low, recoveries on the few defaults that do occur are good, and upgrades continue to outpace downgrades—particularly at the cusp between BB and investment grade, in that "rising stars" are outpacing "falling angels". However, the high yield sector does have periodic corrections and so we could very well see a 100-200 bp rise in yields at some point in the coming months. Any correction this year would likely be due to rate concerns, not credit concerns.

Given the recent rally in the overall high yield market, investors should assess their risk budget and asset allocation so that they have 'dry powder' if yields back up in coming months. For the nimble investor, this could allow price appreciation to be achieved on top of coupon income as the market subsequently recovers.

What are your views on the different parts of the yield curve? What is compelling about the muni market now? What about LDI and the impact on the long end of the curve?

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Andy Chorlton: As I previously stated, the demand for long duration bonds from pension plans is considerable. We are also seeing flatter credit curves from 10 years to 30 years driven by pension demand and expect this trend to continue. The curve could easily be inverted as the weight of new demand overwhelms the available inventory. The UK pension market has been dealing with this phenomenon for many years now and curves there are inverted. The impact in the UK market was so significant that the government yield curve there was inverted for a number of years in the last decade. While we do not forecast that in the US, it is relatively easy to construct a scenario which shows the US yield curve flattening significantly from where it is today.

Due to the evaporation of the buffer that existed with many of the investment banks after Dodd-Frank and the Volker rule, are we in a situation that bonds are so illiquid that it is difficult to operate daily value mutual funds? How can risk be mitigated?

Wes Sparks: It is a significant issue in the corporate market since the financial crisis in that dealers are acting less like market makers and more like brokers. The will only buy bonds if they can quickly sell them to another customer. That means that we can see a pretty material downdraft in the market when there are mutual fund outflows and general selling of credits. The way we handle it is by separating credit risk management from liquidity management, which means that we often will sell protection in CDS or the CDS indices because we can trade those in larger sizes and they remain more liquid in risk-off periods than cash bonds. So, we can still have cash in the portfolio, but keep exposure via the CDS market. The other thing that we do is also focus on smaller issuers, which contrary to general perception, tend to hold in better during general market volatility. We do this as the larger, most liquid issues, which are bought and sold by primarily by ETFs, go down more when the market is volatile.

Is there a reasonably likely scenario where European banks will de-lever like US banks have?

Wes Sparks: As a credit investor you want to look at those areas where management teams are still deleveraging. In the US, banks have largely deleveraged already and are further along in the credit cycle than their European counterparts. That said, I think there are still opportunities out there. It is a good time to invest in European banks because they are selling underperforming assets, becoming more regulated, and are more focused on capital ratios. We want to ensure that we are not going to be confronted with a situation like in 2011 when the market seized up and European banks weren't able to fund themselves. We think that the European Central Bank is much more proactive and acting more "Fed like" than in 2011.

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How do mutual fund flows impact various sectors of the fixed income market? What opportunities will be created as institutional investors step in?

Wes Sparks: Mutual fund flows have a bigger impact on the high yield sector than they do on the investment grade corporate bond market. That's because mutual funds comprise a greater percentage of the investor base in high yield than is the case in investment grade, and also when redemptions do occur, the investment grade market is more liquid and it's easier to sell high grade bonds to raise cash without making a market impact than it is in high yield. In fact, over time, the correlation between mutual fund flows and excess returns in investment grade credit is virtually zero – so fund flows aren't the key driver of performance in investment grade. In high yield, selling by mutual fund managers to raise cash can contribute to a market correction, but that is what can create a buying opportunity because institutional investors may wait a bit until the market sells off before they step in to buy. Fund flows are a coincident indicator at best and, at extremes, fund flows in high yield can be seen as a contrary indicator. As long as the fundamental backdrop hasn't changed, several weeks of large outflows from mutual funds can create a backup in yields sufficient enough to attract institutional investor demand and a bounce can occur. That happened last July, for example, when we also saw high yield fund flows turn positive as the market rebounded.

Andy Chorlton: The taper, or more accurately the fear of the taper, was much more of a factor for retail investors, especially in the municipal market. In the second half of last year, municipal bonds fell out of favour with sustained mutual fund redemptions triggering forced selling by the mutual fund managers. Last year we saw $70 billion of mutual fund outflows from the municipal bond funds with no natural buyer on the other side – this is predominantly retail market. The sell-off created a really compelling value opportunity. Following the creation of the Build America Bond market, not only are institutional investors more familiar with municipal credits but also there is a good comparison of relative value between the taxable and tax exempt markets for the same credit risk. Despite the headlines, the municipal sector is not as volatile as one might think. Puerto Rico and Detroit do not represent the wider market. We have a significant allocation to tax exempt municipals across strategies even where there is no tax benefit.

Jim Barrineau: Over the past eight months, we have also seen steady outflows among retail investors in the emerging market sector. However, institutional investors have maintained their investments in emerging markets. This past January, the large amount of new issuance was digested by the market very well by institutional investors. We are beginning to see the first signs of stabilization among retail investors in emerging markets. Encouragingly this could help reduce the volatility in the asset class.

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High yield bonds often behave more like equities and less like fixed income investments. Can you share your thoughts on credit spreads and your outlook for high yield in this environment? What kind of potential volatility are we likely to see with high yield this year, and how should investors navigate that?

Wes Sparks: Yes, high-yield bonds are more correlated to equities than Treasuries but that is particularly the case early in the credit cycle when yields are high and spreads are wide. At this point in the credit cycle when spreads are tighter, the correlation between equities and high yield is lower and the correlation between high yield and Treasuries is higher as they are more rate sensitive.

Wes, you say that high yield is in the fair value range. Where do you see opportunities in the High Yield market?

Wes Sparks: While it's true, I do think the US High Yield market overall has limited upside from here, there are still several areas of the market that provide good investment opportunities right now. First, emerging markets bonds have sold off to a point where overall valuations are compelling, and some fundamentally sound credits have been sold right along with troubled credits. Emerging market debt has fallen out of favour since last May when investors began to anticipate Fed tapering of its large scale asset purchase programme so that the average yield of the emerging market high yield bond universe is now 250 bps higher than the US high yield index.

Second, there is an increase in the number and diversity of companies in the Pan-European market issuing high yield bonds for the first time (which had previously relied on borrowing from their bank). The European high yield sector looks very rich versus the US market. It's very well justified because durations are shorter, quality is higher and the technical conditions are even stronger in that demand in Europe vastly outpaces supply.

Third, there are many single-B and triple-C rated companies where the management teams are still focused on deleveraging; in some cases, these are companies that have done an acquisition and are using cash flows to pay down debt to get back their target leverage ratio, or are private companies that are being dressed up for an equity IPO. Fourth, subordinated debt of banks – those which are selling their riskier business units, deleveraging the balance sheet because of regulatory changes, and focusing on improving capital ratios – can provide good value.

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