Fixed income investing in the late cycle

February 8, 2019

IN BRIEF

- Over the last decade, investors have been incentivized to "hunt for yield" in riskier asset classes by unorthodox monetary policy, which sucked the yield out of traditional "safe havens."
- Investors should remember that "safe haven" asset classes may not have higher yields, but can potentially provide protection in the later stages of the economic expansion.
- When selecting fixed income investments in this environment, investors should think carefully about knowing what they own, evaluating performance and determining whether cheaper is better.

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THE DECADE-LONG HUNT FOR YIELD

As the global economy struggled in the wake of the financial crisis, global central banks stepped into the breach, launching multiple waves of asset purchases and implementing low or even negative interest rates to stimulate growth. Questions remain over the effectiveness of this policy, but it certainly did kick-start the hunt for yield. Investors moved out of "safe haven" assets, which now lacked yield, and ventured into other areas of the financial markets seeking stronger returns.

The strategy of taking on more risk in order to sustain traditional fixed income yield is not necessarily wrong. In fact, over the course of this cycle, it has delivered results to investors. A portfolio invested just in U.S. Treasuries returned 2.1% per year between 2009 and 2018; meanwhile, sectors like local currency emerging market debt (EMD) returned 8.2% per year, and U.S. high yield returned 11.1% per year*. In short, investing in higher yielding sectors delivered higher returns over the last decade.

However, in the later stages of an economic expansion, reaching for yield becomes more concerning. **Exhibit 1** compares the yield of different fixed income sectors to their correlations to equity market performance; a proxy for risk. Essentially, it illustrates a very simple concept—higher yield equals higher risk. As a result, investors should be wary of allocating too much to higher risk fixed income: these sectors may offer the juiciest yields, but they tend not to provide portfolio protection in the event of a market sell-off.

*Albeit, both EMD and U.S. high yield delivered these returns with much higher volatility, 10.3% annualized volatility for EMD and 17.8% for high yield.

U.S. investment grade: The growth of BBB corporate debt, the lowest investment-grade (IG) rating, has been alarming. In December 2008, 29% of U.S. corporate debt was BBB. As of January 2019, that number was at 49%.

U.S. high yield and leveraged loans: In 2018, 87% of debt issuance was considered to be covenant-lite, meaning that it offers very little or no protection to bondholders. This is a record high in the asset class.

European high yield: 21% of European high yield trades had a yield below that of the U.S. 10-year Treasury, despite having an average credit rating 12 notches below it.

Emerging market debt: In June 2017, Argentina issued a 100-year bond at a yield of 7.9%. Despite the fact that Argentina has defaulted six times since 1950, this debt issuance was 3.5x oversubscribed. Furthermore, the amount of debt issued by emerging market (EM) corporates has increased dramatically since 2008. Total market cap has risen from USD 200billion to over USD 1.2trillion, making it a similar size to the U.S. high yield market.

These examples are not meant to generate fear amongst investors, nor to suggest that we should not venture into these asset classes. Instead, they highlight the need to be active and diversified in managing fixed income risk allocations, and demonstrate how some areas of the financial market may be too exuberant. Therefore, investors should proceed, but with caution.

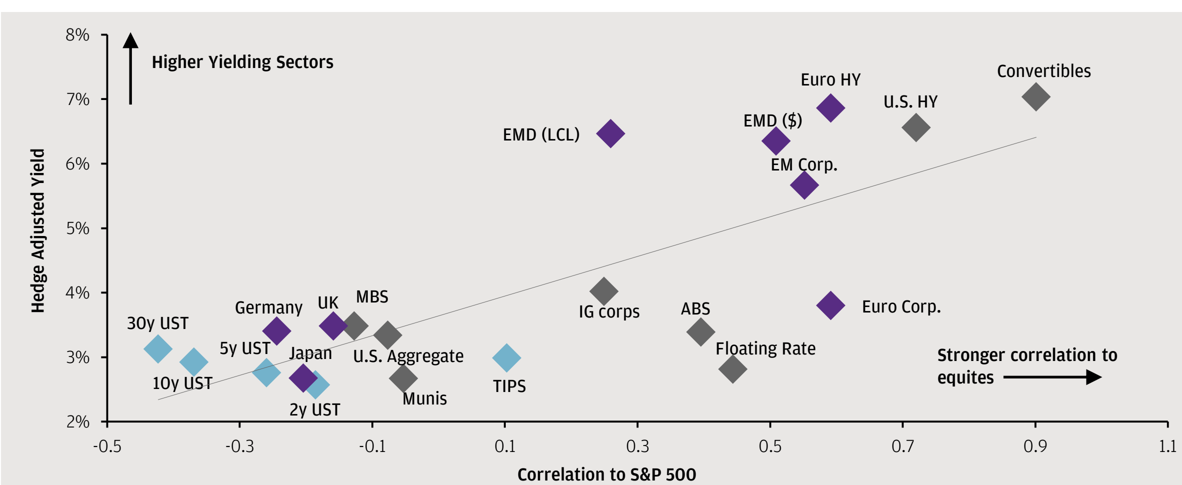
How should investors be positioned?

In the late stages of the economic expansion, investors should be wary of introducing too much risk into their portfolios. Now is the time to reevaluate and consider applying shock absorber, allocating to those lower correlated sectors, like the U.S. Agg, that can help provide portfolio protection if we hit a bump in the road. Ultimately, this may involve sacrificing some yield.

Applying shock absorber within fixed income investing also involves smart investment selection. There are a few things investors should do:

1. **Know what you own:** As mentioned earlier, investors have been hunting for yield, which has pushed them to more flexible styles. Increasingly, investments

EXHIBIT 1: CORRELATION OF FIXED INCOME SECTORS VS. S&P 500 AND YIELDS



Source: Bloomberg, FactSet, ICE, J.P. Morgan Asset Management. Sectors shown above are provided by Bloomberg and are represented by – Barclay's U.S. Aggregate; MBS: U.S. Aggregate Securitized - MBS; ABS: Barclays ABS + CMBS; IG corps: U.S. Corporates; Municipals: Muni Bond 10-year; U.S. High Yield: Corporate High Yield; TIPS: Treasury Inflation-Protected Securities (TIPS); Floating Rate: FRN (BBB); EMD (USD): Barclay's EM USD Aggregate; EMD (LCL): Barclay's EM Local Currency Government Index; European Corporates: Bloomberg Barclays Euro Aggregate Corporate Index; Euro HY: Bloomberg Barclays Pan-European High Yield index. Country yields are represented by the global aggregate for each country except where noted. Yield and return information based on bellwethers for Treasury securities. Correlations are based on 10-years of monthly returns for all sectors. International fixed income sector correlations are in hedged U.S. dollar returns except EMD local index. Yields for all indices are in hedged returns using three-month LIBOR rates between the U.S. and international LIBOR. *Guide to the Markets – U.S.* Data are as of January 31, 2019.

have ventured off-benchmark, taking on more risk to help boost performance in a low-yield world. In the intermediate bond category, top quartile investments have had an average allocation of 10% to high yield and 20% to low-quality IG bonds over the last 10 years. These large allocations to low-quality bonds may have helped boost returns, but they could hurt performance during the next downturn.

2. **Do not overlook 2008:** It has now been over 10 years since the financial crisis, meaning that many fixed income investments can now display a decade of performance without highlighting how their funds performed in the downturn. In the intermediate bond category, the top quartile of investments over the last 10 years has had an average correlation of 0.25 to equity markets. While the next downturn may not be like 2008, these positive correlations might not offer much protection to overall portfolios during the next recession.

3. **Cheaper is not always better:** While the U.S. Agg index does carry low correlation to equity markets, investors should strongly consider the benefits of using active management in this space. With the U.S. Agg at its 30-year low in yield and 30-year peak in duration, inheriting these characteristics from a passive investment in an effort to minimize fees may not always be the best solution. Strategies with the ability to actively allocate across high-quality sectors and manage duration while still providing low correlation to equities may be the more prudent approach.

INVESTMENT IMPLICATIONS

- The decade-long hunt for yield has created a number of distortions within the fixed income markets. Investors should be wary of these issues when making asset allocation decisions within fixed income markets.

- Now is the time for investors to add shock absorber that dials down exposure to high-risk sectors that have high correlations to equity markets and increase allocations to possibly safer, diversifying parts of the market, like U.S. Agg, U.S. Treasuries, Mortgage Backed Securities (MBS) or Municipals.

- Investors need to be aware the trade-offs when selecting fixed income investments. Maintaining diversification and knowing what you own is paramount this late in the expansion.

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