THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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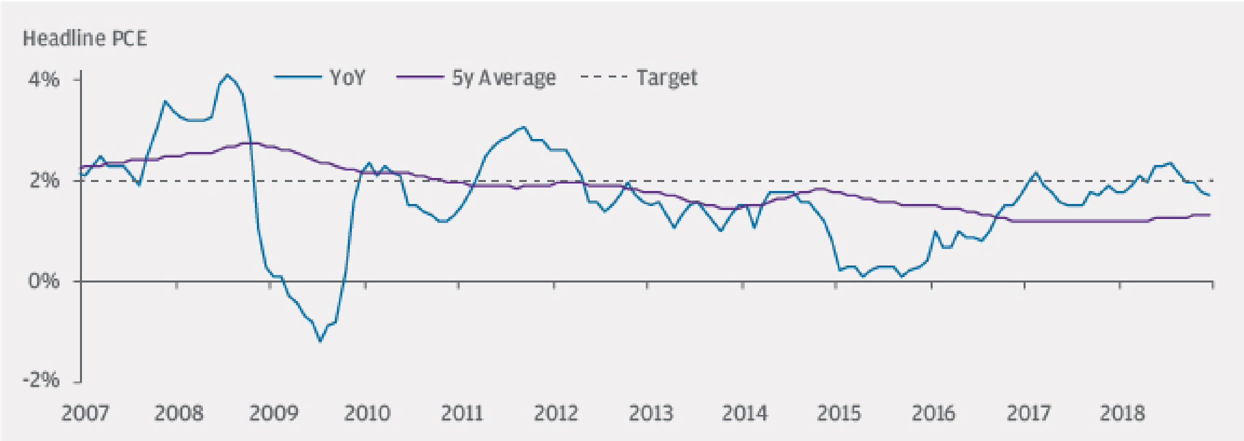
A longer ride

Dovish central banks have the potential to extend the cycle—and therefore the positive environment for credit. Despite the strong performance year to date, we see opportunities for selective investors.

Fundamentals:

While we may yet see a global growth benefit from China policy stimulus or from a positive resolution to trade tensions, central banks are now almost uniformly dovish. The Reserve Bank of New Zealand is the latest to cite low inflation and lower growth expectations as reasons to expect lower future rates, while recent comments from Mario Draghi have reiterated eurozone weakness. The Federal Reserve (Fed) has led the way towards looser policy with a pause in rate hikes and the announcement of an end date for its balance sheet reduction. It now also looks likely that US policymakers would be prepared to tolerate a significant period of above-target inflation, should it materialise, given that the Fed's preferred measure has been well below target on a longer-term average basis for almost a decade. The likely result is a prolonged business cycle—a potential positive for credit markets. However, idiosyncratic risk should not be ignored, and late-cycle behaviour should be watched closely for signs of deterioration. For example, some large companies have recently engaged in M&A activity and will need to de-lever to keep their current ratings. Generally, though, corporates look disciplined, with debt growth slowing to around 0% year-on-year in December: an encouraging sign this late in the cycle.

Average inflation has been well below target, so the Fed could tolerate a higher print for some time



Source: Bloomberg, Bureau of Labor Statistics; data as of 31 December 2018. PCE: Personal Consumption Expenditure; YoY: year on year.

Quantitative valuations:

Credit has done well year to date, with investment grade (IG) corporates up 4.2%—begging the question of how much more upside we can expect. Although valuations have become richer overall, some areas have lagged and have room to tighten further. Namely, BBBs have tightened by only 35 basis points (bps) to a spread level of 161 bps, a less pronounced move than that seen by A-rated credits, which have tightened by 27 bps but to a much lower level of 91 bps. Another persuasive argument in favour of IG in this late-cycle environment is the unusual condition of the correlation between government rates and credit spreads turning positive (typically, it is negative, with spreads widening when core rates rally). For example, while Bunds have rallied by 26 bps in March, European IG spreads have actually tightened by 5 bps. In an environment where lower government rates look increasingly likely, this dynamic could bode well for credit. (All data as of 26 March.)

Technicals:

Technicals are widely supportive across fixed income markets. Net supply is down for high yield, emerging market and US IG credit, with demand increasing, as evidenced by inflows in almost every sector. European IG is the outlier in terms of supply (with almost EUR 20 billion more new issuance than at this stage last year), but demand is robust. As in other sectors, retail fund flows have been strong, with European high grade funds recording inflows for the third consecutive week and the pace of inflows increasing. While investors might be grappling with other late-cycle conundrums, the technical backdrop is not one of them. (All data as of 26 March.)

What does this mean for fixed income investors?

A prolonged economic cycle and supportive technicals should result in further opportunities to take advantage of risk assets. However, caution is warranted, and selectivity will be key as the end of the cycle draws nearer (or as the cycle extends). Fundamentals should be monitored closely in order for investors to satisfy themselves that companies are maintaining balance sheet discipline.

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