THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

19 September 2019

Defensive shift

Given our view that the global economy is just as likely to contract as expand over the next three-to-six months, is it now time to position fixed income portfolios more defensively?

Fundamentals:

The view from our recent quarterly strategy meeting is that, over the next few months, there is now an equal chance of a sub-trend growth environment and an environment where markets price in a recession. The key issue is trade. Although there has been a recent reduction in trade tensions between the US and China, existing tariffs—along with the threat of more—are leading to a slowdown in global economic activity. Chinese data has been particularly weak of late, with market observers increasingly revising growth expectations below 6%. US data (such as consumer confidence and retail sales) has been a little more promising, but developed economies are clearly feeling the effect of trade wars, with manufacturing weakness feeding into the broader economy. Central banks are scrambling to prescribe an appropriate policy response, with the Federal Reserve (the Fed) cutting US interest rates for the second time this year on 18 September. However, the ability of central banks to avert recession is limited. While the Fed has relatively abundant monetary ammunition, the European Central Bank (ECB) is constrained by a deposit rate that is already well into negative territory. With fiscal measures not yet in play, it may be prudent for investors to reduce risk.

Quantitative valuations:

Recent market moves have offered an opportunity to reduce risk. Core government bond yields have backed up significantly, with US 10-year Treasury yields rising almost 30 basis points (bps) to around 1.8% so far this month, having fallen over 50bps in August. The August rally was likely overdone, driven by seasonal factors and geopolitical headlines that have since dissipated somewhat. Nevertheless, the broad direction for rates over the coming months is likely to be lower, and thus current levels may offer a more attractive entry point to add government duration. Meanwhile, recent strong performance in risk assets means that now might be a good time to trim from a position of strength. Global high yield valuations look particularly stretched, for example, with spreads having tightened by over 60 basis points since 15 August to less than 100bps above their post-crisis tights, despite the less compelling fundamental backdrop.

Recent rate backups and spread tightening offers an opportunity to shift up in quality

Source: Bloomberg; data as of 18 September 2019. OAS = option-adjusted spread.

Technicals:

Technicals, not fundamentals, have driven much of the positive return in fixed income markets this year. Demand remains strong for high quality assets, with investors absorbing a strong increase this month in the supply of investment grade credit, which has already reached the total for September 2018. In Europe, high quality corporates are likely be supported in the coming months by the resumption of the ECB's corporate bond purchasing programme, with the ECB expected to purchase EUR 3 billion to EUR 4 billion of bonds each month, with no specified end date. Given the recent backup in US Treasury rates, technicals should also prove supportive for government duration, with momentum indicators now suggesting that Treasuries may be oversold.

What does this mean for fixed income investors?

Unless we see a rollback in trade tariffs and a meaningful move towards improved US-China relations, global growth is likely to continue to falter. With central banks accommodative, the ensuing grab for yield may continue to propel risk assets to further positive returns, but risks are mounting, while valuations are questionable. With core rates expected to fall further, and with investors continuing to search for high quality yield, recent market moves might provide a good opportunity to position portfolios more defensively.

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