Fixed Income Review

2014 has been a difficult year for strategists. The US 10 year is certainly not going to end the year at 4% and most of the other consensus trades have yet to pan out. There has been no "Great Rotation" into equities, Europe has not been the place for either equities or bonds, and the end of investing in Treasuries has certainly not worked out well….so far.

2014 has also been a year of extremely low volatility despite numerous potential "risk off" geo-political events percolating throughout the year. Gaza, the Ukraine, Iraq, the Pacific, Hong Kong…. it has been almost non-stop and this is one reason why US Treasury yields have been within a narrow range despite rapidly improving data in the US. Despite all of this risk assets rallied for the first half of the year, and even the mini sell off over the summer reversed fairly quickly.

More recently volatility has spiked up and some of this can be attributed to geo-politics as mentioned above, but also to the end of QE in the US and expectations of a withdrawal of liquidity and how that might affect markets going forward. At the same time a slowing Europe and China have begun to impact expectations of growth going forward.

The Fed has done a good job of managing market expectations so far and the increased transparency of central banks generally has been a good thing. In contrast to the Fed, the Bank of England has been all over the place in terms of guidance, and the ECB is a perfect example of the Emperor really not having any clothes.

In any event, the bywords of "Lower for Longer" is something to consider seriously. In a world where economic growth remains fragile even in the only economy to show improvement so far (the US) and with low inflation despite trillions of dollars of stimulus it is right to question whether this recovery stage of the business cycle will be here for many years yet.

In this environment, the Fixed Income cycle has been extended. Credit remains interesting in the US, and High Yield especially should show decent returns for the rest of the year. In Europe the situation is more fluid and there is the real risk of further pressure on riskier assets in the short term, particularly in those countries where growth is either not coming through or beginning to falter.

General Themes:

China slowdown and related impact upon the global economy
Increasing unrest in the Middle East
Lower oil price – raw material cost benefit
Low inflation in the developed world

Duration/Interest Rates

Duration has been the clear driver of Fixed Income returns for 2014. Credit has done ok, but it has been all about higher quality, longer maturity bonds. We continue to see relatively strong data out of the US, but the real question here is whether it is strong and sustained enough. There are enough uncertainties to anchor the Treasury curve at these lower levels, and despite

the Fed dots, the market is still under-pricing the forward velocity of rate rises, so there is still an argument to be made that the path to economic recovery remains at least somewhat uncertain.

This is best illustrated by the continued inflows into investment grade credit funds. We tend to think that the real opportunity lies in good quality High Yield companies that will benefit from the improving US economy. There has been a degree of technical weakness over the last month or so but we believe that this will dissipate and the market will rally into year end.

In the US

The data so far has been mixed. Employment continues to improve, consumer sentiment is also getting better but is volatile, and the GDP run-rate is back on track after a very poor Q1. Despite all of this, the US 10 year is still sub 2.40% versus 3.0% at the beginning of the year. The Fed is beginning to sound more hawkish but at the very earliest we are talking about a 25bps move in interest rates sometime around the middle of next year. This is not 1994! We continue to like High Yield here and think credit is poised to outperform US Treasuries.

What to watch:

1. The strength of the US$ will provide a break on inflation and allow the Fed to remain accommodative for longer than perhaps the data is suggesting.
2. Sustained improvement in the labour participation rate and wages
3. Improvement in construction

Europe

The argument that Europe is the better place for bonds as a result of there being almost no chance of interest rates going up for some time does have some credibility. Unfortunately the economic situation is teetering on the edge of something far worse – deflation and a real slowdown again. This will impact High Yield, and peripheral credits. The market is asking for QE but this is not something that is achievable in the short term. Things will get worse before they get better. A focus on good quality bonds in core Europe makes sense.

What to watch:

1. Inflation bottoming/beginning to stabilise
2. Euro weakening further
3. A significant expansion of the ECB balance sheet

Risk assets

The volatility that we have seen over the last month or so is something that should not come as a surprise. The market has shrugged off a lot over the past several months, but the fear of the end of QE in the US, the IMF pronouncement on slower global growth plus a disappointing ECB meeting have all resulted in risk off generally. Investors are rightly cautious but the market is beginning to look interesting again.

Bull or Bear for Q4?

Bull for High Yield in the US, bear in Europe for High Yield. We need to see some stabilisation. This should result in flows back into the asset class.

Bear on US high quality duration, bull on European high quality duration. It is all marginal though, and we think the US 10 year ends the year sub 3%.