MIRABAUD 1819
Asset Management

FIXED INCOME MARKET UPDATE

Q1 2018

THEMES FOR 2018

1. *WE CONTINUE TO BE POSITIVE ON CREDIT AND IN PARTICULAR HIGH YIELD*
2. *VOLATILITY MAKES A COMEBACK*
3. *ETFS LOSE SOME OF THEIR LUSTRE*
4. *THE US OUTPERFORMS EUROPE WITHIN FIXED INCOME*
5. *LOCAL CURRENCY EM IS ALSO A POSITIVE FOCUS FOR US IN 2018*
6. *THE US 10 YEAR ENDS THE YEAR ABOVE 3% BUT CLOSER TO 3% THAN 4%*
7. *THE 10 YEAR BUND MOVES CLOSER TO 1%*
8. *OIL AVERAGES AROUND $55, PLUS OR MINUS $5 UNLESS WE HAVE A GEO-POLITICAL SHOCK*
9. *INFLATION PICKS UP IN THE US BUT GRADUALLY*
10. *THE FED RAISES RATES 3 TIMES ALL THINGS REMAINING EQUAL*
11. *RISK THAT THE US DOLLAR BUCKS CONSENSUS AND STRENGTHENS*
12. *GEO-POLITICAL RISK INCREASES*

ROUND-UP WITH ANDREW LAKE, HEAD OF FIXED INCOME

INTRODUCTION

2017 was the complete Goldilocks scenario for risk assets; decent but not excessive global growth, a continuation of QE support, low interest rates and no sign of inflation. Markets were consistently strong all year – North Korea, French elections, turmoil in the Middle East – none of these events upset market sentiment.

The year ended with Treasuries and Bunds selling off and some nervousness in markets generally. This was not unexpected given the strength of returns during the year. 2018 started with a huge rally lead by those sectors that had struggled somewhat at the end of 2017 – Energy and Telecommunications. Commodities also rebounded.

Since then, volatility has returned primarily as a result of market recalibrating expectations of interest rate rises from the Fed at a time when valuations across the board were overextended. Equities re-priced as a result of Treasuries widening and general sentiment has been fragile since, given the violence of the move, exacerbated by certain ETF products and programme traders. The good news is that this was far more technical than fundamental and it is too early to call this a bear market.

Where do we go from here? Is the Fixed Income cycle finally turning? Is Bondmageddon becoming a reality? Volatility is back with a vengeance and we need to make sure we do not throw out the baby with the bath water. Whilst it has come earlier than expected, volatility throws up opportunity and this is what investors need to focus on at this stage. From a fundamental perspective, nothing material has changed. What has changed is investor complacency with regard to risk and reward. The markets have not been behaving as one would expect in the short term, with correlation heightened across normally disparate asset classes. If one takes a step back there are some potential opportunities forming for the first time in a while and this is what we are spending our time analysing.

KEY THEMES FOR 2018

A transitional and more complicated year sums it up nicely. Higher interest rates and an increase in volatility. We have seen flows out of Fixed Income as a result of this, especially from High Yield, and at the same time we are seeing a wall of primary issuance. M&A is likely to be a bigger risk in 2018, and private equity activity is likely to increase. Dividends and share buyback remain a key use of funds raised from both tax breaks, equity and bond issuance. Whilst debt is being extended, we are not seeing a general reduction in leverage or indeed a significant uplift in capex.

Fundamentals are generally still supportive for credit. Interest coverage is high, and default rates remain low. Whilst we are seeing some deterioration of credit quality, this is idiosyncratic in nature and not widespread. All signs that we are towards the end of the current cycle. Having said that, 2018 is not the year that we see recession coming. Much will depend upon inflation – if it really picks up and we see more frequent and urgent interest rate rises from the Fed, then a slowdown become a much higher possibility. The current gradual rise, with a more passive Fed, waiting upon data would be generally supportive for risk assets. Europe is further behind the curve and suffers from none of these threats at present, although absolute yield levels and low break evens make the European Fixed Income market vulnerable to a move higher by the Bund.

Geo-politics will be a big unknown this year. A more aggressive US foreign policy, coupled with a more energised Russia and continued issues in the Middle East could be de-stabilising for economic growth.

INTEREST RATES – THE WITHDRAWAL OF LIQUIDITY BY THE FED

The Fed's policy of maximum communication and transparency has paid dividends. The market has been aware of – if not always believing – the Feds intentions each year with regard to interest rates. In fact, the volatility we have seen in US government bonds over the last few months has been as a result of market expectations moving more into line with the Feds projections for interest rate rises this year.

There are, however, **two primary concerns surrounding the withdrawal of QE**:

- The first is that the largest buyer of Treasuries (the US government) is reducing its purchases just as borrowing requirements are about to increase as a result of tax cuts, infrastructure spending etc.
- The second concern is that inflation, so long ignored by investors, may suddenly increase beyond current levels and will require either more interest rate rises than expected (4 rises are being talked about now) or at the very least a move wider in Treasuries to over the dreaded 3% threshold.

"A gradual widening in Treasuries over an extended period would allow the market to adjust. Rising inflation alongside solid fundamentals would not necessarily be bad for certain parts of Fixed Income in the US and credit should do well in this environment."

All of this speculation has come in the first few months of 2018, as Treasuries have widened significantly. This has put pressure on equities given the average dividend yield on the S&P is somewhere around 1.87% give or take and on certain areas of Fixed Income, especially investment grade with low break-evens or high correlation to the underlying government bond market. Volatility is back with a vengeance and fear has taken hold.

Taking a step back, the recent 30 year Treasury auction went well. The most recent CPI number from the US showed that inflation is indeed ticking up, but at a gradual pace and is by no means out of control. Whilst the jobs date remains strong, there has not been a corresponding uplift in wage growth. Whilst we believe that this will come, it will be a gradual process. Where bottlenecks are forming is in areas of the economy where skilled workers are needed – construction being one – and also in transport and logistics.

"Mirabaud Asset Management Fixed Income Team is still positive on High Yield in this kind of environment."

Anecdotally, having spoken to several of the large US homebuilders over the last few weeks, long term 30 year rates can go up approximately another 100bps before affordability becomes an issue.
Fundamentally the global economy is in good shape and not a lot has changed in the last few months. The recent sell-off has resulted in US High Yield once again yielding over 6%, which we would consider an attractive level given fundamentals. There are no signs of an impending US recession this year.

In addition, the fear of +3% Treasuries is perhaps misguided to some extent. A rapid move wider over a short space of time would indeed create turmoil, but a gradual widening over an extended period would allow the market to adjust. Gradually rising inflation alongside solid fundamentals would not necessarily be bad for certain parts of Fixed Income in the US and indeed with gradual policy movement from the Fed, credit should do well in this environment. I am still positive on High Yield in this kind of environment

ECB – BEHIND THE CURVE?

"Fixed Income market looks skewed as a result of the CSPP and with the potential to move wider this year."

Mr Draghi has done an excellent job of managing market expectations since his "whatever it takes" statement several years ago. The issue now is that QE has worked! The Eurozone economy is doing well, unemployment is coming down slowly, inflation is slowing ticking up but from a very low base and the CSPP is still very much in evidence – all extremely supportive for risk assets generally.

The issue is that the dialogue hasn't materially changed. The dovish taper was introduced for the first time in the second half of 2017, and more recently the strong Euro and low inflation have been highlighted as areas of concern. Given where valuations are generally in fixed income and given the rapidly improving fundamentals, the market looks mispriced – skewed as a result of the CSPP and with the potential to move wider this year. Even if the status quo is maintained, and Bunds do not move out of their current range, the carry is de minimus in Europe for a fixed income investor.

INFLATION – WHERE IS HIDING?

"Fears are overdone. Inflation will pick up and some elements of the Fixed Income market will suffer but should not upset the overall performance for credit this year."

January's 0.3% rise in core CPI in the US combined with a strong average hourly earnings report was enough to flash a warning sign to hitherto complacent investors. Despite this and signs that import price inflation is finally affecting consumer prices one should not get too carried away. We have been very vocal about the market underestimating inflation for most of 2017, but we have also been clear that it will be a steady rise higher rather than a sudden violent jump. The market has overshot and we think fears are overdone. Yes, inflation will pick up and yes some elements of fixed income will suffer, but if we are right it will not be enough to upset the overall performance for credit this year.

ENERGY – MORE VOLATILITY?

Energy Energy has once again flattered to deceive so far this year. Despite being a high Beta sector, returns have been very credit specific, particularly in the High Yield portion of the market. The oil price has been extremely volatile, despite OPECs best efforts to instil a degree of confidence in the market ultimately re-balancing at some point. The US shale producers have continued to increase production and have benefited from continued access to the capital markets and leaner and more efficient production and cost structures. Overall the Energy Sector has been disappointing from a total return perspective and has not tightened despite WTI being at $60.

“Permian players are still well positioned with lower break-evens. We continue to like midstream assets and select E&P companies while gas producers have been reduced.”

As usual no one really knows where the price of oil will end the year. The general consensus is that the price will be lower than it is today. That premise is based upon the current demand/supply situation moving into surplus supply as a result of shale producers bring more online as a result of $60 oil. An increase of 1.9m barrels a day by the end of 2018 is being mooted by analysts and of that 1.6m barrels will come from shale producers. Permian players are still the most well positioned with lower break-evens. We continue to like midstream assets and select E&P companies. Gas at $2.50 seems also to be the consensus. Gas has been under pressure given the demand/supply imbalance is more accentuated as a result of gas being a by-product from shale oil alongside standard gas suppliers. We have generally been reducing our exposure to gas producers at this point.

COMMODITIES AND THE US DOLLAR

A weak dollar means strong commodity prices. Consensus would thus suggest that commodities should generally perform well. Given the global growth backdrop, the fundamentals also seem to be supportive. China remains the big risk both from a demand and a supply perspective. One risk to this outlook would be if the consensus view on the USD is wrong. If we do have heightened geo-political risk, we could see a move higher in the USD. In addition, Larry Kudlow, the new Chief Economic Advisor has gone on record stating that he would like to see a stronger dollar. At present the focus is on the twin deficits, but if this should change and the dollar move higher, then we could see some pressure on hard currency EM.

Loose fiscal and tight money should be good for the dollar, yet the consensus trade is for it to weaken further from here. So far that has been the case as fears over much larger current account and budget deficits are outweighing all else. The risk is that the dollar does bounce at some point and that will have a knock-on effect for Emerging Markets, which have enjoyed a rather benign investment environment for the last several months.

CHINA – WILL SLOWDOWN?

The eternal question…will China slowdown? Now that President for Life Xi is firmly in control (he was anyway given he was already head of the Communist Party and chairman of the Central Military Commission which aren't constitutionally limited) we may see further focus upon more regulatory oversight of the financial system – shadow banking, inflated asset values and excessive debt are key concerns for China’s continued stability. Xi has also focused on sustainable energy policy moves, which will obviously impact longer term industrial processes and consumption. In actual fact this was not as significant as one would expect. What this means in the long term for China is unknown at present but the direction of the economy will be pivotal both for global growth, demand for commodities and general sentiment around EM.

IS THERE ANY VALUE LEFT IN FIXED INCOME?

The end of Fixed Income is something that crops up every year. The 30 year bond bull market, a cycle that is abnormally long, the end of QE….all are cited as reasons for why Fixed Income as an asset class is over. Everyone is entitled to an opinion, that's what makes market, but it is clear that whilst certain element of the Fixed Income universe will struggle in the current environment, other areas will do relatively well. Let's not forget that equities also benefitted from 10 years of QE and most other asset classes operate at historically elevated valuations. In addition there have been some rocky times over the course of the last 30 years – Savings & Loans crisis, Russia in 1998, Long Term Capital blowing up, the bursting of the Internet bubble and of course the Great Financial Crisis in 2008. We even had a Eurozone blip in 2011 and the oil collapse in 2015…..so bonds have not had it all their own way.

GOVERNMENT BONDS

We have increased our exposure to government bonds in the unconstrained strategies. This would seem a bit counterintuitive given our negative comments on the asset class for the last couple of years, but we have been positioning the funds for more inflation and thus have been gradually building a position in US TIIPs and very short dated US Treasuries. Generally we continue to see the risk/reward skewed to the downside and view government bonds as one of the areas of Fixed Income that will continue to be under pressure in a rising rate environment.

INVESTMENT GRADE CREDIT

Generally speaking will be under pressure as government bonds move wider. Much of the spread compression was done last year, and it is hard to see them compressing further from here. In the US there has definitely been pressure on returns – US Investment Grade has a -2.5% return YTD (C0A0 Index) - but historically we have seen buyers come back into the market at around these levels – 3% on the 10 year US Treasury and around 4.5% for a standard BBB rated credit). If we do see some stabilisation then we could see more flows into US IG.

European IG is slightly negative so far this year (-0.04% for the EUAS Index) mainly on the back of the Bund rallying in from the wides in February. With low break evens it is the Bund that will continue to drive underlying performance. The market is still relying on QE and the CSPP to backstop current levels despite a more robust economic outlook. We are sticking to our view that at some point solid economic growth alongside full capacity utilisation will result in inflation ticking up and Bunds moving wider.

HIGH YIELD

High Yield is seen as problematic and flows out of the asset class would suggest that investors no longer see the risk/reward as acceptable especially with negative headlines around the liquidation of Toys R Us and the default of iHeart Radio. There will be more of these situations, but that is to be expected on an idiosyncratic level with over leveraged legacy LBOs.

US High Yield is now yielding on average around 6%, with no real change in the underlying fundamentals. Corporate profits rebounded in 2017, and the last set of quarterly results were also strong. To some extent this improvement in earnings offsets the increase in leverage that we are seeing. Even credits perceived to be problematic like CenturyLink and Frontier showed signs of improvement. The market remains very idiosyncratic with investments being made on a case by case basis. We are taking advantage of the current bout of volatility and finding some interesting opportunities both in the primary and secondary markets.

High Yield has actually outperformed over the recent market turmoil, and whilst some areas are more interest rate sensitive – BBs for example – there are still less correlated credit stories to look at where the spread is still wide enough to cushion the blow of higher Treasury yields.

EMERGING MARKETS – HARD VERSUS LOCAL

Hard currency EM both IG and HY is trading at tight levels versus US IG and HY. In addition, the direction of the dollar will be a large influence given the large weighting to commodities for EM. Local currency is a different matter. It is a larger market, with more depth and liquidity. There are element of this market that are uncorrelated to the US or the Dollar, and looking at the performance YTD this is the one area of Fixed Income that has performed reasonably well. As a result we are continuing to add to local currency EM in the Funds that allow it. Shorter duration is the sweet spot for us as there are attractive returns on offer without taking too much duration risk.

POLITICAL RISK – THE TRUMP ADMINISTRATION

Geopolitics could be one of the key drivers for markets this year. It has been an area that has been shrugged off by investors before – Brexit, Trump, Italian, German and French elections, North Korea….the list goes on and none have been defining moments for the markets. This time it might be different. President Trump has replaced more moderate members of his Administration with foreign policy hawks like Bolton and Pompeo. Steel tariffs and now $50bn of further targeted tariffs on Chinese imports could precipitate a trade war should China decide to react commensurately. The other concern is if the US unilaterally pulls out of the Iran atomic accord. That will drive up the price of oil in the short term. The market is assuming that this is hot air and like the steel tariffs Trump will make a lot of bellicose statements whilst not actually doing a great deal so this may again be a non-event but it is a real risk for markets at this point.

FUND POSITIONING

We continue to have a large weighting to the US. Given the move in Treasuries some parts of US Investment Grade are looking interesting on a case by case basis. We continue to like elements of High Yield both in the US and Europe. One technical dynamic is that European and Asian investors are no longer buying USD bonds given the onerous hedging costs. We, however, are finding some investment opportunities in European High Yield given the hedging advantage for US Dollar investors is significant. In addition we are increasing exposure to local currency EM in the funds that can invest.

CONCLUSION

This cycle will end as a cycle always ends; with the Fed raising rates too far and causing a recession. We do not see this as an imminent danger but will be monitoring leverage and debt burdens of credits we own and analyse as it will be these companies that will be pressured once earning slow or reverse. Given the primary focus of companies has been to extend debt at lower interest rates for longer maturities, higher interest rates will not be problematic for a lot of companies for the next few years. It will be those companies with regular and large refinancing needs which will struggle.

marketing@mirabaud-am.com | www.mirabaud-am.com

Author: Mirabaud Asset Management Fixed Income Team