



Changing Dynamics and Opportunity in the Global Bond Market



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The dynamics of the global bond market are changing, as a prolonged period of low inflation, low growth and low interest rates has seen income returns on bonds hit new lows.

As bond investors become accustomed to persistently low yield levels, the quest for income is driving new investment priorities and encouraging some to adopt a more strategic, unconstrained approach. Here, BNY Mellon investment management company Standish explores the latest market trends and strategies in global bond markets.

The dynamics of the global bond market are changing, as a prolonged period of low inflation, low growth and low interest rates has seen income returns on bonds hit new lows. This, in turn, is prompting much soul searching among investors about both the outlook for global bond markets and the best approach to generate income for their portfolios. For many, the days of income being the primary driver of returns in bond investments have effectively passed, even as fixed income as an asset class remains what many consider to be a 'reliable' investment amid uncertain and volatile markets.

Against a backdrop of ongoing market intervention and unconventional policies such as quantitative easing (QE) by central banks, the overall outlook for global bond markets in the months ahead looks mixed, according to market commentators.

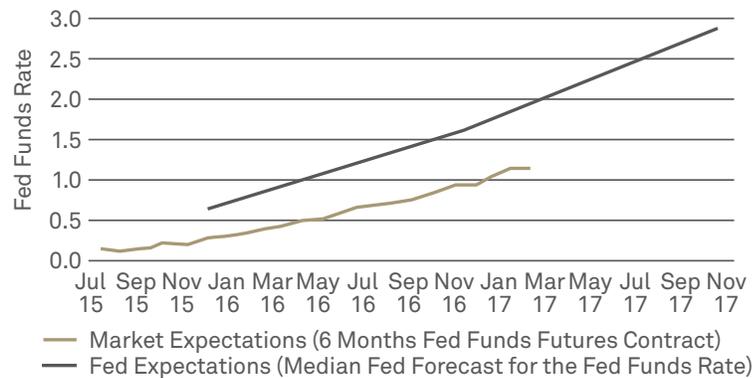
Ratings agency Moody's expects global net inflows to bond funds to remain in positive territory this year with limited credit deterioration in such portfolios, while other analysts predict increased volatility and widening credit spreads throughout the rest of 2015.¹

Either way, persistently low bond yields look set to be a feature of the market for some time to come.

¹ Bond market outlook: Brace for volatility. Charles Schwab. 18 December 2014. Yellen says expects rate hike this year, but cites labour weakness. Reuters. 10 July 2015.

In this environment we believe long-term interest rates will rise only modestly higher after a period of volatility as some of the longer-term factors holding down rates take time to play out.

Market vs. Fed Expectations For The Fed Funds Rate



Source: Bloomberg and the Federal Reserve as of 6 July 2015.

MIXED OUTLOOK

Widespread expectations the US Federal Reserve (Fed) will raise interest rates this year² have also raised fears a new bond bear market may be on the horizon.³ This is despite the fact any rises would be from a very low base, given current rates across major markets are at or near record lows.⁴

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For interest rates to show any consistent rise, or for yields to move to sustainably higher levels, markets would require consistently strong economic data coming out of major markets, such as the US. In particular employment and inflation growth would need to be strong. Instead, globally, we currently face a very mixed economic picture that varies on a country by country basis.

In the US, for example we do think the positive recovery can continue and we could see some strong macroeconomic data coming out from here. If this does happen, and inflation picks up, then we could see the Fed begin to raise short-term rates, perhaps to a greater degree than is currently priced into the market. On the other hand that doesn't necessarily mean we will see a big spike in longer term rates. As much as we think inflation might rise, we don't think we will return to the point we were at in pre-crisis levels in terms of growth, so that will put a natural limit on how high longer term yields can go.

² Yellen says expects rate hike this year, but cites labour weakness. Reuters. 10 July 2015.

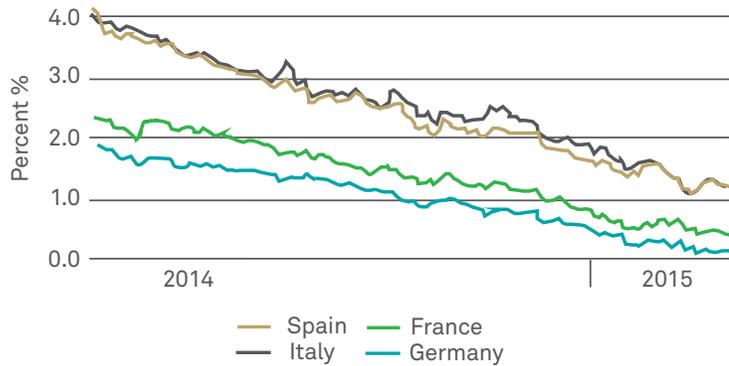
³ Winners and losers in the bond fund fallout. FT. 18 May 2015.

⁴ UK interest rates remain at record low of 0.5%. BBC. 09 July 2015.

According to our outlook, interest rate movements look more uncertain outside the US, though the UK does share some of its key characteristics.

The UK has exhibited similar tendencies to the US in terms of the path taken by the Bank of England (BoE) and the data coming out of that market tends to be very similar, perhaps with a slight lag. But once you get outside of the US/UK, every market is unique – whether in continental Europe or other markets such as Japan and Australia.

Ten Year Government Bond Yields



Sources: FactSet; Agence France-Presse/Wall Street Journal as of 13 April 2015.

While the appetite for income among mainstream bond investors remains strong, its traditional means of delivery no longer appears fully functional.

The persistently low levels of interest rates in recent years have not been the only factor affecting bond yields. The ongoing market impact of interventionist and experimental policies such as QE and quantitative and qualitative easing (QQE) in markets such as Europe and Japan has also helped drive yields to persistently low levels, encouraging many investors to place their money in higher return, higher risk assets such as sub-investment grade bonds and other more specialised fixed income instruments. While the appetite for income among mainstream bond investors remains strong, its traditional means of delivery no longer appears fully functional.

While every market is different, it is more difficult for us to see rate rises or significant yield increases ahead in those markets outside of the US and the UK because we still think we are dealing with a number of specific credit overhangs which are likely to keep yields low.

We believe investors need to be more active in their sector and country sector selection and rotation to generate bigger returns.

INCOME SQUEEZE

We believe the demand for income among traditional mainstream fixed income investors and the capacity of these assets to generate solid returns in the current market isn't dead but investors in the current market will have to reorient to a much lower level of yield. The days of income being the primary driver of returns in mainstream bond portfolios are definitely over, at least for the foreseeable future, although there will still be an income component. In addition, bonds will likely continue to offer a high level of investment security.

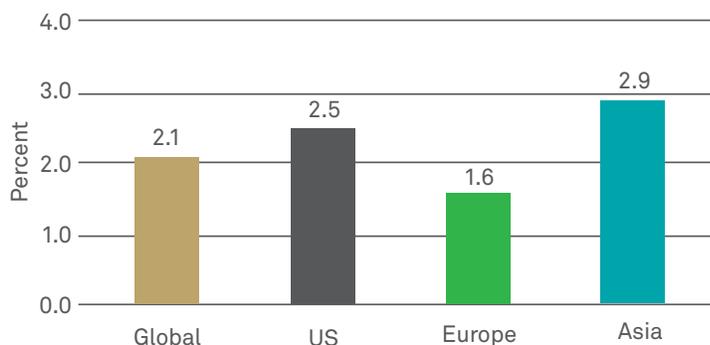
Investors must work harder to find value and income, exploring an ever wider pool of global investment opportunities and diversifying portfolio holdings where necessary.

We believe investors need to be more active in their sector and country sector selection and rotation to generate bigger returns. They also need to be more active in rotation across individual securities as well.

A WIDER UNIVERSE

A number of alternative fixed income assets lie across the risk spectrum and, as such, offer a wide range of risk/returns; such as high yield bonds (currently offering attractive returns with historically low default rates) to more mainstream investment grade assets. More complex and illiquid assets such as bank loans and securitised debt (including asset backed securities (ABS), commercial mortgage-backed securities (CMBS) and special purpose vehicles (SPVs)) also offer the attraction of strong returns but are considered to be higher risk and less liquid than conventional mainstream bonds.

High Yield Default Rates 2014



Source: Moody's as of 1 June 2014.

Municipal bonds and emerging market (EM) debt are other asset classes which can, in some cases, also provide higher returns with commensurably higher risk. We see EM debt as a potentially strong area of opportunity in the year ahead. While emerging market growth has underperformed expectations over the past three years, we also believe current pessimism around the asset class is an overreaction.

The market has recently seen a perfect storm for EM currencies and countries and, until now, we've tended to avoid EM debt. But we do think this asset class is going to present a big opportunity once we have more clarity around potential Fed interest rate rises and more stability around oil pricing – both of which we believe will occur at some point this year.

Despite rising geopolitical risk in specific emerging markets such as the Middle East and Ukraine and a slowdown in Chinese growth this year, we believe certain local emerging bond markets – including Latin American centres such as Brazil and Mexico – continue to present positive fixed income investment potential and opportunities for portfolio diversification.

LIQUIDITY CONCERNS

Beyond immediate returns, the mainstream fixed income market has traditionally been viewed at the ‘safer-more-stable’ end of the spectrum than other investment classes such as equities, real estate and commodities. As such, mainstream bonds have become a traditional means to match the maturing liabilities of long-term investment schemes such as pension funds. This has not changed despite the new lower return, lower income aspect the market has seen recently.

While higher risk fixed income investments have become popular in the low yield/return/low interest rate environment that followed the financial crisis, many investors still appreciate the relative stability mainstream bond investing can bring to their portfolios.

Highlighting ‘surety’, income and liquidity as three main qualities investors have always sought from bond markets, Standish believes they should pay particularly close attention to the liquidity component in what has become an increasingly volatile fixed income environment.

Changes in the investor profile of fixed income buyers have also had an impact on the investable universe. Retail ownership of fixed income instruments has grown rapidly in recent years. According to Morgan Stanley data about 20% of US high yield was owned by mutual funds, compared to 5% in 1993.⁵ Against this backdrop, the market has seen an almost commensurate decrease in the ability of the market to cope with fixed income inflows and outflows, as increased regulation, such as the introduction of European Union capital adequacy requirements (Basel III), has significantly impeded banks from taking on inventory.

As the proportion of the sector owned by retail investors has risen, resulting in reduced dealer balance sheets for the availability of trading, it has prompted an increase in volatility across the board in both the primary and secondary markets.

This is now a feature of the sector investors definitely need to factor into their allocations. The fixed income market has grown exponentially in recent years and there are some very large players out there variously trying to trade in both primary and secondary markets. Now it’s so much more difficult to trade, the moves on some redemptions become exaggerated. You have to be able to react to that and be more nimble in your allocations.

Many investors still appreciate the relative stability mainstream bond investing can bring to their portfolios.

⁵ Morgan Stanley data as at 30 June 2014.

We believe investors may need added protection via adequate liquidity premiums to shield against increased volatility and default risk.

Other factors can also influence market volatility, whose anticipated levels are commonly measured by the VIX index. So-called high frequency trading has also come under the spotlight in recent months. This followed a wild swing in US bond yields last October⁶ in which the 10-year US Treasury note yield plummeted to 1.86 before quickly rebounding⁷ in moves partly blamed on electronic trading. New regulation of the sector looks likely⁸ but last year's sudden spike in bond market volatility was said to have underlined the need for close continued investor vigilance.

MARKET PROTECTION

Looking ahead, we believe investors may need added protection via adequate liquidity premiums to shield against increased volatility and default risk. As many higher yielding bonds tend to have higher risk profiles and may offer constrained liquidity, we recommend investors carefully assess the yield of the instruments they invest in versus their likely liquidity.

If you were comparing a sector historically and you were looking at, say, the excess spread or yield you were getting for a particular sector or bond versus the chances of default you would want to be adequately compensated for this risk. Today, investors need to demand a higher liquidity premium from many of these sectors because the volatility is higher so spreads should be generally higher than they were historically because of the lower liquidity available in certain sectors of the bond markets. In many cases, they are not.

Market changes in the post-financial crisis world of QE, growing regulatory intervention and other variables have raised some questions about bond sector valuations. For instance, how can investors best assess the value of a bond when the market continues to be seriously impacted by intangibles such as increased regulation and political and policy makers' intervention? We remain sanguine on this point, noting that bond sector valuation has always been a complex process and both QE and other post-financial crisis changes have simply added extra parameters to those already taken into account by market participants.

6 US report into October bond meltdown calls for review of automated trading. FT. 14 July 2015.

7 Treasury turmoil finds no smoking gun. FT. 14 July 2015.

8 US report into October bond meltdown calls for review of automated trading. FT. 14 July 2015.

In trying to ascertain the value of a bond you are never solely reliant on a point estimate, always a range of potential values. The only difference in the current market is that when you are coming up with that range, you need to introduce another variable which is central bank demand and potential changes in that demand. The valuation process appears more challenging than it used to be but in reality it is not. Fixed income has always been complicated but factors such as QE and other variables do need to be taken into consideration.

RENEWED VOLATILITY

Valuation issues aside, the next 12 months look set to test the nerves of even the calmest of global investors. Last year's geopolitical problems in Russia, the Ukraine and Middle East and the 2014 collapse in oil prices were swiftly followed by a range of other concerns, including an unusually harsh and economically damaging US winter.

More recently, the Greek debt crisis has sent fresh jitters through fixed income markets and a recent plunge in the Chinese equity markets has also brought fresh volatility to bond markets. All of these factors present both potential threats and opportunities for investors. The key to success in such markets is to remain nimble and open to potential opportunities.

In the current market it is important to adopt a flexible, carefully targeted investment approach. You have to hold liquid positions because you can't necessarily rely on steady returns from any fixed income asset class over, say, five straight years. Ultimately, you have to be able to address shifting market fortunes such as currency depreciation and rising volatility via trading.

As the fixed income market has grown, the amount of dealer capital available to trade fixed income has also fallen. In this environment it pays to adopt a more tactical approach to allocations. You no longer just take notice of fundamentals, you have to look much more at technicals in fixed income as well.

In this environment it pays to adopt a more tactical approach to allocations.

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