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Focus on: Developed Markets Fixed Income

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Ongoing central bank interventions, increased political risk and the potential for rising defaults all look set to be key themes for 2017. Here, **managers from Insight and Standish** ask the question: what could the next 12 months have in store for fixed income investors in developed markets?

Outside of monetary policy decisions, what do you see as the biggest challenges for the year ahead for corporate debt investors?

Peter Bentley: From a top-down perspective, investors increasingly need to be aware of political event risk. The surprise outcome of the UK referendum and U.S. election highlighted this. In 2017, Germany and France both go to the polls in an environment in which fringe separatist political movements are looking to consolidate their growing support.

Lucy Speake: One important challenge is the rise in idiosyncratic credit risks in investment grade markets. A significant contributor is a wave of mergers and acquisitions (M&A), which often benefits a company's shareholders at the expense of its bondholders. In a low-growth environment, management teams struggle to deliver shareholder growth organically and so M&A or shareholder buybacks become a natural solution. However, this usually leads to an uptick in leverage ratios, which is a risk for credit investors.

Issues surrounding corporate governance are another factor. Examples include last year's Volkswagen scandal and the controversy surrounding Deutsche Bank and the U.S. Department of Justice.

Thant Han: Financial market regulation is tightening, dealer inventories have fallen to reduce balance sheet risk, and trading volumes have declined despite increased supply via cheap funding. While we believe this indicates we're in the later stages of the expansion phase of the credit cycle, we think we still have at least a year before we transition into a downturn phase.

Even though we've already reached the average length of the previous two credit cycles, the prolonged period of historically low interest rates has made this time different. The

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downturn phase is typically characterized by a recession — but we're not forecasting that in the near term since we don't see the excesses that usually precede these periods.

The consumer is broadly in good shape, bank balance sheets are strong and corporate liquidity is solid. History also suggests the expansionary phase may continue well after monetary policy tightening (which has yet to occur in any meaningful way).

Do you believe default rates will increase in 2017? Which sectors look vulnerable?

Peter Bentley: We expect the default environment for investment grade issuers to remain benign in 2017, with positive growth and low yields allowing issuers to refinance their debt at attractive levels. Strong investor demand is also evident, even at these low yield levels.

An uptick in defaults has been evident in the U.S. high yield market, but this was mostly related to energy companies struggling with lower oil prices. Should commodity prices fall further, this would put additional pressure on this sector. In Europe and the UK, there is still support from central bank purchases.

Thant Han: While ratings have been migrating lower for a while now, the trend accelerated because of commodity-related downgrades. In our view, increased demand for returns and indiscriminate buying of spread products make most segments of the corporate bond market vulnerable to a correction. We think event risk in the industrial sector remains elevated due to the historically low 'all-in' cost of debt. This suggests it makes sense to have a skew towards defensive sectors such as utilities and financials, where equity capital appears double pre-crisis levels due to regulators' demands.

We also note lending standards have a high correlation to default rates; tighter standards are typically followed by higher defaults. In the U.S., after several years of loosening, banks have just recently started to tighten these standards, so we do believe default rates have scope to move higher.

What do you see as the biggest tailwinds for your asset class in 2017?

Lucy Speake: We expect stable, positive growth across the U.S. and Europe next year and this should create a supportive environment for credit. At the same time, some of the tailwinds that drove the asset class in 2016, notably the European Central Bank's (ECB) corporate bond purchase program, are likely to fade away, and we are mindful of that.

Thant Han: The most relevant tailwind for Eurozone bonds is accommodative monetary policy. Subpar economic growth trends and low inflation in the Eurozone make a strong case for the ECB to stay the course with unconventional policy measures and zero-bound interest rates for the foreseeable future. Elsewhere, other major central banks, such as the Bank of Japan (BoJ), have adopted policies to cap select Japan Government Bond (JGB) yields from rising while in the UK unconventional measures remain deeply entrenched in the Bank of England's (BoE) policy framework in the aftermath of the Brexit result. In the U.S., the lower-for-longer era of central bank policy appears to be drawing to a close. That said, the U.S. interest rate futures market is no longer pricing in

a path for higher longer-term interest rates despite expectations of a rate hike over the near term. All in all, this suggests developed markets rates should stay low in 2017.

What's the outlook for central bank intervention in the next 12 months and how might this affect your market?

Lucy Speake: We expect global monetary policy to remain accommodative across the developed world through 2017.

In the U.S., the pace of interest rate hikes is likely to be slow. In Europe, we believe the ECB could well maintain its current negative interest rate policy for the foreseeable future.

Meanwhile, monetary policy is showing signs of reaching its limits. The ECB and the BoJ are finding eligible government bonds increasingly scarce and may need to adjust the rules or expand the universe of eligible assets. However, policymakers have also shown increased concern about the impact of negative interest rate policies and flat yield curves on their banking sectors. The BoE, for example, has ruled out a negative interest rate policy and the BoJ has added flexibility to its annual purchases to target higher yields at longer maturities.

Peter Bentley: While we expect monetary policy to remain supportive of credit markets, we believe speculation over policy decisions may create volatility in credit spreads. We think investors able to implement absolute long or short directional exposure could exploit this. Credit easing initiatives, such as targeted long-term refinancing operations (LTRO) in Europe and the term funding scheme (TFS) in the UK will relieve pressure on banks from the low-policy-rate environment.

In the UK, the package of accommodative measures already announced to combat Brexit risks has important implications for sterling and the path of inflation. Those able to adopt active currency exposure may be able to add value through periods of currency volatility.

Notably, the TFS will be supportive of the mortgage market and this may feed through to sentiment in UK-structured credit markets such as residential mortgage-backed securities (RMBS), which we believe offer excellent value.

Thant Han: Fed officials might fight about quarter percentage points but ECB and BoJ policymakers seem to be having significant doubts about their ongoing projects. The ECB has to fine tune its program in order to extend asset purchases. Hemmed in by their own rules, they appear reluctant to do so.

We think (though no one can be sure) the intent of the BoJ's cap on the 10-year JGB yield was to put in place automatic accommodation should inflation rise. The problem here is the lack of a direct mechanism to push inflation higher. The BoE shows more eagerness to pull the levers of policy and will probably do so soon.

The extended stay of major central banks in the terrain of unconventional policy, along with their inability to generate inflation, has positioned about one-third of the universe of developed sovereign debt in negative territory. This provides powerful support to any fixed income instruments with a positive coupon.

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