A Rising-Yield Survival Kit

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NEWTON
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A look back at an eventful year in fixed income and, with a more volatile period likely to unfold over 2017, Paul Brain, Newton Investment Management's global dynamic bond strategy portfolio manager, offers seven tools for trying to cope with a change in prospects for bond markets.

Without doubt, the addition of fiscal stimulus to the mix of options from the authorities has introduced a potential negative for bond markets. The concern that such stimulus won't be effective could be irrelevant if the authorities believe it is the solution and just keep applying it until it works. The result could be inflation (the nemesis of bond markets) if it works, but increasing debt loads if it doesn't. Ultimately, bond yields can't rise too far in an environment of high debt, and we would expect the authorities to cap government bond yields if they do. We therefore expect a great deal of volatility in government bonds, followed by a decline in yields later in the year as the economy starts to lose momentum. As a result, we are likely to employ a number of varied strategies described in this article to try to ride out the volatility we anticipate over the coming months, before looking to reinvest in government bonds at higher yields later.

A YEAR OF POLITICAL CHANGE

The government bond markets ended 2016 largely unchanged, but this disguised considerable bond and broader financial-market volatility over the course of the year. The mounting electoral rejection of the developed-market political and economic status quo (characterized by weak growth and rising inequality) was most powerfully illustrated by the UK's Brexit vote and Donald Trump's U.S. presidential victory. This helped reinforce the shift from monetary to fiscal policy expectations, and rejuvenate U.S. growth and inflation projections amid an oil-price recovery.

In contrast to these latter (potentially paradigm-changing) events, heightened deflation and anxieties about Chinese growth fueled rising demand for "safe-haven" government bonds during the first quarter of 2016, driving sovereign yields to new lows by the late summer. Stabilizing Chinese and broader developing-world growth and a reversal of U.S. rate expectations enabled credit, and emerging-market assets in particular, to perform strongly, before the prospect of "Trumponomics" (i.e., greater fiscal stimulus and trade protectionism) pushed the dollar and U.S. Treasury yields higher. But while the Federal Reserve reinforced its rate-tightening projections with a 0.25% hike in December, other major central banks maintained their accommodative monetary stance. In the UK, the Monetary Policy Committee's 0.25% rate cut and reactivation of its dormant quantitative-easing program in the wake of the vote to leave the European Union ensured gilts were the standout performer, while the Bank of Japan's yield targeting and continuing asset purchases ensured further curve flattening.

With the U.S. dollar having already appreciated considerably against many of the world's other major currencies, and European Central Bank and Bank of Japan base rates largely stable from the second quarter, calendar-year moves against the euro and yen were only modest (up 2.9% against the former; down

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2.9% against the latter). Meanwhile, renewed monetary easing and elevated uncertainty surrounding the UK's economic outlook following the Brexit vote ensured sterling was among the weakest performers (down 16.5% against the dollar), alongside those currencies seen as particularly vulnerable to the changing U.S. economic and political landscape (the Turkish lira and the Mexican peso, both down over 16% versus the greenback).

A NEW TACK TO BOOST ECONOMIC GROWTH

Since the global financial crisis, central banks have been using loose monetary policy as the main tool to try to stimulate economic growth. However, recent moves by the European Central Bank, the Bank of Japan and others into the uncharted territory of negative interest rates, and the crowding out of investors from the bond markets, suggest to us that such an approach may be becoming counterproductive. Meanwhile, the U.S. Federal Reserve decided in December to raise short-term interest rates, and it has forecast a faster pace of tightening over 2017. We believe it is becoming increasingly clear that politicians are looking to try a different tack to drive economic growth: fiscal stimulus.

Tax cuts and the loosening up of the relentless increase in regulations could reignite some of the "animal spirits" that have been lacking since the financial crisis. Economic growth could be supported and investment reignited with increased government spending on infrastructure. Government debt would increase, but this would be funded by the central banks, which print money to pay for the debt. Arguably, everybody wins.

Hold on though. If growth is picking up, won't this ignite the latent inflationary trends that are just below the surface? Won't we then get the bear market in bonds some have been anticipating? Possibly, but we think there is a limit (somewhat higher than current levels) at which the increased cost of very high debt may lead the authorities to try to lock bond yields.

However, in the meantime, the move towards fiscal stimulus is a significant change from the predominantly loose monetary/tight fiscal policy that has been in place since the global financial crisis, and, as such, we anticipate that it will have a significant impact on bond yields. The short-term expectation that this will lead to higher inflation could cause yields to rise, but in some countries we think this is likely to be offset by central-bank buying (aimed at keeping a lid on borrowing costs).

To our mind, it is easy to see that fiscal schemes will be different for each country, and that central banks' response will also be varied. As a result, the bond market reaction is also likely to be diverse.

HOW TO COPE WITH THIS SIGNIFICANT CHANGE IN PROSPECTS FOR BOND MARKETS

First of all, in our view, adjusting interest-rate exposure when yields are expected to rise, and diversifying into other countries which are not subject to falling bond markets, is going to be more important than ever.

In addition to taking a flexible approach, we employ an increasing number of techniques we believe can help generate returns when markets are changing rapidly. The following are seven ideas that seek to improve incremental return and reduce volatility.

1. U.S. Treasury Inflation-Protected Securities (TIPS)

When long-term inflation expectations drop, these securities start to offer value. This occurred at the beginning of 2016, when the falling oil price was expected to push headline inflation to very low levels. Once the oil price had stabilized, and working with our in-house commodity analysts, we concluded that it could continue in a well-defined, but low, range for some time. This would mean that the year-over-year inflation rate would start to rise once more (as the previous years' falls dropped out of the calculation). Also, as it became clear to us at the beginning of 2016 that monetary policy was reaching its limit, we began to anticipate a shift towards fiscal stimulus, which could be interpreted by the market as more inflationary. As a result, we built up a 10% position in TIPS.

2. Consider bonds in countries where rates could be cut, and where there is unlikely to be a fiscal program (e.g., Australia and New Zealand)

If a country is still looking to keep rates low, or even cut them further, and does not need to resort to a combination of fiscal and monetary stimulus, bull-market trends may be maintained. We see both Australia and New Zealand as fitting into this category.

3. Cross-currency positions

After a prolonged period of easy money, and then a collapse in the main export of several countries, there are bound to be national differences. If you add in the inevitable political uncertainty, there is scope for significant divergence in the performance of individual currencies. For example, we are concerned about the political and economic stability of the European Union and countries such as South Korea. On the other hand, the relative value of currencies such as the Australian dollar and Swedish krona are, to our mind, attractive if rates are no longer being cut and commodity prices are rising. To take advantage of these differences, we have sold the South Korean won and the euro forward, and on the other side we have bought the Australian dollar and Swedish krona.

4. Targeting companies that could benefit from an increase in infrastructure spending and tax changes

Investing in the relative performance of companies that are able to increase profits from the extra money that could be put into various infrastructure plans seems to us a sensible thing to do. Companies that may benefit directly, such as cement companies, or perhaps indirectly, such as utilities, could be used to gain exposure to this changing trend in spending. Existing infrastructure companies, which could gain extra capital, could also be attractive from this perspective.

5. Yield-curve positioning

As some countries move towards a mixture of loose fiscal and monetary policy, we think the corresponding rise in inflation expectations should tend to make the longer end much more volatile, while the front end is likely to be locked by the maintenance of low short rates. To try to anticipate this, consider switching out of longer-dated securities, and moving to the middle part of the curve.

6. Floating rate notes

In some countries, short-term interest rates seem likely to rise. Floating rate notes have coupons that are directly linked to cash rates, and therefore their income return should rise if rates rise.

7. Bank bonds

We believe steeper yield curves and fewer regulations, plus a better economic growth outlook, should help the profitability of banks and their bonds.

INVENTIVE APPROACH REQUIRED

There is a continuing need to battle the negative effects of the credit crisis and high debt levels. Policymakers' armory in this battle is evolving—from the use of monetary policy alone, to the use of fiscal policy as an additional tool. We think a more volatile period in bonds is likely to unfold, in which investors' inflationary concerns could rise, and it is our conviction that bond investors will need to be more inventive. We believe we have the tools to address the challenges—through a flexible-duration approach, and also by diversifying into a variety of uncorrelated sources of return.

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