How might developed market bonds respond to the new normal in central bank policy? In this Q&A, fund managers from Insight, Newton and Standish offer their views for the year ahead.

Has there been a fundamental change in the way fixed income markets operate and how do you envision this playing out in 2018?

Paul Brain: Things have changed since the credit crisis in 2008. There’s been significantly more non-financial corporate issuance, a shift to negative yield investing and the growth of transactions away from traditional market makers. The build-up of corporate debt, especially in the past three years, leaves the market vulnerable to a deterioration in economic growth and potentially a rise in defaults. As central banks look to remove their emergency support for bonds, negative government bond yields may be confined to history. The growth of electronic trading will continue to help investors find liquidity. However, this won’t stop periods of dysfunctional markets.

Brendan Murphy: Liquidity has deteriorated in global fixed-income markets over the past few years and this could affect pricing and transaction costs in times of market stress. While it’s possible we’ll see some changes on the regulatory front, particularly in the U.S., the more likely change will occur in the size of government balance sheets, which may have peaked as the Federal Reserve (the “Fed”) and the European Central Bank (ECB) look to withdraw stimulus.

How will bond markets react to the tapering of asset-purchase programs?

Lucy Speake: Our view is that tapering is unlikely to have a substantial impact, at least at first. The Fed, for example, clearly flagged its intention to begin reducing its balance sheet months in advance. Importantly, the approach of central banks to normalization of monetary policy is a gradual one. For instance, up to $4 billion per month of U.S. mortgage-backed securities (MBS) can initially run off the Fed’s balance sheet but MBS issuance was around $120 billion in August 2017 alone. The ECB is set to taper in 2018 and this is also widely expected.

Nonetheless, there may well be some bouts of volatility in asset classes directly affected by changes in central banks’ purchase patterns, such as government bonds, corporate bonds and asset-backed securities (ABS), and these may provide opportunities for diligent active fixed-income investors.

Brendan Murphy: Tapering has been well telegraphed and will likely progress at a gradual pace. As long as the approach is gradual, we agree the impact is likely to be limited. That said, any upside surprises in macroeconomic data which lead central banks to tighten more quickly than expected may increase bond market volatility. Inflation is probably the key data point to observe here since the...
current low-inflation environment allows central banks to tighten very gradually. If that inflation backdrop were to change and central banks needed to try to combat higher inflation, either by raising rates or rapidly reducing the size of their balance sheet, bond markets could react quite negatively.

**Paul Brain:** We see the anticipation of tapering leading to slightly higher bond yields but we also think that, once that has occurred, demand will come back from investors concerned about how the tightening of monetary policy will affect the economy and risk assets.

**What do you see as the biggest risk to sovereigns for the year ahead?**

**Lucy Speake:** From an economic standpoint, most sovereigns are benefiting from the first synchronized global upswing since the financial crisis. However, political risks haven’t gone away. Political polarization continues to be on the rise, as does support for anti-establishment political movements. The German election in September 2017 and separatist tensions in Spain have been reminders of this. Looking ahead, Italy is the next major nation to go to the polls at a time of strong support for the anti-establishment Five Star Movement.

The direct implications for political event risks can be sovereign ratings downgrades. This can have a knock-on effect on credit as bank credit ratings are often linked to their sovereign.

**Paul Brain:** We think the biggest risk to sovereign bonds is the potential for higher inflation. So far, a number of factors, not least new technology and an abundance of surplus capacity, has dampened inflation expectations but there is a chance domestic inflation (caused by tight labor markets) could become ingrained and difficult to stamp out without a recession.

**Brendan Murphy:** We have the same view: we see inflation as the biggest risk to sovereigns in the year ahead. Expectations are quite low by historical standards despite significant improvements in GDP growth and tighter labor markets in a number of countries. The risk is that the high level of employment starts to manifest itself into stronger wage gains, which in turn pushes prices higher. For now, labor cost pressures remain muted and there’s little evidence of rapid wage gains but we still classify it as a major risk as we look forward to 2018.

**Have we really seen the end of NIRPs and ZIRPs (negative and zero interest rate policies) and what does this mean for the future direction of yields?**

**Paul Brain:** NIRPs and ZIRPs are gradually disappearing but in the longer term they could easily come back. The next economic slowdown may see a rise in fiscal support but this has its limitations and now that central banks have used emergency funding rates (NIRPs, ZIRPs and quantitative easing), they won’t be slow to put them back on.
Lucy Speake: Monetary policy expansion showed real signs of reaching its limits in the autumn of 2016, when central banks became concerned about the effects of low yields and flat yield curves on banks, institutions and savers. It’s therefore possible that the all-time lows in yields are behind us. At the same time, the global economy is unlikely to be able to contain a rise in yields to their pre-crisis levels. As central banks gradually make their way towards a “new normal” in monetary policy which will be materially more accommodative than the pre-crisis “normal,” it’s likely yields will be range-bound but biased toward modestly higher levels.

Brendan Murphy: One of the biggest consequences of ultra-loose monetary policy has been a reduction in the term premium across a number of bond markets. Zero and/or negative interest rates have pushed investors further out on the curve in order to earn a bit more yield. As the global economy improves, we believe we’re likely to see a period of policy normalization across a number of economies. One result might be the restoration of term premiums in a number of yield curves. Our view is that this could lead to higher yields and steeper yield curves in a number of countries.

Where do you see the best opportunities for the year ahead?

Paul Brain: In this gradual rising rate environment with initially higher inflation, investing in inflation-linked securities seems attractive. Occasionally, the duration risk of these securities could be offset using government futures.

For most of 2018, economic growth is likely to be positive and corporate defaults low. We think it’s possible to adopt a selective credit approach that seeks companies that could benefit from more government help for economies. Gradual increases in defense expenditure, infrastructure spending and any tax changes targeted toward certain companies could be used as a guide.

Brendan Murphy: We take a similar view: that one of the most attractive fixed-income sectors is inflation-linked bonds.

They look attractive based on cheap valuations and the prospect for upside inflation surprises in developed economies as labor markets improve. We see a lot of value in inflation-protected bonds in the U.S. and Japan, two countries where we think market participants are underestimating inflation.

Lucy Speake: In global credit markets, leverage metrics are on the rise in most sectors, so areas in which they are actually still recovering can be attractive. The most notable areas include European banks, whose capital ratios are still on the rise. Elsewhere, ABS continue to offer an attractive “complexity premium” over corporate debt, while benefiting from strong fundamental and technical value, in our view.
Duration is a measure of the sensitivity of the price—the value of principal—of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years.

**Risks**

**Bonds** are subject to interest-rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. **Equities** are subject to market, market sector, market liquidity, issuer, and investment style risks, to varying degrees. Investing in foreign denominated and/or domiciled securities involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries. **Management risk** is the risk that the investment techniques and risk analyses applied will not produce the desired results and that certain policies or developments may affect the investment techniques available to managing certain strategies.

Insight Investment advisory services in North America are provided through four different investment advisers registered with the Securities and Exchange Commission (SEC), using the brand Insight Investment: Cutwater Asset Management Corp. (CAMC), Cutwater Investor Services Corp. (CISC), Insight North America LLC (INA) and Pareto Investment Management Limited (PIML). “Newton” and/or the “Newton Investment Management” brand refers to the following group of affiliated companies: Newton Investment Management Limited, Newton Investment Management (North America) Limited (NIMNA Ltd) and Newton Investment Management (North America) LLC (NIMNA LLC). NIMNA LLC personnel are supervised persons of NIMNA Ltd and NIMNA LLC does not provide investment advice, all of which is conducted by NIMNA Ltd. NIMNA LLC and NIMNA Ltd are the only Newton companies to offer services in the U.S. Newton is a wholly owned subsidiary of The Bank of New York Mellon Corporation. Standish Mellon Asset Management Company, LLC (Standish) is a wholly owned and independently operated investment management subsidiary of The Bank of New York Mellon Corporation (BNY Mellon).

Securities in Canada are offered through BNY Mellon Asset Management Canada Ltd. (BNYM AM Canada), registered as a Portfolio Manager and Exempt Market Dealer in all provinces and territories of Canada, and as an Investment Fund Manager and Commodity Trading Manager in Ontario. BNYM AM Canada is an indirect wholly owned subsidiary of The Bank of New York Mellon Corporation (BNY Mellon). BNYM AM Canada, Insight, Newton and Standish are affiliates. BNY Mellon Asset Management Canada Ltd., 200 Wellington Street West, Suite 305, Toronto, ON M5V 3C7.

Views expressed are those of the manager(s) stated and do not reflect views of other managers or the firm overall. Views are current as of the date of this publication and subject to change. This material has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular investment, strategy, investment manager or account arrangement. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Please consult a legal, tax or investment advisor in order to determine whether an investment product or service is appropriate for a particular situation. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. The Dreyfus Corporation, Insight, Newton, Standish, and MBSC Securities Corporation are companies of BNY Mellon. © 2018 MBSC Securities Corporation, Distributor, 225 Liberty Street, 19th Floor, New York, NY 10281.