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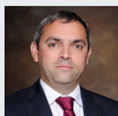
POLICY INSIGHTS

February 2018

The view from our global fixed income portfolio managers.

Time to Reprice Fixed Income Premium?

GLOBAL INVESTMENT TEAM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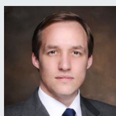
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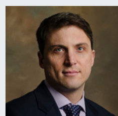
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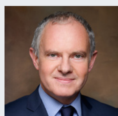
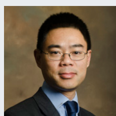
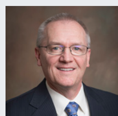

Quentin Fitzsimmons


Ju Yen Tan


Steven Huber

Since the financial crisis, aggressive monetary easing measures have suppressed the premiums that investors have demanded for holding fixed income assets. But with major central banks moving toward monetary tightening, the compensation required for holding bonds is likely to increase. This became a key discussion point during our latest investment policy meetings, in which the team drilled down into which types of premia are most at risk as we enter this new era in fixed income markets.

Developed market government bonds have come under significant pressure over the past few weeks as investors have started to reprice the liquidity premium attached to central bank actions. After years of cash being pumped into the global financial system, the tide is turning and liquidity is being withdrawn. Central banks are tightening monetary policy in synchronization, and it is even speculated that the Bank of Japan (BoJ) may now consider removing some liquidity from the market by letting yields move slightly higher.

"The fear of missing out is real for the Bank of Japan—they face the risk of being the last major central bank to provide liquidity at a time when others are already tightening monetary conditions," said Quentin Fitzsimmons, portfolio manager and member of the fixed income global investment team.

The recent correction has helped to correctly price in higher premiums in some countries. In the U.S., for example, the five-year/five-year forward break-even rate currently hovers around the 3.25% level, which is above the Federal Reserve's current long-term terminal rate expectation of around 3%.

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–Quentin Fitzsimmons, Portfolio Manager and Member of the Fixed Income Global Investment Team

What about inflation premiums? After years of subdued inflation, there is the potential for price pressures to increase across developed markets on the back of stronger global growth, higher oil prices, and tight labor markets in several developed countries. The team noted that Germany, in particular,

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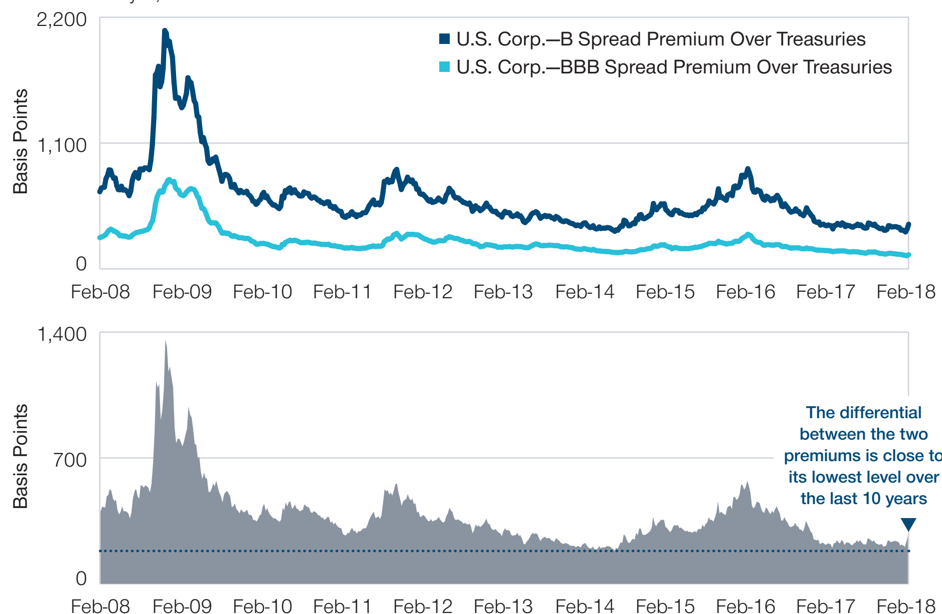
> “The European Central Bank has effectively tied its hands behind its back by committing to an 18-month forward guidance plan.”
>
> –Quentin Fitzsimmons, Portfolio Manager and Member of the Fixed Income Global Investment Team

FIGURE 1: U.S. Corporate Premium Over U.S. Treasuries

As of February 9, 2018



Past performance is not a reliable indicator of future performance.
Sources: BoA Merrill Lynch and T. Rowe Price.

stands out in this regard: with record-low unemployment and ongoing economic strength, there’s a risk that price pressures in the eurozone’s largest country could begin to rise—possibly amplified by the European Central Bank not acting quickly enough.

“The European Central Bank has effectively tied its hands behind its back by committing to an 18-month forward guidance plan,” said Mr. Fitzsimmons. “There is a risk that inflation pressures begin to build sooner, however, particularly in countries like Germany, where the output gap is rapidly closing.”

So far, the price of Germany’s 30-year bonds is yet to reflect these risks and, as such, was singled out as one of the preferred developed market bonds to express a short duration bias or underweight position. In other markets, the team noted that inflation-linked bonds remain an attractive opportunity as protection against the risk of rising inflation pressures. In particular, the U.S. continues to offer reasonable value.

Meanwhile, demand for credit remains fairly robust as strong global growth and a low default environment is supportive for fundamentals. However, the credit premium is looking somewhat stretched, with spreads relative to government bonds at historic lows, especially if analyzed on a risk-adjusted basis. Similarly, the differential between BBB rated and B rated bonds is at record lows—generally a sign that the market is no longer differentiating between rating qualities and risk structures.

“Some credit markets are almost priced for perfection,” said Mr. Fitzsimmons. He noted that the premium between BBB rated prime auto asset-backed securities (ABS) and BBB rated subprime auto ABS is almost nonexistent at a time when delinquencies in subprime auto are back to their 2008 levels.

These conditions suggest it may be time for credit premiums to reprice higher. But what is going to be the trigger point—higher bond issuance, less central bank buying, or investor sentiment shifting? While the potential catalyst for wider spreads remains unclear, the volatility shown in credit markets recently is a good reminder that investors are likely to require a higher credit premium at some point this year.

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