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IS FIXED INCOME STILL FIT FOR PURPOSE IN TODAY'S DIVERGENT WORLD?

The investment world is becoming more and more confusing, particularly in fixed income markets. In a client update, Arif Husain, the Head of International Fixed Income at T. Rowe Price, examines the role of fixed income and whether its traditional characteristics can continue to fulfil the needs of investors.

The starting point for every investor must be to define what success looks like. For us at T. Rowe Price, success is delivering on your promises. We believe investing in fixed income markets is not meant to be overly exciting. Your bond allocation is not something that keeps you up in the middle of the night.

So what is the role of fixed income? In our view there are three purposes: income, downside risk management and diversification. Perhaps I am old fashioned, but I still look at fixed income in this way. While we have witnessed quite a lot of innovation in recent years, ultimately every bond strategy is trying to achieve one or more of these objectives.

The only element of investment that is pretty much certain is the coupon from fixed income securities. The only thing that can stop a coupon is default, but this does not happen very often. In recent years, the volatility of coupons has been incredibly steady.

The element of downside risk management in fixed income has also been on display in recent years, leading to a fairly decent annualised return. In addition, average correlations to equity markets have been low. Diversification has done its job, particularly during tough periods for stock markets, which seem to be occurring more regularly today.

Overall, fixed income has done its job. However, will this remain the case? Coupon levels have fallen considerably, while lower bond yields could have an impact on downside risk management. Diversification is still there, but this has not always been the case. August 2015 was a good example, when fears over China gripped global investment markets. At a time when equity markets were hammered, bond yields also spiked. The real pain point in markets is when fixed income stops behaving the way it should.

"The current divergence of central bank policies has created a fertile ground for fixed income investors."

WE NEED TO REIMAGINE WHAT SAFETY IS

Participants in fixed income have been confusing investors with all the different strategies on offer – such as 'Unconstrained', 'Flexible', 'Dynamic' or 'Absolute Return'. Ultimately, these strategies are all trying to do the same thing: deliver for investors through the cycle.

What are we trying to do here? We are trying to achieve regular predictable returns, with robust downside management and diversification from equities when it matters. What sets us apart from our peers is the culture of T. Rowe Price. Those who know us know we are conservative and would never do anything to jeopardise the trust we have with our clients.

While we can use our unconstrained abilities for offense; we mostly use it for defence. To us, this is what fixed income investing is all about. Many of our peers will hold a lot more credit, for example. There is nothing wrong with holding credit, but you cannot have too much if you truly want diversification from equity markets.

The bulk of our portfolio is in what we label Core Stable Positions; these are safe and relatively boring government bonds from all parts of the world. The lifeblood of this portfolio is in safe government bond markets. We like government bond markets with large pensions and insurance industries, where there are natural buyers for these assets. This means we cannot hold a country like Mexico in the core part of a portfolio, as about 77% of its market is owned by foreigners.

On the edges we look for a few higher return opportunities to give the portfolio a little kicker. We also look to add hedges if required. These are simple liquid derivatives. At all times we ensure we have a portfolio that is transparent; we want our clients and their clients to understand what is happening.

Our duration can go as high as 6yrs and low as -1yr. We do utilise this flexibility. While we tend to build up duration gradually, we can cut duration rapidly when we see danger coming. Our average correlation to equities since inception of our strategy has been about zero, while we are also lowly-correlated to high yield and emerging market debt. If an investor wants to buy high yield, they can buy a high yield strategy. There is no reason for a portfolio such as this to be correlated to these markets.

A GREAT ENVIRONMENT FOR A GLOBAL BOND MANAGER

The current divergence of central bank policies has created a great fertile ground for fixed income investors. We are witnessing many central banks at different stages in their cycles, with some hiking and some cutting rates. In fact, some developed market central banks which were about to raise rates have been forced to cut once again. This might be might be a lesson for the future. In any event, this divergent environment is great for a global fixed income manager, and it is not finished.

A major theme today is the current phase of deleveraging. We first witnessed this in the US and then in Europe – now it has moved to emerging markets. In a deleveraging cycle, you end up with a glut of savings. This essentially means yields will stay lower for longer. As for global growth, it is unexciting. The US economy is somewhat underperforming, while a benign Europe is probably doing better than it should be.

Inflation is beginning to become an issue in the US. Housing inflation, a large component of core CPI, is running at about 3-3.5%. In services, wage inflation has jumped from about 1% to about 3%. The only thing currently supressing the core CPI number is goods, held back by a strong dollar and low energy prices. However, these elements appear to be stabilising, which could lead to 3% core inflation in the US. This would be a major problem for Janet Yellen. In fact, it is an ever bigger concern for equities; no one is ready for 3% inflation in the US.

COULD WE SEE STERLING/DOLLAR FALL FURTHER

One of the themes we incorporate through our process is an element of behavioural finance. What this tells us is forecasting has been proven to underestimate volatility. Every forecaster underestimates volatility, over both the short and long term. Sterling at parity to the dollar would be a 2.8x standard deviation event. This is not a crazy scenario.

The upcoming UK vote on whether to remain or leave the European Union could have some very negative outcomes if the UK votes to leave. On the flipside, it could also be positive if for sterling if the UK votes to remain in. June will be a pivotal month for investment markets – with another Greek negotiation, the Brexit vote and a Federal Reserve meeting a few days following this. It is highly likely we will be running zero risk at this juncture.

If you are a central bank or a government, imagine the repercussions if the UK votes to leave. Financial markets will not respond well. Greece was minimal in the overall scheme of things, but the UK is a far different proposition. What will the Fed and ECB do if this occurs? The Fed could be forced into a rate cut, not a hike as currently expected. The UK cannot even consider raising rates in this environment.

The Brexit talk is also having a major impact on confidence. If you are the CEO of a car manufacturer for example, there is no way you would look to build a factory in the UK right now. This vote is highly unpredictable, highly impactful and highly important to the world. Even if I were sitting with Canadian investors and talking specifically about the Canadian bond market, Brexit would still be the largest risk on the horizon.

WE ARE REACHING AN INFLECTION POINT IN FIXED INCOME

Fixed income has clearly done well in meeting its traditional objectives. However, given the current environment of low rates and divergent policy, it will be difficult for fixed income to continue serving its purpose in a traditional way.

Investors are at a crossroad. If they turn left, it means using fixed income as a return and income-seeking asset class. By turning right, investors are accepting fixed income's role as an anchor, a diversifier. If you turn right, you cannot be heavily invested in areas such as high yield or emerging market debt.

The problem is most investors are somewhere in the middle at the moment. However, we are almost at an inflection point; investors need to make a decision on which way to turn.

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