Fixed income 2021: Finding opportunities in a challenging market

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With the end of the pandemic possibly in sight — but seemingly no end to the liquidity flooding markets — what are the implications for fixed-income investors? To learn about the many risks and opportunities ahead, Pensions & Investments spoke with Henry Song, fixed-income portfolio manager, Diamond Hill Capital Management; Rob Waldner, chief strategist and head of macro research for Invesco fixed income; and Dan Janis, senior managing director, head of global multisector bonds, at Manulife Investment Management.

Pensions & Investments: What's your 50,000-foot view of fixed-income markets today? How much has the pandemic driven that view, and are you revising it, given the glimmers of the end in sight?

HENRY SONG: The pandemic and the Fed's ensuing response have given investors a solid year of returns in 2020. But looking at the fixed-income market now, our view is that bonds are priced at or near perfection, with little upside both from an interest rate perspective and a spread perspective. We are in a low-yield and low-spread environment. Bonds still generate income, but not much in absolute-return terms. In our view, there are more downside risks, given the strong recovery post-pandemic.

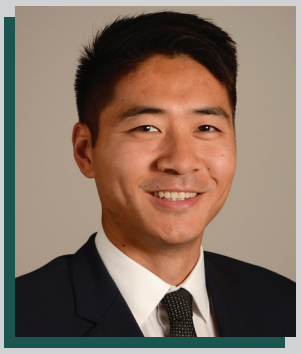
DAN JANIS: As the broad distribution of the vaccine gains traction and restrictions on the global economy are lifted, economic growth should pick up and interest rates on high-quality assets will likely go higher. So I want to have a lower-duration bias to those. Within credit markets, valuations are through their long-term averages, but there is still some value in select high-yield corporates and emerging markets, and we see opportunities on the currency side as well. When you're looking at total-return opportunities in foreign bonds, you can take on some [foreign exchange] risk. In the developed markets, you may see 2% to 3% appreciation against the U.S. dollar, while on the EM side, potentially 5% to 7%. So there are some opportunities to glean from global markets, but you have to be really selective on how you look at the world.

ROB WALDNER: The 50,000-foot view in fixed income is that we have a valuation issue, driven by vast amounts of liquidity put into the system to improve growth. So while fixed income does offer yield, and there is a place to get return, valuations are tight. Those types of valuations will be a challenge for investors for the next six months to a year, but they will be supported by very strong liquidity, developed market central banks and growth. We're well above growth expectations for 2021. We'd agree there are opportunities in certain pockets, particularly in emerging markets, but we're cautious on overall fixed income.

P&I: Are central banks on the right track? They have been flooding the markets with liquidity, fueling the recovery from the pandemic-induced recession. What are the long-term implications of the continued buildup of the Fed's balance sheet?

WALDNER: We have to acknowledge that central banks have done an extraordinary job of managing through the pandemic so [that] an economic shutdown did not become a credit crisis. They had a trial run with the global financial crisis where they developed tools that they used and they did a phenomenal job. Going forward, the trick is going to be to keep the stimulus in the system to reach their targets of getting inflation up above 2%. The hard part for them is going to be to keep their messaging consistent so that the market doesn't tighten too soon.

SONG: Their response early last year was necessary, and it was bold. Many parts of the fixed-income market had severe liquidity issues at that time. There is the greater issue of too much debt on the Fed's balance sheet, but low borrowing costs right now will alleviate some of this concern.



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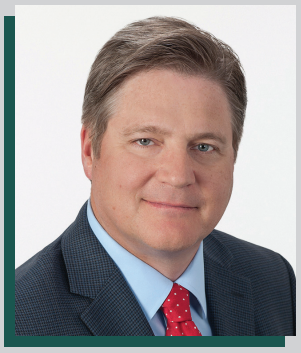

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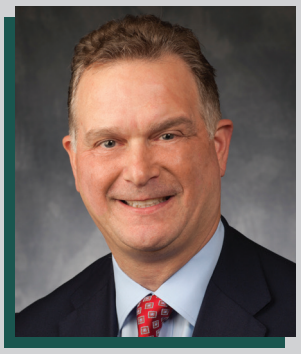

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It's important how we spend the debt. If the central banks simply continue to support the market, the market will work itself out but will remain distorted and on life support for a long time. We've seen the imbalance in the supply and demand right now in the fixed-income market. Investors continue to pour more money in, yet the Fed is reluctant to have the tapering talk right now.

Our view is they should, at this point, start talking about tapering and guiding the market. Maybe that means some short-term volatility, but the Fed no longer has to support some of these markets. For example, let's look at the Fed's agency mortgage purchases. It certainly helps keep the primary mortgage rates low, which helps homeowners, but at the same time it's driving up home prices and creating some of the inequality in this country. So there are areas where the central banks can start tapering their support.

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>
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JANIS: Three points. One, when you look at the long-term implications of the Fed and other central banks building up their balance sheets, that could crowd out bank lending. Two, it could lead to overvaluation. The average investor is probably reaching a bit too much. Three, the Fed has to figure out when they're going to scale this down. They have to be good [public relations] people to make sure that it is not a surprise when they taper down. I don't see tapering until in 2022. However, those three issues could lead to excessive volatility down the road.

P&I: What's your view on inflation and rates for 2021? What does this mean for fixed-income investors?

JANIS: We think the Fed is willing to run the economy a little bit hot, even if that means letting inflation run above 2% for some time. What does it mean for fixed-income investors? High-quality long-duration assets could come under pressure, and you have to be careful. This means we have to position the portfolio to thwart the impact of duration in a rising-rate environment. So that could be currency or credit elements that can help improve your return to offset some of the negative impact of duration.

WALDNER: In 2020 inflation was quite low due to the pandemic. It will go up in 2021. The challenge for the Fed is to get inflation expectations durably up to 2% or above. The market is going to be hypersensitive to any communication the Fed gives that they are going to pull stimulus out of the market. The big risk we see in the market in 2021 is a taper tantrum-type event where the market starts to see inflation go up, but the Fed is unable to convince us that they're going to stay the line and keep policy easy — then you would get a taper tantrum.

SONG: I agree with both Rob and Dan. The Fed really wants to get inflation up above 2%. We think the bigger risk is that inflation goes up dramatically, a surprise on the upside that goes well above their target. There's certainly some anecdotal evidence already supporting this view. Housing prices are running hot, which has a direct impact on rent. Outside of the two coasts, rent has gone up in most parts of the country. That's a big

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portion of inflation measurement. Another anecdote is about supply chain disruption. Microchips could really run the price up for a lot of consumer goods from cars to iPhones. This disruption may not get fixed in the near term, since it needs global cooperation. There are a lot of hidden risks. I definitely would be wary of long-duration assets in the current environment, especially high-quality assets that don't have a lot of spread.

P&I: What are the trade-offs in seeking yield and taking on more risk in this environment? Where are the best opportunities for income?

JANIS: Our advice to institutional investors, because a lot of them have high-quality core or core-plus mandates, is to complement that. Global multisector fixed-income strategies give you the flexibility to invest anywhere around the globe. We do like the China market. It has stability in the currency, which is probably getting stronger. You're getting competitive yields in a market that, over time, is getting more liquid, and as liquidity grows, you can be more comfortable taking a bigger position.

Some of the Asia emerging markets, in dollars and in local currencies, present yield opportunities ranging between 4.5 and 7%. There are opportunities when you look at Indonesia, Malaysia and the Philippines. Those economies are less prone to government spending, so they're not going to have that overhang of crowding out. They have the potential for some currency kick and yield enhancement. Some of the Latin American [emerging markets], whether it be Brazil and Mexico, are not as well run on the COVID side, but there could be some yield and currency plays there. You want to have that global focus to take advantage of some of the EM parts of the markets.

SONG: We find a lot of attractive options in the securitized product space, especially in asset-backed securities and some selective commercial mortgage-backed securities. The primary reason is because most bonds in those spaces tend to have fairly short duration, which goes with the theme of avoiding longer-duration assets. It is also a smaller market. A lot of the Fed's programs didn't directly impact those markets, and they lagged in terms of recovery. Because investors didn't get the full benefits of the central bank actions, the spreads present a lot of value compared with other sectors. We focus on high quality assets that are shorter in duration and offer a relatively attractive yield.

Securitized products are often under-allocated in investors' portfolios because they are heavily tilted toward consumer risk. Most people own equity or fixed income that is heavily exposed to government and corporate risk. Securitized products are a nice diversification away from that risk.

WALDNER: You have to be careful about the risks that you're taking looking for yield because spreads are quite tight. We do think that the economy is going to surprise to the upside this year. While that's good for credit and supports credit risk, it means being a little more cautious on duration. Typically, investors might look to go out the yield curve. In 2020, it was a great idea. We think in 2021 it's going to involve being in other asset classes that are less dependent on U.S. yields.

We're encouraging institutional investors to think about opportunities outside of the core fixed-income asset classes. That would be private credit and bank loans. A stronger growth outlook is good for all corporate credit, so we like both of those asset classes. For institutional investors, global debt — in particular, local [emerging market debt] — is very attractive. Local China offers a nice mix of positive real yields and a big liquid market — it's attractive in that it is uncorrelated with risky assets in the United States.

P&I: Tell us more about the specific opportunities in emerging markets that you are watching.

WALDNER: We like local currency emerging markets now, so that means buying emerging markets in their own currency. Within that, we like broad exposure. I would highlight again one particular opportunity that is very substantial, and that is China. The Chinese market is very large and offers a lot of liquidity, strong credit quality, strong government backing and good policymaking. It gives you positive real yields and diversification from developed markets. We think that's a great opportunity for a core allocation in portfolios.

JANIS: In fixed-income investing, sometimes what you don't own can be as important as what you do own. Today, Argentina and Venezuela are off the table. Russia, Ukraine, Turkey and South Africa are a little bit too volatile right now, but there are opportunities in Brazil, Columbia, Mexico, Indonesia, China, Malaysia and [the] Philippines. You can buy them in U.S. dollars or in local currencies, but with our view for a weaker U.S. dollar in 2021, we expect local EM to outperform.

On the developed markets side, my favorite is Canada. The economy there should do well. They have over 30

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million people and the COVID situation is going to get better. The currency is still undervalued, and I think there is potential for a 3% to 5% move there. You're getting less yield than in the US, but with the currency kick, there is a potential for a greater total return.

P&I: What is your view on the U.S. dollar?

JANIS: Last year we had the beginning stages of the dollar decline. This year, it will probably not be as aggressive on the developed markets side, maybe a 2% to 3.5% potential when you are looking at the euro or sterling, maybe a little bit more in Canada, Australia or New Zealand. But on the emerging markets side there could be a 5% to 7% move. That could offset some of that duration risk that we talked about earlier and gives you a positive return that hopefully is better than high-quality indices.

WALDNER: In recent years we've been in a dollar-appreciating environment. That's changing. The primary reason is that we're going to get a big pickup in global growth as we get past this virus. And very strong global growth combined with a very easy Fed is a recipe for a weaker dollar.

The Fed is making valuations very tight in U.S. fixed income, but they're giving you an opportunity: non-dollar assets. So we think investors should consider migrating to non-dollar assets.

P&I: What other guidance are you giving your clients? What are the greatest challenges you're hearing in terms of investing in fixed income today?

JANIS: The question is, Where are you going to get yield without increasing volatility too much? The key is position size. EM presents an opportunity, but you're not going to overweight the EM side too much. You have to balance EM with some high-quality markets like Canada, Singapore, etc., and then I think U.S. dollar weakness can offset some of that duration risk. We look at four risks: interest rate, credit, currency and liquidity. If you can balance those, you're going to get a competitive return with controlled volatility as we go forward.

On the credit side, you really have to be careful where you tread. We're being careful on how we select industries, issuers and credit qualities while also ensuring that we allocate and diversify our credit risk appropriately. A focus on liquidity has also hopefully calmed investors' fears as we go forward in this environment.

WALDNER: The biggest question we get is, What do I do about negative real yields? Most developed markets are significantly negative. And our answer is you need to have a diversified credit portfolio, which includes some of the things I talked about surrounding bank loans. And we would point to a place where you may still have some preservation of capital in your fixed-income portfolio, which, again, is China. So, a diversified credit portfolio with an allocation to Asian fixed income, particularly China, and some emerging markets, is our answer.

P&I: How would you rank the opportunities and risks you are seeing?

SONG: The securitized product sectors would be our first pick for opportunities followed by agency mortgages — select [collateralized mortgage obligations] specifically — and corporates. One of the biggest risks is grabbing yields blindly in this environment. A lot of companies are being propped up by the Fed response and shouldn't be trading where they are. It's hard to pick between investment grade and high yield on a macro level; it will come down to how each manager approaches this space.

P&I: How can active management best add value now? What about in terms of environmental, social and governance investing?

SONG: We have always been a proponent of active

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management because as we look at the investable fixed-income universe in the U.S., a third of that universe is not included in the index. That's a huge underrepresentation of some highly valuable assets. Our philosophy and process has always been about bottom-up security selection. We have exposures to assets outside of the index that have a substantial spread advantage to those included in it. There is a trade-off on liquidity, but it has proven to work over long periods of time.

In regard to ESG, while we don't have a formalized process, it is something we look at. The market appreciates ESG-focused assets, and they are trading at a better valuation. That's something we take into consideration as we make investments and assess the total-return profile of a bond. Quite frankly, we have had exposure to the environmental front for a long time, before ESG was even en vogue.

Many asset-backed securities involve clean energy, which is a sector we favor and usually have exposure to.

WALDNER: We think there are two ways that active management can really help you in a portfolio. One, when you have such tight valuations, getting the credit part — the fundamentals — right is extremely important. And two, we're finding that more and more, having a fully formed ESG capability gives you a big leg up on index investing. You're able to help the client achieve their goals by being able to fully integrate some of these risks — whether it be environmental, social or governance issues — into your portfolio.

JANIS: ESG is an integrated part of our investment process, from analysts' bottom-up perspectives to portfolio managers' top-down views. As we go forward, that has to be a key part of your investment process, to understand if companies are actually doing what they tell you. We think of ESG analysis as being part of our active investment process that can add value to our clients' portfolios as companies improve their ESG metrics.

As far as being an active manager, the ability to pivot when things change is also very important relative to a static portfolio. Last year, March was the pivot point to go into credit, to take duration down and also to take advantage of the volatility in currency markets. The ability to trade around your credit bucket, manage your [foreign exchange] risk, manage duration and add value by tactical trades, are all part of active management that static portfolios don't employ [that] can add value to our clients' portfolios.

P&I: Many DC investment menus have only one fixed-income option outside of stable value, typically a core or a passive option. What might participants be missing out on?

WALDNER: We think the right strategy now, as I've mentioned, is a diversified credit strategy — and you're just not getting that in a core fixed-income option. Core options tends to be heavy on duration and light on credit. We think the risk-return profile going forward should be the reverse: heavier on credit and lighter on duration.

JANIS: Global multi sector fixed-income strategies give them the opportunity to take advantage of the breadth and depth of global markets across countries, sectors, yield curves and currencies. They're missing out on that opportunity set. I agree with Rob. Duration should be shunned, and currency and credit risk should be embraced.

SONG: Investors need more diversified options to round out their core. Certainly, there's a need to have more short-duration options on the table at this time, and securitized products can work well.

P&I: What is it about the securitized market that you believe provides you with an edge in building a well-diversified portfolio that may deliver consistent returns?

SONG: There are structural advantages to the securitized market that are often overlooked. A lot of investors don't have a great understanding of that part of the market, but we think it can add protection for bondholders. In 2020, the securitized market performed well during the pandemic. Some securitized bonds have very short durations. They were paying off or greatly reducing their leverage. You can make the argument these bonds held up well without the Fed's assistance.

Ever since the pandemic, we're seeing a rebound in new issuance. New issues in the securitized space are even more enhanced than previously. Some of the

2020 vintage are actually the best bonds we have seen over the last few decades. I think this space has gotten a bad reputation for its role leading up to 2008. The space has evolved quite a bit since the global financial crisis. When we look at it from a credit perspective, with the structural advantages and better covenants, it's a lot more investor friendly than a lot of corporates.

P&I: Do you see an increasing role for factors in fixed income? Is this analogous to smart beta products for equities?

WALDNER: Yes, it is analogous to smart beta. We've done a lot of research on factors. Factors are directly applicable to fixed income. The advantage of using factors in fixed income is that investors who are primarily concentrated on fees can look to smart beta driven by factors to improve their returns for very little fee effort. This is a compelling space for anybody who's looking to reduce their fees yet get better returns on a benchmark. We all know that fixed-income benchmarks are inherently inefficient because they're built around the amount of debt that is issued by the issuers. You can use factors to reweight those benchmarks and come up with a better-performing benchmark.

This smart beta or factor-driven systematic investing in fixed income is clearly superior to a passive strategy. To the extent that you want to have passive and then use your active budget for satellites, you should be using factors to drive your core allocations.

P&I: What are your key takeaways for investors from our discussion on fixed income?

SONG: Investors really need to reevaluate their portfolio and ask themselves what role fixed income is playing, whether it's there for defensive purposes or if they're looking for income generation. They can look at strategies like securitized products, for example, to diversify their portfolio and generate extra income in this low-rate environment.

JANIS: Historically, core and the core-plus domestic strategies have worked out pretty well as a key component of a broader asset allocation. But we're in a new environment where, with all the stimulus, there's going to be some traction on the economy. Rates are going to gravitate higher. So taking a more diversified approach away from the domestic core and taking advantage of currencies, short duration [and] credit, and also pivoting at certain times, can become very, very important to generate attractive returns going forward.

WALDNER: I would build on what Dan said. Core strategies now have very low yields. They have a real valuation problem, and so although they've done well for decades, they're probably not going to do as well in the coming decades. So you have to look outside of the core. We would highlight credit such as bank loans and local emerging markets. And don't underestimate China. Just because it's a political foe doesn't mean it shouldn't be in your portfolio. ■

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