

News & Views

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How AR bond funds address today's markets

The rise of potential headwinds for certain areas of fixed income is no secret but that doesn't mean all bond funds should be avoided.

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Over the past decade, investors have become accustomed to bouts of volatility. While financial crises have been characteristic of markets in recent history, the volatility that markets have experienced since the global financial crisis has been on a different order of magnitude. Looking ahead, there are few signs that this era of volatility will come to an end. In fact, it is possible that we could be reaching an inflection point in fixed income as central banks appearing to reach the limits of monetary policy and political risks, particularly the US election result, causing government bonds to retreat from the record lows they set this year. In an era where the only certainty is more uncertainty, volatility is inevitable in both government bond and credit markets. However, while this will be a concern for most investors, for active investors able to take a flexible absolute return approach – this may actually be good news.

Could government bonds be at an inflection point?

Since the financial crisis, expansionary monetary policy has supported government bonds, and for much of 2016, a record US \$10 trillion of government bonds traded at negative yields.

However, in 2016, central bankers suddenly showed signs of falling out of love with expansionary monetary policy. Of particular concern was the effect of low or negative yields and flat yield curves on institutions such as banks.

This first prompted the Bank of Japan to announce an initiative designed to steepen its yield curve. Rumours later surfaced that the European Central Bank would scale back its quantitative easing purchases (later confirmed in December). This resulted in global government bonds retreating from their unprecedented highs.

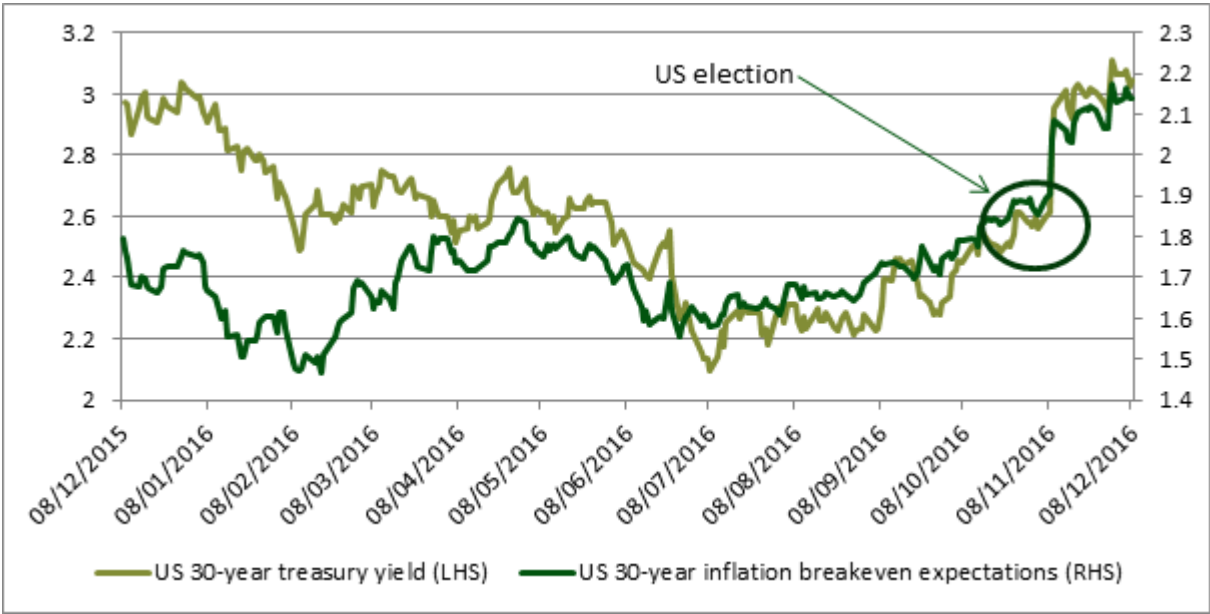
This trend was boosted after the election of Donald Trump in November. The surprise result made the prospect of significant fiscal stimulus in the US more likely, pushing up inflation expectations. 10-year US Treasuries recorded their worst day in 25 years immediately following the result. Currently, the 2-year US Treasury yield is currently at 1.1%, its highest level since 2010, while longer-dated Treasuries are around one year highs.

It remains too early to tell whether this represents the beginning of a sea-change in bond yields. However, the uncertainty makes bouts of volatility increasingly possible.



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Figure 1: US inflation expectations and bond yields receive post-election boost



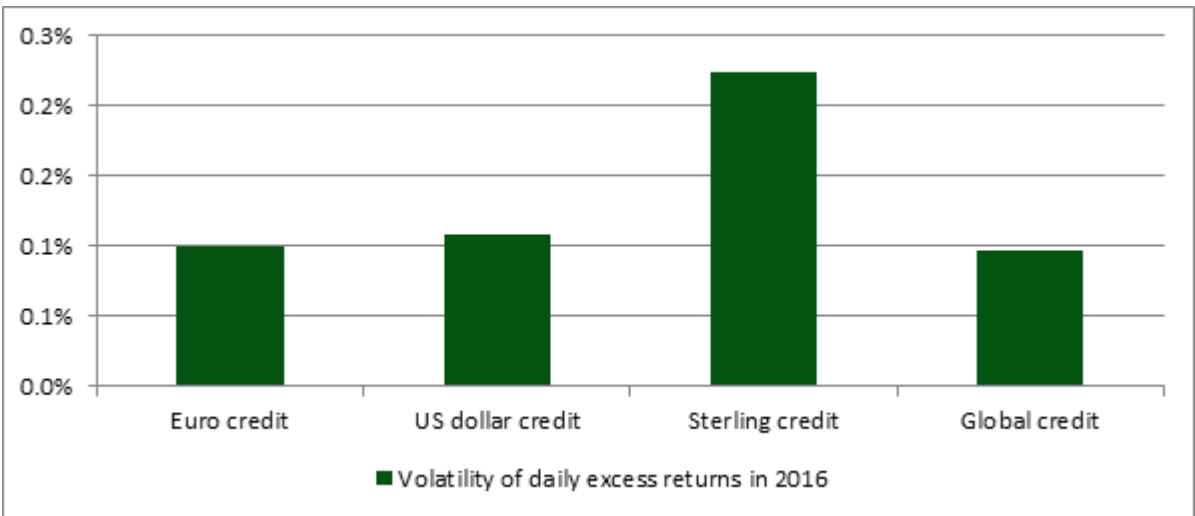
Source: Bloomberg, December 2016

Political risk and corporate bond markets

Regional politics have also had an impact on credit markets. According to data from Bank of America Merrill Lynch, the sterling credit market has been twice as volatile as its US dollar and euro counterparts this year (on an excess return basis). This is largely attributable to the surprise result of the UK referendum on EU membership, and the aggressively supportive response from the Bank of England in the aftermath.

The euro credit market has been the least volatile of the three, having been directly supported by purchases from the European Central Bank for much of the year. The US dollar market has performed the strongest on an excess return basis, aided by the positive reaction to the US election result and stability in the oil market. Global credit has been the least volatile, demonstrating the potential value of global diversification in a world of regional politics.

Figure 2: Political risks lead to regional credit market volatility



Source: Bank of America Merrill Lynch, December 2016

Looking ahead, the political calendar is busy with regional political events that markets will watch closely, and therefore volatility relating to politics could continue. For example, France and Germany will go to the polls next year in an environment in which populist and insular political movements are looking to consolidate their growing support. Furthermore, the UK is set to invoke Article 50 of the EU Treaty, Donald Trump will assume power in the US and Italy will form a new government at a time when markets are focusing on the health of the nation's banks.

Turning volatility to your advantage

Volatility is treated with trepidation by a number of investors but is actually helpful for certain strategies. Absolute return approaches that invest either long or short across the entire global fixed income universe are not dependant on yield levels or market direction to deliver consistent returns. Instead, they look to pinpoint relative and absolute value opportunities within and across issuers, sectors and entire global regions.

For example, when the monetary policy outlook is divergent in two different countries, a strategy that is long one market and short the other may be a key source of value. In credit, investors can avoid areas where political risks are not adequately rewarded by prospective returns in favour of markets that offer more value. An ability to adopt long and short exposure can capture value in both rising and falling markets. However, the success of such an approach is increasingly down to resource, experience and manager skill.

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