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HOW TO SNIFF OUT BOND OPPORTUNITIES IN AN ILLIQUID MARKET

Lower trading volumes mean investors need to learn how to deal with the tendency of fixed income markets to overshoot, says Raman Srivastava, co-deputy chief investment officer at Standish.

Highlighting some of the unintended consequences of central bank easing in recent years, Srivastava says: "There's more money in the world. Since the financial crisis, central banks have flooded markets with money and it doesn't look like it's going to end any time soon." The result, he says, is the current low or even negative yield universe, which in turn is creating both challenges and opportunities for investors.

One consequence of the widely discussed hunt for yield has been enduringly strong flows into high yield assets. What is perhaps less known is the degree of long term growth in higher yielding debt markets. Net annual flows into the asset class have been positive in 17 of the past 23 years, for example. Net outflows have only occurred in six of those 23 years.[1]

Meanwhile, retail ownership in the asset class has also skyrocketed. According to Morgan Stanley data, about 20% of US high yield is now owned by mutual funds or ETFs. That compares with 5% in 1993. Observes Srivastava: "More of the market than ever before is now owned by retail investors."[2]

Accompanying this overall growth in the levels of debt has been an almost commensurate decrease in the ability of the market to cope with inflows and outflows, as increased regulation, such as Basel III, has stymied the ability of banks to take on inventory.

According to Srivastava: "As the market has grown, the amount of dealer capital available to trade fixed income has fallen. The liquidity of bond markets versus equities has always been low but now it is even more so."

The trend is reflected, he says, in the frequency of bond trades versus that of equities. In January 2015, for example, the percentage of NYSE stocks with zero trades was 0.1%. For bonds, that figure was 53%. The percentage of equities with more than 25 trades a day was 99.7%. For bonds, that figure was 0.4%.[3]

But what to do with this information? Srivastava says investors need to take the implications of this new environment into account. For Standish, one focus has been to become more tactical in its allocations. "You no longer just take notice of fundamentals, you have to look much more at technicals in fixed income as well," says Srivastava.

One instance was the so-called 'taper tantrum' of 2013, where the market reacted to comments by then US Federal Reserve (Fed) chairman Ben Bernanke on gradually reducing or "tapering" US quantitative easing. The result was a sudden outflow from the high yield space and a material widening of high yield spreads.

"Coupled with lower overall liquidity in the market, this kind of technical event creates an environment where markets may be liable to overshoot," says Srivastava. "Now it's so much more difficult to trade, the moves on some of these redemptions become exaggerated. You have to be able to react to that. You have to be more nimble in your allocations."

Looking forward, Srivastava highlights emerging market (EM) debt as one area of potential opportunity in 2015. He notes how emerging market growth has underperformed expectations for the past three years but describes current pessimism around the asset class as an overreaction. He explains: "It's been a perfect storm for EM

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[1] Source: JP Morgan, 28 February 2015.
[2] Source: Morgan Stanley data as at Q2 2014.
[3] Source: Morgan Stanley, 31 January 2015

currencies and countries and until now we've tended to avoid EM debt. But I do think this is going to be a big opportunity once we have more clarity around the Fed interest rate hike and more stability around oil pricing, both of which we believe will occur within the next three months."

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