INSIGHT: SPIKE IN BOND YIELDS HAS CREATED ATTRACTIVE ENTRY POINT

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Stable, modest growth that does not require a strong policy response can be a boon for certain sectors of the fixed income market, according to Insight Investment's Adam Mossakowski.

The recent spike in European government bond yields has presented investors with an attractive entry point, since the sell-off infected other markets and was not particularly discerning says fixed income manager Adam Mossakowski.

German Bunds led the way with yields on the benchmark 10-year bond rising from a low of 0.05% to 1% since mid-April. For those with long memories this is reminiscent of the behaviour of Japanese Government Bonds (JGBs) back in the early 2000s when the Bank of Japan started asset purchases.

Mossakowski says: "After an initial grind lower in yields following the introduction of asset purchases, yields then sharply rebounded from their lows, jumping more than 1% and precipitating a 6% capital loss."

Confounding expectations

The monthly return profile of JGBs during the early 2000s showed just how volatile traditionally 'low-risk' assets can be, contrary to many investors' expectations. Mossakowski says a 2% yield is not enough compensation for the sort of volatility that could see an investor lose 2% or even 4% of capital in one month.

Prior to the sell-off which began in April the yield on 10-year Bunds was just 5 basis points. "This could also have implications for the UK Gilt market and US Treasuries. In the 2013 'taper tantrum' yields rose and there was a 7% capital loss in 10-year Gilts. Since the end of January this year there has been a 6.3% capital loss," says Mossakowski.

Similar to the return profile of JGBs over a decade ago, 10-year Gilts have displayed increased volatility since the introduction of QE in 2008 with lower yields to compensate. "In any given month the asset class could lose you 4% and yet yields have been lower than 4% since 2008 and at times as low as 2%. This prompts the question of whether investors can generate an income from fixed income markets any more or if the coupon is there to compensate you for the volatility," Mossakowski says.

Credit contagion

Against this backdrop of underlying rate volatility there is a risk of contagion feeding through to credit spreads. This type of relationship was witnessed in 2013 in the initial market reaction to the potential of the QE taps being turned off, but so far there has not been such a stark reaction from the corporate debt sector in response to the price action in Bunds, Mossakowski says.

There has been a modest sell off in US investment grade credit, though this is largely due to lower oil prices and the relatively large index weighting in energy companies, rather than higher yields in Europe. High yield has been worse hit.

"Many exploration and production companies which have financed projects through high yield debt became unviable with the lower oil price and that saw a few defaults. This fed through to the investment grade sector via the pipeline companies and we are actually constructive on that sector because we feel it has been overly

punished. These companies are not exposed to the oil price in the same way because as long as people need to transport it from A to B, they will have to pay to do so."

Limiting liquidity woes

Mossakowski believes there are still underlying liquidity problems in the market but does not see that as being a one-way street: "It is just as bad to buy in bull markets as it is to sell in bear markets when liquidity is constrained."

He is wary of the European credit market because he thinks the European Central Bank has created an unhealthy dynamic through buying sovereign bonds and asset backed securities and forcing yield compression. This has pushed investors up the risk spectrum in search of yield.

"Long-dated US dollar-denominated credit has also backed up significantly, leading to a 6% capital loss. We believe this can reverse to deliver a significant gain because the sector is currently displaying the level of spread you would expect in a recession and we are not in recession. A 2% yield on US investment grade corporate debt is a lot of compensation for low default rates and we do not believe there is anything out there to prompt a spike in defaults. We are in a 'Goldilocks' scenario: not too hot, not too cold, boring, stable, modest growth which does not require a policy response and this is good for credit markets," he explains.

The team's response, Mossakowski says, has been to "own as much credit as we can without buying the parts of the credit market we do not like. That shows how constructive we are on the asset class".

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