UBS

US fixed income

Beyond benchmark fixed income investing - update | 21 September 2017

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- Both high quality long duration and riskier credit segments have performed well this year. This comes as geopolitical tensions pushed down sovereign yields, while strong fundamentals and technicals have tightened credit spreads.
- Despite it's shorter duration (5.1yrs vs 6.0yrs), the beyond the benchmark theme portfolio has outperformed the Bloomberg Barclays Agg by 30bps this year. Strong performance in credit segments have made up for the theme's shorter duration and higher quality bias.
- Amidst the uncertain backdrop, keeping balance in a fixed income portfolio will remain important. We believe having a dispersion of sectors gives investors the ability to obtain extra yield in a risk-controlled way.

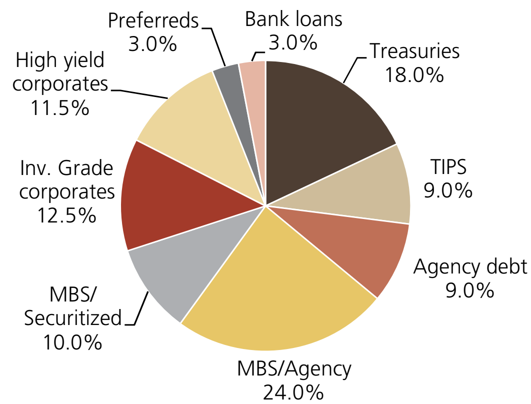
Theme overview

"Beyond benchmark fixed income investing" recommends that investors diversify bond portfolios away from traditional taxable fixed income benchmarks that are heavily government-weighted, such as the Bloomberg Barclays Aggregate Index. In addition to investment grade (IG) corporates, which are represented in the Aggregate index, the theme incorporates other types of credit-related asset classes such as high yield (HY) bonds, securitized products such as CMBS, preferred securities, and senior loans. Within the government allocation, it also has exposure to Treasury Inflation Protected Securities (TIPS), which are absent from the traditional benchmark. We believe that having exposure to these additional asset classes should lead to superior risk-adjusted returns over the longer term.

What's been working for the theme?

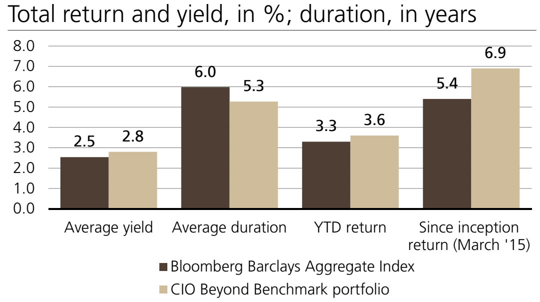
Given how well both long duration and credit spread products have performed this year is once again surprising. Long-term government bond yields declined by over 20bps and HY credit spreads narrow by 55bps over the same period. Normally such a plunge in benchmark rates would signal a poor economic environment or central bank

Fig. 1: Theme portfolio asset class weightings
In %



Source: Bloomberg, UBS, as of 19 Sept. 2017

Fig. 2: Theme portfolio characteristics and returns
Total return and yield, in %; duration, in years



Source: BAML, UBS, as of 19 Sept. 2017

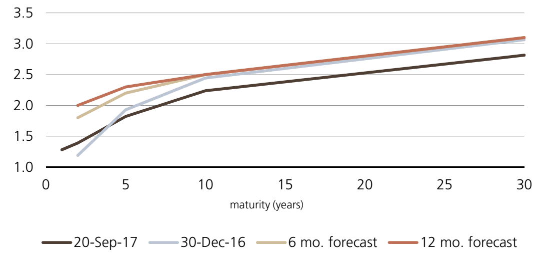
mistake. Instead, this dichotomy stems from the impact that accommodative global central banks have had in pushing non-US sovereign yields lower and the influence this has on US government yields. It also stems from the market pricing out less optimism on the US policy agenda that had been cause for rising yields following the election last November. At the same time, credit spreads have tightened as low yields globally have resulted in a steady source of demand for investment grade (IG) corporates. While demand for high yield (HY) has not been as strong, it's benefited from declining default rates and more supportive oil prices recently. Preferred securities have been the best performing US fixed income segment (+10%) given the asset class' long duration and the compression of risk premiums for US and European financial instruments.

Treasury Inflation Protected Securities (TIPS)
The year-to-date return on the TIPS index is currently 2.5%, which is just shy of 2.6% for nominal Treasuries. The TIPS market has finally broken its six month losing streak as the CPI data release for August was above market expectations. Currently the 5-year break-even inflation rate is 1.78%. Today's break-even inflation rate is middle of the road versus the 1.56% June low and 2.06% February high. UBS anticipates inflation to increase to 2.1% in 2018. Although this is well above the current market expectation of future inflation, we await stronger commentary from the Fed becoming more positive in our tactical house view positioning. However, we maintain a strategic allocation in the asset class in the beyond the benchmark theme portfolio. We believe that when interest rates rise on the back of growth and inflation, TIPS will outperform nominal US Treasury securities.

Amidst the uncertainty, maintain balance
We continue to see yield developments outside the US as having strong influence on the shape of the US yield curve, which should make for a more gradual rise in longer term yields. History shows when the Fed tightens, the yield curve flattens. This time, the curve is currently very flat and may be leading the Fed's actions. Within high yield credit, we see spreads as slightly expensive at 366bps. Normally HY bonds can do well if the Fed is hiking rates on the back of stronger growth. At this time, however, we see potential for more limited spread tightening given how far spreads have already compressed.

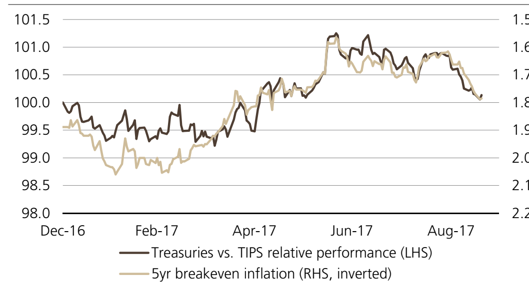
US taxable fixed income investors find themselves in a challenging market environment characterized by low starting yield levels, bouts of volatility, and a longer, drawn-out fed tightening cycle. The most widely used benchmark is the Bloomberg Barclays Aggregate Index, which suffers from several flaws, in our view. We believe that investors can circumvent benchmark shortcomings by diversifying bond portfolios beyond a traditional benchmark and adopting a more flexible approach to active fixed income management. Keeping balance in the portfolio will remain important and having a dispersion of sectors gives investors the ability to obtain extra yield in a risk-controlled way.

Fig. 3: The Treasury curve has flattened YTD
Yield, in %



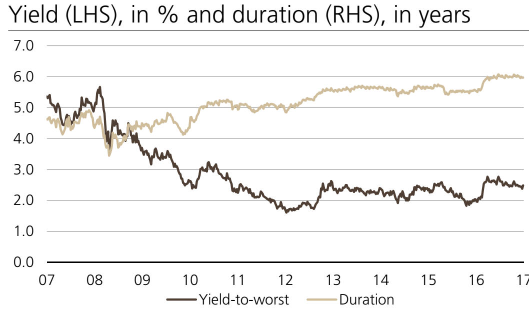
Source: Bloomberg, UBS, as of 20 Sept. 2017

Fig.4: TIPS gaining back ground recently
Treasuries vs. TIPS (LHS); 5yr break-even inflation (RHS), in %



Source: Bloomberg, UBS, as of 19 Sept. 2017

Fig.5: Bloomberg Barclays Agg: low yield and high duration
Yield (LHS), in % and duration (RHS), in years



Source: Bloomberg, UBS, as of 19 Sept. 2017

Appendix

Statement of Risk

Municipal bonds - Although historical default rates are very low, all municipal bonds carry credit risk, with the degree of risk largely following the particular bond's sector. Additionally, all municipal bonds feature valuation, return, and liquidity risk. Valuation tends to follow internal and external factors, including the level of interest rates, bond ratings, supply factors, and media reporting. These can be difficult or impossible to project accurately. Also, most municipal bonds are callable and/or subject to earlier than expected redemption, which can reduce an investor's total return. Because of the large number of municipal issuers and credit structures, not all bonds can be easily or quickly sold on the open market.

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	Rating Agencies			Credit Ratings
	S&P	Moody's	Fitch/IBCA	Definition
Investment Grade	AAA	Aaa	AAA	Issuers have exceptionally strong credit quality. AAA is the best credit quality.
	AA+	Aa1	AA+	Issuers have very strong credit quality.
	AA	Aa2	AA	
	AA-	Aa3	AA-	
	A+	A1	A+	Issuers have high credit quality.
	A	A2	A	
	A-	A3	A-	
	BBB+	Baa1	BBB+	Issuers have adequate credit quality. This is the lowest Investment Grade category.
	BBB	Baa2	BBB	
	BBB-	Baa3	BBB-	
Non-Investment Grade	BB+	Ba1	BB+	Issuers have weak credit quality. This is the highest Speculative Grade category.
	BB	Ba2	BB	
	BB-	Ba3	BB-	
	B+	B1	B+	Issuers have very weak credit quality.
	B	B2	B	
	B-	B3	B-	
	CCC+	Caa1	CCC+	Issuers have extremely weak credit quality.
	CCC	Caa2	CCC	
	CCC-	Caa3	CCC-	
	CC	Ca	CC+	Issuers have very high risk of default.
	C		CC	
			CC-	
	D	C	DDD	Obligor failed to make payment on one or more of its financial commitments. this is the lowest quality of the Speculative Grade category.

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Appendix

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