

Bond Bites

High pressure on yields. **Handle with care.**



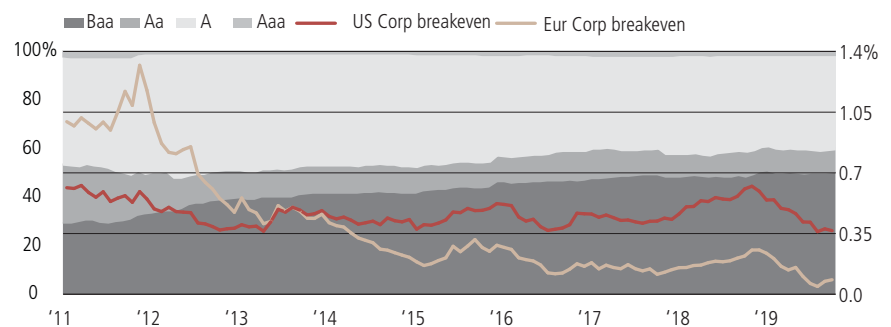
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Over many millions of years whales have evolved so that they can survive thousands of feet under the ocean without being crushed to oblivion by enormous pressure. Some have evolved lungs that are completely compressible, forcing all the gasses into their bloodstream where they can dissolve under the pressure.

Thus they can avoid the painful and possibly fatal decompression sickness or 'bends' experienced by human divers who do not take adequate care. Investors have had far less time to adapt to the enormous crushing pressure on future bond returns exerted by central banks. But they may face a painful readjustment process without careful preparation.

Take for example investment grade corporate bonds; a preferred habitat for many investors looking to add income to portfolios. While yields (and hence prospective future returns) have not quite been crushed to nothingness a unique set of challenges has arisen. In the Eurozone the investment grade corporate universe yields just 0.43%, close to a record low. That is still higher than many government bonds, which often yield below zero, but offers very little reward for investors. It means yields can rise by only 0.08% overall before the loss in price cancels out the expected annual income, to give a zero annual total return (remember that in bonds prices move inversely with yields) *. This yield move is known as the annual 'breakeven'.

Evolution of rating distribution and breakevens (right hand scale)



Source: Bloomberg Barclays Global Aggregate Corporates index, Bloomberg Barclays US Corporates index, Bloomberg Barclays EUR Corporates index as at 31 October 2019.

* An approximation but in simple terms this is the index yield divided by its duration. All yields as at end of October 2019.

That is a pretty skinny margin of safety for yield hungry investors. ECB action can still provide some comfort; it has recently rebooted its asset purchase program which can reduce yield volatility, but there are other risks. Over the last 20 years the average credit quality of the market has fallen such that 50% is now BBB rated; the lowest category of investment grade. And the 'breakeven' has fallen. A sudden increase in defaults or credit downgrades, a recession becoming more likely or even just a weaker growth outlook could all lead to an increase in yields as investors demand more compensation for risk. The situation is similar in the US, but not quite as extreme. The overall investment grade corporate yield is higher at 2.86% and the annual breakeven is 0.37% but the chart shows that the long term trends in both USD and EUR are for lower overall credit quality and more sensitivity to an increase in yields.

Managing these risks is a delicate balancing act. There are still justifiable reasons for owning corporate bonds, in part because of the ongoing stimulus provided by central banks but also an outlook that is tilted toward sub-trend growth but avoids

recession. We expect credit returns to exceed government bonds in these conditions, albeit modestly. But low rates and asset purchases are no panacea for rising corporate leverage, low productivity growth and limited earnings growth.

To balance our constructive outlook versus more challenging valuations we take an active approach to managing corporate bonds in our global funds. So while we do not expect serious market disruption in the near term those lower breakevens mean we have reduced our corporate bond risks in recent months, particularly in Europe. And we prefer more defensive sectors such as utilities, healthcare and communications.

Our active approach has paid off over time. For example our Global Flexible Bond strategy has outperformed the Global Aggregate Index by an annualised 2.1% since inception. (Data as per end of October gross of fees).

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