Lower for Longer: Where to Find Yield Today?

UBS ETF Market Matters

The 'Lower for Longer' environment continues to put pressure on investors' ability to achieve return objectives. Yields on government debt of developed countries as well as broad fixed income benchmarks (e.g. Euro Aggregate) are currently at historical lows.

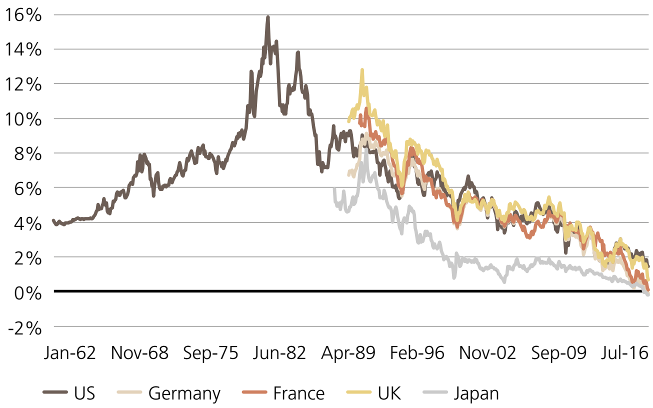
In contrast, sub-investment grade bonds and emerging market debt have yields in the range of 4–6%, which is not far off from historical medians. Compared to high yield, emerging market sovereign debt has exhibited more robust performance in recent years and currently has a better credit quality mix.

Investors considering passive investments into emerging market sovereign debt should carefully examine how to avoid excessive concentration risk and look to reduce exposure to the most indebted sovereigns. This can be simply achieved with a capped index, where a single issuer has no more than e.g. 3% of exposure, resulting in a more diversified and risk-balanced allocation.

Traditional investing challenged?

For decades, the investment paradigm for many investors centred on constructing core equity-bond portfolios to meet return objectives. In the past, the equity component would regularly have provided healthy returns (often double digit), while bonds were expected to provide diversification benefits and thus reduce portfolio downside risk in times of distress. In addition, the broad decline in interest rates since 1980s boosted fixed income valuations; see Figure 1 for the evolution of the 10-year government yields for major developed economies. Given that there is limited room (if any?) for further interest rate reductions, investors face a very challenging environment in the fixed income space. This has forced investors to search for yield beyond advanced economies and high quality credit.

Figure 1: Yields on government bonds with 10-year duration across developed markets.



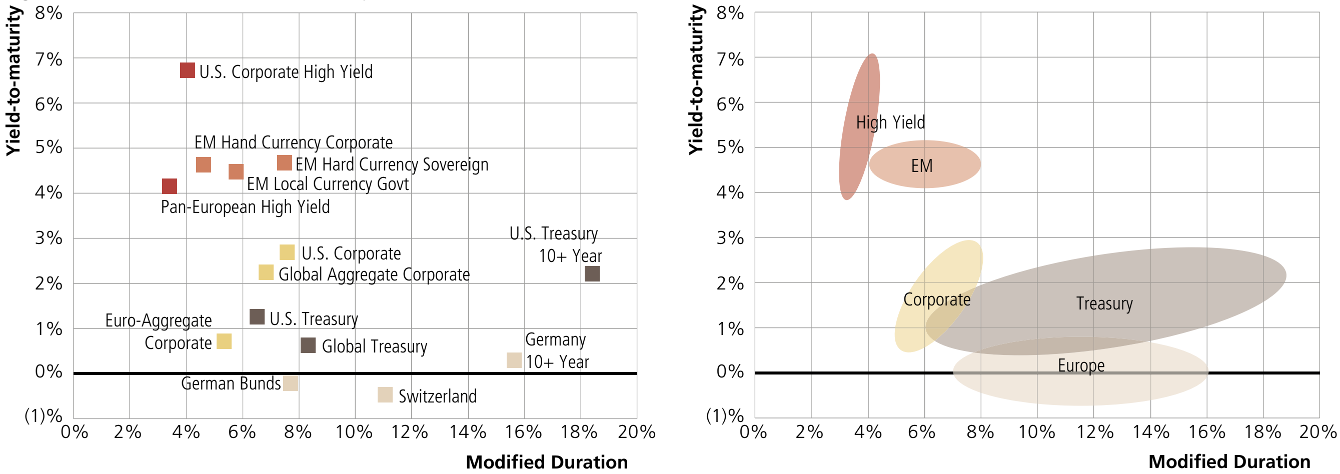
Source: Bloomberg, UBS Asset Management, data as of August 15, 2016

Where is yield today?

This is currently one of the most frequently asked questions by investors. Figure 2 shows the current yield-to-duration landscape. The global treasury index yield-to-maturity (YTM) stands at 0.63% with a modified duration of 8.2%, implying a rather high sensitivity to possible interest rate changes. In Europe, yields are very low with German Bunds and Swiss bonds below zero at 10 year maturity. The U.S. is a bit more attractive with 10+ year treasuries offering on average just over 2%.

From core corporate benchmarks, the Euro Corporate Aggregate has a yield below 1%, while the Global Corporate Aggregate and U.S. Corporate indices are between 2 and 3%. A relatively decent yield pick-up is currently accessible through high yield credit and emerging market (EM) segments (Figure 2). For example, U.S. corporate high yield has a YTM near 7% with a rather short duration of 4%. EM hard currency sovereign debt has a YTM of 4.7% with duration of 7.4%.

Figure 2: Yields and durations across major fixed income benchmarks.

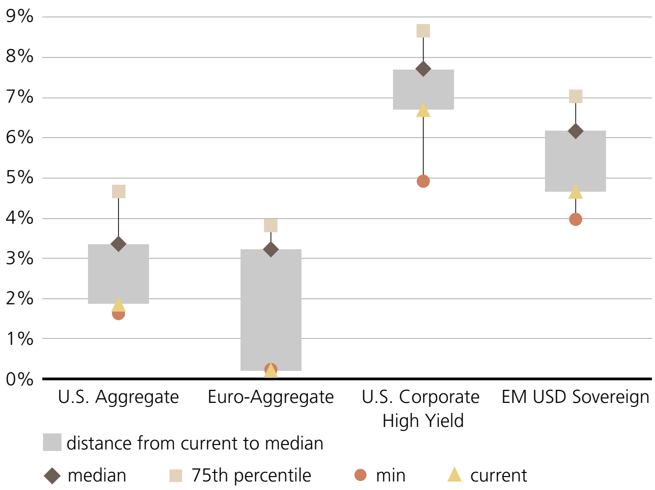


Source: Barclays Point, UBS Asset Management, data as of August 15, 2016

Figures 3 and 4 show yield and duration in a time perspective, and in particular relate their levels to historical values. The Euro-Aggregate yield has significantly compressed and clearly is at its lowest level since the introduction of the Euro. Similarly, the US Aggregate yield is currently low, though has seen a modest pick-up from its bottom. In contrast, the current yield levels of U.S. High Yield as well as of EM debt are above their lows, by approx. 180bps and 70bps respectively.

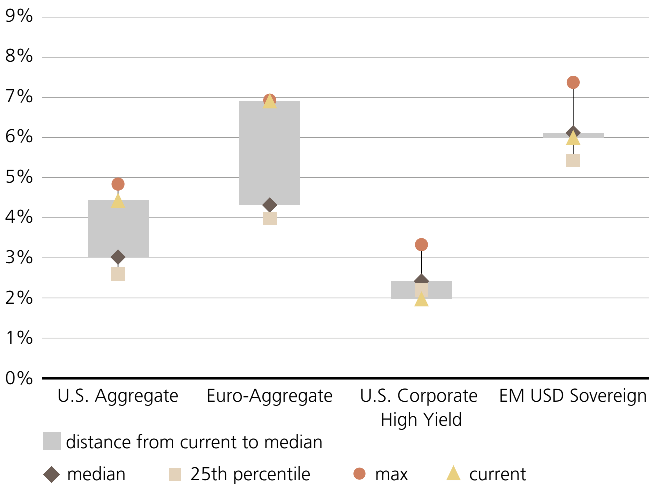
In terms of interest rate risk, in Figure 4 we see that duration of Euro-Aggregate increased substantially as a consequence of the ECB quantitative easing program and reduction in longer term financing costs. For the US Aggregate this trend is a bit muted, although duration is still close to its historical maximum. In contrast, emerging market debt and high yield have duration levels in line with their medians and thus might be better positioned in case of possible interest rate increases.

Figure 3: Yield distribution on selected bond indices. (measured over Mar'03-Jul'16, monthly data)



Source: Barclays Point, UBS Asset Management, data as of August 15, 2016

Figure 4: Duration (modified adjusted) on selected bond indices (measured over Jan'98-Jul'16, monthly data).



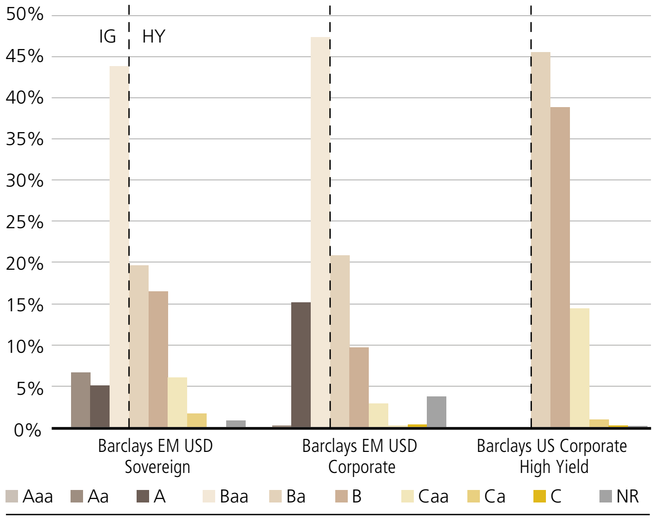
Source: Barclays Point, UBS Asset Management, data as of August 15, 2016

Is sovereign emerging market debt attractive?

While both high yield credit and emerging market debt have relatively attractive yields, Figure 5 shows that the latter has a better rating quality balance. While the US High Yield is composed of non-investment grade bonds, more than 55% of emerging market sovereign debt has an investment grade rating, including a significant amount of 'Aa' debt. Looking at sovereign vs. corporate emerging market debt, the rating distributions are fairly comparable: the sovereign index has a larger share of 'Aa' exposure and lower share of non-rated exposure, while the corporate index has marginally more bonds in the 'A', 'Baa' and 'Ba' categories.

Another key consideration for investors in making fixed income allocations is liquidity. Figure 6 shows that generally, US High Yield has the worst liquidity cost score (i.e. the highest cost estimate for a roundtrip execution), followed by EM USD corporates. In contrast, the EM USD sovereign has a liquidity cost score closest to that of the US Aggregate. Investors require liquidity the most during stress events when price fluctuations increase such as during the 2008-2009 financial crisis. Examining this period, it is clear that EM USD sovereign was as liquid as US Aggregate, whereas the other indices incurred substantial liquidity disruptions.

Figure 5: Credit rating composition of selected indices covering emerging market and high yield debt.



Source: Barclays Point, UBS Asset Management, data as of August 15, 2016

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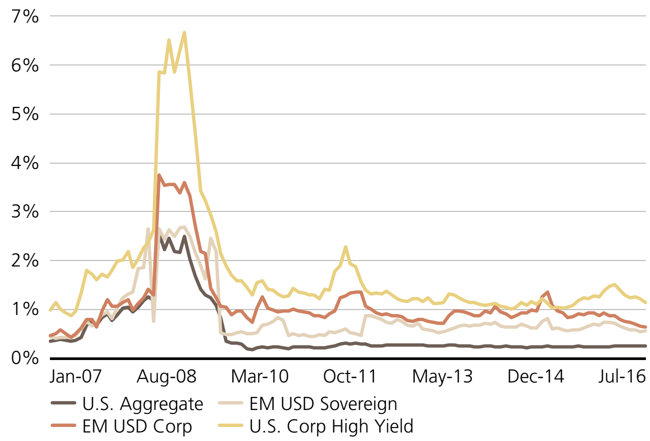
Are all sovereign EM debt indices the same?

Importantly, investors should recognize differences between various EM sovereign debt indices, which may have substantial impact on returns. In a standard EM market-cap index, countries issuing more debt have larger weights and thus exposure is concentrated in a handful of most indebted sovereigns (on an absolute basis). As of H2 2016, about 52% of total EM hard currency debt originates from seven countries (Russia, Brazil, Mexico, Venezuela, Turkey, Indonesia and China). Over the past 10 years, the debt of these countries provided on average a 0.24% monthly excess return over duration neutral US treasuries, which is below an average return for all EM countries of 0.37%. It might therefore be a good idea to reduce exposure to the most indebted sovereigns, whilst tilting exposure to the less indebted sovereigns.

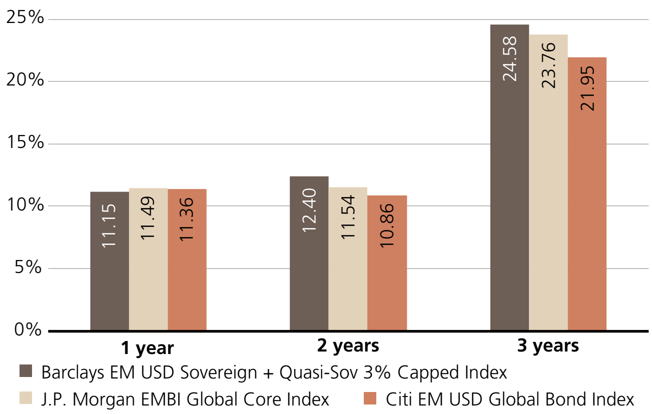
To ensure better diversification, a simple yet economically meaningful approach to cap issuer risk may be applied. Figure 7 presents performance of several major EM USD indices over 1, 2 and 3 year horizons. All indices have delivered robust performance with 3-year cumulative returns in the range of 22–25%. Yet the Barclays EM USD Sovereign + Quasi sovereign index with a 3% issuer cap has outperformed the other uncapped indices by up to approx. 250 bps cumulative over 3 years (or approx. 80bps annually). These return differentials are mostly attributable to the impact of capping, i.e. the largest EM issuers have lagged lately in performance. Not all EM indices are the same, so deeper understanding of their construction may prove critical.

Figure 6: Liquidity cost scores for a selection of bond indices.



Source: Barclays Point, UBS Asset Management, data as of August 15, 2016

Figure 7: Performance of major EM USD benchmarks for the most recent 1, 2 and 3 years (i.e. cumulative percentage returns) as of end July 2016.



Source: Barclays Point, UBS Asset Management, data as of August 15, 2016
Past performance is not indicative of possible future returns.

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UBS ETF (LU) Barclays USD Emerging Markets Sovereign h. CHF UCITS ETF	0.47%		CHF	Physical	No	LU1324516720	SBEMS SW
UBS ETF (LU) Barclays USD Emerging Markets Sovereign h. EUR UCITS ETF	0.47%		EUR	Physical	No	LU1324516308	FRCK GY
UBS ETF (LU) Barclays USD Emerging Markets Sovereign h. GBP UCITS ETF	0.47%		GBP	Physical	Yes	LU1324516480	SBEMH SW

Data as of 30 September, 2016

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