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Changing times

Fixed income investors need to stay nimble

UBS Asset Management

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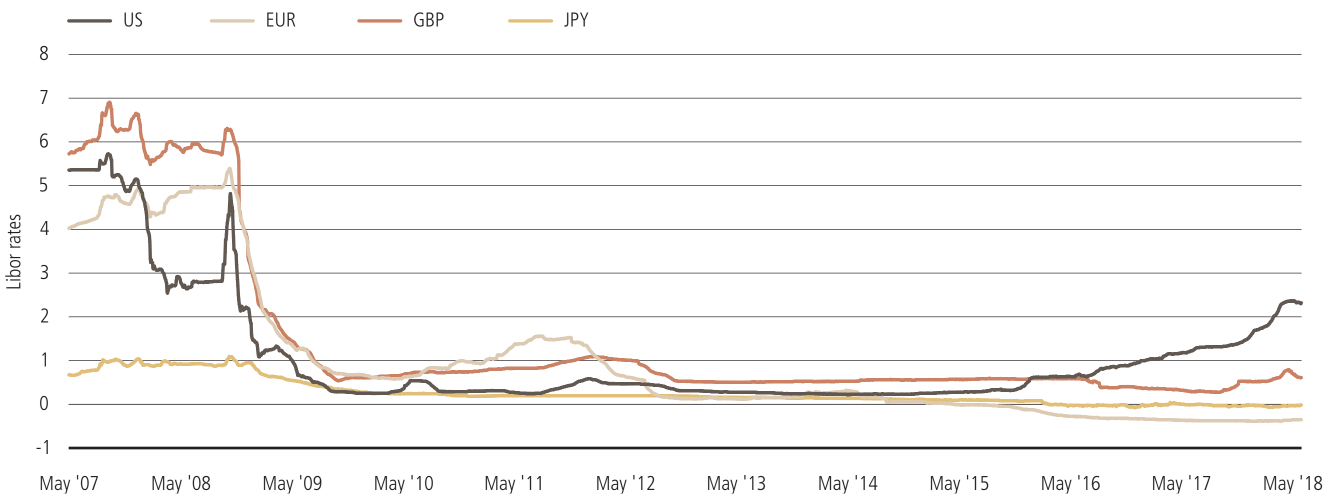
One of the most notable features of the global fixed income market in 2018 thus far has been the sharp increase in USD Libor rates—the market interest rate at which banks lend dollars to each other in London over various short-term horizons. Libor rates—and the spread between Libor and market expectations of the Federal Funds rate – are therefore widely watched benchmarks and seen by many as a gauge of overall credit market conditions. The 60 basis point increase in USD Libor since the start of the year to levels last seen in the financial crisis in 2008 (See Exhibit 1) has therefore prompted much comment and consternation. The increase, however, has not been accompanied by equivalent increases in EUR Libor or GBP Libor. This suggests very strongly that the increase reflects specific technical factors in the US market rather than investor concerns about overall bank creditworthiness.

In our view, the increase in US Libor likely reflects a combination of factors. US tax reform has precipitated a repatriation of US dollars held overseas by US corporations. This overseas cash had become a significant source of funding for global markets. The owners of this cash are not simply leaving this money on deposit once repatriated. By employing some of this cash for M&A and capital expenditure, demand for commercial paper and other money market instruments from corporates is falling. All this comes at a time when the widening US budget deficit is being funded by increased US Treasury Bill issuance. Unsurprisingly given the volume of issuance, the US Treasury is having to compensate investors with higher yields. In turn, this puts upward pressure on money market rates by 'crowding out' commercial paper markets. Despite the increase in front-end rates, volatility in global fixed income markets has remained

Exhibit 1: Libor Rates



Source: Bloomberg Finance LP, as of May 31, 2018.

relatively subdued. As the US Federal Reserve continues on its path of monetary policy normalization at a time when the issuance schedule for US treasuries is significant, we suspect volatility is likely to increase.

How to take advantage of the current environment

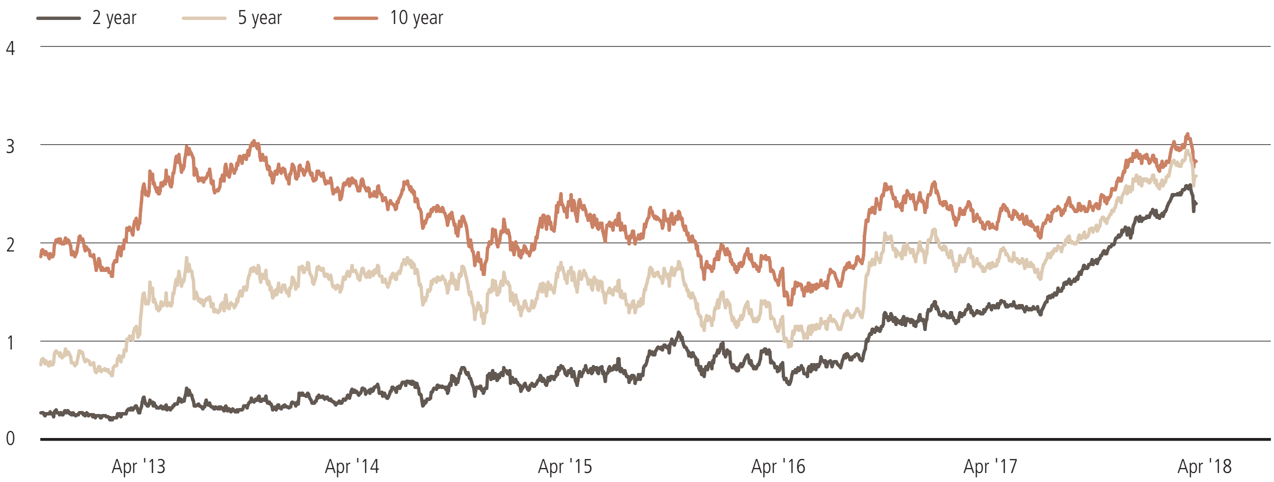
Floating rate bonds

Floating rate bonds have two components—one component is based on a floating reference rate, such as Libor, and a second component being a spread, which is based on the bond issuer's credit quality. Depending on the individual bond terms, the coupon is adjusted periodically, typically quarterly, so any increase in interest rates is soon reflected in the yields of the bonds. Therefore cash flow will increase in a rising rate environment. Because coupon rates mirror the market interest rate, floating rate bonds have very low price sensitivity to changes in interest rates.

Short dated credit

For investors concerned about a sustained increase in interest rates, credit exposure at the front end of the yield curve looks attractive. Given the tremendous flattening of the US yield curve that has occurred (Exhibit 2), short dated credit exposure looks particularly interesting on a risk-adjusted basis. We believe carry (coupon earned) provides a solid income stream with limited downside risk given fundamentals in corporate credit continue to look healthy. And while leverage has increased in some segments, a focus on shorter maturity issues increases the ability to project the financial health of issuers.

Exhibit 2: Yield curve flattening 2-, 5- and 10-year US Treasuries



Source: Bloomberg Finance LP, as of May 31, 2018.

Securitized investments
Securitized assets such as mortgage-backed securities (MBS), asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) possess many positive attributes including enhanced yield and the secured nature of the bonds. In the current environment perhaps one of the more important and underappreciated attributes is the diversification these assets can provide. Securitized bonds exhibit low historical correlations to both investment grade and high yield corporate credit. For example, in Exhibit 3, agency mortgage-backed securities exhibit moderate correlation to investment grade credit and virtually zero correlation to high yield. yield.

For bondholders who have benefitted from traditional corporate credit over the last several years, incorporating securitized assets into a broader portfolio construct can potentially help reduce volatility and enhance risk-adjusted returns. Moreover many of these securities, particularly CMBS, have floating rate features.

Exhibit 3: Correlations

	Agency MBS	ABS	CMBS
IG Corporate	0.54	0.54	0.48
HY Corporate	0.02	0.59	0.73

Source: Bloomberg Barclays; all data annualized as of December 31, 2017. IG Corporate = Bloomberg Barclays U.S. Investment Grade Corporate Index. HY Corporate = Bloomberg Barclays U.S. High Yield Corporate Index. Securitized = Bloomberg Barclays U.S. Securitized Index. MBS = Bloomberg Barclays U.S. Mortgage-Backed Securities Index. ABS = Bloomberg Barclays U.S. Asset-Backed Securities Index. CMBS = Bloomberg Barclays U.S. Commercial Mortgage-Backed Securities Index

Fixed income: Changing times from Panorama: Mid-Year 2018.
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