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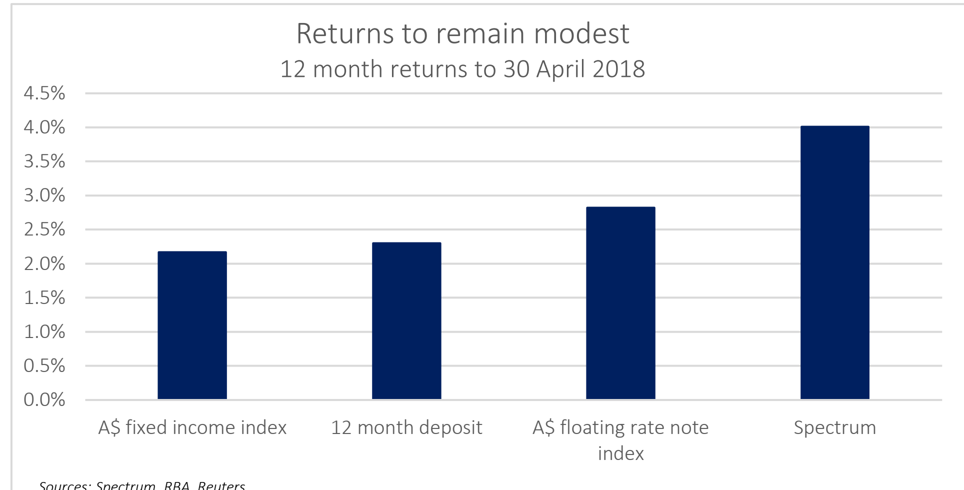
Trying to win the relatively ugly contest

Sometimes, investing is easy. Most of the time, it's a challenge. Then there are times like now where most asset classes look unattractive. For low risk investments - deposits, government and investment grade bonds - the modest returns of late may continue for the near term. As a corporate bond fund manager, our quest in this environment is to be the least ugly. Protect capital, beat deposits and then ready ourselves for improving returns as investment conditions improve is how we plan to manage our funds.



Corporate bonds – investing at midnight

The post GFC era of collapsing government bond yields, declining default rates and narrowing credits spreads is at its end. For investors already in corporate bonds, the tough times have begun. JP Morgan Chase & Co noted that U.S corporate bonds have recently had their third worst 100 day period since 2000.

Corporate bond returns are largely made up of credit "risk free" and credit risk returns. Or in other words, returns from government bonds and compensation for default risk. While the government bond yields have caused problems of late, both components face headwinds for near term performance.

Demand and supply looking ugly for government bonds

In many parts of the world, Government bonds yields are rising (prices are falling). Locally, the story is similar. The A$ Bloomberg fixed rate index has generated just 0.58% in the year to date as at 30 April 2018.

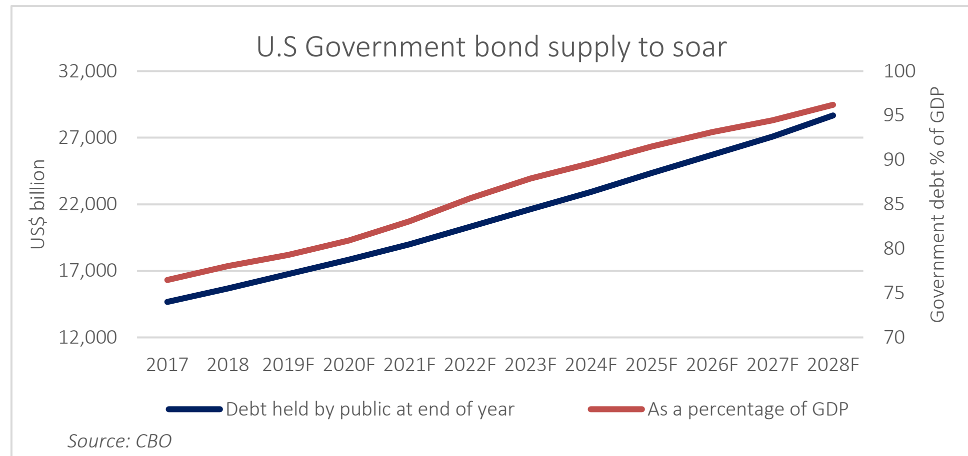
The reason for this investor pain is largely because the reversal of the greatest economic experiment ever – the circa $14 trillion of quantitative easing - has begun.

The U.S Federal Reserve has recently started to trim its $4.5 trillion holdings in government bonds and other securities. The reduction is around $30 billion per month increasing to $50 billion soon.

The European Central Bank may follow later this year or delay it until after their new president is elected in November 2019.

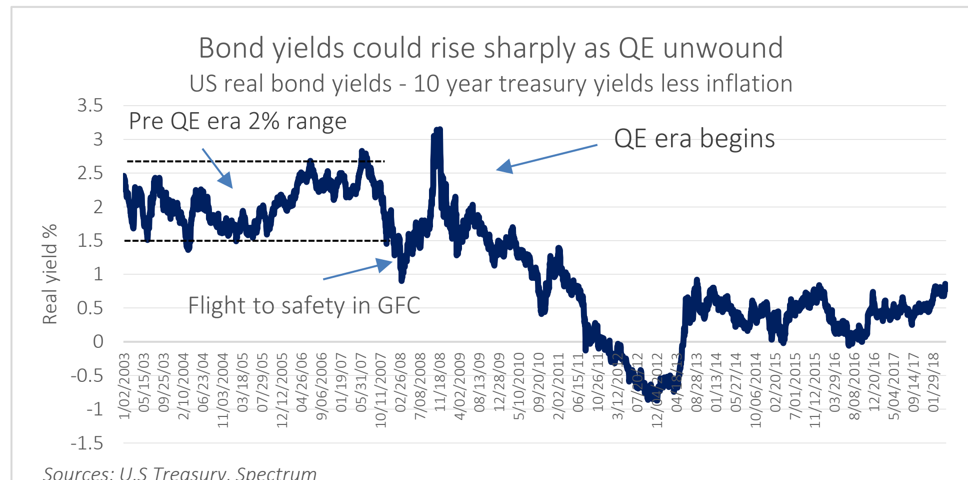
The previous pillar of blind demand for bonds – central banks – is crumbling.

At the same time, bond supply looks set to soar. For example, total U.S government debt is set to increase by around $US 1 trillion each year according to the Congressional Budget Office. If correct, total U.S government will double by 2028!



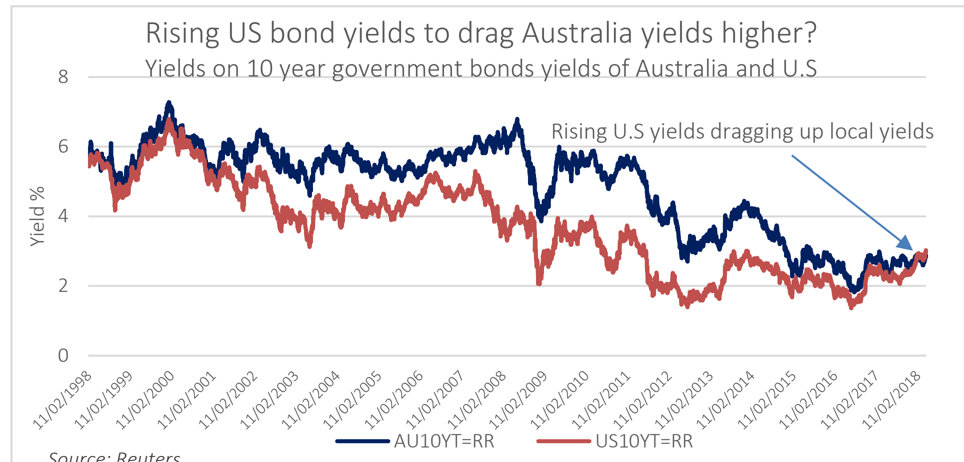
As QE recedes fundamentals can re-emerge

From a fundamental valuation view, there are also some basics pointing to higher bond yields. For example, if U.S inflation remains in the region of 2% and the *real* interest rates for 10 year bonds return to a more typical pre GFC 2% level, then a 10 year U.S treasury yield will hit 4% - up from the current 3% yield.



Risks for Australian government bonds

An Australian investor should worry about U.S bond yields because they drive our bond market. Should bond yields in the US keep rising, they will likely drag up Australian bond yields with them and push returns down on fixed rate bonds.

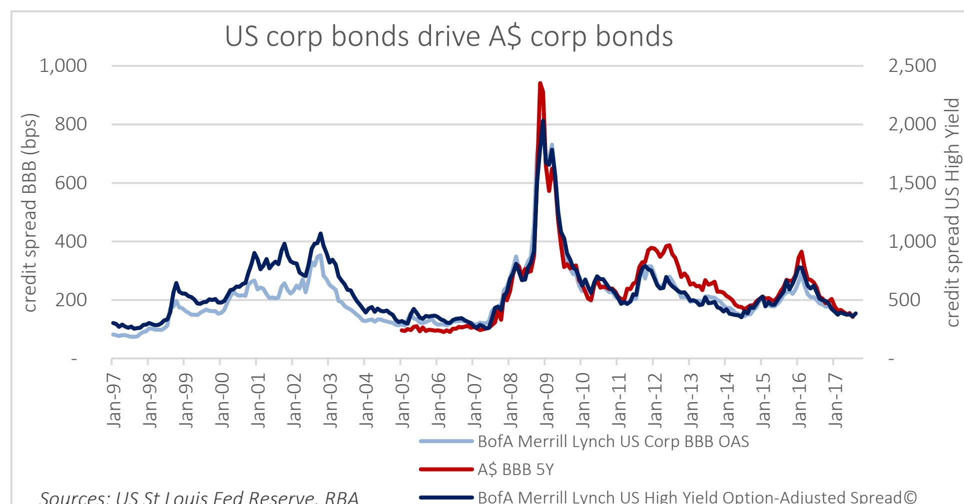


As good as it gets for credit?

Credit spreads are near historical lows. But so too are global and local default rates. Hence *credit* valuations arguably are not overly demanding considering immediate risks. Looking ahead we are not so sanguine.

If we are right about rising yields, this could be the catalyst for higher defaults. This will result in rising interest costs for borrowers. Eventually, this pushes the weakest borrowers closer to default. And as defaults start to mount, the credit taps start to tighten, slowing the flow of credit. All things being equal, this begets more defaults and the downward credit cycle kicks in.

While the scenario above is largely a U.S high yield story, it is likely to have repercussions in the Australian corporate bond market. U.S corporate default expectations drive U.S junk bond spreads. This, in turn, drives both U.S investment grade credit spreads which impact on Australian corporate bond spreads. This relationship is depicted in the graph below.



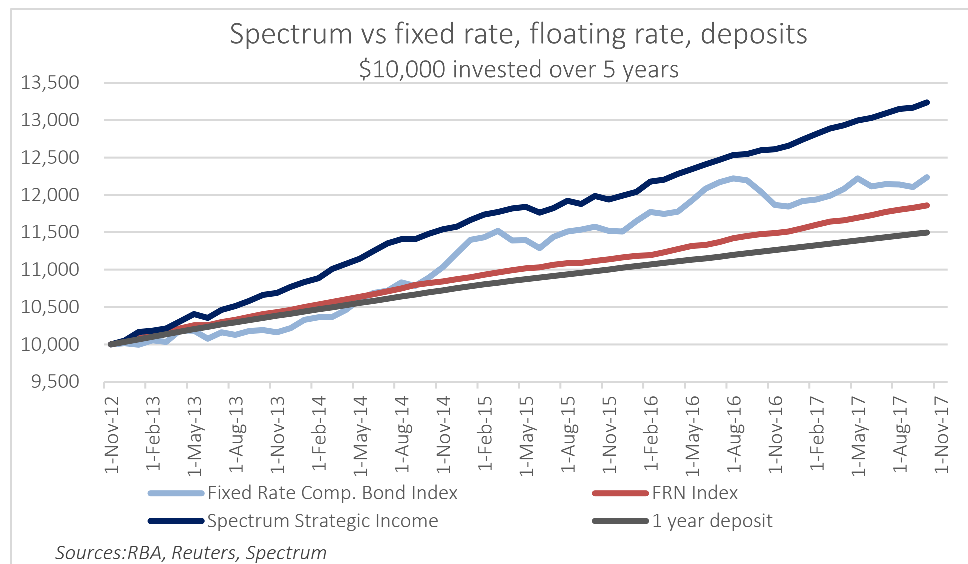
What to do in a tough market

Noted above are some tough impediments to performance for A$ corporate bond fund managers. There are, however, strategies a fund manager can use to reduce the impact of tough investment conditions:-

1. Keep investments mainly in floating rate notes. This shields the performance from the negatives of rising global yields. In contrast, fixed rate bonds fall when yields rise.
2. Maintain a conservative credit exposure. This means maintaining high levels of highly rated bonds while keeping the sensitivity to widening credit spreads[1] moderate.

Accept being ugly but protect your capital

Compared to the past few years A$ corporate bond returns are poised to be lower in the near term. We accept we are in an ugly asset class. We have come to terms with it. But in doing so, we are able to focus more on capital preservation in the near term. Eventually, investment conditions will improve. Then we will venture to turn up the excitement dial. Until then, we will be boring and reliable and try to win the relatively ugly contest.



1. We measure this by credit spread duration.

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