portfolio construction forum

Finding value in a coupon driven market

Greg McGreevey & Greg Stoeckle | Invesco | 11 Februrary 2014

2013 was a transitional year for fixed income investors as the market woke up to the reality that extraordinarily accommodative monetary policy would not go on forever. The wakeup call was issued in the content of a May speech by US Federal Reserve Chairman Ben Bernanke when he said that the Fed would consider tapering its bond buying program. Reaction to the speech and anticipation of tapering drove the yield on the benchmark 10-year US Treasury note up over 120 basis points during the summer months. This touched off renewed volatility and confronted investors with negative returns tied to rising interest rate exposure.

Since then, the Fed has definitively announced an initial round of tapering on the back of increasingly positive economic news, but we were still left with negative total returns of -2.02% on the Barclays US Aggregate index and -2.60% on the Barclays Global Aggregate index for the year. On a positive note, the market had a rather subdued reception to the December tapering announcement, and both US and global fundamentals appear to be trending in a good direction as we head into 2014.

So where does this leave us for 2014?

1. What are the dominant macro trends that will influence the fixed income markets in 2014?

We believe the most important theme that will influence markets in 2014 is the level of growth that is going to be produced in both developed and developing economies in a post tapering world. Since the Great Financial Crisis, markets and market returns have been heavily influenced by central bank policy. We believe that markets are now transitioning from an environment driven by policy to one that is driven by growth and inflation, and, importantly, how growth and inflation evolve relative to market expectations.

Beyond this important transition, there are three developments we are watching. One is how investors will deal with the impact of what will be lower returns on their investments relative to what they have experienced over the last several years. The second development has to do with fiscal and monetary policy in a still highly levered world and one that has uneven and uncertain levels of growth, in my opinion. Third is the impact of structural change in China, Japan, and emerging market countries and how such changes are enacted. How these developments evolve could significantly impact markets globally.

Finally, I think it is important for investors to note that we have come off several years of solid market performance particularly in the credit markets where investors could generate good returns by just being in the market. Looking ahead, investors are going to have to be more discriminating. We think alpha generation through good security selection is going to be much more important than it has been in recent years.

2. You point out that one of the key themes for 2014 is likely to be a lower return environment relative to recent years. How do you see that influencing markets and investor behavior?

If you step back a minute and look at how returns have been driven over the past number of years, I think the Fed has done a phenomenal job getting investors to move into other asset classes beyond cash and Treasuries. They managed to get investors to allocate into more risky asset classes, and that has driven prices up in these markets. In addition to driving yields down for residential and corporate borrowers, their goal was to create a wealth effect through higher asset prices, and, from that effect, to attempt to get higher levels of consumption, driving overall levels of growth and employment higher. The Fed has certainly accomplished the first part of their object – that is, lower yields and higher asset prices – and, although not as robust as in prior cycles, better growth and employment.

Now we find ourselves in an environment where asset prices and asset returns are at least fairly valued or, in some cases, somewhat elevated relative to where they were several years ago. I think investors today are really asking, “How do I look at asset allocation and returns overall in an environment where asset prices are fully valued?” Given current valuations, I think expectations for future returns have to be lowered – and this comment applies to both the fixed income and equity markets. Assuming our assessment is correct, then how investors deal with this prospect will be a big driver of markets in 2014 and perhaps beyond.

3. Although not a perfect proxy for the entire market, the US mutual fund industry had some interesting flow patterns in 2013 that we can use to dissect demand. A few notable statistics are: $22.7 billion of fixed income outflows during the first 11 months of the year versus $197 billion of inflows into equity related funds. This was a marked reversal from prior years.

Looking underneath the broader trends, there are a few interesting facts in terms of specific sector flows, as these were very uneven across the marketplace. The top three fixed income sectors with inflows were bank loans, nontraditional bond funds, and short-term bond funds, while the largest three sectors suffering outflows were intermediate bond funds, municipal bond funds, and intermediate government funds. What does this tell us in terms of the influence of flows and how will flows impact returns in 2014?

Ultimately, flows in the market are going to be what dictate asset prices and returns, so they are something we follow very closely and will continue to follow over the course of 2014. Understanding what drives investor behavior is critical to understanding flows.

From a macro standpoint, recent asset returns have been correlated with overall liquidity in the market, which is something that any investor would expect, and specifically, returns have been correlated with the change in size of central bank balance sheets. Clearly, too much liquidity in the market is always going to drive asset prices higher, and the lack of liquidity is almost always the factor that creates significant market corrections.

You pointed out a couple of very telling statistics in the mutual fund arena where investors are doing a much better job today, than they have in the past, of going into asset classes that produce better returns, or, as you pointed out for 2013, into areas that have been less sensitive to the movement in interest rates.

You also pointed out that equity flows were much greater in 2013 than fixed income flows. This outcome was a change from asset allocation in the previous four years. As we talk to investors to get a feel for what flows are going to be over the course of 2014, we are not getting a sense that there will be continued or significantly increased inflows into equities at the expense of fixed income overall. That is really going to depend on the level and volatility of interest rates – and, we believe that fixed income market action will be heavily influenced this year by growth and inflation and how they play out relative to market expectations.

4. Risk assets performed best in 2013 with the credit markets ultimately turning in the fixed income market's highest relative returns. But current valuation levels are looking rather tight. How does this impact expectations for fixed income returns in 2014, and how will these returns be generated?

I believe asset prices are fully valued across both equity and fixed income markets overall. We have experienced very strong returns in the equity market in 2013, and we have also had strong returns in the very credit sensitive parts of the fixed income market, most notably high yield and bank loans. The more rate sensitive components of the fixed income markets have experienced flat or negative total returns for the year as interest rates have moved up.

If you look at almost all broad categories of fixed income markets, they are trading at a price above $100 with the exception of bank loans. In addition, many of those fixed income sectors are close to their 52-week high valuations, or low credit spreads. This leaves little room for continued spread tightening of the kind we have seen in recent years, and less opportunity for the price appreciation component of the total return equation. That means returns are going to be driven largely by yields in 2014.

Looking at overall yields, because underlying Treasury yields have moved up, many fixed income sectors now have yields higher than they were a year ago. That fact is a really important consideration for investor flows given the continued high demand for income and yield in the market. We expect this demand to continue given aging demographics, the funded status of many benefit plans, and other factors. Despite valuations being full, we find ourselves in a fixed income market with yields that are more attractive than they were a year ago and investors need for income.

5. Although yields have moved up, with spreads and valuations tight, it seems there is little room for error on the return front in 2014. Is it fair to say that the market has transitioned from being a beta driven market to one where more active management is going to define success?

Absolutely. I think it is one of the most important things for investors to consider in 2014. It is simply not possible, in my opinion, for the market to continue to produce outsized returns given what we talked about in terms of asset prices. Given that asset prices are fully valued, one has to uncover hidden opportunities across the board in alpha generation space. In recent years, investors needed only to have made an allocation to credit markets broadly to generate attractive returns.

We don't believe that is going to be the situation in 2014. If we are right, active management is going to be critical and the most important driver of returns in 2014. This is not a year to be a passive investor in index funds. Alpha generation is a zero sum game, so it is going to be critical for investors to pick the right investment manager – one who has the ability to move in and out of individual opportunities, or can uncover those individual alpha opportunities to add returns to their portfolio.

6. So is it fair to say that it is not just moving into the market in the right securities, but also knowing when to move out of the market and sell the right securities?

That ability is critical. As we move through 2014, it is going to be important to uncover those opportunities that will generate strong alpha within particular market sectors. There will be times when prices are driven to a point where we have captured the value in a given opportunity. From there, we will want to move on to the next opportunity. There are also going to be times, in a post-tapering world, when the market is going to go up and it is going to go down – anybody who has been in the investment market place understands this fact. You have to know when to reduce or increase your overall level of risk in order to generate above average returns, that is, to pick inflection points in the market. This ability to remain nimble in deploying both tactical asset allocation and alpha generation will be a distinguishing factor for successful investors, in my opinion, over the next year.

7. What are the big risks to the market in 2014?

I think the risks are related to what we think are going to be the big drivers in the market overall for the next year. First, we think a big driver is going to be growth, and most notably US growth. If US growth significantly over or undershoots expectations, we think either extreme could have a dramatic impact on asset returns in 2014. US growth that is much stronger than expectations would likely generate higher interest rates, truncating overall fixed income returns as a result. We also believe stronger growth would also lead to US dollar appreciation which could negatively impact EM market flows and pricing, especially for those countries with twin deficits.

The second risk has to do with how US employment develops. Assuming that the low labor participation rate is, at least in part, structural, we could see the unemployment rate drop to a level at or below 6% in 2014. Should that occur, the market may not believe the Fed's forward guidance, and it may begin to adjust for the prospect of higher short term interest rates. This type of uncertainty could push yields up, increase volatility, and cause the yield curve to flatten.

The third risk we will watch is what happens in China. Growth in China has been a significant macro driver since the financial crisis and is correlated with asset returns since that time. China is attempting very significant structural change, trying to move from an investment driven to a consumption driven economy. The prospect of policy or other missteps is something that looms large against that backdrop.

Finally, we will look at the developed economies of Japan and Europe for different reasons. The impact of structural change will require them both to conduct further monetary actions. Whether Japan can go through the final leg of their three-legged plan in dealing with cultural and economic job growth change is something we and the markets will monitor closely. With regard to Europe, we believe the Eurozone continues to operate with a significant amount of leverage, and it will need to resolve this leverage over time. These types of deleveraging cycles almost always result in GDP growth below trend levels, but can be favorable for asset prices when done effectively.

8. What would be your top recommendations for fixed income investors in 2014, and how should they be thinking about allocation strategies?

Now that the US central bank has moved, and tapering is going to be largely completed over the next year, we believe asset returns are going to be driven by growth and inflation. We are going to get back to what drives asset returns which is where we are in an economic or business cycle. If you believe that, then you have to put the economic cycle in perspective and highlight where you think different countries are going to be in that cycle over the course of 2014. Then we can talk about returns, and specifically within the fixed income marketplace, where we think there are going to be the best opportunities.

I personally believe global growth is going to somewhat higher in 2014 than it was in 2013. I believe the US and Japan will generate at or above trend GDP growth, with European growth continuing to be below trend, but higher than it was in 2013. I believe strongly that the Fed will not raise short term interest rates before the end of 2014, thereby keeping yields at the long end of the curve capped at lower than historical levels.

I believe this backdrop implies close to a 0% return for cash, given that we think the Fed will continue the zero interest rate policy that they have pursued for some time, and around 5% for returns for credit sensitive assets like high yield and bank loans. For asset classes within this broad risk spectrum, we would expect returns to range between 0% and to 5%, depending on the asset class, its duration, and yield.

The key is that returns are not going to be evenly distributed. As a result, we believe the most attractive opportunity in the fixed income markets will be credit sensitive asset classes like high yield and bank loans that will continue to be supported by investor flows and where individual managers can add a lot of value if they have the skills to select the right alpha opportunities overall. Investors can add value, too, if they can tactically add or remove exposure as particular sectors become overbought or oversold.

To summarise, in this post-tapering world, markets will be more driven by growth, inflation, and liquidity. Income will dominate fixed income total returns, but these returns will not be evenly distributed over the year. Markets will overshoot and undershoot. Investors will benefit from an active approach that nimbly adjusts to tactical allocation and alpha generation opportunities.

Greg McGreevey is CEO of Invesco Fixed Income. This interview was conducted by Greg Stoeckle, Head of Invesco Fixed Income Investment Solutions.