2010 fixed income outlook

WITH GLOBAL MARKETS COMING OUT OF RECESSION, ALBEIT SOME LESS FORCEFULLY THAN OTHERS, ANDREW CATALAN FROM STANDISH OUTLINES KEY DRIVERS FOR FIXED INCOME MARKETS FOR TODAY'S INVESTORS.

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The capital markets staged a remarkable rally in 2009 after nearly collapsing the prior autumn following the demise of several major financial institutions. The unprecedented coordinated global response by central banks provided the liquidity and support that fuelled the comeback. The equity and credit markets, which had the largest declines in decades, appeared to have no bottom as investors fled risky assets to the relative safety of cash, treasuries and gold. After a brief up-tick in late 2008, the markets again sold off in the first quarter of 2009 until a rally materialised in early March. Over the last nine months of 2009, risk aversion was cast aside and investors piled back into risky assets.

At the centre of the storm were financial institutions posting massive losses as mortgage-related securities were marked down. When it became apparent in early spring that the largest systemically important global banks would not be allowed to fail, investor confidence appeared to have been gradually restored. The Troubled Asset Relief Program (TARP) provided capital to most banks and finance companies whether or not they had requested assistance. The Temporary Liquidity Guarantee Program (TLGP) provided funding so that institutions that could not roll over commercial paper or short term debt would not default unnecessarily and escalate the crisis. Other programs such as the Fed's Term Asset-Backed Securities Loan Facility (TALF) were initiated to support the asset-backed and mortgage markets. The price of the help was of course greater scrutiny, criticism and even outrage by the public and politicians. Despite the turnaround in markets, the "Great Recession" left the economy weakened.

Considering the fundamentals

The economy was generally weak during 2009 punctuated by persistently high unemployment and the continued de-leveraging of the consumer. The earnings picture remained bleak throughout 2009 as weak demand and deflation in most industries resulted in lower revenues. Companies responded to lower demand by cutting expenses and capital expenditures and strengthening balance sheets. Cash has been built up and margins are improving, resulting in a negative financing gap. Companies therefore have the funds to expand, assuming they see a pickup in activity. While the lack of growth may not be ideal for equity investors, bondholders are in an attractive part of the credit cycle. Company management teams are doing the right things to navigate the weak economy and capital markets, placing the safety of the company ahead of shareholder pressures.

There are several industries that we believe are poised to perform well in 2010. Our analysis considers fundamentals, credit momentum and valuation in assessing relative attractiveness across industries over a three to six month horizon. Currently, insurance, metals and mining, cable, and banking appear relatively attractive as compared to other sectors. Within the financial institutions group, we continue to emphasise large global firms given their progress in fixing the balance sheet and the continual importance to sustaining the recovery.

Market technicals

Technical drivers to a great extent fuelled the rally in 2009 as fundamentals took a back seat. The implied level of defaults and downgrades that was priced into spreads was multiple times that experienced during any previous period[1]. Once the worst case scenario was off the table, investors had an insatiable demand for securities. Liquidity, however, remained constrained over most of the year. Since the crisis appeared to have centred on the very financial intermediaries that had previously facilitated trading, the de-leveraging of that sector reduced flows. Dealers moved from acting as principals to acting as agents.

The demand for bonds was partly met by substantial new issuance. Total issuance for 2009 by investment grade companies in the US corporate bond market totalled $1,075 billion, while those rated below investment grade issued $162 billion[2]. Corporate issuance should exceed $600 billion in 2010, with about 50% coming from the financial sector and the balance from industrials. Note that this level of issuance is insufficient to offset maturities and coupon payments. An up-tick in mergers and acquisitions, which appears likely, should result in some incremental issuance. Build America Bonds (BABs), and other taxable municipal issuance, will constitute a material component of supply in 2010. While these are not in the Barclays US Corporate Index, they will be a more meaningful part of the Barclays US Credit Index with over $100 billion expected in new issues during 2010.

Outlook

The financial crisis and weakened economy will likely pose some volatility and risks in 2010, which we outline as follows:

- Concern with sovereign credit quality will increase. These include not only the ones most in the headlines such as Dubai and Greece, but others that have deficits and substantial debt issuance.
- Municipalities will also be facing fiscal challenges.
- The impact of the eventual removal by central banks of emergency liquidity and support programs.
- A weak economy punctuated by persistently high unemployment and troubled housing market could result in a less robust recovery.
- Regulation and legislation centred around banks and health care may result in unintended consequences.
- Idiosyncratic or event risk will heighten in 2010 as the lack of organic growth and the reopening of the capital markets are both drivers of transactions.
- A continuation of the inflation vs. deflation debate and resultant volatility around interest rates.

The events of the previous two years will require time to heal. Our outlook for the corporate bond market remains constructive for 2010 despite the massive spread rally that transpired last year. The "easy money" has been made to a great extent, and returns in 2010 will likely be in line with historical figures. Our expectation is that spreads will continue to grind tighter and are expected to end the year in the +100 bps to +125 bps ranges for investment grade. Excess returns are expected to be positive with corporate bonds outperforming Treasuries. Compression should continue with less distinction by credit quality. This will present opportunities in the BBB and crossover (BBB/BB and high BB) segments. Credit curves should normalise as imbalances in the market are exploited, providing the most attractive opportunities in the intermediate part of the curve.

2009 was the year of "beta" with virtually all companies and industries posting incredible gains. Going forward with spreads normalising, low breakeven spreads[3] will necessitate careful credit assessment and relative value. Currently, we believe spreads are fairly valued, but under our base case scenario as the economy recovers, spreads should continue to tighten. Our themes for 2010 are:

- Gradual economic recovery will lead to improved corporate fundamentals.
- Continued strong demand from pension funds, insurance companies and foreign buyers. Supply will be insufficient to meet demand and concessions will be close to zero.
- Credit momentum will remain positive as improving fundamentals are somewhat off set by an increased focus on shareholders. Expect heightened event risk, although not as detrimental as experienced in the last cycle.
- Valuation march toward historical averages. Some parts of the market are overpriced, while others offer value, resulting in the need for careful credit selection as the "beta" trade will not be effective past the early part of 2010.
- Credit curves and capital structures inefficiencies will normalise.

Standish's investment strategies are distributed in the UK by BNY Mellon Asset Management International Limited.

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1 Source: Bloomberg league table

2 Source: Bloomberg

3 Breakeven = amount of spread that offsets widening, approximately = spread/duration