The benefits of a strategic approach to global bonds

Peter Cazalet
J.P. Morgan Asset Management

Monique Stephens
J.P. Morgan Asset Management

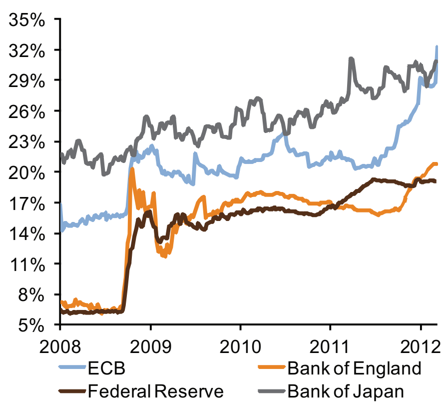
The fixed income sweet spot

Although government bond yields remain at very low levels, the broader fixed income universe has much to offer investors. Indeed, with interest rates at record lows and central banks pumping in liquidity, the current environment may be viewed as a sweet spot for fixed income investing.

Liquidity support creating a favourable fixed income environment

In 2012 to date, risk assets have powered ahead, with US equities reaching levels not seen since before the collapse of Lehman Brothers in 2008. The reason for this strong performance is the level of liquidity in the system. The European Central Bank's second long-term refinancing operation (LTRO) in February saw 800 banks take up a total of EUR 530 billion in three-year funding – and this follows the injection of EUR 489 billion in the first LTRO in December. Since the introduction of the LTRO, risk appetite has improved dramatically. Italian two-year bond yields spiked to 7.5% back in November, with concerns mounting over Italy's ability to refinance its debt. The same bond in early March was yielding around 2%, and Italy is on target with its refinancing over the year to date.

Figure 1:



Source: Bloomberg , March 2012

The extraordinary liquidity support is not coming only from the European Central Bank. The Bank of England announced a further GBP 50 billion of quantitative easing (QE) in February, while the Bank of Japan unexpectedly announced the equivalent of GBP 90 billion of additional QE. The Bank of Japan also announced a new 1% inflation target after more than two decades of zero inflation/deflation, a commitment that is expected to require yet more asset purchases. In emerging markets, meanwhile, several central banks have begun to cut rates and China has reduced the reserve requirement ratio for its banks. In sum, this global trend represents the biggest increase in liquidity since 2009 (Figure 1).

These liquidity injections are of course not without risk. One way to think of the LTRO is as a drug. The drug has done a good job of healing the patients – indebted European sovereigns and the ailing European banking sector – in the short term, but the long-term impact might be that of many drugs: addiction. Investors will need to keep a watchful eye on the ability of weak banks and sovereigns to wean themselves from central bank dependence.

However, the high levels of liquidity in the system create an extremely favourable environment for fixed income. Interest rates are expected to remain lower for longer: the Federal Reserve has indicated that it still believes rates will be at extremely low levels until the end of 2014, while the Bank of England has maintained the current record-low rates for three years now and is also not expected to move until 2014. In a low rate environment, investors go in search of yield – if they own cash, they move into government bonds; if they own government bonds, they move into investment grade corporates; if they own investment grade corporates they move into high yield. This is positive news for fixed income investors.

Positive investment climate expected to continue

In the coming years, the favourable environment for fixed income looks set to persist. The

Figure 2: Looking towards the future

	2006*	2012*	2016*
Economic Backdrop	Leveraging	Early stages of deleveraging	Continued deleveraging
BoE Base Rate (avg.)	4.64%	0.50%	0.50%
Gilt 10 yr	4.50%	2.11%	1-3%
UST 10 yr	4.79%	2.02%	1-3%
IG Corp OAS (GBP)	79	316	150-250
HY Corp OAS (USD)	325	609	350-550
EMBIG	206	342	150-300
Liquidity	ample	declining	impaired
Regulatory Environment	lax	tightening	strict

Source: JPMorgan Asset Management ,*Average over the year 2006, ** As at 12th March 2012 ***2016 figures are a hypothetical assumption

deleveraging cycle that began back in 2008 remains in its early stages, and has a long way to run. Debt levels in developed countries are still too high, and we expect them to continue to come down. As a result, Gilt yields and US Treasury yields may be expected to remain rangebound. Based on these assumptions, we expect to see yield compression in certain sectors of the fixed income market as investors are forced to move up the risk spectrum (Figure 2).

Attractive opportunities in high yield and emerging market debt

The key to bond investing in this environment will be dynamic and active sector allocation. Given the positive market conditions, the decision for investors will not be whether to be in fixed income or not, but where best to allocate to take advantage of the opportunities.

Parts of the debt market that currently appear attractive include high yield, which continues to benefit from strong fundamentals. Companies are in excellent health, and remain very cautious about taking on leverage. Default rates are low by historical standards, and we do not expect them to rise markedly this year. Technical factors are also favourable, with companies finding it easy to roll over their debt given the high number of investors entering the asset class. Finally, valuations are attractive, with investors being well paid to take on the additional risk of investing in high yield versus investment grade credit and government bonds.

In the euro market in particular, there are real opportunities, with solid high yield companies in the core Eurozone appearing to offer good value. Euro-denominated high yield bonds suffered last year from the general aversion to European assets that resulted from the debt crisis. However, euro high yield issuers benefit from better average credit quality than their US peers, with a lower average duration and a higher average yield. The liquidity injections from the ECB have served to weaken the euro, which is also good news for euro high yield companies, since many of them are exporters and therefore benefit from euro weakness.

Emerging market debt also looks appealing in the current environment. Bond investors are essentially moneylenders, and, like moneylenders, should be focused on the ability and the willingness of the borrower to pay. Assessing the global markets on this basis, emerging markets are simply better equipped to pay, given their lower debts and lower deficits compared with their developed market peers. This is borne out in the recent activity of rating agencies: while developed economies have been seeing downgrades to their credit ratings, emerging market economies are being upgraded. The average credit rating on the emerging market index is now investment grade.

So emerging markets are *able* to pay. They are also *willing*, given their desire for their economies to play a bigger role on the global stage. And, like high yield, emerging market debt currently compensates investors well for the risk they take on.

A flexible, strategic bond approach is key

Bond investors can capitalise on these and other opportunities offered by the current fixed income sweet spot by replacing rigid bond benchmarks with cash and taking a strategic view across global bond markets and sectors. Such a flexible, international approach can help improve diversification and boost risk-adjusted returns.

By allocating dynamically across global bond markets and sectors, investors can access a huge global opportunity set and position themselves wherever the greatest opportunities lie.