Fixed-income investors: Be flexible, be defensive or be different

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In the current environment, Gene Tannuzzo believes investors should consider three choices depending on their outlook.

Economic data has been deteriorating for much of 2019, albeit at a slower pace more recently. What should a fixed-income investor be focusing on in this weakening economic environment?

Gene: A weaker economic picture doesn't mean you have to avoid everything. Our approach is to take a defensive view of cyclical sectors and look at areas that are more domestically focused, domestically sourced and domestically consumed. We don't see this as a time to hide under the table. It's not a liquidity crisis, like we saw in 2008, but it is a time to be defensive. Mortgage- and asset-backed securities continue to be attractive in an environment where yields are compressed. Service-related industries like technology, food and beverage, utilities and telecom are generally domestically focused areas and can perform quite well. Optimally, you want to have the flexibility to pivot as warranted by market conditions.

Gene Tannuzzo, CFA
Deputy Global Head of Fixed Income

Can you speak to your duration profile right now and where you find better value on the curve?

Gene: Sure, but let's define duration first. Duration is interest-rate risk in a bond portfolio. So, as interest rates rise, the current value or the current price of our bond goes down and vice versa. We should be concerned about that because the longer we lend our money, the more sensitivity we have to duration or interest-rate risk. As interest rates go down, it's an opportunity to make money. Long duration means you've invested your assets in long-dated cash flows. That might be a 30-year bond to a company or the government.

In 2019, we've been shifting from long duration to shorter duration securities. I think 1.6 years was the low point so far in 2019, and today we sit around 2.75 years, but we started the year above a 5-year duration. I expect that to be a very dynamic profile. If we get into an environment where growth deteriorates and the Fed acts more aggressively, bringing front-end rates down, I believe it could be beneficial to the front end. We could also see growth accelerate, similar to 2016 when yields went up, but long maturity yields went up even more. Right now, I think the better risk-adjusted returns will be the front end of the curve – particularly the two- to five-year segment.

Can you talk about your view of high yield as we head into 2020?

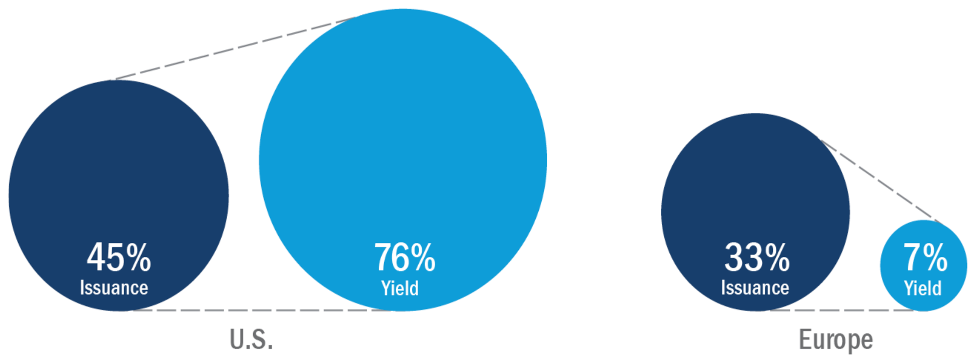
Gene: Overall, our high yield allocation is very low compared with where it has been in the past. As we close out 2019, we expect defaults in high yield to rise to 4% overall. However, those defaults will be concentrated in a few, very troubled sectors: we expect the energy default rate to be over 11% and telecom to be almost 7%. If you drill down in energy to oilfield equipment services, the default rate is likely to be more than 20%. But if we look at healthcare, financial services, media, real estate or retail, we can find industries with default rates below 2%. Within loans, we see a similar large dispersion. You just have to be very careful about opportunities in this sector.

How does the U.S. look relative to other regions?

Gene: If you look at the U.S. bond market, it makes up something like 45% of all debt in the world. But if you look at it on a yield basis, it contributes 76% of all yield. About a third of the bonds in the world come from Europe, but it contributes only 7% of all the yield in the world. So, while yields are low, the U.S. still offers a value proposition that's unique.

For fixed-income investors around the world, the U.S. offers a unique value proposition

The U.S. bond market contributes significantly greater yield relative to its share of bonds issued.



Source: Based on the Bloomberg Barclays Multiverse Bond Index, year-to-date through 11/30/19. The Bloomberg Barclays Multiverse Index provides a broad-based measure of the global fixed-income bond market. The index is the union of the Global Aggregate Index and the Global High Yield Index as it represents investment-grade and high-yield bonds in all eligible currencies. It is not possible to invest directly in an index.

Past performance does not guarantee future results. Indices shown are unmanaged and do not reflect the impact of fees. It is not possible to invest directly in an index.

Has the U.S. dollar affected your view on opportunities?

Gene: Historically, large spikes in the trade-weighted dollar tend to be correlated with periods of industrial weakness. Things like port volumes, rail car loading, truck volumes and air freight are all contracting about 5% year-on-year now. Earnings for S&P 500 companies that have greater than 50% of their earnings overseas are contracting by mid-single digits. Companies that make more than half their sales domestically are seeing earnings growth. This bifurcation is significant.

Generally, we don't think that this is an environment to take a lot of foreign currency risk. We are selective about emerging markets, looking for markets whose economic growth is not burdened by the strong U.S. dollar. There are some African and Latin American countries that have weathered the storm well — that's where we have exposure. But I also want to highlight that we don't have significant emerging markets positions at this time.

I think the question a lot of folks have is, where do we go from here, and how do we position our best ideas in this type of environment?

Gene: I think investors have three options depending on their outlook: be flexible, be defensive or be different. For those who want to be flexible, focusing on asset allocation and evaluating whether or not the reward is worth the risk is critically important, because opportunities — be it duration or credit management — are likely to be selective.

If you want to be defensive, you may want to take shelter in duration-sensitive products. Historically, when things go south, investors buy duration; they buy U.S. government bonds and core bond-type products that benefit as yields move lower. Being defensive can also mean taking shelter from everything like volatility in equities and volatility in rates. In that scenario, a short bond product makes the most sense.

Being different means looking for uncorrelated sources of return, and for us, that means a more dynamic approach to investing in structured credit like mortgage- and asset-backed securities. I would caution that taking this path requires flexibility, because the range of opportunity within the structured space varies.

[Q&A: Interest rate discussion and forecast]

There are risks associated with fixed-income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

The S&P 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.
The Bloomberg Barclays Global Aggregate Bond Index is a measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.
Bloomberg Barclays Global High Yield Index is a multi-currency measure of the global high yield debt market. The index represents the union of the U.S. high yield, the pan-European high yield, and emerging markets hard currency high yield Indices.

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