GENE TANNUZZO, CFA

DEPUTY GLOBAL HEAD OF FIXED INCOME

BE FLEXIBLE, DEFENSIVE OR DIFFERENT

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?

Tannuzzo: 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 telecoms are generally domestically focused areas and can perform quite well. Optimally, you want to have the flexibility to pivot as warranted by market conditions.

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

Tannuzzo: 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 five-year duration. If we get into an environment where growth deteriorates and the Federal Reserve acts more aggressively to bring short 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?

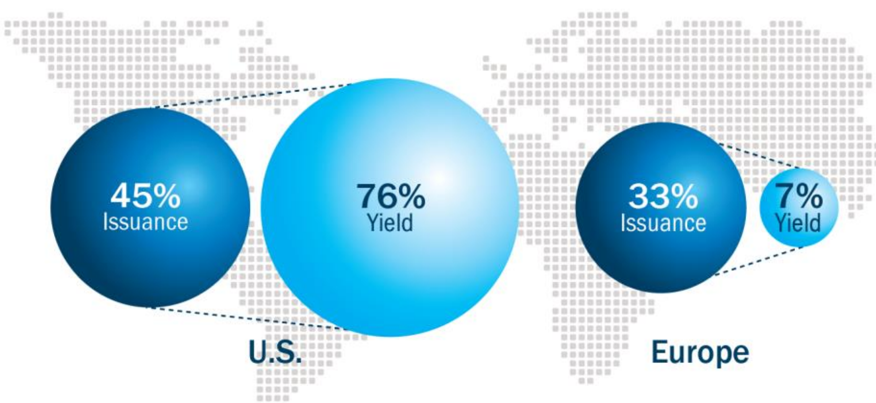
Tannuzzo: Overall, our high yield allocation is very low compared to where it has been in the past. As we close out 2019, we expect defaults in high yield to rise to 4% overall. However, those defaults will be concentrated in a few very troubled sectors: we expect the energy default rate to be over 11%, and in telecoms 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 bank loans, we see a similarly large dispersion. You just have to be very careful about opportunities in this sector.

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

Tannuzzo: If you look at the U.S. bond market, it makes up close to 45% of global debt. But on a yield basis, it currently contributes approximately 77% of all yield. About a third of global bonds come from Europe, but that only produces 7% of global yield. So, while global yields are low, the U.S. still offers a value proposition that stands apart.

Exhibit 1: Share of global bond market value vs. yield

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



Source: Bloomberg Barclays Bond Multiverse Bond Index as of November 30, 2019

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

Tannuzzo: Historically, large spikes in the trade-weighted dollar value 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.

We don’t think that this is an environment in which to take a lot of foreign currency risk. We are selective about emerging markets, looking for markets whose economic growth is not burdened by a 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 want to highlight that we don’t have significant emerging markets positions at this time.

Where do we go from here, and how should investors position their portfolios?

Tannuzzo: 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 they 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 conditions deteriorated significantly, investors bought duration—U.S. government bonds and core bond-type products—which benefit as yields move lower. This worked well in 2008.

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 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.

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