Schroders

For Financial Intermediary, Institutional and Consultant use only.
Not for redistribution under any circumstances.

Bizarro World

August 2019

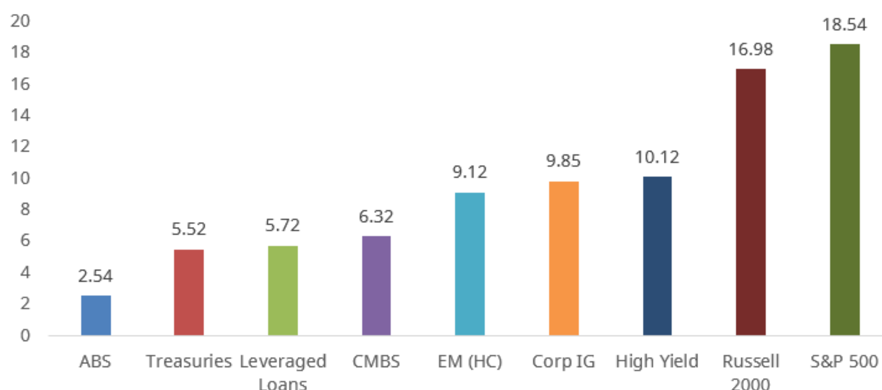
By the Schroders US Multi-Sector Fixed Income team

It seems like markets are back in the land of Bizarro World, where up is down and down is up. Some of you may remember this as a fictional comic book planet where the villain Bizarro lived, the opposite version of Superman. Others might remember the reference from the popular sitcom "Seinfeld", where Elaine befriends "Bizarro Jerry", a character who is like Jerry but the opposite. In our current Bizarro World, risk assets rally on bad economic data and sell-off on good data.

The most recent example of this was demonstrated after the release of the June payroll report. By all accounts, the data release beat expectations and confirmed the US labor market remains robust, a report that should have been well-received by investors. But instead, equity markets immediately dropped, with the Dow falling nearly 200 points in the two hours following the payroll data. This bizarre reaction reminds us of just how dependent markets have become on central bank liquidity. In this central bank-induced Bizarro Market, a good payroll print means the Fed is less likely to aggressively cut rates and that environment is less favorable for risk assets.

Indeed, the first half of 2019 saw remarkable gains across a variety of asset classes, with many fixed income sectors posting near double-digit returns.

Figure 1: Year-to-date total return (%)



Source: Bloomberg, as of June 30, 2019. Performance shown reflects past performance, which is no guarantee of future results. Returns are those of widely used, unmanaged index proxies. Investors cannot invest directly in any index. Actual results would vary due to, among other things, fees and expenses.

A large part of this rally is attributable to the notable pivot made by global central banks to assure markets that they would be willing to intervene to sustain the economic expansion. Although the Federal Reserve recently cut rates, the market is discounting nearly 75bps of rate cuts for the remainder of the year. This has led to tremendous returns in Treasury markets, in addition to continued momentum in credit markets. With risk assets now having retraced nearly all of the weakness from late last year, we think the easy money has been made and would suggest investors tread with a degree of caution when it comes to higher-beta sectors. Our expectation is that fixed income broadly will remain well supported in the second half, but will post more modest, coupon-like returns.

In July, the US economy will enter the longest expansion in its history. While the economy is still in expansionary mode, the pace of economic growth has clearly slowed as trade policy uncertainty takes a toll on business confidence and capital expenditures. We are also seeing the lagged effects of reduced fiscal stimulus, higher interest rates and a stronger dollar weighing on economic output. One bright spot remains the US consumer, who has benefited from an unemployment rate at generational lows in addition to lower taxes and

modest wage gains. Consumer leverage remains healthy and a still-elevated household savings rate suggests that consumption growth will remain moderate. Globally, the slowdown has been starker with growth in Europe expected to hover barely above stall speed in 2019 and Chinese growth projected to drop to its lowest levels since 1990. This has increased pressure on the respective central banks to support policy initiatives aimed at boosting growth.

At the moment, risk assets appear to believe in the omnipotence of central banks. Easier monetary policy has buoyed risk assets for the better part of a decade, and investors continue to chase returns in response to lower bond yields. One only needs to look at global equity indices (nearly every major market is posting half-year returns in excess of 10%) as compared to their fundamental underpinnings. First quarter earnings growth in US equities was essentially flat from a 20% run rate in late 2018 and expectations for the second half aren't much brighter. Multiple expansions, instead, has driven equities higher, as markets perceive the monetary-policy driven liquidity environment to be enough to keep risk sentiment positive.

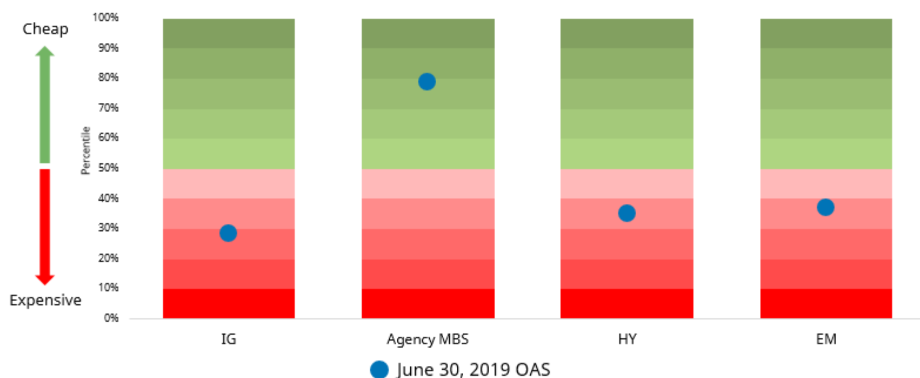
Another alarming example of liquidity trumping fundamentals in Bizarro World is the 14 junk-rated corporate issuers in Europe whose bonds are trading with a negative yield! This amounts to €6 billion or 2% of the European high yield market and is in addition to the $13 trillion of global debt with negative yields that exists globally. With flows rather than fundamentals driving returns, we suggest investors proceed with caution at this current juncture. Markets will need to navigate various cross-currents in the second half of 2019: uncertainty with regards to trade, a Fed that is easing amidst a cyclical slowdown, Brexit and the ramp-up of the 2020 election cycle… just to name a few. Our view is that the easy money in most markets has been made and that risk assets will face some challenges ahead. This is particularly true as valuations in credit sectors are now approaching the more expensive end of their cyclical range. The liquidity environment will likely keep risk assets supported, but it's difficult to see material appreciation from here absent a change in underlying fundamentals.

Figure 2: Market value of negative yielding debt ($ trillions)

Source: Bloomberg, as of June 30, 2019.

Valuation metrics tell us that corporates have only been more expensive 25% of the time versus their long-term history at a time when corporate leverage is at cyclical highs. While there are certain pockets of value in the corporate sector, current spread levels and underlying fundamentals results in a diminishing risk/reward profile.

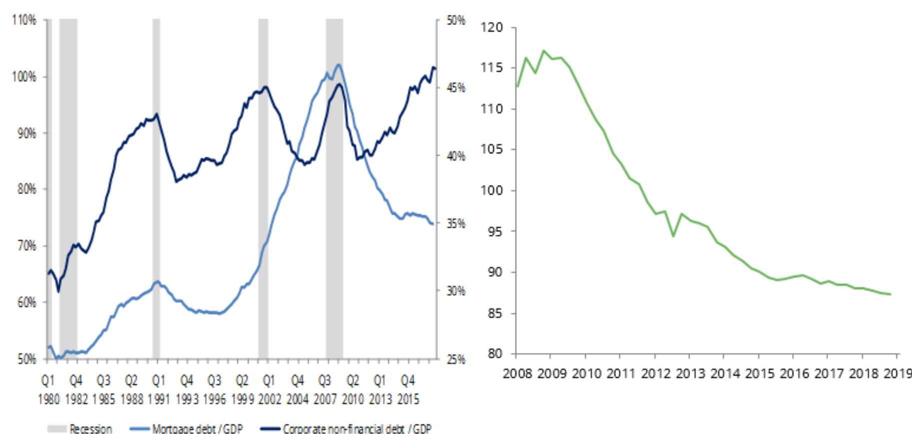
Figure 3: Current percentile of OAS for various spread sectors over the past 10 years



Source: Schroders, Bloomberg as of June 30, 2019. Indices are reflected as follows: IG is Bloomberg Barclays US Corporate Index; Agency MBS is Bloomberg Barclays US MBS Index; HY is Bloomberg Barclays US Corporate High Yield Index; EM is Bloomberg Barclays Emerging Market USD Aggregate Index.

Meanwhile mortgage valuations are near their cheapest levels of the post-crisis period. Fundamentals are also preferable, as debt growth in the mortgage market has significantly lagged that of the central bank induced corporate market. In addition, household debt as a percentage of personal income has come down dramatically since the crisis, further emboldening the strength of the US consumer and the case for relative value in mortgages.

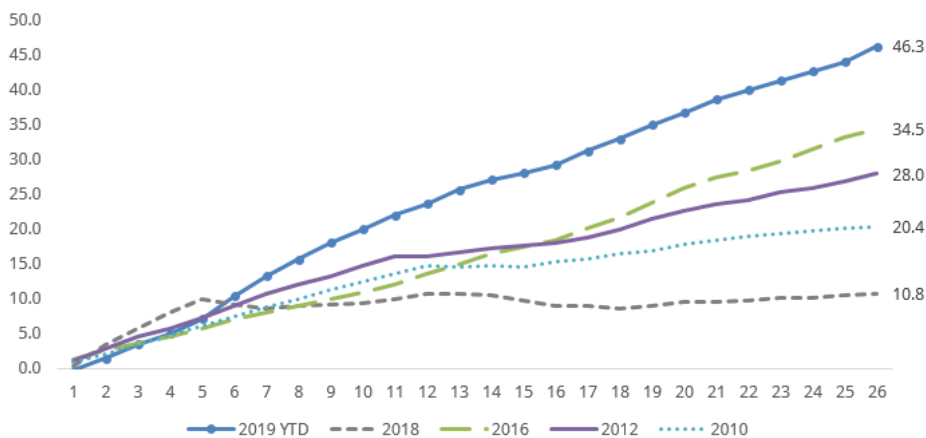
Figure 4: US corporate and mortgage debt as % of GDP vs. Household debt to personal income (%)



Source: Federal Reserve, as of June 30, 2019. MBER. Shaded areas reflect recessionary periods.

In terms of the municipal markets, we have witnessed insatiable demand for tax-exempt bonds. We mainly attribute this to investors seeking higher quality bonds and stability in the municipal market following the volatility of the fourth quarter in 2018. Year-to-date inflows into municipal bond funds have been running at a record pace for 17 consecutive weeks, with a cumulative $39 billion in total. The last time we saw such heavy demand was during the lead-up to the election of 2016 and, from a performance perspective, municipals generally underperformed other sectors in 2016—even on an-after tax basis.

Figure 5: Net Municipal Bond Fund Flows (by weeks for selected years, $ billions)



Source: ICI, as of June 30, 2019.

We expect history to repeat itself over the coming months, resulting in lackluster tax-exempt performance for the second half of 2019. In terms of gauging relative value, we use a measure call the Net Implied Tax rate (or NIT), which captures the relative valuations between tax-exempt municipals and similarly rated corporates. In over 30 years of running tax-aware strategies, the only time this proprietary metric was more expensive was in the summer of 2016, when the NIT dropped to -2.7. At this level, investors at the higher tax rates were forgoing income by owning municipals versus corporate bonds, on an after-tax basis. Today, we are near those lows again with the NIT hovering around 5. Coupled with low municipal Treasury ratios, the market is without a doubt expensive. We are therefore rotating out of tax-exempts into taxable bonds such as mortgage backed securities and corporates, where possible.

The Bizarro Market we find ourselves in is built on the somewhat unstable foundations of central bank largesse providing sufficient liquidity to support valuations regardless of quality. An environment like this provides a false sense of security to investors, disguising the true fundamental risks that they are taking. As long as central banks retain the confidence of the investment community this dance can continue. However, with such a fragile backdrop, expensive valuations and patchy liquidity, the second half of the year will be one for caution. After all, just like the medical profession, the first rule of fixed income investing has always been 'first, do no harm'.

Important information

The views and opinions contained herein are those of Schroders US Multi-Sector Fixed Income team, and do not necessarily represent Schroder Investment Management North America Inc.'s house views. These views are subject to change. This information is intended to be for information purposes only and it is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument mentioned in this commentary. The material is not intended to provide, and should not be relied on for accounting, legal or tax advice, or investment recommendations. Information herein has been obtained from sources we believe to be reliable but Schroder Investment Management North America Inc. ("SIMNA Inc.") does not warrant its completeness or accuracy. No responsibility can be accepted for errors of facts obtained from third parties. Reliance should not be placed on the views and information in the document when taking individual investment and/or strategic decisions. The information and opinions contained in this document have been obtained from sources we consider reliable. No responsibility can be accepted for errors of fact obtained from third parties. The opinions stated in this document include some forecasted views. We believe that we are basing our expectations and beliefs on reasonable assumptions within the bounds of what we currently know. However, there is no guarantee that any forecasts or opinions will be realized. Sectors/Indices/countries mentioned for illustrative purposes only and should not be viewed as a recommendation to buy/sell. SIMNA Inc. is registered as an investment adviser with the U.S. Securities and Exchange Commission and as a Portfolio Manager with the securities regulatory authorities in Alberta, British Columbia, Manitoba, Nova Scotia, Ontario, Quebec and Saskatchewan. It provides asset management products and services to clients in the United States and Canada. Schroder Fund Advisors, LLC ("SFA") is a wholly-owned subsidiary of Schroder Investment Management North America Inc. and is registered as a limited purpose broker-dealer with the Financial Industry Regulatory Authority and as an Exempt Market Dealer with the securities regulatory authorities of Alberta, British Columbia, Manitoba, New Brunswick, Newfoundland and Labrador, Nova Scotia, Ontario, Quebec, and Saskatchewan. SFA markets certain investment vehicles for which SIMNA Inc. is an investment adviser. SIMNA Inc. and SFA are indirect, wholly-owned subsidiaries of Schroders plc, a UK public company with shares listed on the London Stock Exchange. This document does not purport to provide investment advice and the information contained in this newsletter is for informational purposes and not to engage in trading activities. It does not purport to describe the business or affairs of any issuer and is not being provided for delivery to or review by any prospective purchaser so as to assist the prospective purchaser to make an investment decision in respect of securities being sold in a distribution. Past performance is no guarantee of future results. Further information about Schroders can be found at www.schroders.com/us or www.schroders.com/ca. Schroder Investment Management North America Inc., 7 Bryant Park, New York, NY 10018-3706, (212) 641-3800.