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Fixed income valuations: don’t tread on me

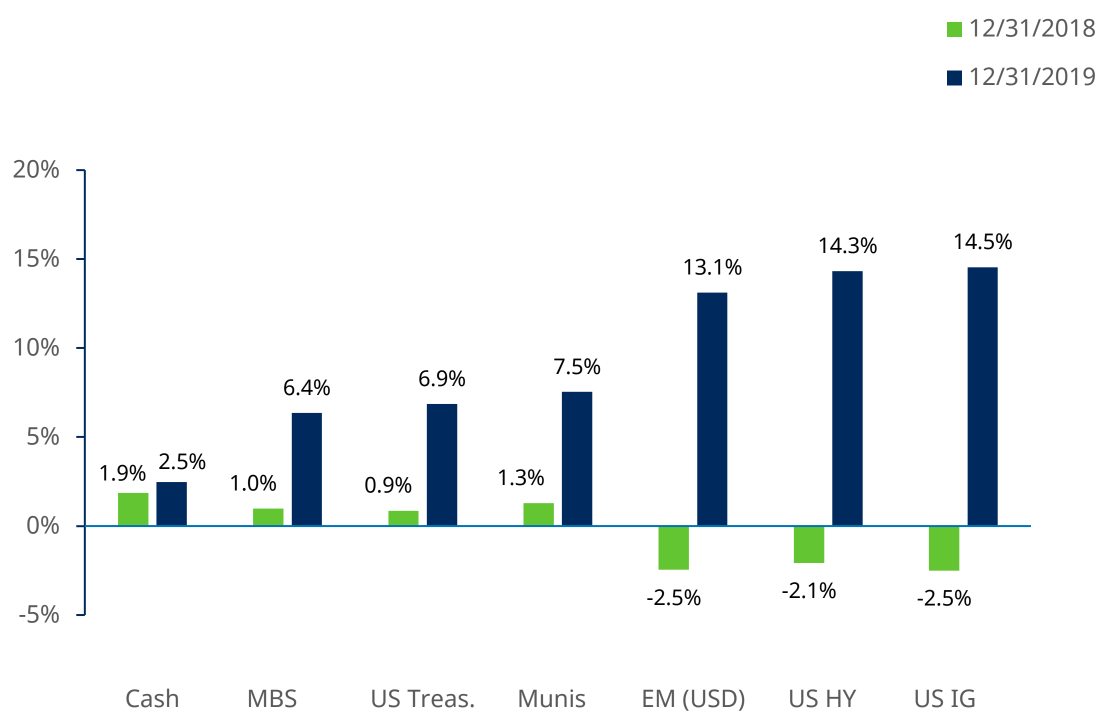
January 2020

By the Schroders US Multi-Sector Fixed Income team

- **We think it will be important to tread carefully this year with valuations at high levels and fundamentals now seemingly deteriorating.**
- **Global growth may stabilize, but we see little chance of a material upswing. Yields are most likely to remain range-bound with the Federal Reserve on hold.**
- **We see some selective opportunities in lower-risk and more consumer-related credit, but remain cautious, retaining cash for when better opportunities arise.**

If 2018 was the year when everything went wrong for bond markets, 2019 was the year when everything went right (see Figure 1). The Federal Reserve (Fed) reverted to easing mode, government bond yields collapsed, credit spreads narrowed and overseas demand for US assets was insatiable. Given the starting point, it is unlikely that fixed income returns in 2020 will come close to the double digits many investors have enjoyed this past year.

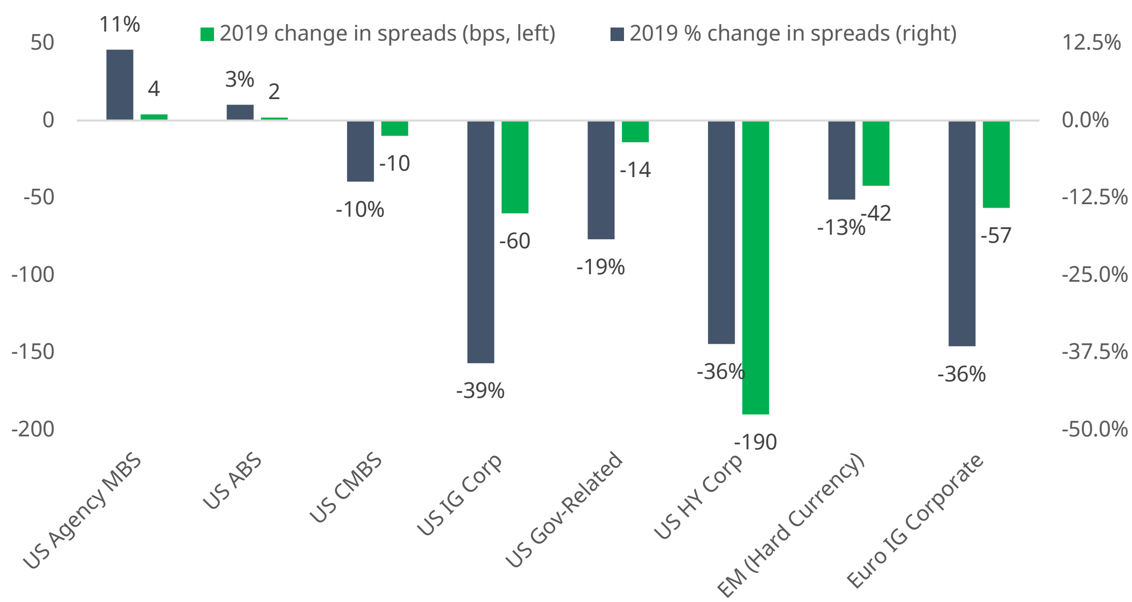
Figure 1: Increased sector returns from 2018 to 2019



Source: Bloomberg, as of December 31, 2019. Past performance is no guarantee of future results. Based on asset class index proxies.

Our outlook last year painted a compelling case for higher quality fixed income, for 2020 it is a little more nuanced. Government bond yields are almost half what they were in late 2018. Credit spreads – across both high yield and investment grade – are approaching multi-year lows. While the strong consumer was a constant trend throughout the year, many related securitized sectors did not experience a similar decline in risk compensation; however, differentiation between low and high quality borrowers seems to be absent at current spread levels. All this is to say, investors need to tread carefully.

Figure 2



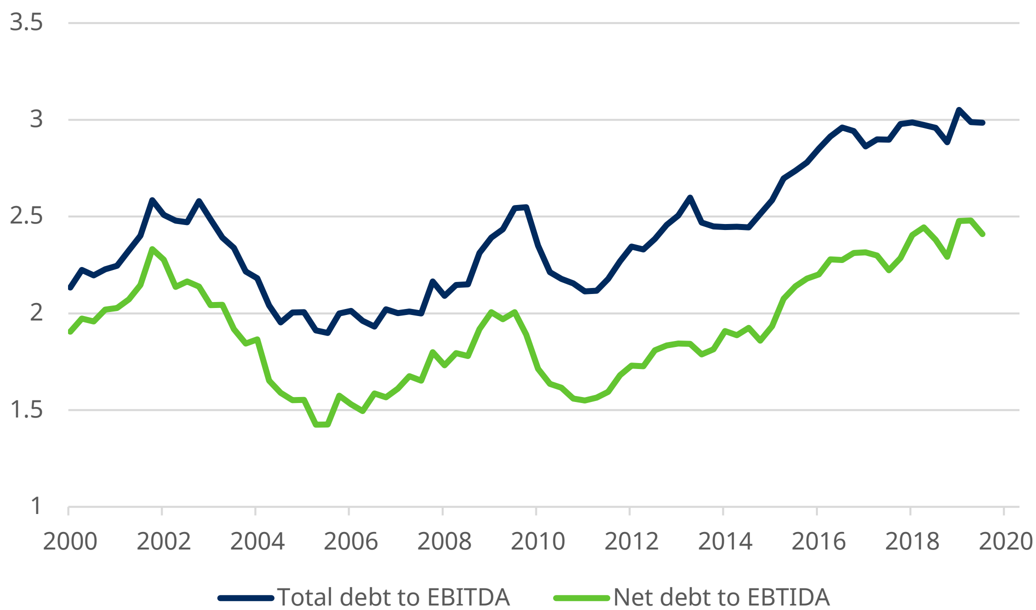
Source: Bloomberg, as of December 31, 2019. Past performance is no guarantee of future results. Based on asset class index proxies.

Valuations across a variety of asset classes, particularly credit, are approaching new highs while many of the fundamental drivers have been deteriorating. This creates an unstable equilibrium, suggesting the risk/reward balance in many assets is less favorable than it has been in some time. Given this backdrop, we are more defensive across our portfolios. We believe significantly better opportunities to redeploy capital will arise in the coming quarters. Having ample liquidity to redeploy during periods of market volatility is one of the best investments we believe we can currently make.

Prices rising, fundamentals stalling – buyer beware

The continued largesse of central banks, and the increased global stock of negative-yielding debt, which peaked at $17 trillion in 2019, has driven this disconnect between valuations and fundamentals. US corporate re-leveraging continues to climb, ballooning over the last decade and reaching peak heights by 2019 (see Figure 3). An indiscriminate demand for debt with positive yields drove investors to US credit despite shrinking earnings, slowing growth, deteriorating corporate balance sheets and increasing political risk.

Figure 3: US Corporate Index leverage



Source: Bloomberg, as of September 30, 2019.

However, we may be approaching an endgame in this merry-go-round of perpetual accommodation and relentlessly higher asset prices.

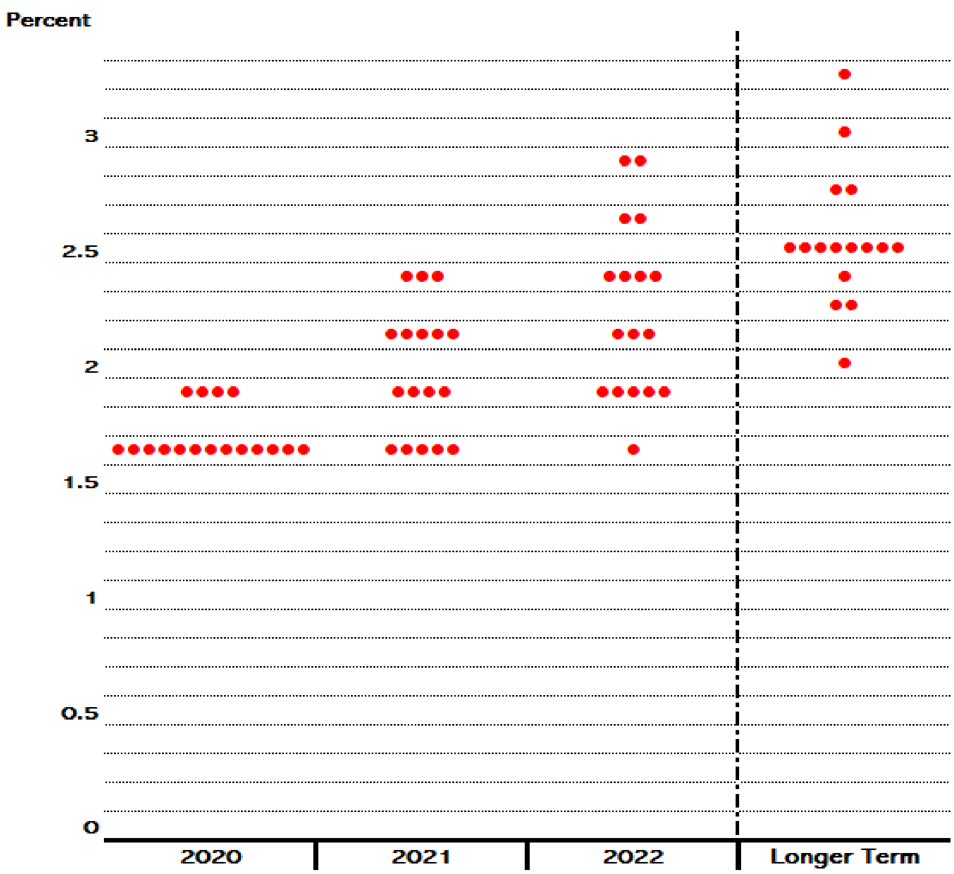
Why? Central bank ammunition is running low. The negative consequences of low to negative rates is increasingly in focus, and returns for overseas investors are no longer compelling as the cost of hedging currency risk has risen. Additionally, many investors are now buying assets unhedged, which makes demand increasingly vulnerable to any retreat in the dollar. This could prompt a rush for the exit.

Global economy stabilizes but downside risks persist

Although the recession fears prevalent a few months ago may have subsided, downside risk to the US economy persists. Projected 2020 global growth will be close to the lowest level in the post- crisis era. Any cyclical upswing next year is likely to be mild, as late-cycle dynamics of rising wages, limited capex and geopolitical headwinds weigh on economic growth and sentiment. The already modest US growth remains vulnerable to an increasing reliance on US consumer strength and a positive resolution of trade negotiations. Should either of these factors deteriorate, US growth could be substantially weaker.

After three “insurance cuts” through 2019, the Fed hopes to have done enough to alleviate the headwinds weighing on growth, and the motivation to move rates in either direction from here seems low, as evidenced by the Fed’s dot plot which illustrates their forecast for the Fed Funds rate (see Figure 4).

Figure 4: The Federal Reserve's Dot Plot



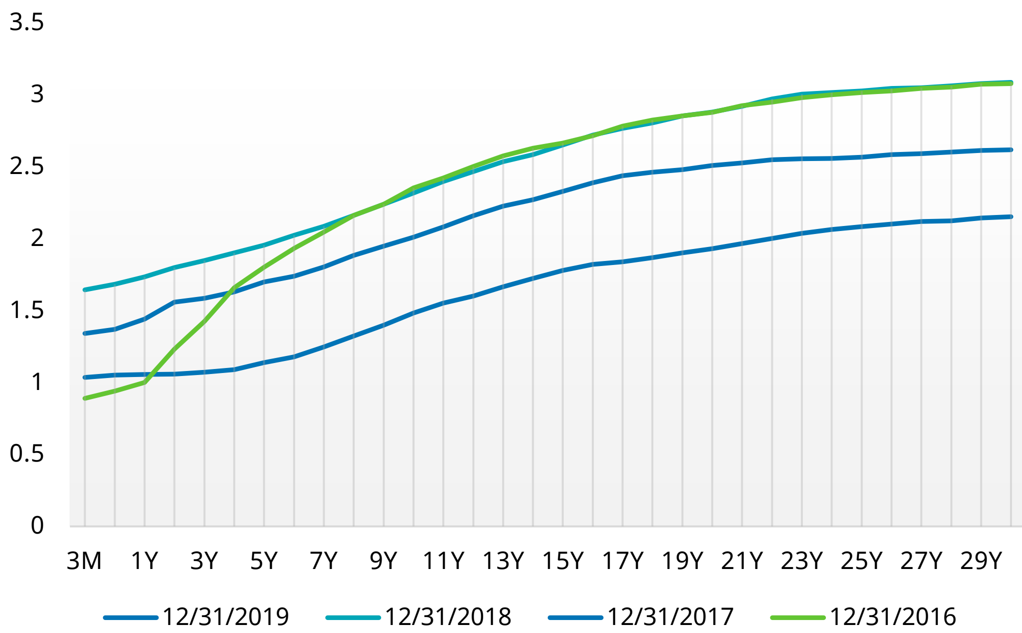
Source: US Federal Reserve, December 2019. The opinions stated in this document include some forecasted views. We believe that we are basing our expectations and beliefs on reasonable assumptions within the bounds of what we currently know. However, there is no guarantee that any forecasts or opinions will be realized.

However, with inflation absent, a strong dollar, and a deteriorating profit cycle, we think rates are more likely to go lower than higher.

We also expect range-bound bond yields over the next 12 months given the same rationale. Modest cyclical improvements may put some upward pressure on rates early next year, but the structural dynamics of growing debt, negative demographics and deflation remain relevant.

The municipal market had a record-breaking year on many levels in 2019. Municipal bond inflows broke the 2009 record of $78.6 billion, reaching $98.3 billion, which included 52 weeks of consecutive inflows. The dearth of viable after-tax alternatives is one contributing factor, while the lack of inflationary pressures and Fed cuts are larger contributors to the insatiable retail demand for tax-exempt municipal bonds. This resulted in new records for absolute municipal yield levels. In general, 10-year municipals reached a new low of 1.21%, and 30-year municipals were an eye popping 1.83% (see Figure 5).

Figure 5: AAA Muni Yields



Source: Bloomberg, as of December 31, 2019.

Low absolute rates also had an impact on how municipal issuers would approach the market. We saw $82 billion in taxable municipal bond issuance, which was in line with the amount we saw when Build America Bonds were issued in 2009 and 2010. If rates stay this low through 2020, our expectation is that taxable municipal issuance will be well north of $100 billion and could surpass the 2010 record of $117 billion. Valuations at current levels for tax-exempt municipals are at the more expensive end of fair value, however, taxable municipals have become more attractive.

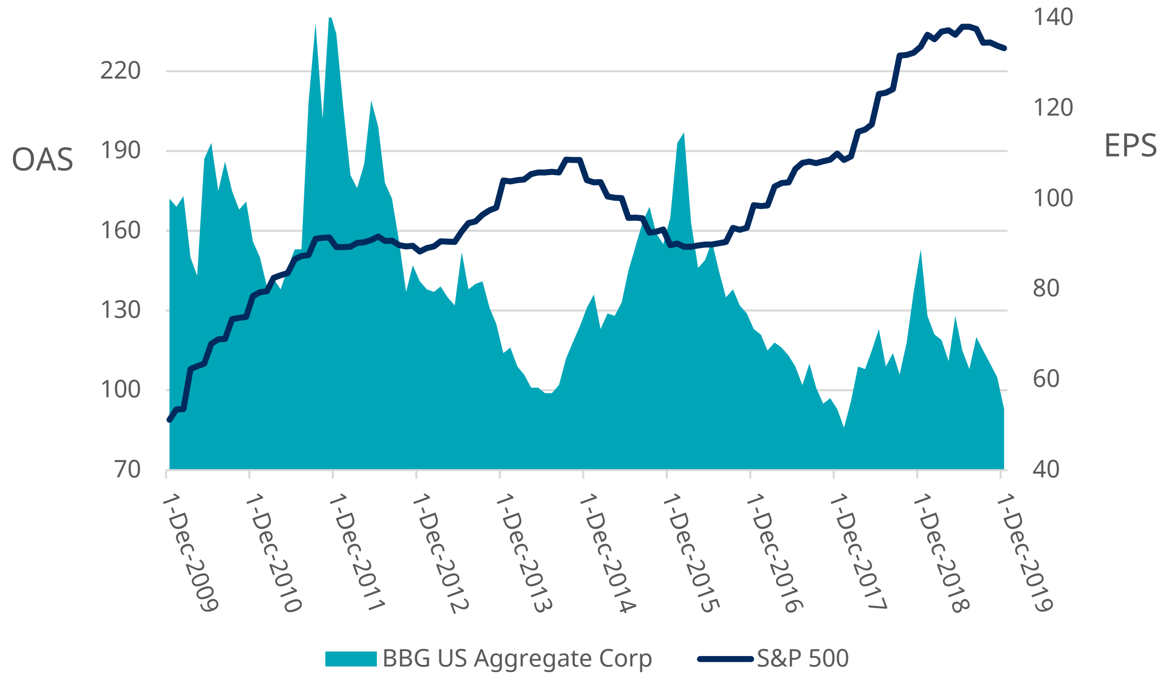
As a result, we will be looking for opportunities to allocate to taxable municipal bonds for both our tax-exempt and tax-aware clients in the coming months.

Patience is a virtue

If investing through several cycles has taught us one lesson, it is that stretching for risk when opportunities are limited rarely ends well. Prudence and patience remain the predominant themes within our portfolios, and allocations to higher-rated liquid assets will enable us to take advantage of higher volatility and more attractive opportunities in the coming months.

Current risk/reward in credit assets has become increasingly asymmetric. Credit spreads are back near their all-time lows reached in 2018, and earning are slowing after years of astonishing growth (see Figure 6).

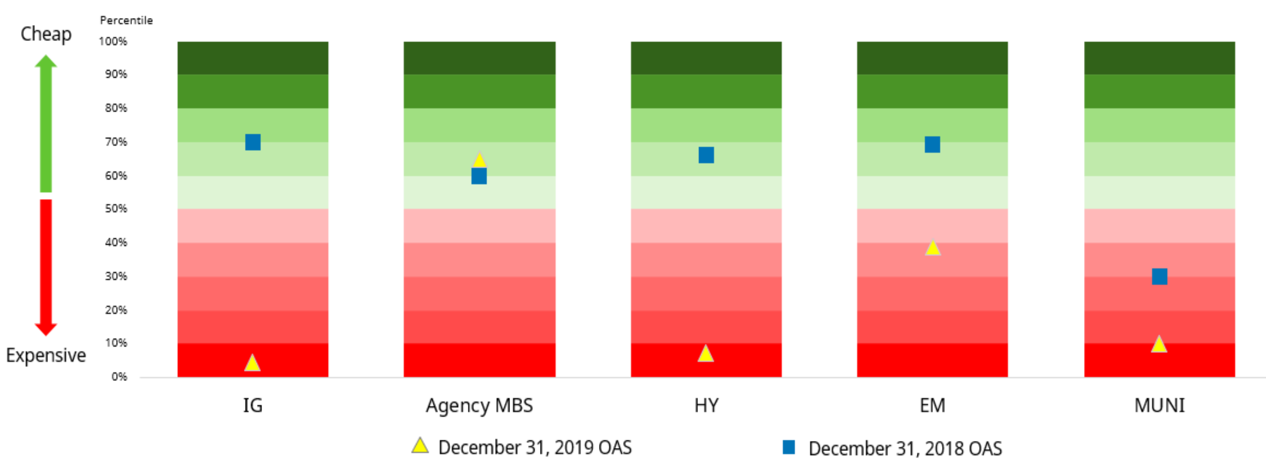
Figure 6: Spread vs. earnings over the decade



Source: Bloomberg, as of December 31, 2019.

Even in the most optimistic scenarios, excess returns will be muted. Credit spreads today are tighter than they have been 90% of the time over the last 10 years. Combined with unappealing fundamentals, central bank reliance, and a technical environment supported by foreign demand, the opportunity for upside appears limited.

Figure 7: Current percentile of OAS for various spread sectors over the past 10 years



Source: Schroders, Bloomberg, as of December 31, 2019. Indices used are the Bloomberg Barclays US Corporate Index, Bloomberg Barclays US Mortgage Backed Securities Index, Bloomberg Barclays Corporate High Yield Index, Bloomberg Barclays Emerging Markets USD Aggregate and ICE Bank of America 1-10 Year US Municipal Securities Index.

The riskiest parts of corporate debt are flashing even stronger warning signs, with increasing stresses in the lower-rated segments of both high yield and leveraged loans. When you scratch below the surface, the record highs for market indices may not be quite as healthy as they first appear.

As we diversify into securitized assets where we see strong relative value, credit risk continues to fall across our strategies. Valuations appear more reasonable, fundamentals geared to consumers are stronger, and the sector is far less reliant on the continued benevolence of European and Asian investors. ABS and mortgages offer more value historically, as can be seen previously in Figure 7, and are geared to the improving consumer balance sheet rather than the corporate one, which is already carrying a lot of debt. The structural protection of the high-quality securitized assets offers augmented stability in times of volatility. This is an easy relative-value decision at this stage of the cycle, looking through our value lens.

You can't predict the future, but you can always prepare

Fixed income returns are likely to be muted in 2020 relative to the double digit returns investors enjoyed in 2019. The Fed is likely on hold, but with a bias to ease, bond yields should remain in a narrow range. The global economy may see some modest improvements as stimulus takes hold, but the recovery will very much be stabilization, rather than a prolonged cyclical upturn. Riskier assets have run significantly ahead of fundamental drivers and we believe caution is merited. Portfolios should be prepared for lower returns and more volatility; we are focused on more liquidity to take advantage of more attractive opportunities and targeting stronger balance sheets in the credit exposure we do take.

When you're not being paid to invest, it's okay to be patient.

Important information