Schroders

Outlook

2013: A year in global bonds

Bob Jolly, Head of Global Macro, looks ahead into 2013

- In fixed income markets a passive approach towards market beta is unlikely to make you rich.
- Markets are likely to remain buffeted by the competing forces of politics and economics.
- The US fiscal cliff will become a fiscal slope.

With yields on developed market bonds still at depressed levels and credit spreads considerably lower than last year, it's clear that a passive approach towards global bond market beta is unlikely to make you rich this year. There cannot be a repeat in 2013 of the bond market returns of 2012. But it will be another year where markets will swing between euphoria – when either growth or politicians offer positive surprises – and misery – when either the political system takes its collective foot off the reform agenda or we see a temporary ebbing in economic momentum.

The long and winding road

Last year the theme of our global bond outlook was 'Turning Japanese', inspired by the hit song of the same name by eighties band The Vapors. We came to the conclusion twelve months ago that although most Western economies shared a number of similarities with Japan in the build-up to the credit crisis, there were critical differences in both the speed and magnitude of policymakers' responses, which had reduced the risks of a Japanese-style lost decade in the West. In hindsight, our conclusion was broadly correct: that there were sufficient differences to suggest both stock and credit markets were offering generous compensation for the embedded risks.

The greatest change in market expectations as we progressed through 2012 has been about the likely timeline for a change in accommodative monetary policy. The return to normality appears to be becoming an increasingly distant expectation. This is why, to continue the musical connection, the theme of this year's outlook is 'The Long and Winding Road', after The Beatles hit from 1970.

Plotting a course

2013 cannot repeat the performance of 2012. Yields on developed market bonds and credit markets are considerably lower, especially for corporate debt. The authorities have had a degree of success in reining in speculation about the eurozone going into a disorderly break-up, and this has driven periphery spreads tighter versus the core markets.

For 2013, where do we see the opportunities to continue to generate attractive risk adjusted return? Before polishing our crystal ball, there are a number of observations that help set our market and economic backdrop.

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Not a time for passivity

Firstly, it's obvious that in fixed income markets a passive approach towards market beta is unlikely to make you rich. Having seen cash rates fall below inflation, investors have moved out along the yield curve and credit spectrum, driving down bond yields. Today, many government bond indices offer nominal yields below prevailing rates of inflation. After the strong rally in 2012, corporate bond yield spreads have narrowed to levels where the yield may be positive in real terms but unlikely to produce a significant increase in passive investors' purchasing power.

Politics to remain a key driver

Secondly, markets are likely to remain buffeted by the competing forces of politics and economics. One of the drivers of the volatility seen in 2012 is recognition that policy error has the potential to make a bad situation considerably worse. Usually, markets can rely on either government spending or central bank easing to come to an economy's assistance should either a domestic or external negative influence drive down short-term growth expectations. Today, with very little policy room for manoeuvre, the negative impact of, say, an oil price or fiscal policy shock, would be considerably worse than normal due to the lack of policy options to deal with such a shock. While problems in the Middle East ebb and flow they clearly show little sign of disappearing altogether.

Politicians face an ongoing need to repair their nations' balance sheets and, with tepid growth expected throughout the West, pro-cyclical fiscal austerity is likely to leave economies needing as much help as possible from central bank authorities. Politicians like to be popular; they therefore find it especially difficult to execute politically unpopular policy measures and structural reforms. Markets dislike uncertainty, perhaps more than they dislike bad news itself. Uncertainty over the probability of both the implementation of structural reforms and whether governments have the willingness to commit what might be described as political harakiri also drive market volatility.

Market pressure

Although there was considerable talk in 2012 of economic reform, it only came about when markets forced policymakers' hands. A cynic might observe that once the market pressure abated so the pressure upon policymakers also abated and their willingness to execute the required change came to a grinding halt.

Why, you might ask, has the Spanish government not signed the politically-damaging Memorandum of Understanding to ensure ECB assistance in financing the Spanish governments funding needs? The most obvious explanation is the abatement in market pressure to do so.

Fade not follow

The mantra successfully used by the Schroders Global Multi-Sector Fixed Income team in 2012 has been 'fade rather than follow'. That is, to buy at times of extreme market nervousness and to sell at times of extreme positivity. We think 2013 will be another year where markets will swing between euphoria – when either growth or politicians offer positive surprises – and misery – when either the political system takes its collective foot off the reform agenda or we see a temporary ebbing in economic momentum.

Trends to watch in 2013

There are a number of important themes we expect to come to the fore in 2013:

1. France will struggle to maintain market confidence. The French economy continues to be overly sensitive to the state, and with so much state intervention it is gradually losing global market share. Its fiscal position is set to continue to deteriorate and 2013 could well be the year when market participants vote with their feet and begin to exert pressure on the French government to embrace a more rapid series of structural reforms.
2. Spain will ultimately sign the Memorandum of Understanding, most likely after a combination of market and EU political pressure has materialised.
3. The UK will struggle with sticky inflation. With inflation acting as a tax on the consumer, economic growth will remain fairly stagnant. Stagflation will be seen as a major negative for both UK assets and sterling.

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Bob Jolly,
Head of Global Macro

Bob Jolly joined Schroders in September 2011 and took up the role of Head of Global Macro in the Fixed Income team, with responsibility for a number of macro and multi-sector portfolios. He was previously at UBS Global Asset Management where he was Head of Global Sovereign, Currency and UK Fixed Income Portfolio Management. Prior to that he spent two decades at Gartmore Investment Management, where his roles included Head of Fixed Income Portfolio Construction and Head of Structured Fixed Income.

4. Japan will finally get serious about removing deflation. The printing presses will whir at potentially twice their historical speed. The Japanese yen will be the most likely casualty.
5. Asian countries – especially China – will introduce measures to boost domestic consumption. The change in the mix of growth will exert further downward pressure on some industrial commodities. The Australian dollar may well have seen its best days in terms of demand for its major exports.
6. The US fiscal cliff will become a fiscal slope. We are about to enter an extended period of fiscal austerity in the US and monetary policy will remain an accommodative offset.
7. Balance sheet repair will be an ongoing feature in both household and government balance sheets; financial repression is here for some time to come. Growth will do well to break stall speed.
8. The risk of a currency battle, perhaps even war, continues to grow. All Western countries want to boost exports to improve growth. The easiest way to boost exports is to boost competitiveness through a depreciation of a nation’s currency. Asian countries are likely to feel pressure to allow a more rapid appreciation of their currencies to help the transition.
9. The Middle East hopefully stops short of a much greater escalation in tension but the pressure cooker will continue to simmer. Risks are quite probably underestimated by markets, especially when you consider the economic havoc a $200 oil price would cause.