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MARKET INSIGHTS

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Strategic bond investing: Solutions for a new bond world

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Introduction

The bond world has been turned upside down. Developed world government bonds, for so long the staples of most bond portfolios, appear to offer little long-term value at current levels, under pressure from high inflation and rising interest rate expectations. In contrast, emerging market debt and high yield bonds, which have traditionally played a more marginal role in most portfolios, are increasingly providing the driving force behind bond returns.

In this paper Nicholas Gartside, international chief investment officer for global fixed income at J.P. Morgan Asset Management, provides an overview of the current macroeconomic environment, explains how the dynamics of the global bond market have changed over recent years, and suggests how investors can position themselves to benefit in this new bond world.

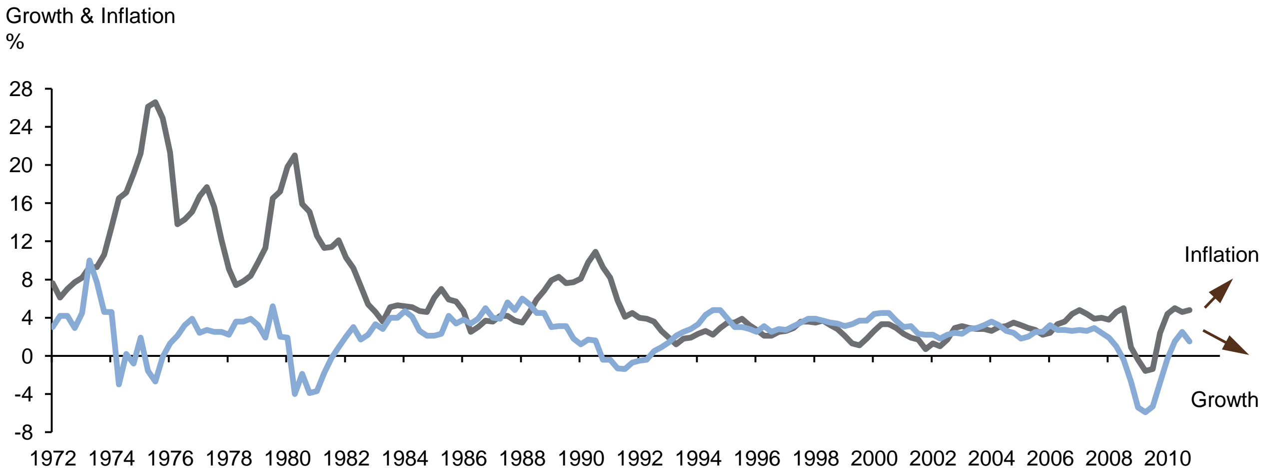
An anaemic economic recovery

The economic recovery in the developed world is being hindered by a massive public and consumer debt burden. The US economy, for example, grew at a disappointing 1.8% annual rate in the first quarter, down sharply from the 3.1% growth achieved in the last three months of 2010. Indicators suggest that US growth may have slowed further in the second quarter, with falling house prices and a weak labour market continuing to undermine consumer demand.

UK first-quarter GDP growth was just 0.5% quarter on quarter, mainly due to a collapse in consumption as the highly leveraged UK consumer continued to pay down debt. With the UK government about to cut spending sharply to tackle its considerable budget deficit, the recovery will come under further pressure as the public sector's contribution to GDP begins to fall.

Meanwhile, in the eurozone the sovereign debt crisis is putting considerable pressure on the peripheral economies of Greece, Ireland, Portugal and Spain. Peripheral GDP has collapsed as governments implement severe austerity packages to cut budget deficits and bring public debt levels down to more sustainable levels.

Exhibit 1 – **UK economic growth and inflation since 1972**



Source: UK Office for National Statistics. For illustrative purposes only.

Central banks are stuck between a rock and a hard place

In this challenging economic environment, western central banks continue to be guided by their specific objectives. In the US, the Federal Reserve (Fed) has a mandate to target full employment and an inflation rate around 2%. With unemployment at 9.1%, capacity utilisation falling and inflation only just above target the Fed looks set to keep interest rates on hold at close to zero for the time being.

In the eurozone, the European Central Bank (ECB) has a clear target to keep inflation at 2%. With inflation currently standing at 2.7% (May 2011), and with growth in the core eurozone economies (particularly Germany) still looking strong despite some recent softness, we expect the ECB to implement further modest interest rate increases in the coming months following the 25 basis points rise to 1.25% in April.

In the UK, meanwhile, the Bank of England faces a conundrum. Consumer demand is weak and unemployment is still too high, but inflation is double target at 4% (May 2011). The high inflation rate would argue for UK base rates to rise from their current record low of 0.5%. But the weak growth outlook means rate increases risk sending the UK economy back into recession, so any tightening from the Bank of England is likely to be limited while the economy remains so weak.

Stagflation – the enemy of bond investors

For developed market government bond investors, the past few years of weak economic growth and low interest rates have been positive for returns. However, there is now a major risk to this benign backdrop – namely stagflation. Stagflation's combination of weak growth and high inflation presents one of the worst possible scenarios for bond investors.

Economies function best when they are growing at a moderate pace, with modest inflation. This was the case in much of the western world from the mid 1990s through until the mid 2000s – a period that Bank of England governor Mervyn King has referred to as the 'Nice' decade (non inflationary, consistently expansionary). Taking the UK economy as an example, during the Nice period growth and inflation were roughly around the same modest level.

Today the UK is seeing much more elevated levels of inflation, while economic growth has dropped below trend. The Nice decade has vanished to be replaced, as Financial Times columnist Martin Wolf has put it, by something much more 'Nasty' (nightmare of austere and stagflationary years). This Nasty combination of high inflation and low growth is the enemy of fixed income investors, as it erodes the future value of a bond's fixed cash flows, both the coupon and interest payments.

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Interest rates – the only way is up

As we've seen, the weak growth outlook suggests the short-term interest rate environment will remain benign in the US, UK and eurozone. However, with inflationary pressures building and with interest rates in all three regions at, or close to, record lows, expectations are for rates to rise gradually back to more normal levels over the coming years. This is generally bad news for bond investors.

As interest rates rise, the value of the coupon paid by a bond falls. If you invest in a bond paying a fixed 3% annual coupon and interest rates rise from 3% to 4%, you will have to wait until your bond matures before you can reinvest at the higher rate.

If you do not want to wait until maturity, which may particularly be the case if you hold a bond that still has a lot of coupon payments remaining (ie it has a long duration), you could entice investors to buy your bond by dropping its price so that the yield becomes more attractive. As a result, rising interest rates usually mean falling bond prices, with longer duration bonds hit the hardest.

Focus on the best, ignore the rest

On the face of it, the outlook does not look favourable for developed bond markets, which are confronted by high headline inflation and the prospect of rising interest rates. Fortunately, the global fixed income markets are broad and diverse. Even though some developed economies are at risk from stagflation, there is still considerable value to be found for bond investors. The key in this new bond world is to focus on the best opportunities, and to ignore the rest.

The rest

1. **Cash** – Record low interest rates and rising inflation means that the real interest rate available for cash deposits in the US, eurozone and the UK is negative. When adjusted for inflation, bank deposit holders are seeing the value of their money gradually eroded.

2. **Government bonds** – Using a combination of real GDP growth expectations and inflation forecasts to work out a theoretical yield suggests that current yields for US, UK, German and Japanese government bonds are significantly lower than would be expected. Added to this, bond issuance is still high, despite austerity measures to cut fiscal deficits, while the investors also face uncertainty over the unwinding of quantitative easing measures implemented in the US, UK and Japan.

Exhibit 2 – **Government bonds looked over valued**

	Real GDP	Inflation =	Theoretical yield	Current 10 year yield
United Kingdom	2.00%	2.30%	4.30%	3.18%
United States	3.00%	2.20%	5.20%	2.93%
Germany	1.95%	1.90%	3.85%	2.92%
Japan	2.77%	0.33%	3.10%	1.12%

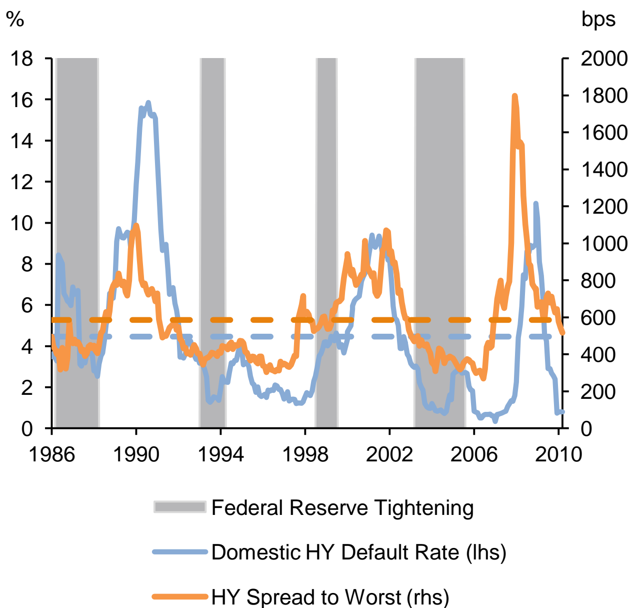
Source: J.P. Morgan Asset Management, Bloomberg, Economic Forecast 2012 and current 10-year yields, as at 16 June 2012.

3. **Inflation-linked bonds** – Breakeven inflation rates (the rate of inflation above which inflation-linked bonds begin to outperform fixed rate bonds) are high. This suggests investors will make money from the inflation protection element of an index-linked bond. However, any gains are likely to be offset by capital losses as interest rates rise. This is because index-linked bonds carry a lot of interest rate sensitivity and only a little inflation protection – for example, the average UK index-linked bond has a very long average duration of about 14 years.

The best

1. **High yield** – We expect high yield bonds to continue to deliver attractive returns this year. They offer an attractive coupon, averaging around 7% per annum, which gives good inflation protection. Also, default rates are continuing to fall as companies strengthen their balance sheets and benefit from rising profitability. As default rates fall, the spread over US Treasuries (a measure of high yield risk) should continue to tighten. We expect spreads to tighten by around a further 0.5-1% this year, which on a five-year duration bond will equate to about a 2-5% capital gain. Added to the high income, investors can expect a decent level of return from high yield this year. Investors should be prepared for some volatility, as high yield bonds have a high correlation to equities and so may experience bouts of volatility if equity markets correct. But given the strong fundamental valuations we would see any pullback as a buying opportunity.

Exhibit 3 – **High yield spreads and default rates**

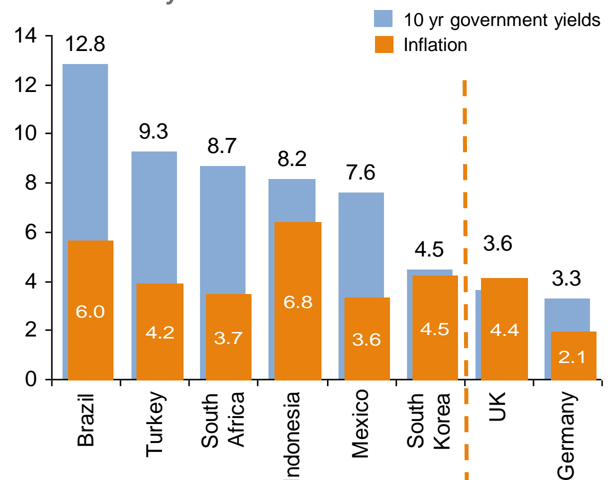


Source: J.P. Morgan Asset Management as at 11 February 2011

2. **Investment grade corporates** – Investment grade credit spreads ballooned out during the financial crisis of 2008/09, providing a once-in-a-generation opportunity for investors to buy investment grade bonds at extreme valuations. Spreads have contracted a lot since then, producing significant gains for investors. Although still above the pre-crisis levels of 2007, we believe it's unlikely that spreads will fall much further given the different capital requirements that now exist for corporations. However, there are many very attractive stock specific opportunities within investment grade. Therefore, investors should look to access this sector using a manager with strong credit analyst resources that are able to hunt out value and mitigate against default risk.

3. **Emerging markets debt** – Credit metrics are much more attractive in the emerging world than the developed world. Emerging markets have lower debt-to-GDP levels and higher economic growth rates, which means they have the resources to repay lenders. However, emerging markets face rising inflationary pressures, which mean investors need to look closely at real yields to see if they are being compensated to take on inflation risk. Brazilian bonds have a headline yield around 12%, while Brazil's inflation rate is running around 6%, so the real yield looks attractive at about 6%. South Africa, Turkey and Mexico also look attractive on this basis.

Exhibit 4 – **Emerging market bonds offer more attractive real yields**



Source: Bloomberg, as at 25 May 2011

Nicholas J. Gartside, *managing director*, is the International Chief Investment Officer, within J.P. Morgan Asset Management's Global Fixed Income and Currency Group. He is responsible for leading and overseeing the activities of our international fixed income teams, as well as being the co-manager of our multi-sector fixed income products and serves on the Currency Investment Policy Committee. Prior to this, Nick was at Schroder Investment Management for eight years, most recently serving as the Head of Global Fixed Income. Nick earned a B.A. in History and Politics from Durham University and an M.Phil. in International Relations from Cambridge University. Nick is a CFA charterholder and holds the Investment Management Certificate from the UK Society of Investment Professionals.

A flexible, strategic bond allocation is key

Bond investors can capitalise on the opportunities presented by today's complex global bond markets by replacing rigid bond benchmarks with cash and taking a strategic view across global bond markets and sectors. Such a flexible, international approach can help improve diversification and boost risk-adjusted returns.

At the moment, our strategic bond allocations are biased towards high yield and investment grade corporate bonds, where improving credit quality is providing good support. We also have meaningful allocations to US mortgage securities (both agency and non agency), which continue to offer attractive opportunities as they recover from the financial crisis, and to emerging markets, both through the emerging debt markets and through emerging currencies.

We maintain a relatively low duration positioning given the likelihood that global interest rates will rise, and have a negative medium-term view on developed market government bonds, which look to offer little value at current yield levels. However, the deflationary impact of the European sovereign debt crisis and the bumpy recovery being seen in the developed world mean we are ready to add duration if and when conditions dictate.

By allocating flexibly across global bond markets and sectors, investors can access a huge global opportunity set and position themselves wherever the greatest opportunities lie in this new bond world.

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