Where now for bonds?
A Q&A with members of the Henley Fixed Interest Team

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Amid a softening of central bank policy, bond markets have had a strong start to 2019, reversing some of the losses that characterised markets in the final quarter of 2018. Looking ahead, what are the prospects for bond markets for the rest of the year and where are there opportunities?

In this article, members of the Henley Fixed Interest team (Stuart Edwards (SE), Michael Matthews (MM), Thomas Moore (TM), Julien Eberhardt (JE) and Rhys Davies (RD)) discuss recent market developments and where they are seeing value.

The Fed has been softening its stance, the ECB has become more dovish and the Bank of England's hands are effectively tied by Brexit. What is your outlook for central bank activity this year?
SE. I think what we have seen in recent months is central banks responding to weaker data and a tightening of financial conditions by adopting a more dovish approach to monetary policy.

The US Federal Reserve have recently sent a strong signal to investors that they have entered a "patient period" on interest rates. As a consequence, the market, which as recently as November 2018 was pricing in a further three 25 basis point hikes in 2019, is now not expecting any further interest rate hikes over the next couple of years. What is also significant, and has represented a major development for financial markets, was the announcement that the Fed is now prepared to adjust the details of balance sheet normalisation in light of economic and financial developments. It stated that it would be prepared to alter the size and composition of its balance sheet if future economic conditions were to warrant a more accommodative monetary policy than can be achieved solely by reducing the Fed funds rate. The latest minutes reiterated this message, stating that FOMC participants thought it desirable to announce a plan to stop reducing the balance sheet before too long.

Historically, the Fed has not been prone to abrupt policy U-turns and it would therefore seem unlikely that they will revert back to a more hawkish stance anytime soon. Given this, I agree with the market that the outlook for US monetary policy is neutral or even slightly dovish for the foreseeable future. I expect the focus for upcoming policy meetings to be on communications related to the Fed's balance sheet, and specifically the timing of the end of the run-off and its eventual size.

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Some have suggested the Fed is making a policy error or that it is having difficulty signalling to the market exactly what it wants. What is your view?
SE. I think that the Fed has been quick to recognise the tightening of financial conditions that occurred in Q4 of last year and the risks that this posed to the US economy. The impact of trade tensions has arguably been deeper and more widespread than previously envisaged and combined with the recent government shutdown, has skewed risks to the downside. In that sense, I think that the Fed has done the right thing. The last thing they want to do is over-tighten and tip the economy into recession. Having a balanced, patient, data-dependent outlook does (almost by definition) create two-sided risks and a degree of ambiguity but this is far from a policy mistake.

What does the current Fed policy mean for the US dollar and emerging markets?
SE. The recent pivot in Fed policy is, by and large, good news for emerging markets, provided the recent downturn in global activity — that partly lay behind the Fed's shift - doesn't turn out to be too deep and protracted. It is also, on balance, slightly negative for the USD, at least initially. The outlook for the USD will partly be determined by how the US economy performs versus the rest of the world (ROW). The big story in 2018 was the concept of US exceptionalism and this drove the USD to outperform from April onwards, a development that many emerging market currency and bond markets had trouble living with. For a sustained and healthy rally in EM assets, what we really need to see is a dovish Fed, a softer USD (or at least one not markedly stronger), an abatement of trade tensions and some convergence in growth between ROW and the US.

How has Fed policy impacted your US corporate bond holdings?
MM. The Fed's decision to pause in its hiking cycle has led to a rally in US bonds and as a result the additional yield these bonds offer over their European counterparts has reduced. In my view, the US corporate bond market was becoming a crowded trade and so the rally provided a good opportunity to take profits and reduce some exposure. For example, I've taken profits on the exposure in Invesco Corporate Bond Fund (UK) to US telecoms company, AT&T. The fund's exposure to this company was increased early last year. This has been a successful position as the bond's spreads tightened on news the company plans to reduce its debt.

Looking ahead, I think the Fed's decision to pause is very significant. The more favourable interest rate environment this decision provides, could, in my view, help corporate bonds to rally further.

What about the European Central Bank. Have they also become more dovish?
SE. Faced with a weakening economic outlook the ECB has updated its forward guidance to say that eurozone interest rates will remain at current levels at least until the end of 2019. It has also announced a new TLTRO (Targeted Long-Term Refinancing Operation) programme. The need for a new programme had been discussed by ECB officials in the lead up to the meeting and so was not completely unexpected. Previous TLTROs have allowed credit institutions to lock in low rates for periods of up to four years and have been important for banks in the eurozone periphery. This new programme will have a shorter maturity with loans up to 2 years with the rate linked to the ECB's refinancing rate rather than the deposit rate, which was used for the previous TLTRO. Although this is clearly a more dovish approach by the ECB, neither of these measures are likely to have a material impact on the Eurozone growth and inflation outlook. For example, in terms of forward guidance, the market was not pricing in any tightening of policy until after the revised guidance date. Overall, the ECB's toolkit remains very limited and if the economy continues to disappoint then I would expect pressure to build for a more meaningful fiscal stimulus. However, our current expectation is that Eurozone economic data will start to show signs of improvement from the second quarter onwards, reducing the need for looser policy from the ECB.

How about the Bank of England?
SE. Taking a view on the UK is much harder. There is very little visibility on the outlook for UK monetary policy with so much dependent on Brexit. An avoidance of a hard Brexit on 29 March 2019 may provide some short-term impetus to the UK economy but with many issues still to be resolved, this will likely fall short of being an inflexion point. There is, perhaps, risk of a hike later in the year but justification for a more aggressive tightening is likely to be limited.

Italian spreads have widened recently. Is this a concern or an opportunity? What, if any, is the knock-on impact on the wider European economy/govt bond market.
SE. The risk premium in Italian government bonds (BTPS) has been elevated since the elections in March 2018 which resulted in a hung parliament and, three months later, a coalition between the right-wing League party and the anti-establishment Five Star Movement. The period since has been volatile on a mixture of concerns over the size of the public deficit and weak growth. Moreover, visibility on the path towards much needed reforms is poor. The government is seemingly unstable and there has to be a high chance of fresh elections at some point in the not too distant future but it is not at all clear that this will result in a stable government. All that said, Italy's commitment to the euro is not at this time in question and that should continue to act as an anchor for BTP valuations, even if the current premium persists. We recognise the structural issues underlining Italy's economy but current valuations and the volatility creates great tactical opportunities.

Did you use the back-up in corporate bond yields during Q4 to add risk in the Invesco Corporate Bond Fund (UK)?
MM. At the start of the final quarter of 2018 the Invesco Corporate Bond Fund (UK) was defensively positioned with a relatively high level of liquidity. As at 31 October 2018, 15% was held in cash, government bonds and bonds maturing within a year. This meant that I was well placed to add to some corporate sectors that had weakened and increase exposure to bank additional tier 1 (AT1). The rally this year has provided the opportunity to take profits on some of these positions. That said, I am still finding opportunities.

Has the duration position of the Invesco Corporate Bond Fund (UK) changed?
MM. The Invesco Corporate Bond Fund (UK) has held a market underweight level of duration for some time and this position has not changed. Currently modified duration of the fund is around 4.5. This level of interest rate risk is clearly significantly below the sterling corporate bond market, but in absolute terms still represents a reasonable amount of duration risk, thereby providing some downside mitigation in periods of market volatility. In recent months government bond yields have moved lower as they adjust to the more accommodative stance being adopted by central banks. So, overall, I think the balance of risk and return is still skewed against a significant duration position and that credit risk provides the better opportunity.

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Do you think there is a risk with the increased size of the BBB market?
MM. There's been a lot written on this topic recently and I think one does have to acknowledge that as the size of the market has increased then so too have the risks. But I'm not as concerned as some of the more alarmist reports. Much of the focus has centred on the risk of mass downgrades of the BBB sector should the economy weaken. I think these risks are probably exaggerated. In general, companies who have built a capital structure based on a BBB rating will take measures to consolidate their credit worthiness rather than risk a downgrade and the associated increase in their cost of capital. We can see this for example with BBB rated, AT&T, which recently committed to cutting its debt substantially. Of course, there will be exceptions and some companies will be downgraded, but I would expect this to be manageable.

Focusing on the fund, I think it is important to remember much of the exposure of the Invesco Corporate Bond Fund (UK) to this part of the market is through subordinated financials and hybrids. Many of the issuers of these bonds are high quality, cash generative issuers with single A or double AA ratings for their senior debt. The BBB rating on their junior debt reflects the subordination risk of the bonds for which the higher yields compensate and so in my view the risk of mass downgrades of these bonds is lower.

TM. As a high yield investor, I think we need to acknowledge that this is a risk. But, at the same time, some of the reports about mass downgrades of this part of the market do seem extreme. Michael mentioned AT&T, another example is GE. Rated AAA in 2009, the company's downgrade to BBB+ last year in many ways encapsulates the markets concern about corporate indebtedness. It is therefore interesting to note that GE is also addressing its debt levels. The company has recently sold its biopharmaceutical business for more than the market was expecting enabling it to reduce its borrowings.

Read more on this topic in the following blog: Is there a problem in BBB credit?

Where is the value in financials?
JE. Over the past year there has been a significant re-pricing of bonds and equities within the financial sector. I think this is particularly the case with bank equity, with many stocks trading at significant discounts to their book value. But I also see value in AT1s. That is not to say that the sector does not face challenges. It clearly does. However, most of these challenges are exogenous to the banks themselves: Italy, Brexit, trade wars and the more dovish tone being adopted by central banks. Importantly, these risks are all largely already priced into stock and bond prices in my view. If one looks at the banks' underlying fundamentals, these are good. Banks have continued to strengthen their capital position and so overall, I do think the sector offers value.

What is your take on the recent decision by Santander not to call its AT1. What does this mean for AT1s overall?
JE. I think the first thing to say is that at Invesco we view the AT1 market on an issuer by issuer basis. The bond covenants for each AT1 are very specific to the individual issue and so thorough due diligence is necessary when investing in this area of the market. The decision by Santander not to call the bond is a useful reminder to the market that the call feature is an option for the issuer and so it is something that we need to think about when conducting our analysis. Santander, have always stated that they will take an economic approach when deciding whether or not to call a bond and so in one sense the decision was not totally unexpected. The bond, which originally had a coupon of 6.25%, has reset to 5-year euro mid-swaps +5.41%. i.e. less than the current coupon. However, what did surprise us, and others in the market, was that in the lead-up to the call date there was very little communication with the market. The message was further confused by Santander's issuance of a new US dollar denominated AT1 in the week prior to the call date, which suggested the bond might be called.

Taking a step back, the fact that banks are taking an economic approach to the call option is a sign that the market is maturing. As part of our approach to managing this risk, one of the important criteria I look at when analysing AT1 bonds is the reset spread. This is the coupon level the bond will re-fix at if it is not called — essentially a spread over mid-swaps. I look for bonds with high reset spreads that compensate for the risk of non-call.

Are there opportunities in high yield?
TM. The high yield sector significantly re-priced in 2018, particularly during the last three months of the year. Year-to-date, some of this has been reversed in a strong market rally. Nonetheless, credit spreads within this area of the market are much more favourable for investors than they were a year ago and as a result I am now able to find opportunities across sectors. Two areas of focus for the Invesco High Yield Fund (UK) are retail and energy. These sectors have come under pressure amid heightened investor concerns and are trading cheap relative to the wider market. However, within both sectors there are still some relatively stable companies, which are conservatively financed. Elsewhere, the end of the ECB's Corporate Sector Purchase Programme has contributed to a cheapening of the BB part of the high yield market, creating some investment opportunities.

As Julien has mentioned, one area of the market that saw significant re-pricing was the financial sector. Spreads for AT1's went from 252bps in January 2018 to 491bps in early January 2019. Having started the year with a low level of exposure to the sector relative to the recent past, I took the opportunity of this re-pricing to lock in some yield and increase the Invesco High Yield Fund (UK) exposure in subordinated financials.

Overall, even taking account of the rally this year, credit spreads remain cheap relative to where they were 12 months ago. What is also significant is that there is now a lot more dispersion within the market. This is something we have not seen in the market for some time and is providing some interesting investment opportunities.

A sector that has come under pressure recently is autos. What is your view on the sector?
RD. This is a cyclical industry and signs that the global auto cycle may be turning have weighed on sentiment for some time. Further adding to the market's concerns is the outlook for China, which is today the largest car market in the world.

There are also more idiosyncratic issues. One example is Jaguar Land Rover (JLR). Across funds we have not owned much JLR or participated in their new issues for a couple of years. However, we have recently added exposure to some funds following weakness. While I believe that the headwinds JLR faces are very real and substantial, I think that the yields available today (the company's 3-year bond currently yields over 8%) compensate for these risks. That said, we do need to be cognisant of the risks to the company and so our focus is on shorter-dated bonds.

Summary
The final quarter of last year saw some significant spread widening in credit markets on the back of weaker economic data and trade tensions. The managers of the Henley Fixed Interest funds took advantage of this environment to add yield to their respective portfolios. In 2019 the Fed has become more dovish, leading to a strong rally in credit markets, which in turn has provided opportunities to take profit on a few of these positions. Yields and credit spreads remain higher than we saw for much of 2018 and we remain constructive on the outlook for the bond markets.

Investment risks

Invesco Corporate Bond Fund (UK)

The value of investments and any income will fluctuate (this may partly be the result of exchange-rate fluctuations) and investors may not get back the full amount invested.

The securities that the fund invests in may not always make interest and other payments nor is the solvency of the issuers guaranteed. Market conditions, such as a decrease in market liquidity for the securities in which the fund invests, may mean that the fund may not be able to sell those securities at their true value. These risks increase where the fund invests in high yield or lower credit quality bonds and where we use derivatives. The fund has the ability to make use of financial derivatives (complex instruments) which may result in the fund being leveraged and can result in large fluctuations in the value of the fund. Leverage on certain types of transactions including derivatives may impair the fund's liquidity, cause it to liquidate positions at unfavourable times or otherwise cause the fund not to achieve its intended objective. Leverage occurs when the economic exposure created by the use of derivatives is greater than the amount invested resulting in the fund being exposed to a greater loss than the initial investment. The fund may be exposed to counterparty risk should an entity with which the fund does business become insolvent resulting in financial loss. The Fund may invest in contingent convertible bonds which may result in significant risk of capital loss based on certain trigger events. Changes in interest rates will result in fluctuations in the value of the fund.

Invesco High Yield Fund (UK)

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