Viewpoint

Fixed Income – Outlook

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2015 – The year of living carefully?

Core fixed income markets are offering lower potential returns at a time when risks in a multitude of guises persist. Does this reflect complacency? Is it evidence of increased risk-taking to meet unrealistic return targets, or is it a positive response to the deflationary forces that are appearing globally? Are all fixed income markets the same? While yields are certainly low, spreads in corporate bonds are not far removed from the long-term norm and in high yield and emerging markets there may be an opportunity in shorter-duration corporate debt and higher-yielding sovereigns.

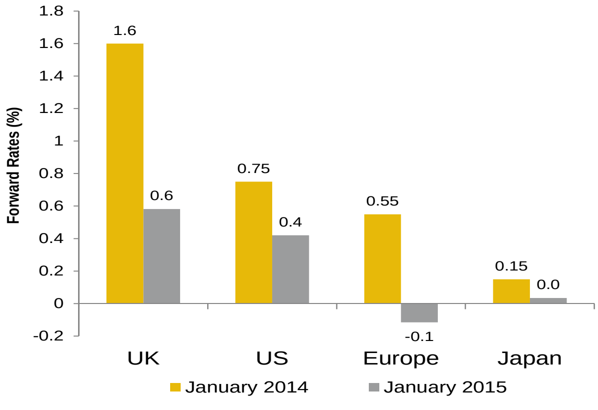
Following a year in which the UK government bond market generated total returns of over 14%, investment grade bonds over 12%, European high yield around 6% (in euro terms) and US dollar-denominated emerging markets around 6%, it is difficult to imagine that returns in 2015 will be as strong. Yields are very low both in historical terms and in relation to present and expected rates of inflation, yet dangers persist, both geopolitical and economic.

We have identified some themes within the market:

1. Investors may be complacent about the outlook for interest rates in 2015

Central bank policy has supported global markets with the combined balance sheet of the G4 central banks (the Federal Reserve, the Bank of Japan, the European Central Bank and the Bank of England) expanding massively in recent years. Meanwhile, market expectations of where interest rates will be by the end of 2015 have moved meaningfully lower from where they were a year ago. Indeed, it is getting hard to imagine that investors could become any more dovish than is now the case, about prospects for interest rates. Thus, markets are discounting one rate increase in the US by the end of 2015, and no increases in interest rates in the UK until mid 2016, while neither is any move expected in the eurozone or Japan.

Figure 1: Market expectations of interest rates at the end of 2015

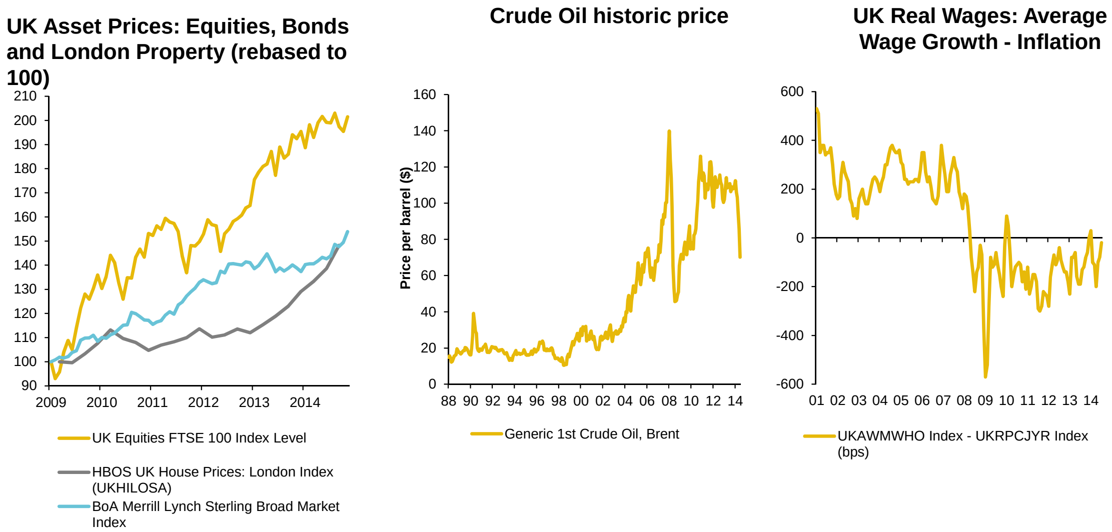


Left: Source Bloomberg, Threadneedle, EcoWin Reuters November 2014.
Right: Source Federal, UK, European, Japanese Forward Rates, Bloomberg, Threadneedle as at 16 January 2015.

2. Declining inflation has supported bond markets

The decline not only in inflation but also in inflation expectations was one of the main driving themes of 2014 and it partly explains why core bond markets have moved so strongly. The huge decline in oil prices, with Brent falling from over US$140 a barrel in 2007 to around US$55 today*, is responsible for some of the fall in inflation and inflation expectations. A lack of aggregate demand in some regions and the absence of any significant sign of wage inflation, even in economies with reasonable growth, such as the US and UK, have added to these disinflationary pressures. Consequently, the contrast between the fortunes of the providers of labour and the owners of assets are meaningful as property, bond and stockmarkets have continued to perform strongly.

Figure 2: Inflation can be a matter of perspective



Top left: Source Bloomberg, Merrill Lynch, Threadneedle as at 30 November 2014. Indices: TUKXG, UKHILOSA, UK00.
Top middle: Source Bloomberg, Threadneedle as at 30 November 2014. Generic 1st Crude Oil, Brent (CO1 Comdty).
Top right: Source Bloomberg, Threadneedle as at 30 November 2014. Spread of Average Weekly Earnings 3 Month Average Growth Whole Economy YoY (UKAWMWHO) minus UK CPI EU Harmonized YoY NSA (UKRPCJYR).

3. Investors no longer appear to be pricing in the increasing political risks facing the eurozone

High and stubborn levels of unemployment remain part of the economic landscape especially for the younger generation in many parts of Europe. There has been little sign of accelerating economic growth and scant indication of rising wages, even years after the global financial crisis. Perhaps unsurprisingly against this backdrop, there has been a rise in the appeal of more extreme political forces in many countries, most recently observed in the election of Syriza with its anti-austerity rhetoric in Greece.

Yet with the ECB's bond-buying programme providing support, peripheral European government spreads have compressed further. Where once in 2012, Italian government bonds offered a 7% yield and 500 basis points of spread, yields have now have tumbled to 1.5% and spreads have collapsed to 120 basis points.

This is not to suggest we expect a rerun of the eurozone crisis. It is more that the comparison between increasing political risks and ongoing economic challenges comes at a time of dwindling spreads and ever lower yields.

Very limited scope for further meaningful returns in some government bond markets

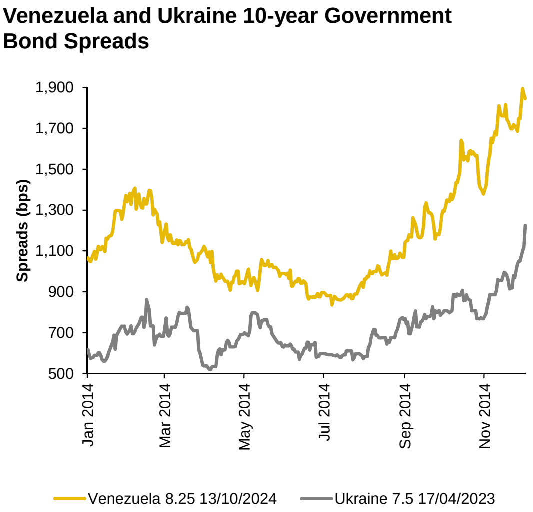
Core government bond yields have been declining since the early 1980s in the UK, the US and Germany. As mentioned earlier, the upside potential in some markets is now very limited in the historical context. German government bond yields have reached record lows with, for example, the five-year bond delivering virtually zero in terms of yields and it is a similar case in Japan, while the yield in Switzerland is negative**. It is only in the US and the UK that there is some upside potential. It is not only fears about Europe's economic outlook that are driving yields lower. Falling inflation is also forcing real yields lower and thus investors are willing to receive lower real returns from investments in these so-called "risk-free" assets.

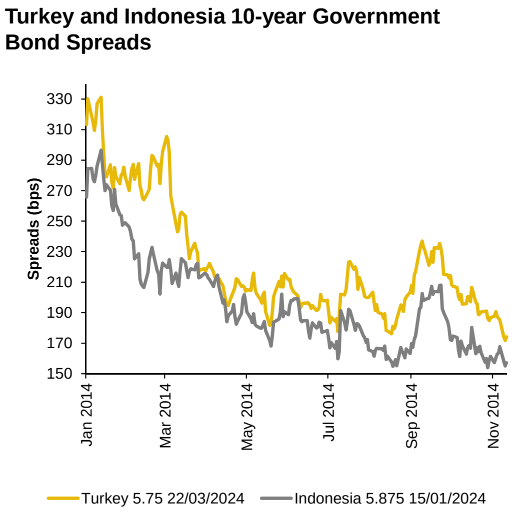
*Price as at 5 February 2015 **As at 5 February 2015

Emerging market bonds are far from homogenous

Varying economic performances, geopolitics and the impact of declining oil and commodity prices are key influences that are causing sharp variations in the performance of emerging market debt. Thus the likes of Ukraine, which has been hit by geopolitical instability and a slowing economy, and Venezuela, which is highly exposed to the falling oil price, have fared poorly in the second half of 2014, while Turkey and Indonesia, which have a much more favourable backdrop, have performed well. This divergence between winners and losers represents an opportunity for active managers.

Figure 3: An environment that favours active managers





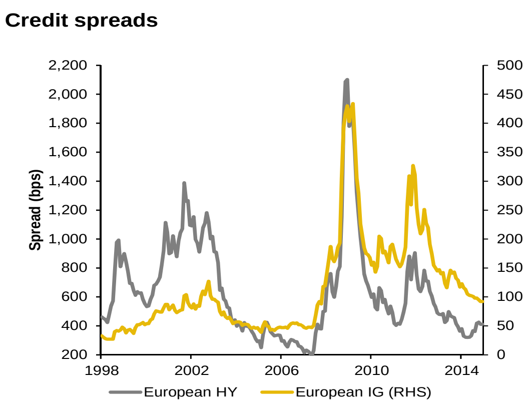
Source: Bloomberg, December 2014.

Corporate and high yield bonds

There is concern that corporate bond spreads have tightened to a level such that a crisis severe enough to unwind several years of accumulated gains could occur. We list in Figure 4 some of the key indicators that might predict an imminent and meaningful correction in credit spreads. As can be seen by the flags attached to the indicators in Figure 4, we do not believe the end of the credit cycle is imminent. Moreover, the sole red flag that we have identified below (abnormally low volatility) can remain red for extended periods.

Figure 4: Key indictors suggest credit cycle has further to run

Key Indicators	Flag
1. Tight policy conditions	
2. A deteriorating economic backdrop	
3. Expensive valuations	
4. Worsening corporate health	
5. Abnormally low volatility	



Left: Source: Threadneedle, November 2014.
Right: Source: Bloomberg, November 2014.

Outlook for 2015

Making financial forecasts is always difficult but in the figure below we have outlined the potential returns in fixed income in 2015 based around three scenarios: a recession in the eurozone; a slow growth world; and a recovery fast enough to generate inflation. Our central view is that we will experience slow growth. In terms of government bonds, unless the eurozone slides back into recession, it will be difficult to see returns that are meaningfully positive. In investment grade, we would expect spreads to tighten in a slow growth environment. However, in the inflationary recovery scenario, total returns in investment grade would be affected by rising government bond yields due to the longer duration nature of this asset class. We would expect to see high yield and emerging markets debt deliver better returns in the slow growth and inflationary recovery scenarios. These divergent outcomes suggest the benefits of pursuing an active approach in fixed income markets.

Figure 5: Outlook for returns in Fixed Income in 2015

Target yields and spreads

	Global Governments Yields (pct)	US IG Corporate Credit Spreads (bps)	USD EMD Spreads (bps)	US HY Spreads (bps)
Current	1.22%	118	353	400
Recession	1.03%	213	475	600
Slow Growth	1.55%	103	300	325
Recovery	2.18%	83	225	275

Source: Bloomberg, Threadneedle November 2014. * Global for this example is assumed to be 33pct US, 33pct Germany and 33pct UK for governments and 33pct US, 33pct EUR and 33pct GBP for corporates ** Additional default rates and recovery values assumed.

Projections are based on Threadneedle's expectations and forecasts of the credit, EM and government bond markets within the three scenarios described above. Additional market spreads, yields and default forecasts have been made to arrive at total return estimates. Projections are not a reliable indicator of future performance.