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PERSPECTIVES

2016 OUTLOOK

A cycle like no other

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Looking into 2016, we see three themes on the horizon for global fixed income markets. First, markets will be pushing on from lift off and monetary policy divergence will be tested. Second, we expect a comeback for credit and carry, with credit too cheap to ignore. Third, diversification will be the only line of defence in times of high volatility and low liquidity.

2015: A SENSE OF RELIEF

As 2015 draws to a close, fixed income investors can look back on the year with some sense of relief. Many events had the potential to derail returns – the Bund shock, China growth concerns, an unexpected RMB revaluation, another leg lower in commodity prices and a flurry of negative corporate news. Despite this, most bond asset classes are ending the year with flat-to-low single-digit returns – not a bad result all considered. However, the year will be most remembered for the inaction of the Federal Reserve (the Fed), putting an anchor on government yields globally. Bond investors were reminded that central banks still err on the side of caution at any hint of market or economic uncertainty. 2015 was also typical of a late stage phase of the economic cycle – leverage and animal spirits rose, jobs growth continued and wages crept higher – yet oddly, the interest rate cycle had still yet to begin. It wasn't a year for a broad-based hunt for yield either, but nor was it one for duration. Importantly, investors diversified across duration and credit fared well, benefiting from the negative correlation between changes in government yields and spreads.

PUSHING ON FROM LIFT OFF: MONETARY POLICY DIVERGENCE TESTED

For government bonds in 2016, the outlook is hinged not only on the Fed, but also on the actions of other central banks. It is hard to see anything but a slow and steady approach to "normalisation". If markets are right, this would be the most gradual tightening cycle ever seen in the inflation-targeting era. The Fed's cautious approach is certainly justified on the basis of it not wanting to derail growth and to combat disinflation, but the flipside is that the Fed may be left with not enough dry powder to protect against future recessions.

The challenge for policy makers globally is they must contend with economic growth and inflation much slower than what they have been accustomed to in previous cycles. Indeed, many economic models that had previously served them well have now become less useful. Low inflation and slower trend growth are the Achilles' heel for central banks, particularly confounded by highly indebted economies, shifting demographics and fading productivity gains.

For the Fed, a key challenge is that even in the presence of decent domestic conditions, they may struggle to deliver higher rates on account of external influences. Slow growth and disinflationary forces should see Japan and the eurozone embark on additional stimulus in 2016. This may place renewed upward pressure on the dollar and US financial conditions, thereby limiting the prospect of an entrenched US tightening cycle. Ultimately, there is a limit to how much monetary policy can diverge across economies and any shift away towards a more normal interest rate environment may require coordination by central banks globally.

Looking at the eurozone, "Japanification" of that economy is dawning. While it may not have the corporate leverage and investment overhang of Japan in the 1990s, its demographic and reform challenges are similarly immense. This secular headwind combined with low inflation leaves the European Central Bank (ECB) with little room to manoeuvre. We see scope for further ECB accommodation next year, including further cuts to the deposit rate and an extension of its Quantitative Easing (QE) programme beyond September 2016. This will have ricochet effects on central bank policy in other economies across Europe, including the Nordics. Meanwhile in Japan, further stimulus is also likely in the face of stubbornly low inflation as macro conditions stay weak and authorities look to encourage capital expenditure.

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Overall, 2016 will see another year of monetary accommodation and central bank balance sheet expansion globally. This is a powerful backstop support for bond markets. The potential for any unwinding of QE remains distant on the horizon – in fact, we do not expect central banks to sell their holdings of government at all. And while a move to a more normal interest rate world is an aspiration for the Fed, there is a limit to it acting in isolation. For investors concerned about duration or a flight away from fixed income, that is reassuring.

A COMEBACK FOR CREDIT AND CARRY: TOO CHEAP TO IGNORE

We expect credit to perform strongly in 2016, with spreads tightening in the face of the global economy entering a latent stage of the cycle. While credit fundamentals deteriorated again this year, particularly in the US, the widening of spreads through 2015 has created valuation opportunities. Indeed, spreads across asset classes are close to three-year highs. This enthusiasm applies across the credit spectrum with investment grade, high yield and EMD all ripe for recovery.

Supporting this expectation are a benign interest rate environment and accommodative central banks, led by the ECB and Bank of Japan (BoJ). This should help to keep refinancing conditions supportive, interest cover ratios elevated and defaults low. The threat of higher US rates may again prompt some investor caution, although spreads are today well wide of the levels seen at the onset of tightening in previous cycles – so there is a substantial cushion for credit markets to absorb a slow rise in US interest rates.

Looking within credit, we like high yield over investment grade on an absolute return basis, while in emerging market debt, we see scope for a recovery in local currency assets. EM FX volatility is likely to stay elevated, and recovery may be a story for the latter half of the year as investors latch onto the attractive carry as well as better signs of stabilisation and rebalancing in EM growth. Esoteric classes should also fare well. Hybrids – bonds with equity-like characteristics – are one of our standout picks for 2016, owing to their combination of carry and spread-tightening potential as investors draw to a new and growing asset class.

Looking across regions, US credit fundamentals weakened most in 2015 although energy issuer concerns as well as broader market technicals were arguably more prominent factors behind the credit market weakness. As the US economic cycle now enters its late stage, we expect a softer year for issuance and more modest corporate re-leveraging. Indeed, 2015 was a volatile year for stocks and while M&A and share buybacks are still a risk for the market, fragile sentiment should dampen animal spirits from their 2015 peaks. If anything, weakness in credit in 2015 has helped to prolong the cycle.

Unlike the outlook for US credit which hinges heavily on valuation support, European credit is more favourably positioned owing to its better balance of drivers, particularly in high yield. Further ECB accommodation combined with better credit fundamentals should draw investors to the asset class. Importantly, European credit has been, and continues to be, a safe haven by lagging the US credit cycle – 2016 should be no different.

But arguably the biggest attraction for credit in 2016 is its position versus other risky assets such as equities. History shows that asset classes such as high yield have proved useful for de-risking growth-heavy portfolios – through high yield investors can capitalise on the latent phase of the cycle, benefiting from attractive carry while also being better protected on the downside. This cycle should prove no different. And while timing the economic cycle is difficult, the weakness in credit through 2015 has provided a useful entry point for cautious late-cycle multi asset investors..

DIVERSIFICATION – CRUCIAL DURING HIGH VOLATILITY AND LOW LIQUIDITY

While 2016 is likely to be a strong year for credit, it is important that investors keep diversification at the heart of any tactical positioning. Valuations in credit warrant an elevated allocation but this should be expressed through a mix of assets. High yield, Emerging Market Debt (EMD) and hybrids are all expected to be beneficiaries. And within EMD, we see merit in adding exposure, including to local currency assets.

Interest rates at the lower bound are giving investors little option but to take extra risk in order to generate returns. This need not only extend to the credit asset classes, but can also extend to the use of duration, currencies and active management. Specifically, interest rate duration and open USD exposure can be used to protect against tail

situations affecting credit, while active management introduces an entirely new diversifiable risk into portfolios.

2015 yet again highlighted the importance of keeping a moderate level of duration in a portfolio and while 2016 may see some uplift in Treasury yields, we believe investors should continue to balance credit exposure with a moderate level of duration. Importantly, investors should avoid being swayed by index compositions and better to combine the sources of duration to capitalise on subtle variations in economic cycles. Currency is another useful diversifier, particularly for those investors facing QE locally and in search of yield. In addition to the carry advantages, US dollar exposure can be a useful hedge against credit risk in extreme situations.

And finally, liquidity is an issue but is difficult to immunise against. Therefore, investors must recalibrate their expectations and diversify exposures across asset classes on the basis of their liquidity characteristics and cash flow needs. The challenge is that those asset classes that are most attractive are also typically the least liquid. Therefore, asset classes such as high yield and EMD cannot be treated tactically, so market beta decisions are best expressed through more liquid assets.

Overall, this is an economic and market cycle like no other – economies have recovered, risk assets have grown, but the next phase of the interest rate cycle is yet to begin. And as the economic cycle enters its late stages, we expect strong returns across credit in 2016 – valuations are simply too good to ignore, especially with central bank support still widespread.

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