JUNE 2014

Fixed income will remain an attractive source of income

Andrew Wells, Fidelity's Global Chief Investment Officer – Fixed Income, believes certain segments of the asset class will be a valuable source of income in the continuing low-inflation environment.

In this Perspective, Andrew discusses his bullish views on the US economy and explains why China remains attractive for bond investors. He also shares his thoughts on the key challenges facing the major central banks and highlights which markets are proving to be risky investment choices.

ANDREW WELLS is Global Chief Investment Officer, Fixed Income at Fidelity Worldwide Investment.

HOW WOULD YOU DESCRIBE TODAY'S FIXED INCOME ASSET CLASS?

I believe yields across fixed income will stay low for some time. While bonds appear expensive relative to history, refinancing bonds is very straightforward and we're seeing stability in fixed income markets that we haven't seen for a long time. You have to consider the current backdrop of banks shrinking their balance sheets, lots of investors looking for income-based solutions and central banks maintaining very accommodative monetary policies. So, if you expect a low-inflation environment to continue, you could argue that bonds are still a good source of income. This is particularly the case where there is central bank commitment to quantitative easing (QE) and we can see interest rates remaining low.

IS THERE ANY RISK OF BOND MARKET UPHEAVAL?

The US Federal Reserve has learned an important lesson that its eventual exit from QE will have to be extremely well managed and communicated to the market. This is to avoid a repeat of last year's so-called 'taper tantrum'. Most fixed income investors are aware that the QE exit point is coming. However, the ongoing tapering process offers a degree of stability in the meantime. Interest rate increases are then likely from mid-2015, but these will need to be handled in a measured and well-articulated way. The Fed should seek to avoid causing market disruption while transitioning to normal interest rates at some stage in the future.

DO YOU BELIEVE THE US ECONOMY IS STILL RELIANT ON CENTRAL BANKING?

Central banks continue to perform many different functions and clearly the US economy still needs help to improve its employment situation. The quality of jobs generated in this cycle has not been great – many jobs are part-time, the participation rate is low – and the soft labour market is still holding back GDP growth. So, there are good reasons why QE stimulus is still needed. However, I'm seeing pockets of potential inflation appear as demand is stoking wage growth, particularly in specialised and skilled areas of the labour force. Overall, however, inflation is still below the Fed's target, as Table 1 shows.

Table 1: Inflation is underperforming central bank targets

	Current inflation	Central bank target
US	1.5%	2.0.%
Eurozone	0.5%	<2.0%
UK	1.6%	2.0%

Source: FIL Ltd. Bloomberg, as at 30 April 2014.

Ultimately, the Fed is focused on achieving a more stable jobs environment and the understandable consequence will be some inflation. I think the Fed – and Janet Yellen in particular – will be happy to be behind the curve. Higher inflation is likely in 2015 and 2016, which may then be addressed by overshooting interest rate rises to rein in inflation. This approach will be worth it if it achieves a better and broader job market recovery over the long term.

IS THE US ECONOMY SET FOR A PERIOD OF SUSTAINED GROWTH?

I am positive about the US economy, the level of innovation there, and the many companies that are strong domestically as well as globally. As the global economy picks up, I think US companies will go from strength to strength and will potentially get rerated in the future. I don't believe that we're going to see stagnation in the US over the next few years. What we'll see is innovation as the intellectual edge that many US companies have will make them leaders in the global economy as it rebounds in the next few years.

ARE YOU AS BULLISH ABOUT THE OUTLOOK FOR JAPAN?

Japan poses a number of interesting questions, notably whether Abenomics has started to work. However, without a crystal ball it's obviously difficult to make any stark predictions. What we know is that Japan is in the very early stages of a very complex economic reform programme. Over the coming months, we'll understand how the April consumer tax hike has affected consumer spending patterns. We'll also have a clearer picture in time about the potential returns from Japanese investment overseas, including in US fixed-asset securities. Although all of these outcomes promise to be very interesting, it is really too early to tell if all three of the Abenomics arrows will hit their targets in time.

WHAT ARE YOUR VIEWS ON EUROPE?

Deflation is potentially a big issue in Europe, highlighted by what could be an aggregate inflation figure of just 0.7% for 2014. That's well below the European Central Bank's 2% target. Cutting the deposit and refi rates should help get the economy moving. But as rates are already at very low levels, the marginal difference that this will have on Europe's economy is somewhat limited. While we will need time to assess the impact of rate cuts as well as alternative stimulus measures to incentivise greater bank lending (such as TLTROs), a broader programme of quantitative easing and asset buying may still have to be rolled out in the future.

COULD A CRISIS IN EUROPE BECOME A BUBBLE?

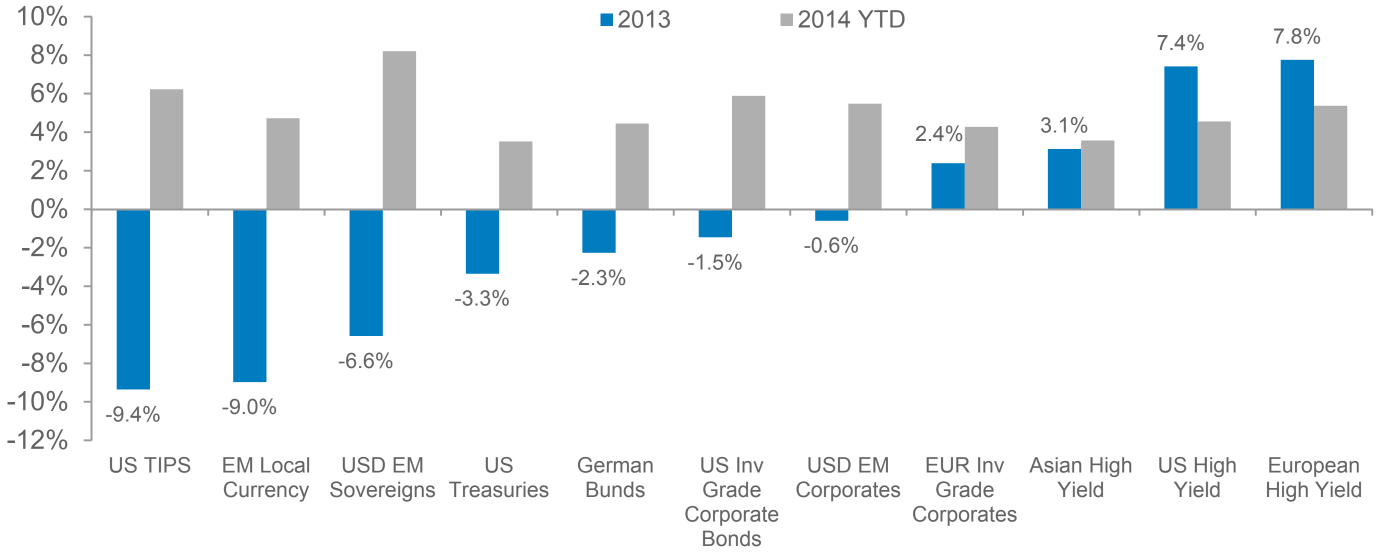
Europe's a very interesting case in fixed income and the region poses a real dilemma for investors – they are seeing a deluge of negative headlines about unemployment, stagnation and low inflation. But considering the 8% return in European high yield in 2013, which made it the best-performing asset class in fixed income, I think we'll continue to see solid returns from European bonds (see Chart 1 overleaf). There are lots of investors looking for income-based solutions, moving along the curve and into credit markets. These investors are switching out of high-volatility equity and also out of cash and money market funds that produce limited return. The region may not seem like the right place to invest as a fixed income investor given low rates, but as we've previously seen in Japan and the US, when there is QE you want to be in the bond market.

WHERE ARE YOU SEEING SOME OF THE BIGGEST RISKS IN FIXED INCOME?

Tail events often constitute the biggest risks. Look at the situation in Ukraine, Venezuela and other emerging markets where we can see there is irrational behaviour in those markets. Fixed income investors on the whole tend to be rational people who like clarity. So, if there is uncertainty around the repayment of principal or the kind of volatility that causes an enormous amount of uncertainty in a relatively liquid market, this is a cause for concern.

Inflation is also a key risk. There is a danger of continued global QE being used to solve various economic challenges, particularly unemployment. This means that at some stage we will get a bout of inflation. Although we may not see this for 12 or even 24 months, inflation is always dangerous, particularly for the long end of the yield curve where there is steepening and massive destruction of value because of the long-dated nature of bonds.

Chart 1: Asset class total returns – 2013 & 2014 YTD



Source: FIL Ltd. Based off BofA Merrill Lynch and JP Morgan Bond indices, using total returns in local currency terms (i.e. all asset classes expressed in USD terms except for European High Yield, EUR Inv Grade Corporates and German Bunds - in EUR), to 28 May 2014

We have to be very vigilant about the way we invest clients' money down the yield curve, making sure investors are protected against inflation in the future. We are increasingly offering a range of funds for multi-strategy objectives. These comprise credit and high yield, but also include government bonds for security and inflation-protected securities that offer tail-risk protection.

DO YOU ENVISAGE WE'LL SEE ANY SHOCKS FOR CHINA?

The Chinese economy is always a concern to fixed income investors, because of its increasing size and importance of government policy which is becoming less transparent. However, I am long-term bullish about China because of the country's key objective to achieve economic stability, notably its objective to have a stable workforce and to achieve stable long-term growth. The fact that China's growth rate might slip from 8% to 7.5% is of little concern because its new rate of growth is on a much bigger economic base. China is also conscious of avoiding housing or credit bubbles, so we are seeing more regulation in these areas. This is good news for the longer run.

The defaults we are seeing in China are healthy because they are part of the country's progression to a fully functioning and normal financial sector. Deregulation of China's stock markets offers a great opportunity. Some stock markets are starting to merge and the passporting of funds and investment products through Hong Kong and into China is a great opportunity. Although there will inevitably be bumps along the way, I think China is a force for good in a global economy in the future.

WHICH AREAS OF FIXED INCOME WILL CONTINUE TO PERFORM WELL?

Across fixed income, high yield continues to perform well and despite occasional volatility, this low-duration asset class offers some protection if interest rates increase. As banks continue to shrink their balance sheets, I expect ongoing high yield issuance with scope for further spread compression as the market digests new deals.

One of the areas where we are a seeing return of investor interest is emerging market bonds. While emerging market outflows were pronounced in 2013 and some of the markets such as Russia, Ukraine and Venezuela clearly face structural problems, others are attractive. Some of the South East Asian markets offer good value, for example.

Perhaps the worst-performing area in 2013 was the inflation market. The deflation that we've seen has meant that inflation-linked securities are very much out of favour, so inflation protection is very cheap in Europe at present. Even in the US, we're starting to see that bounce back. Inflation-linked bonds are a great tail-risk product for fixed income investors to capitalise on.

WHY IS BOTTOM-UP CREDIT RESEARCH SO IMPORTANT IN FIXED INCOME?

There's a certain irony in fixed income as the biggest components in an index are borrowers who want to borrow the most money. But in a basic form, you ideally want to lend money to entities that need it the least. So you almost want to put your fixed income money in credits with the smallest borrowing requirement to ensure you get your principal and interest back. This is an oversimplification but clearly you need to think very carefully about the balance of risk and return – you don't just want to give money to those people who have the greatest demand for it.

Importantly, a good active fixed income strategy must rely on bottom-up credit research to identify sources of value and protect bond portfolios against downside risks. And in today's low-yield environment where credit spreads continue to tighten, bottom-up credit research remains hugely important in shoring up portfolios for any future downturn in the cycle.

IC14/42