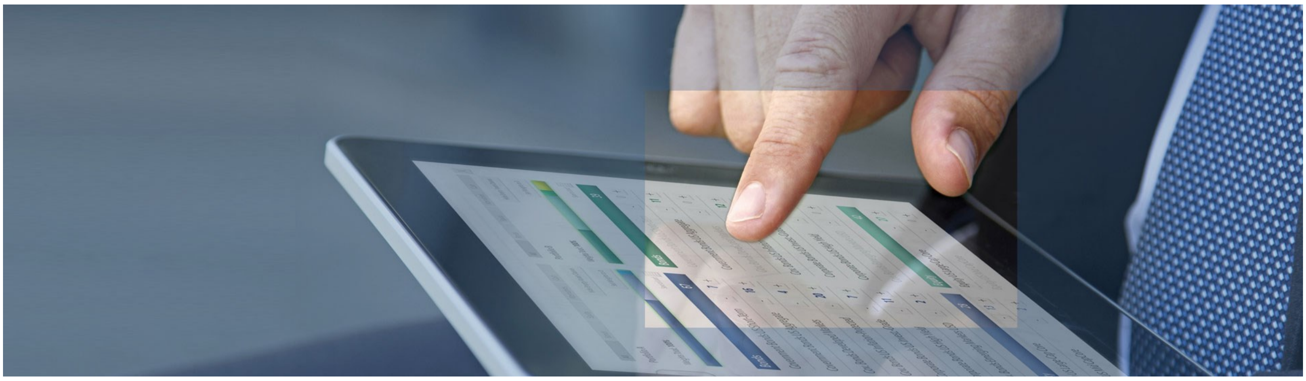
Active is: Finding new sources of income

Low rates are back, so where do you turn in fixed income?

by Mona Mahajan | 12/05/2019



Summary

Investors who need income and return potential should consider an active, balanced, global approach. Consider pairing high-quality investment-grade corporates, Treasuries and select securitised assets with infrastructure debt and higher-quality US, European and Asian high-yield bonds.

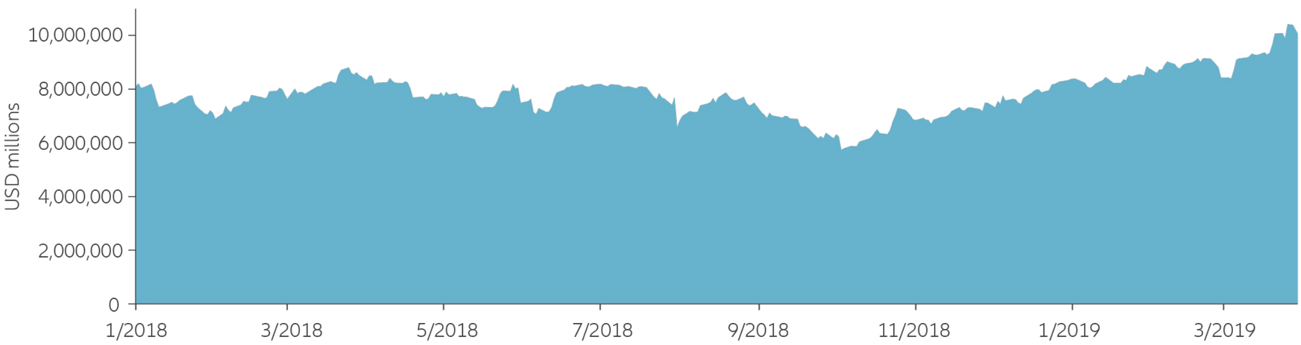
Key takeaways

- Faced with low or even negative bond yields, many investors are looking to preserve income and return potential – and an active, holistic approach could help
- We see opportunities in the securitised fixed-income market and higher-quality corporate bonds, though investors should be cautious and selective with BBB exposure
- For additional income potential, look to higher-quality US high-yield bonds, select global high-yield bonds (particularly from Europe and Asia) and infrastructure debt
- Using these securities in a "barbell" approach can help investors take selective risks while providing the potential for favourable yields and returns

With global growth slowing and inflation still low, most major central banks have paused their plans for raising rates – and in some cases have even begun cutting them. This has pushed bond yields lower around the world. In fact, the amount of negative-yielding US dollar-denominated debt has risen to more than USD 10 trillion globally, as the chart below shows.

A record amount of debt now has negative yields

Bloomberg Barclays Global Aggregate Bond Index negative-yielding debt



Source: Bloomberg. Data as at 31 March 2019.

As a result, many investors once again are looking to preserve income and meet return expectations. We suggest taking a holistic, active approach to building fixed-income portfolios using a "barbell" approach – taking selective risks for higher income potential while using more defensive positions to balance overall risk. On one end of the barbell could be high-quality investment-grade corporates, Treasuries and select securitised assets. On the other could be BB rated US high-yield bonds, European and Asian high-yield bonds, and infrastructure debt.

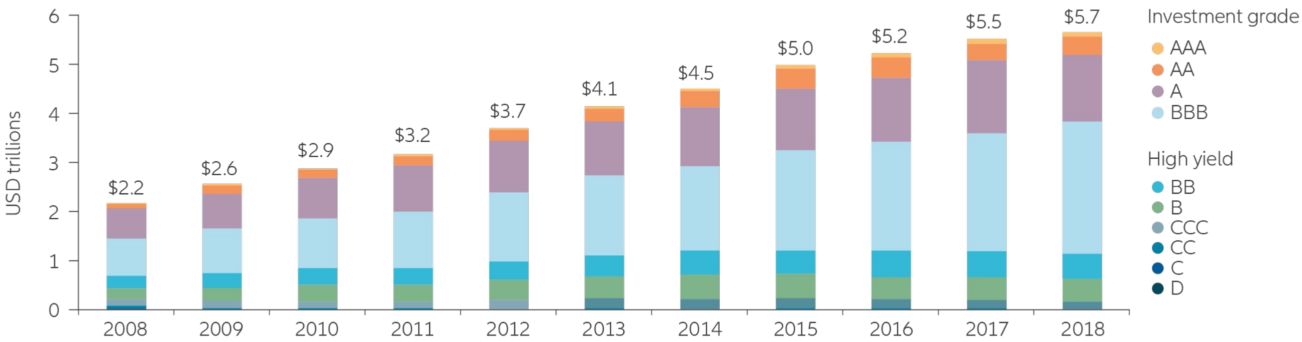
In the investment-grade universe, look to higher-quality bonds

Among investment-grade securities, we see opportunities in higher-quality corporate bonds and the securitised fixed-income market.

1. Look to higher-quality corporate bonds. The US investment-grade bond market has doubled in size since the 2008 financial crisis, but overall credit quality has deteriorated. The landscape is increasingly dominated by assets with BBB ratings, as shown below; these are on the low end of the range that qualifies as investment-grade. As US economic growth slows and corporate earnings moderate, we suggest repositioning towards higher-rated securities, such as bonds rated A.

More investment-grade bonds have lower BBB ratings

Ratings of the US non-financial corporate-debt market



Source: Bloomberg. Data as at 31 December 2018. Calculated using ICE (Intercontinental Exchange) investment-grade and high-yield bond indexes, excluding the issues of financial firms, as at 31 December for each year shown.

Although there are specific areas of the BBB marketplace that look attractive, we believe investors should become increasingly selective and active in this space. The US economic cycle is now in a more mature phase, and low rates are once again tempting corporations to take on more debt. Consider focusing on issuers with:

- Credible plans to reduce their debt burdens (known as "de-leveraging").
- Consistent free cash-flow levels, which can often be found in monopoly-like businesses with the ability to take on debt.
- Attractive subordinated-debt issues, which are riskier but can offer more attractive terms; look for issues from high-quality banks and utilities.

2. Consider securitised fixed-income assets. One area of the investment-grade bond universe that offers attractive diversification opportunities is the securitised fixed-income market. These are pools of assets with cash flows that are divided and sold to investors, and they tend to be tied to what we view as more resilient economic sectors: consumers, residential housing and commercial real-estate. Among the more attractive opportunities are:

- High-quality asset-backed securities (ABS), such as AAA rated credit cards and prime auto, which tend to be liquid and can complement Treasury or cash holdings.
- More specialised areas of the ABS market such as franchise ABS, single-asset commercial mortgage-backed securities and non-agency mortgage bonds. These can help investors diversify their investment-grade bond holdings, and can be good alternatives to BBB rated corporate bonds.

For enhanced income potential, look for higher yields with higher quality

For investors in search of additional income and yield, we see opportunities in higher-quality US high-yield bonds, select global high-yield bonds and infrastructure debt.

1. Go higher quality in US high yield. Within what Moody's estimates to be a USD 1.2 trillion US high-yield marketplace, the highest-quality BB rated segment remains relatively attractive. These issuers have better credit profiles, tend to offer shorter-duration bonds and have higher yields than investment-grade securities. Our focus remains on companies with visible earnings streams and no imminent refinancing risks. As the economic cycle matures, US high-yield investors may have an opportunity to invest in "fallen angels" – BBB rated assets that have been downgraded to high-yield status. These corporations could improve their debt profiles and once again become investment-grade assets.

2. Explore high-yield issues in Europe and Asia. To diversify holdings and enhance yield potential, consider investing in global high-yield issues – particularly from Europe and Asia. Europe's substantial economic slowdown has made these bonds less expensive, and they are generally more conservatively positioned: nearly 73% of the market is BB rated versus 46% in the US, according to ICE. This has helped lower the default rates for European versus US high-yield issues, particularly during downturns. Asian high-yield bonds – especially US dollar-denominated ones – may also provide higher yields than their US counterparts. The Asian high-yield market is primarily dominated by Chinese companies, and we believe China's economic outlook is good thanks to its stabilising economy and the potential for a resolution to the US-China trade dispute.

3. Diversify with infrastructure debt. Infrastructure-debt investments – which are privately financed projects such as airports and water pipelines – are often highly regulated and can have predictable cash flows, longer maturities and lower loss rates than corporate bonds. While there may be liquidity constraints, their additional yield potential and lower correlations with equity and traditional fixed income can provide a valuable source of diversification. In addition, ESG (environmental, social and governance) investors can find synergies in infrastructure debt, since many of these projects focus on renewable energy, social infrastructure (such as universities, hospitals and schools), and conventional energy and utilities (such as waste- and water-treatment facilities).

Build your bond portfolio with a "barbell" approach

Although investors are facing low yields from government bonds globally, we see opportunities to invest actively across the fixed-income spectrum – particularly with a "barbell" approach that balances safer with riskier investments. On one end of the barbell could be high-quality investment-grade corporates, Treasuries and select securitised assets. On the other could be BB rated US high-yield bonds, European and Asian high-yield bonds, and infrastructure debt. Combined, this approach may be able to help investors take selective risks while providing the potential for favourable yields and returns.

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Summary

Higher yield potential and added diversification aren't the only qualities attracting fixed-income investors to Asia. The region's bond markets are large and growing, and reform-minded governments are providing the necessary policy support to maintain growth.

Key takeaways

- Economic growth in Asia is supported by China's stabilising demand and the efforts of Asian central banks
- Asian bonds offer attractive yield potential, particularly compared with the typically low to negative yields of bonds from more developed nations
- Asian credit fundamentals remain broadly stable: companies generally have lower debt levels and are maintaining adequate cash levels on their balance sheets
- Our medium-term outlook for China's bond market remains positive thanks to policymakers' efforts to balance growth and stability, and the trend towards more open, integrated markets

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