Russell Investments

Q2 2018 Fixed Income Survey

Key takeaways

Throughout the year we ask leading bond and currency managers to consider valuations, expectations and outlooks for the coming months. This quarter's survey included 62 responses from managers with specialisms ranging across eight fixed income sectors:

1. Global rates
2. Global investment grade credit
3. Global leveraged credit
4. Securitised non-agency credit
5. U.S. municipal bonds
6. Developed currencies
7. Emerging markets hard currency
8. Emerging markets local currency debt.

Executive summary

Broadly, this survey has indicated that global managers have accepted – and made room for – some market volatility. As interest rates begin to rise in the U.S. and more globally, there does seem to be a consensus that we may begin to see some market dislocation, particularly around valuations and spreads on an absolute and relative basis.

One thing that remains clear is that managers across all eight specialities are a lot less bullish overall than they were last quarter. From our perspective, we believe that the survey respondents this quarter may have understated the volatility potential in a variety of places.

As always, we will be keeping a close eye on market developments. Savvy investors should remain vigilant, stay nimble and consider adding some portfolio diversifiers that perform well in rising interest rate environments.

Below we outline the key findings and conclusions from each of the eight surveys.

Global rates

Summary

On the back of repricing in the U.S. Treasury market, rate expectations are up everywhere in the U.S. Overall, managers are recognising that the U.S. Federal Reserve (Fed) is determined to act. This is particularly clear from the expected increase in the Fed terminal rate, inflation (CPI) and the 10-year Treasury interest rate.

Key findings

- Managers expect more rate hikes this quarter, compared to last. And the forward curve has also priced in this dynamic. The expectation is now evenly split between 3 and 4 rate hikes, whereas last quarter the majority expected 3 hikes.
- The Federal Reserve funds rate peak expectation has moved up from 2.65% to 3%, as more expect further rate hikes. That would mean about 5 more hikes from today, which would argue we're more than halfway through the hiking cycle. As the Fed continues hiking, we've seen a consistent uptick in expected terminal rate.
- Core CPI is expected to steadily move up, now at 2.16% (versus 2.06% last quarter) on a 12-month view from today.
- We've also seen a rise in interest rate expectations for 10-year Treasuries - now expected to rise to 3.28%, up from 2.92% last quarter. However, this is in line with rate increases we've already seen since last survey.

Credit

Summary

While range bound is the flavour of the day for spreads across most credit sectors, the skew has flipped from moderate tightening to moderate widening for global investment grade credit, leveraged credit, and securitised non-agency assets.

When looking at specific asset classes, U.S. high yield has fallen from consistently being the most favoured leveraged credit sector. The consensus is now much more diversified including U.S. high yield, U.S. leveraged loans, european high yield, european leveraged loans, emerging market high yield, and collateralised loan obligations (CLO) mezzanine tranche. On the whole, this implies that the expertise in multiple sectors has become quite valuable.

Key findings

Global investment grade credit

- We've seen a skew towards spread widening in global investment grade credit. 38% of managers surveyed now see moderate spread widening, versus 19% last quarter. 6% see moderate spread tightening, versus 19% last quarter. 53% believe spreads will be range bound, similar to last quarter.
- That being said, more managers feel current spreads compensate for the risks of deteriorating credit fundamentals over the next 6 to 18 months. Previously, more than half felt they didn't. That has dropped to 28%. Now more than half of managers feel they do to some degree, with 19% feeling that spreads are compensating adequately, compared to 13% last quarter.
- The view is currently split on whether leverage will increase for BBB-rated companies over the next 6 to 18 months, but the majority feel it will be stable.
- Subordinated financials finally lost the top spot as most favoured sector, with operating company senior financials now taking the top spot. Subordinated financials are still second favourite. Corporate hybrids are now the least favourite, replacing utilities.
- Within regions, the U.S. finally lost its top spot as most favoured region in global investment grade credit. Europe ex-UK is now number one while the UK is the least favourite region.

Global leveraged credit

- The view on spreads has skewed towards some moderate widening (30% this quarter versus 5% last quarter). Last quarter, we had a skew towards moderate tightening (26% versus 10% this quarter). The majority (60%) still expect range bound spreads versus 68% last quarter.

- 90% of managers last quarter felt corporate fundamentals were either modestly or materially improving. This quarter, the number is down to 55% with 35% seeing corporate fundamentals remaining the same and 10% seeing modest deterioration (versus 5% last quarter).
- This quarter, we saw a large shift in the most favoured credit market. Previously, U.S. high yield bonds were consistently the most compelling, but this has dropped from 42% last quarter to 16% this quarter. U.S. leveraged loans are now the most favourite at 26%, but that is actually the same percentage as last quarter. Instead, the opportunity set is less consensus. The fall in high yield brought up sectors such as emerging market high yield (from 5% to 16%) and CLO mezzanine tranche (from 11% to 21%).
- The weighted average total return expectation for U.S. high yield over the next 12 months is 4.4%, down from 5.2% last quarter.
- Retail is still the highest concern for managers down from 47% to 33%. Concerns for the healthcare sector however, have increased up to 27%.
- Although the skew is towards some deterioration, the large majority (70%) continue to maintain current risk levels, similar to last quarter's 68%.

Securitised non-agency credit

- Non-agency mortgages share the pedestal with BBB-rated CLOs as the most attractive securitised sector on a 12-month horizon.
- The skew moved towards decreasing risk instead of adding risk compared to last quarter with the majority (67%) maintaining risk – the same percentage as last quarter.
- While non-agency credit remains at the top, optimism has tempered versus previous quarters. The majority of managers have felt there would be moderate to significant tightening in non-agency mortgages across the previous five surveys. This quarter, that number dropped sharply with only 7% feeling there would be moderate tightening. 67% see range bound and 27% now see moderate widening of 10 to 30 basis points (bps) – the most we've seen in any of our surveys.
- However, 0% felt there would be significant widening of greater than 30bps. This is in line with our view that valuations are no longer as attractive as they once were. But, we believe the asymmetry of the risk still seems better than other credit sectors due to the seasoning of mortgages and increases in home prices since the depths of 2008.
- Managers are fairly split on whether mortgage basis is attractive.
- 59% of managers believe the biggest risk to commercial mortgage backed securities is shopping centres or the retail sector more broadly.

U.S. municipal bonds

Summary

Municipal bond managers are bullish on municipal high yield bonds outperforming U.S. high yield over the next 12 months, and are just as bullish relative to U.S. high yield as they have ever been in any of our previous surveys.

Key findings

- The skew towards moderate yield increases is still present, but this has tempered somewhat relative to last quarter where 79% expected a moderate increase (versus 57% this quarter). The recent yield increases likely helped moderate the negative view.
- The outlook for 30-year AAA-rated municipal bond/treasury ratio remains the same.
- Previously, the skew was for moderate spread tightening. This quarter, the consensus is range bound at 62% with the remainder split between moderate spread widening or tightening.
- Managers are just as bullish on municipal high yield versus corporate high yield as they have ever been in any of our previous surveys since the end of 2016. Now, 83% expect municipal high yield to outperform corporate high yield, up from 61% last quarter.
- The view on Puerto Rico bonds is negative, with 58% believing the return will be negative over the next 12 months.

Developed currencies

Summary

The majority of managers surveyed expect G10[1] and emerging market foreign exchange (EM FX) volatility to increase, while the U.S. dollar (USD) has increased in favour.

Key findings

- Managers still expect G10 and EM FX volatility to increase, but this is down to 82% and 71% respectively, vs 100% last quarter. This is likely on the back of an increase in volatility broadly across asset classes this year.
- There is still difficulty finding consensus in sterling (GBP), with Brexit uncertainties still weighing on the currency.
- A skew towards bullishness can be found on euro and yen.
- There was no love for USD last quarter, but now 12% think it can be the top performing currency over the next 12 months. The remainder of survey participants remain split between another G10 currency or a basket of EM currencies.

Emerging markets

Summary

Within hard currency, the majority of survey respondents have a range bound view, but the skew towards moderate tightening still remains (versus other credit sectors skewed towards widening), albeit less-so than the previous quarter. The bullish sentiment towards emerging market foreign exchange (EM FX) last quarter proved to be ill-timed. Local currency emerging market debt is still preferred over hard currency emerging market debt, but less so than the previous quarter. The recent market sell-off may have tempered some of the enthusiasm.

Key findings

Emerging market hard currency

- The skew towards modest tightening remains to be the view for hard currency J P Morgan EM Bond Index global spreads over the next 12 months, but the view has moderated from 59% expecting so to 46%. 19% now expect modest widening, and 8% expect significant widening compared to 0% and 3% last quarter, respectively. 23% expect range bound.
- Argentina remains the most favoured overweight in emerging market hard currency debt (HCEMD) with 34% of managers positioned this way, even after recent stress in the currency and request for support from the International Monetary Fund.
- The Philippines and China are tied for largest underweights in EM debt hard currency portfolios.
- It would seem managers have reduced allocations to local currency EM debt, within their hard currency portfolios, since last quarter.

Emerging market local currency debt

- Managers still favour emerging market local currency debt (LCEMD) over HCEMD, but on the margin less so, especially over the next year.
- Last quarter, the bullish sentiment towards EM FX was just as strong as we had seen in any of our previous surveys since July 2016, but it proved to be ill-timed. 46% of managers thought FX would be a strong contributor to performance over the next 12 months, while 49% believed slight positive. This quarter, 13% believe slight detractor, 6% believe neutral, 61% believe slight positive, and only 19% believe strong positive. We've seen a 7% fall in EM FX since the last survey, which will serve as a major headwind to strong EM FX performance 12 months forward from the February survey.
- The view on EM local rates remains pretty close to last quarter, with 32% believing rates are cheap – the same as last quarter. Meanwhile 58% believe rates are fair value, down from 65%, thus the expensive camp has moved up

[1] G10 currencies are the U.S. dollar, euro, sterling, Japanese yen, Australian dollar, New Zealand dollar, Canadia dollar, Swiss franc, Norwegian dollar and the Swedish krona.

slightly from 3% to 10%. Interestingly, after decoupling from developed market rates for the second half of 2017 and Q1 2018, we've seen a 50bps rise in the J.P Morgan EM Government Bond index yield this quarter.

- Views on inflation falling peaked in Q3 of 2017, when 62% of managers expected inflation to fall. That number has fallen to 10% now, with 65% feeling neutral about inflation and 26% now feeling it will go higher.
- The weighted average expected return from LCEMD over the next 12 months is 6%, which is down about 1% from the previous quarter, despite cheaper valuations.
- The Mexican peso is back to the top - now the most favourite currency to outperform the USD over the next 12 months. It briefly lost the top spot last quarter, but has otherwise been favourite four out of the last five surveys now. Last quarter's favorite – the Indonesian Rupiah – dropped off completely. The Russian ruble, Argentinian peso and Turkish lira (TRY) are all neck and neck for second place.
- Clearly, there's a strong tug of war between poor fundamentals and attractive valuation.for TRY. Whilst it is in the second spot for most attractive currency, it also remains the least favourite currency (although less so than previous quarter falling from 32% of responders to 22%). The remainder is very diversified, as the consensus seems difficult to find. This surprisingly, is a similar dynamic to last quarter.

For more information:

Call Russell Investments at +44 (0) 20 7024 6000 or visit russellinvestments.com.

IMPORTANT INFORMATION

Unless otherwise specified, Russell Investments is the source of all data. All information contained in this material is current at the time of issue and, to the best of our knowledge, accurate. Any opinion expressed is that of Russell Investments, is not a statement of fact, is subject to change and does not constitute investment advice.

Issued by Russell Investments Implementation Services Limited, Company No. 3049880. Registered in England and Wales with registered office at: Rex House, 10 Regent Street, London SW1Y 4PE. Telephone 020 7024 6000. Authorised and regulated by the Financial Conduct Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS. Russell Implementation Services Limited is regulated in the United Arab Emirates by the Dubai Financial Services Authority as a Representative Office at: Office 4, Level 1, Gate Village Building 3, DIFC, PO Box 506591, Dubai UAE. Telephone +971 4 359 0322.

KvK number 67296386

© 1995-2018 Russell Investments Group, LLC. All rights reserved.

MCR-00423 EMEA-1631 Issued: June 2018 Expires: June 2019