Heartwood
Investment Management

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Investment Insight

# Weekly Insight

## Striking the right balance in fixed income – it's not simply duration

Logic dictates that borrowers should pay lenders and not the other way round. However, the world of negative interest rates is defying that logic and investors are increasingly challenged to find value across global fixed income markets when yields are so low. Going forward, the risk is that investors are likely to capture more of the downside in market sell-offs than upside in market rallies, and therefore we anticipate higher levels of bond market volatility.

Managing fixed income in the current environment is more challenging and demands investors stay focused on preserving capital as well as seeking return. Over the last few years, investors could make attractive returns from investing in longer-duration assets as yield curves flattened. However, we believe there is less value to be found by simply taking duration exposure alone, as well as more downside risk.

## Yields are unsustainably low

Of course, it would be impossible to determine with any certainty the point at which interest rates will start to rise; for now we remain under the scenario of 'lower for longer'. However, there are rational reasons to believe that yields at current levels are unsustainable:

1. While headline inflation will stay low, deflation threats in developed economies have diminished. The rise in oil prices will feed through into headline inflation in coming months.

2. Labour markets are reaching full employment, particularly in the US, and this should put modest upward pressure on wages.

3. From a UK perspective, Sterling's devaluation will ultimately be inflationary, though somewhat offset by lower growth. Further out, a weak currency, large current account deficit, wider fiscal deficit and credit ratings downgrades will be less supportive to UK gilts.

4. We have been saying for some time that central banks cannot be solely responsible for stimulating growth and reflating economies. Governments will at some point have to share the load. A large fiscal stimulus package in the form of significantly higher infrastructure spending could spook bond markets and lead to even higher debt levels in developed economies.

5. The US treasury market tends to exert a gravitational pull towards other developed sovereign bond markets. When the Fed restarts its tightening programme, currently priced for early 2018, this is likely to push yields higher globally.

Therefore, investors need to be able to strike the right balance between participating when bond prices are rising and avoid getting caught out should yields move meaningfully higher, such as during the taper-tantrum episode in mid-2013. It is a difficult conundrum, but we believe the optimal risk/return approach is twofold.

Clear Thinking

## Contact

To find out more about the Heartwood strategies, visit our website or contact your local representative.

### Stay short but seek higher yielding opportunities

First, we believe it is important to stay fully invested in government bonds on a market weight basis, but in short-duration assets that we would be happy to hold to maturity should interest rates rise. While this position will not always fully participate if bond markets rally, it should help to preserve capital if yields rise sharply.

Second, we are holding a bias towards some higher yielding areas of the credit market. We believe that the current environment is ripe for active investors who are able to cast their net wider and search out value in more esoteric areas of an $87 trillion global fixed income universe [Source: Bank of International Settlements]. In the post-financial crisis years, banks have retrenched from lending, fuelling growth in public debt markets - euro high yield, emerging corporate debt, as well as specialist areas, including infrastructure and peer-to-peer lending. These sectors are less duration sensitive and offer investors a higher yield premium for the credit risk taken (i.e. risk of default). Within our own portfolios, we have been increasing exposure to emerging market sovereign debt and US high yield energy bonds, where valuations look more attractive relative to sovereign bond yields. In addition, we are continuing to seek out yield opportunities in property and infrastructure.

Fixed income continues to play an important diversifying role in a multi-asset portfolio and can provide defence in risk-off periods, such as in the days after the UK referendum result. However, the duration trade is less obvious these days and it is now about finding the right balance between preserving capital and extracting value from niche areas of the market.

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