PineBridge Investments

Fundamentals In Focus:
Find the Bright Side In Fixed Income

Markets have entered an unprecedented period of intervention and influence by global central banks. With this has come heightened market volatility and market dislocations, but we see room for optimism.

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Markets have entered an unprecedented period of intervention and influence by global central banks. With this has come heightened market volatility and market dislocations.

This period of intervention and influence from global central banks is far from ending: Although the Fed has its eye on normalizing monetary policy and interest rates, central bank balance sheets elsewhere around the world will likely continue to grow, and monetary policies should remain tilted toward an accommodative stance. Japan and Europe have doubled down on quantitative easing and adopted negative policy rates, and China has been gearing its monetary policy to spur anemic domestic growth conditions. This means that the Fed will likely struggle to diverge from other major central banks.

As spreads have widened over the past three to six months, we have focused on areas of the market with the best value that offer the most attractive opportunities. These are assets whose valuations have deviated most from the fundamentals amid volatility: bank loans, contingent convertible (coco) bonds, and subordinated financial institution bonds.

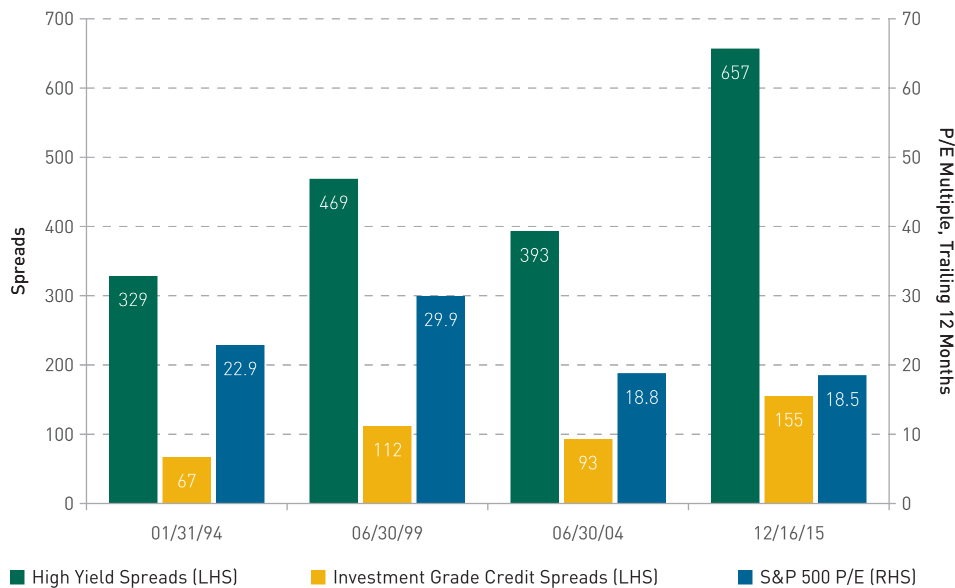
Expect more frequent and more severe ups and downs in the market

The US unemployment rate continues to grind lower, with the economy expected to reach full employment in 2016. The Federal Reserve has consistently stated that it is data-dependent in its decision making process. The most important variable for the Fed right now? Wages. The good news is that, with unemployment already at the Fed's target, we think it will start to lead to higher wages. In fact, we are already seeing signs that wage inflation is starting to build.

On the negative side, the US dollar rally, combined with falling energy prices, has put the manufacturing and industrial sectors into recessionary territory. While recent data show some signs of stabilization in the industrial components, the revival is weak and could easily slide back into dangerous territory.

The dollar strength has also resulted in declining import prices and has been one of the contributors to weak inflation. However, with the recent stability of exchange rates and energy prices, we expect inflation to start approaching the Fed's target.

One important thing to note is that conditions in financial markets are not nearly as accommodative as in prior Fed rate hike periods. We don't appear to have the overheated financial market conditions, such as runaway growth or capital market bubbles, that we typically had in the past, which means the Fed really doesn't need to tighten capital market conditions. Multiples are much more restrained than they have been in prior rate hike cycles as well.



Source: Bloomberg, Barclays, and PineBridge Investments. As of 9 March 2016. For illustrative purposes only. We are not soliciting or recommending any action based on this material. Any views represent the opinion of the manager and are subject to change.

Conditions today are not as accommodative

Liquidity dynamics have also changed. Since 2008, regulation has drained liquidity from fixed income markets. As a result, dealer inventories have declined while the credit market has expanded dramatically. Typically, on a good day everyone wants to buy and on a bad day everyone wants to sell. You don't have an intermediary willing to take risk and smooth that transition on good days (when everyone wants to buy) and bad days (when everyone wants to sell).

This resulted in less diversity in bond ownership and trading, which means we can expect more frequent and more severe ups and downs in the market. Investors need to take that factor into account when building portfolios to focus on being well diversified. Typically, it helps to focus on smaller positions to make it easier to maneuver in this market. This will be important as volatility continues and it becomes harder to identify the best investment opportunities.

Overly pessimistic valuations are creating attractive opportunities

Market pricing implies a higher level of risk than economic and corporate fundamentals suggest. What's the cause? A flight to quality from a fear of a pullback in central bank accommodation that is not happening. With these levels, plus our expectation that relatively easy central bank accommodation will continue, we think spreads are attractive.

Investment grade

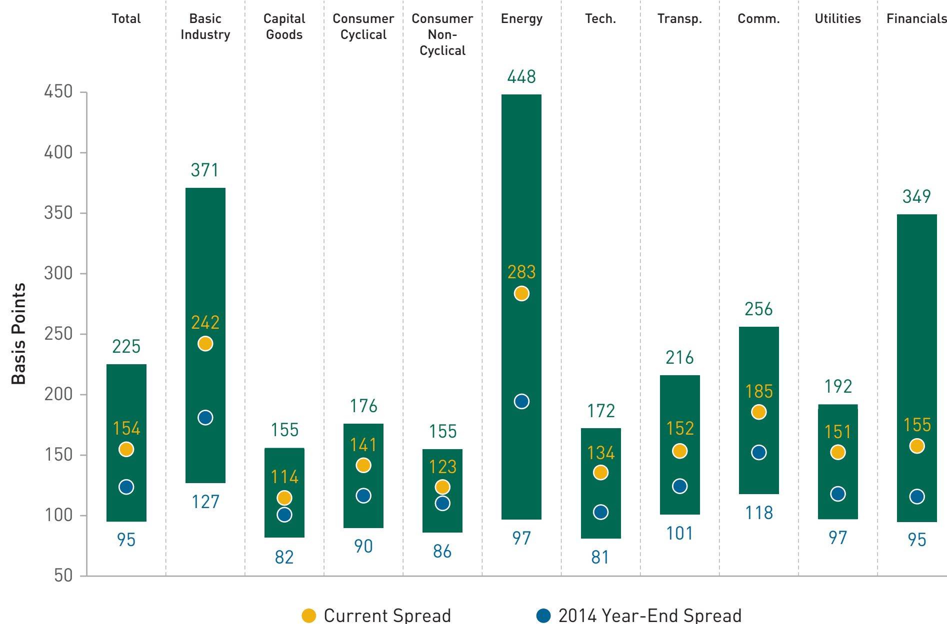
Credit valuations are more attractive today than one year ago, with some sectors at historically cheap levels. In particular, we like financials because they are supported by strong balance sheets. Many of these companies are systemically important financial institutions for their economies and also have monetary policy support, especially from the European Central Bank (ECB). They don't face the kind of default risk that many names in the energy or commodity sectors contend with as volatility is likely to continue in commodity prices. Bank performance in annual stress testing exercises confirmed their resilience.

Financials have sold off significantly, particularly in subordinate and lower levels of debt. We prefer the risk/reward of subordinate risk in a bank with strong fundamentals rather than taking credit risk that depends on improving volatile asset prices, such as those for commodity-related issuers.

Within investment grade, we are also finding opportunities in the subordinated and additional tier-1 (AT1) coco markets. They have low susceptibility to the type of event and default risks that are present in other areas. Also, it is essentially in the banks' and the central banks' interests to keep these financial institutions viable. To do that, banks have to pay the coupons on their AT1 and coco products.

Investment Grade Credit Spreads — Option-Adjusted Spread by Sector

Ranges since January 2010 with Current and 2014 Year-End Levels



Source: Barclays and PineBridge Investments. Investment grade credit is represented by the Barclays US Credit Index. As of 31 March 2016. For illustrative purposes only. We are not soliciting or recommending any action based on this material. Any views represent the opinion of the manager and are subject to change.

Investment grade credit valuations appear attractive relative to recent history

High yield

When it comes to fundamentals, we are seeing a lot of the same themes in high yield as we see in investment grade credit. Interest coverage ratios, as well as expected default rates for the upcoming year, are in relatively good shape. While default rates are expected to increase to above historical averages, most of that increase has taken shape in commodities, specifically in the energy and materials sectors. For much of the rest of the high yield market, we see relatively healthy fundamentals and historically low defaults. That's much better than what we would normally expect at this part of the credit cycle.

One area we think is particularly attractive within high yield is bank loans. They have low commodity exposure, and we expect them to maintain default levels that are lower than the historical average. We have also seen relatively few leveraged buyouts. The after-effect of the selloff and risk aversion have made bank loan credit spreads attractive.

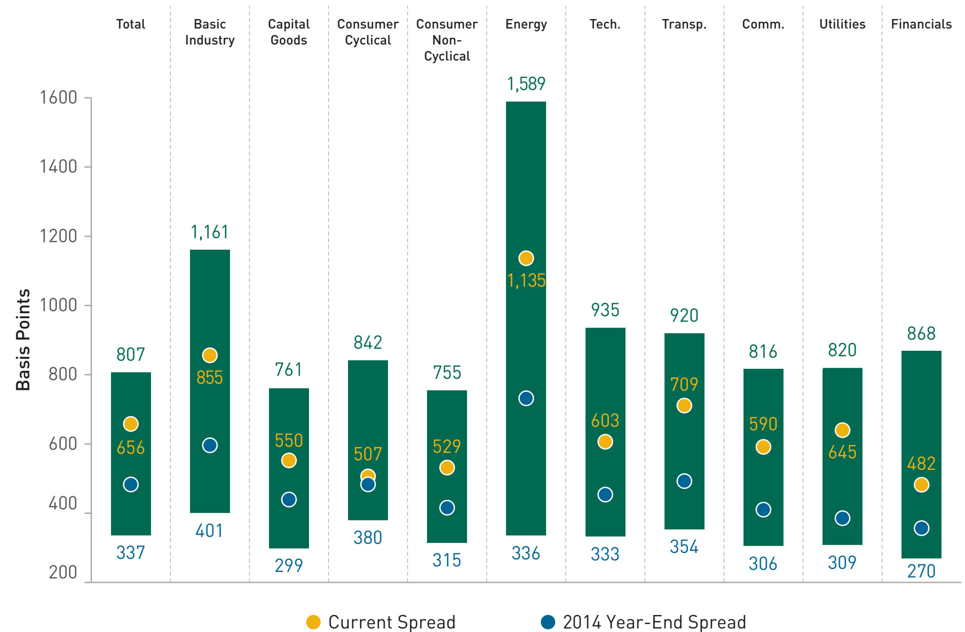
Another way that we have been taking bank loan risk is through CLO B tranches. Risk aversion and reduced liquidity conditions have driven debt yields for CLOs disproportionately higher than those for underlying loans. We recommend investors identify cheap valuations in relation to fundamentals.

We've seen a significant rally in the high yield markets in recent weeks. Valuations had reflected what we would consider to have been a US recession scenario, which made high yield very cheap. We think the market has been overly pessimistic and that high yield spreads, as well as credit spreads, continue to offer value. Overall, we think high yield companies are well positioned to pay off their debts, though certain sectors will continue to come under significant pressure.

Valuations appear to be pricing in more downside risk than is warranted in some sectors

High Yield Credit Spreads — Option-Adjusted Spread by Sector

Ranges since January 2010 with Current and 2014 Year-End Levels



Source: Barclays and PineBridge Investments. High yield is represented by the Barclays US High Yield Index. As of 31 March 2016. For illustrative purposes only. We are not soliciting or recommending any action based on this material. Any views represent the opinion of the manager and are subject to change.

There’s room for a bit of optimism

We think the US Treasury yield curve is likely to flatten as the Fed seeks a path toward policy normalization, while longer-term inflation expectations remain subdued. Continued global quantitative easing and the prospect of expanded policy stimulus from the ECB, Bank of Japan, and People’s Bank of China should support credit spread asset classes. Heightened volatility is likely to persist in the short term as investors balance slower global growth conditions with the potential for improved employment, and inflation data in the US dictate a continued hawkish Fed tone.

We think global growth will eventually pick up — in contrast to the market’s overly pessimistic expectations — and be accompanied by stabilization and modest improvement in oil prices as supply/demand imbalances fade. For investors, this outlook means that they have to be more nimble than ever to take advantage of opportunities in asset allocation and security selection.

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