WHAT NEXT FOR FIXED INCOME?

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Investors in fixed income have experienced a great calm during the decade since the global financial crisis, and in many ways this torpor has merely extended a trajectory that stretches back much further. It is around 30 years since interest rates in major nations peaked before embarking on a prolonged decline that still endures today.

With hopes of a renaissance in yields repeatedly dashed, the longevity of this trend has come as a surprise in many quarters. Yet now, amid the winding down of central bank intervention, something at least slightly different finally seems to be looming on the horizon. According to the findings of the first-ever Invesco Global Fixed Income Study, the great calm is at last coming to an end.

It is traditional for a calm to precede a storm, but our study – which involved interviews with 79 fixed income specialists working for pension funds, sovereign investors, insurers and private banks around the world – suggests a less dramatic sea-change. The majority view is that we are about to venture into the still relatively benign waters of a "new normalisation".

We use this term with care, because the consensus among our respondents is that what lies ahead will be untypical. The broad expectation is that the coming "normalisation" will be characterised by slow-to-moderate economic growth, gradual increases in central bank interest rates – resulting in a flattening of yield curves – and little risk of global inflation.

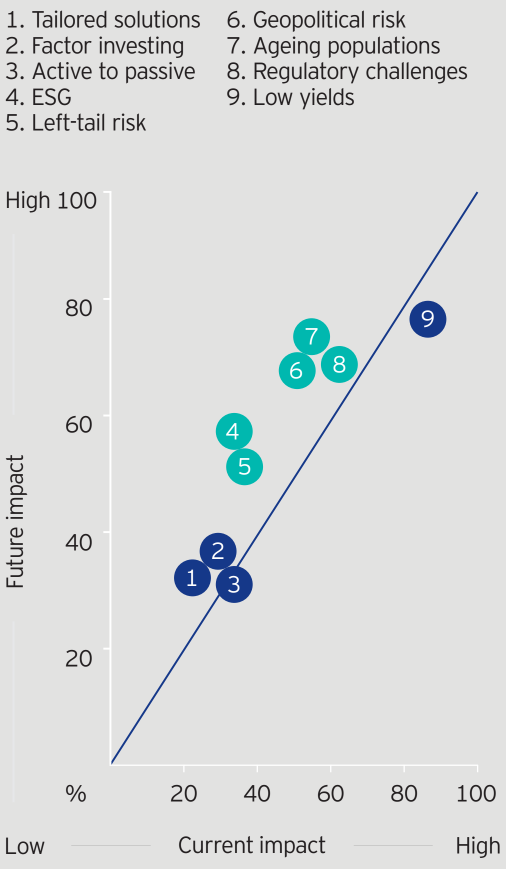
What is this likely to mean for fixed income investors? Before attempting to answer this question we first need to touch on some of the other key themes to emerge from the inaugural Invesco Global Fixed Income Study.

Low yields and beyond

The low-yield environment remains the single biggest challenge facing investors in fixed income (see figure below). It is an especially notable concern among pension funds and, to a lesser degree, sovereign wealth funds and private banks.

Encouragingly, our respondents generally envisage making progress in tackling the problem. There is a widespread belief that the situation is set to ease, even if only partially, and that this will create room for manoeuvre in addressing a number of related issues.

Macro factors, current and 3-year future impact on fixed income portfolios (% citations)



Source: Invesco Global Fixed Income Study 2018.

Foremost among these is the matter of ageing populations and their potential impact on pension funds, whether in terms of liabilities or income objectives. Insurers, meanwhile, find themselves in the midst of a tightening phase of the regulatory cycle and must contemplate the prospect of tougher asset, liability and risk-based capital management regimes. In addition, as we will discuss in more detail in the next section, the sector is adjusting to the rapid rise of ESG.

ESG in the fixed income space

The incorporation of environmental, social and governance considerations into investment decisions has become a cornerstone of many equities-based strategies in recent years. Fixed income often follows equities' lead, and the ascent of ESG appears to offer no exception.

Some 35% of our respondents now apply ESG principles to their fixed income portfolios. Large European investors are at the vanguard of a shift that is being driven by factors including peer and stakeholder pressure and the social and political climate of specific countries or regions. DC pension funds have the highest current and likely future uptake of ESG strategies, and this trend is likely to intensify as the representation of more ESG-conscious millennial members grows over time; for now, by contrast, private banks and insurers see ESG as of less importance.

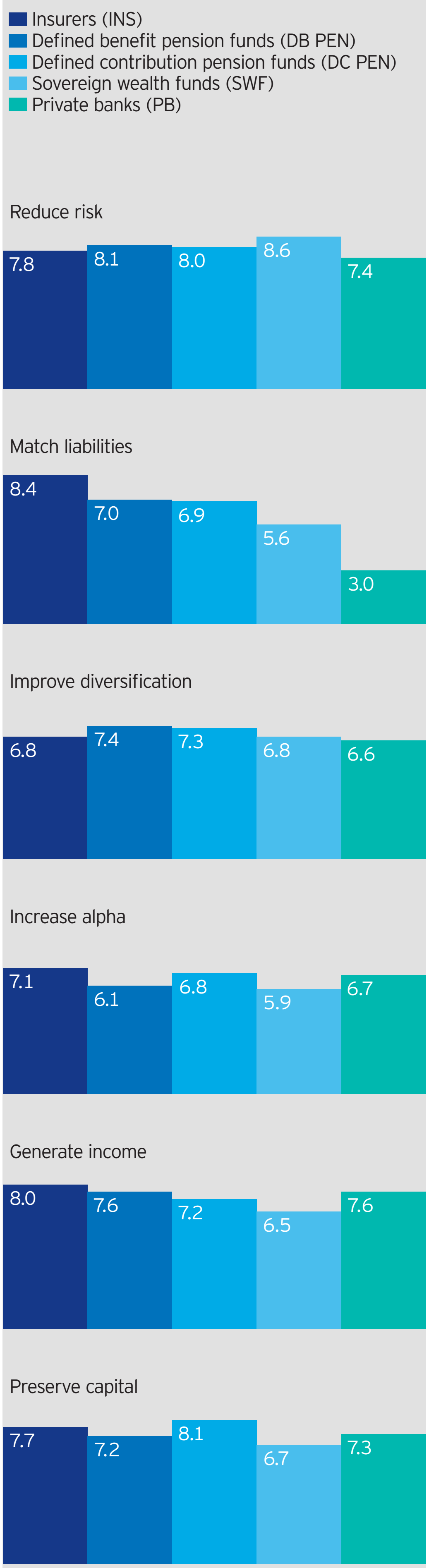
The Global Sustainable Investment Alliance, a collaboration of the world's biggest sustainable investment organisations, reports that negative/exclusionary screening is the most popular responsible investing strategy. Our study echoes this assertion for the fixed income sector.

Alternative credit

The great calm has compelled many investors to rotate into riskier assets in a bid to expand their search for yield. This move further up the risk-return spectrum has been especially conspicuous during the past three years. Our findings indicate a further readjustment in anticipation of the great calm's end.

In light of a predicted rise in yields, many investors now look set to increase their allocations to core fixed income. Some 63% of respondents signalled their intention to follow this path, with DC pension funds and insurers leading the way. Recent developments such as pensions

Reasons for investing in fixed income, by segment



Source: Invesco Global Fixed Income Study 2018.

deregulation – witness, for example, the advent of "pensions freedom" in the UK – have fuelled renewed demand. Funding for this return to more traditional asset classes should come predominantly from equities.

Alternative credit is still favourably regarded overall, with our respondents expressing a mainly positive view of the next three years, but a more selective approach now seems likely. Emerging markets are seen as offering particularly good value at present, while the likes of high-yield debt, structured credit and direct lending are deemed comparatively expensive.

The journey ahead

After 10 years of drifting through the great calm, many investors in fixed income will surely be interested – and maybe even relieved – to see their voyage take some kind of meaningful turn. So how might the journey unfold?

The overarching takeaway from the first-ever Invesco Global Fixed Income Study is that the way ahead invites a mixture of optimism and caution. The outlook is positive relative to recent experience, but it is not positive relative to ingrained assumptions of robust growth rates and cyclical booms.

A summary of respondents' reasons for investing in fixed income is telling here. It shows that in the run-up to the "new normalisation" era, allowing for inevitable variations between segments, fixed income is still used principally to reduce portfolio risk, preserve capital, generate income and match liabilities (see figure opposite).

In other words, investors still rely on fixed income to meet its long-established goals and to deliver its time-honoured benefits in a portfolio context. Such is the case even after a period that has left them eking out returns as yields in one sector after another have become compressed.

Going forward, this challenge will require even more flexibility and adaptation from institutions and asset managers. The waters of "new normalisation" may not promise a raging storm, but they will be uncharted.

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