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Spotlight on fixed income

Investing in a world of (Brexit) uncertainty

December 2019

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- Recent history is rich with examples of misjudgements about the outcomes of political events.
- Markets do not always react in the way experienced market participants might expect them to when outcomes of events surprise them.
- Instead, one can navigate elevated uncertainty surrounding outcomes and reactions, by focusing on the value available for the risks that prevail, and retaining 'dry powder' to take advantage of opportunities that arise.

The folly of forecasting

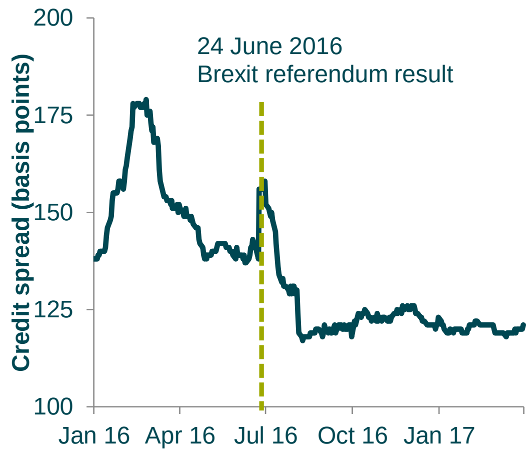
Most investors focus on a top-down 'forecast' or 'view-based' investing approach. They seek to identify the path of key economic variables, the push and pull of political and central bank policy stresses, and to anticipate what they may mean for markets. They then use those expectations to determine primary investing decisions in their allocations to asset classes, interest rates, yield curves, country preferences, and even currencies.

We believe that applying forecasts can introduce significant volatility into returns, essentially relying on an ability to consistently forecast an array of (often conflicting and frequently interrelated) variables, and to anticipate the market response. As bottom-up value-based investors, we believe in focusing on potential returns available, by assessing the fundamental, or underlying, credit risk of issuers. We can then determine whether risk and pricing are misaligned, by comparing the market price of the debt to the issuer's credit risk. In our experience, this enables us to deliver consistent longer term returns, crucially without reliance on trying to forecast market moves.

Right expectation, wrong reaction?

In the political arena forecasting can be fraught with uncertainty, and can lead to erroneous assumptions. Taking the Brexit referendum as an example. If you had correctly anticipated the 'Leave' result and positioned accordingly, you would likely have implemented a strong negative view of UK credit markets based on the prevailing expectation of how the market would react. The actual market response would have confounded you, with UK credit spreads spiking wider for one day, then rallying for the next six weeks (Fig 1).

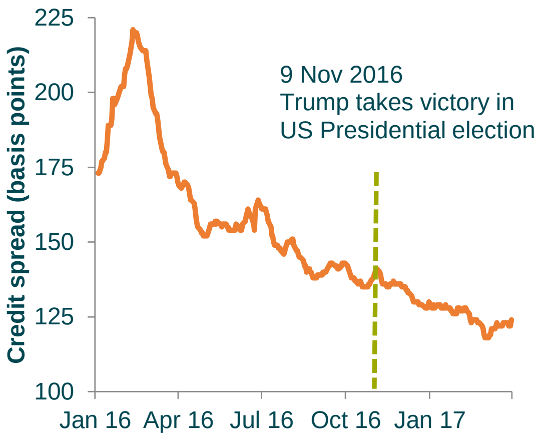
Figure 1. UK credit only briefly upset by Brexit vote



Source: ICE BAML UK non-gilt index (UN00), Bloomberg. As at 4 Dec 2019

Similarly, the credit market response to the surprise election of President Trump in November 2016 was unexpectedly muted. Conventional wisdom at the time, considered a Trump victory as likely to be unfavourable to credit markets. In fact, US credit spreads continued to steadily tighten through the winter, with little notable volatility in the months following the election (Fig 2).

Figure 2. US credit confounded expectations over Trump



Source: ICE BAML US Investment grade corporates (C0A0), Bloomberg. As at 4 Dec 2019

Identify the risks you want to take

In addition to credit markets, political events can also have an effect on interest rate markets. For example, the forthcoming election in the UK will likely have a profound impact on the level of UK government debt issuance, given the manifesto spending pledges of the main parties. This, in turn, could create exceptional volatility in gilt yields. However, in our multi-asset credit strategies, we have always sought to hedge or remove interest rate and yield curve risks, maintaining interest rate duration close to zero. This leaves our portfolios with almost no exposure to movements in the direction of underlying interest rates that might arise from market-moving events, political or otherwise.

As a consequence of the types of unpredicted reactions that can arise from events both political and economic, we do not invest on the basis of forecasts. Where Brexit is concerned, this means that we are cognisant of those companies that may be more exposed to, for example a harder Brexit, where no deal has been agreed between the UK and European Union. The analyst would assess the impact this might have on their credit fundamentals. We would then assess whether the risks and pricing were misaligned, based on current market pricing of those risks.

Assessing value now, not guessing future paths

In respect of the forthcoming general election, credit analysts will naturally consider sector and company specific risks. As an example, the threat of nationalisation may affect their fundamental views of utilities broadly and certain companies specifically. These considerations will be combined with the other factors, such as regulatory risks, capital expenditure and carbon emissions requirements, and our current assessment is that the sector offers poor relative value. Aggregating this analysis means we are currently very negative on most companies in the utilities sector.

In other areas, heightened Brexit concerns and uncertainty last summer, enabled us to switch from a number of fairly valued, but fundamentally weaker, peripheral European banks into cheaply priced UK banks with much stronger balance sheets, on very attractive terms. We will always assess each opportunity separately, building portfolios from a highly diversified range of issuers. We look at the individual valuations and risks we observe today, and ask ourselves whether we are being compensated for the risks of investing in an issuer.

Being prepared to react

The other key aspect of our approach is to always ensure we have ‘dry powder’ to take advantage of unexpected events and opportunities that arise regularly in markets. This takes the form of maintaining a base of ‘defensive’ high quality, liquid assets and cash, available for deployment. Where we observe that valuations are becoming over-stretched, and we are not seeing compelling opportunities, we will wait, adding to our defensive assets until we do see better opportunities. Rather than trying to predict the (often binary) outcome of events, be they political events, economic data releases, or central bank policy decisions, we are, instead, well-placed to capture the opportunities that routinely arise from them.

Wise words about forecasting

While many investors believe in their ability to forecast markets correctly, we have long been advocates of the wisdom provided by the Nobel laureate, Niels Bohr, who said, “prediction is very difficult, especially if it’s about the future”. Wise words indeed…