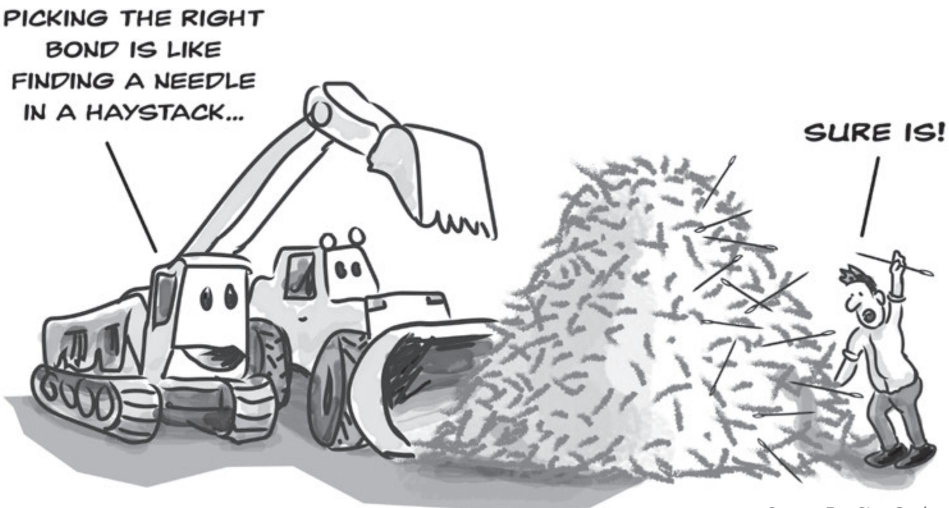
Fixed **income** insights

Like finding lots of needles in a haystack

We have a new Fed Chair nominee in the form of Jerome Powell, but with core inflation constrained and the long-run GDP growth trajectory unchanged, there is not a lot of room for the presumptive new Fed chairperson to dramatically alter monetary policy.

Stronger recent GDP numbers highlight how far the global economy has come from the global growth fears in 2015 and the Brexit vote volatility in 2016, but these developments have been largely absorbed and priced in, leaving participants looking for value in the market. As such, our focus on bottom-up security selection has increased as we continue to identify stories where the market has overreacted or underreacted to single name headlines. Interestingly, amidst a rush to index funds, ETFs and smart beta, picking the right bond has the feel of a lost art.

We have enjoyed using pop culture as our foil to illustrate themes in the bond market, but sometimes there are fewer events or upcoming announcements to parody or analogies to draw. In some ways, this lack of metaphors is itself analogous to the rather benign current market conditions. Instead we look to history, the proverbial needle in the haystack, as we find that many market participants have effectively eschewed security selection as infeasible or non-productive, while we view security selection as a prime opportunity for differentiation.



Source: Top Step Design

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That's it?

As we look forward to this differentiation, we look back to the trailing 12 months through September 30, 2017, when the Bloomberg Barclays Aggregate Bond index returned 0.07%. While this result appears disappointing at first blush or a market of little news, neither is the case. For many years, rising interest rates have been front and center in the collective investor mind as a point of concern for fixed income. Yet, during this trailing year, rates rose over 70 basis points on the 10-year Treasury, a near 50% increase from the low starting point of 1.59%, and the outcome was far from catastrophic.

Even in this environment, Treasuries delivered a relatively minor loss of -1.67%. The index's flat performance was driven by the positive performance of non-governmental sectors, with credit and mortgages returning 1.96% and 0.30%, respectively.

This is normal?

This context is of particular importance given that the Federal Reserve officially commenced the plan to begin the wind-down of their $4.5 trillion balance sheet in October. While the Fed balance sheet has long been a support for fixed income markets, their exit plan is so deliberate, so methodical and so transparent, we believe its impact is largely priced in to U.S. interest rates.

While the European Central Bank (ECB) is not ready to take that step, they have announced their own deceleration of accommodation. The ECB will begin decreasing their monthly purchases of fixed income securities, though the balance sheet will continue to grow, albeit at a slower pace. In tandem, these suggest the slow normalization of monetary policy globally is becoming less hypothetical and more real, though it will proceed at a glacial pace.

If the third quarter return outcome seems surprising, the economic impact of the Fed's rate hikes would then seem shocking. While the Fed has tightened monetary policy three times in the past year vis-à-vis increases in the Fed Funds rates, overall monetary conditions have eased during the same time period. The Fed rate hikes are but one component of rates, just as rates are but one component of market returns. In both cases, the concerns to date have been overwrought. In fact, strengthening financial conditions reflect lower borrowing costs for issuers, which has allowed for continued issuance and strong performance as supply is met by demand.

U.S. financial conditions

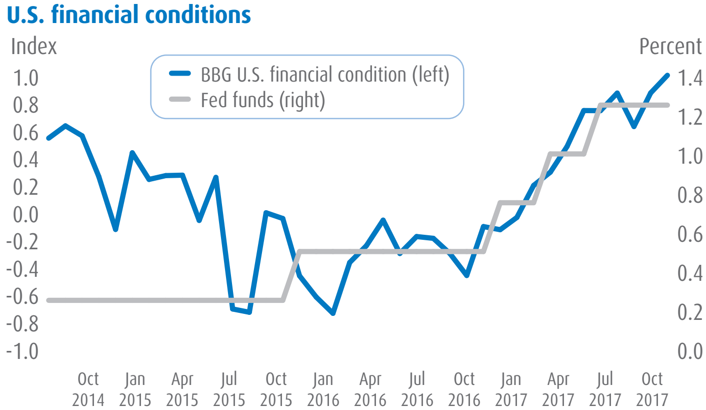

Chart source: Bloomberg Barclays

Treasuries are down, spreads are tight

As Treasuries declined in price and rates rose over the past year, most non-governmental sectors performed well. The result has been that sectors such as U.S. investment grade credit spreads have tightened to inside of historical median levels. The same tightening phenomenon can be seen in terms of all manner of spread sectors, from U.S. Corporate High Yield to Emerging Market Debt. This tightening reflects the combination of not only the rise in yields, but the strong global growth environment and in the case of corporates, strong profits. As these positive economic environments may be prolonged, so too may the periods of spreads remaining below the historical median. Though not the standard, such was the experience for Credit for nearly a decade from 1991 to 1998 and another four-year period from 2003 to 2007. The history suggests that such valuation levels should prompt additional caution and scrutiny, but do not suggest an imminent reversal.

U.S. credit option adjusted spread

Chart source: Bloomberg Barclays

For some sectors, notably bank loans, strong demand has led to a weakening of deal covenants. For traditional bonds, the continued strong demand has led to a continued proliferation of issuance. According to SIFMA (Securities Industry and Financial Markets Association), issuance of corporate debt has topped $1 trillion each year since 2010 and is on pace for a record issuance of close to $1.7 trillion in 2017.

Plenty of fish in the sea

While bond issuance continues to be strong and even setting new records, the opposite is true for the equity markets. Investors have lamented the declining number of public equities, which has been observed in the lack of initial public offerings (IPOs) and continued delistings due to factors such mergers & acquisitions.

The result has been that not only have equity markets failed to grow in issuers over time, but the absolute number of public securities has declined meaningfully. For example, the Wilshire 5000, which is intended as a 'total market' index (and named for the approximately 5,000 stocks it included at inception in 1975), had but 3,503 constituents as of September 30, 2017. In fact, it has been a dozen years since the index contained 5,000 securities.

In 1995, the number of stocks and bonds was roughly equal at approximately 6,900. However, that date reflects a relative peak for stocks and nadir for bonds. Since that time, the number of equities has fallen 46% while the number of bonds has grown 120%. The now frequent laments that equity investors suffer from a lack of choice cannot be expressed for the bond market, where the opportunity set is robust and growing.

Number of public securities since 1990

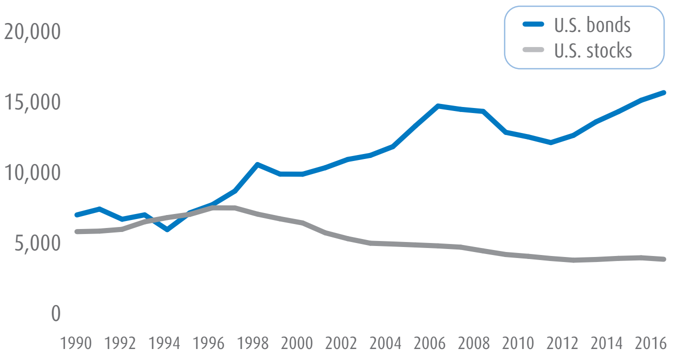

Chart sources: Bloomberg Barclays, Doidge, "The U.S. Listing Gap" and Credit Suisse estimates.

Of particular note is not just the number of securities, but the dispersion among them. Looking back to the end of 2005, a period with similar levels of overall credit spreads, our analysis of securities shows that the 25th/75th percentiles were approximately 60% to 140% of the median security spread. Using the same analysis at the end of the third quarter 2017, we found that the gap had widened to 50% to 165%. This greater differential reflects trends we have highlighted in previous pieces, such as ratings migration and extending maturities. It also emphasized the greater opportunities to add or detract value through selection.

Let's make a deal

Interestingly, the Bloomberg Barclays index rules have been adjusted multiple times to raise the minimum deal size to be included in the index during this time. In 1990, a bond could be only $25 million and be included in the index. This was doubled in 1992 and again in 1994, raised to $150M in 1999, to $200M in 2003, $250M in 2004 and $300M in 2017. So the growth of observed fixed income issues is despite more restrictive criteria for what constitutes an index-worthy issuance.

This increase in minimums corresponds to an increase in average deal size. As the maturities of issued debt have extended to capitalize on rates, fewer new deals have come to market, but those new deals have been growing steadily larger. The larger deal sizes are beneficial for secondary market liquidity, which becomes of added importance as bonds remain outstanding longer and new issuance, while robust, remains a fraction of the market.

Number of new deals vs. deal size

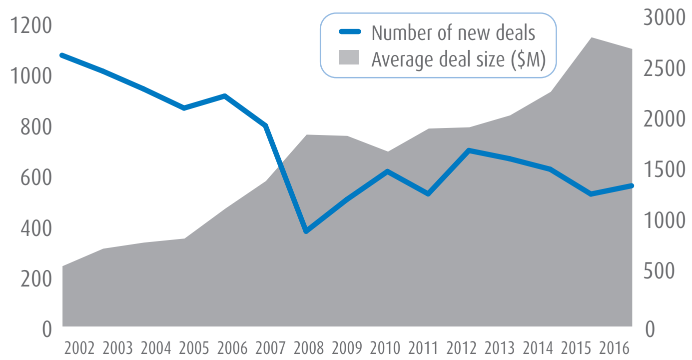

Chart source: SIFMA

It's either a very small haystack or there are a lot of needles

Our analysis of duration adjusted returns of the investment grade credit index (including Treasuries and agency mortgages skewing results) shows that even modest positive security selection can be additive. The 55th percentile of issuers returned, on average, 28 basis points above the median and 48 basis points above the average per year since 2010 (including the more dramatic 2008, 2009 returns that amplified these results). With an index of 1,007 issuers as of September 30, 2017, there are 550 issuers that would fit the bill. A more ambitious target, the top 25% of issuers, returned 3.7% per year of excess returns versus the median of 1.8%. A small number of good, but not great picks, and a lot of median ones, would serve an investor well.

With an average of about six issues per issuer, an additional layer of value can be found when discerning between the various bonds from a single issuer. Further, while mergers have decreased the number of public equities, some of the bonds of predecessor firms survive, and may be attractive due to, or in spite of, the conditions of the merger.

Seek and ye shall find

The proliferation of bond market issuance and the ability to find additional basis points at relatively low levels of dispersion would suggest security selection as a prime opportunity within the market. However, in examining the Morningstar Intermediate Term Bond category, we find another story. Eighty percent of the $1.4 trillion categories assets are held in funds with over 1,000 holdings. Nearly another 10% have between 750 and 1,000 holdings. A mere 5% of the assets are held by funds with under 400 line-items, the level at which a holding would have an average of a 0.25% exposure.

While there is no magic number of holdings that suggests a focus on selection, it strains credulity that the funds with four-figure holdings lists are deriving meaningful returns from bond picking. Conversely, having below a threshold of holdings is a necessary, but not sufficient, condition for generating security selection alpha.

Conclusions

The landscape for spread sectors seems strong, but the potential for further spread compression seems limited given the recent tightening of spreads across non-governmental assets. Rates, too, face the challenge of normalizing policy and improving economic data, though offset by multiple factors such as low inflation and robust demand.

This situation comes at a time when the trend to passive and smart beta strategies suggests a de-emphasis on security selection as a key factor in investment returns. However, while the equity market has suffered a decline in the number of choices, fixed income has seen a proliferation of issuers, issues and, ultimately, choices for investors. Demurring from a potential source of returns seems counterintuitive. However, that appears to be the more common path today.

With headlines, both business and political, driving volatility in individual issuers, there seems to be an acute opportunity for nimble capital to react and take advantage of the current environment, an opportunity we intend to pursue. It may be like finding a needle in a haystack, but there sure are a lot of needles.

Portfolio positioning

Interest rates/duration: Narrowing the duration gap versus benchmarks as U.S. Treasury rates appear reasonably well-balanced given the current economic and geopolitical backdrop; however, balance sheet reductions from the Fed and ECB tapering warrant monitoring

Credit: Overall, global demand for U.S. fixed income remains strong; Broadly-speaking, U.S. corporate balance sheets have managed the credit cycle well; credit spread compression towards historical averages—offset by strong corporate earnings—suggests risks largely in balance; while primary market concessions continue to underwhelm, significant new issue supply should persist and create additional opportunities in secondary markets

Securitized: Concerns for mounting pressure on U.S. agency MBS have largely abated as the Fed balance sheet normalization plans proved rather benign; following some OAS pressure, which was expected, risks appear fairly well-balanced; CMBS "dupers" appear attractive relative to similarly-rated cross sector opportunities

High yield (HY) and emerging markets (EM): Highly selective approach to higher credit beta opportunities as lower quality credit stories appear fully-priced relative to the investment grade/higher quality buckets

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