INVESTMENT
INSIGHTS

Bond Investing in a Low Interest Rate, Low Yield, Low Inflation World

Paul Brain, Fixed Income Investment Leader at Newton Capital Management Ltd, describes the topsy-turvy world of a global fixed-income investor.

Paul Brain
Fixed Income Investment Leader
Newton Capital Management Ltd

P&I: How would you describe your team's investment approach?

Paul Brain: We are active, global fixed-income investors without a bias toward any local market. We use long-term themes to help understand the direction of markets. Fixed income is heavily influenced by macroeconomics and interest-rate trends. Using a global approach can be a great way to diversify risks, while being active provides the flexibility to pursue attractive returns around the world.

P&I: How does this translate into an investment process?

Paul Brain: We have an experienced team that uses themes and models to construct a globally diversified fixed-income strategy. The themes are there to help us try to understand the long-term dynamics of economies, and therefore interest-rate trends, currency values and bond market returns. The models help us evaluate what the underlying economic variables are worth. We are constantly asking what valuation level is appropriate for certain bonds and how much is priced in at the moment.

Since 2008, we have been following a "debt burden" theme. In this low interest-rate, low-yielding, low-inflation world, we don't think that debt burden is going away quickly. That sets the scene for the models and valuation techniques. Ordinarily, that scenario might suggest that bond markets are too expensive. But in reality, if growth is going to continue to be low, then maybe those yields are actually fair value. So we effectively have a subjective overlay at the end that comes from our experience as a team.

P&I: Is it a bottom-up or top-down approach?

Paul Brain: Our approach is top-down and lends itself to the tight-knit team we have in London. We work with other Newton investment managers and analysts with different disciplines (such as those covering equity or multi-asset strategies) to gain a more holistic view of markets. We use a relatively small team to identify opportunities because we want to maintain maximum flexibility. We believe it works because we aren't looking to replicate an index; we are looking for opportunities. We tend to have concentrated portfolios of 60 to 70 positions vs. an index composed of more than 10,000 securities, so we are able to be nimble and dynamic.

P&I: How would you describe the global fixed-income market today?

Paul Brain: In a sense, we believe it's completely irrational. We have all observed that central banks have been distorting markets. The bond markets have become a conduit of monetary policy, arguably losing some of their value in determining a true measure of risk and interest rates. To some extent, we see this as a necessary evil because of the need to work through the debt burden through the financial repression of low interest rates and yields. Hopefully, you get some growth and inflation on the other side. That's the mechanism that's been running since 2008 and we don't see that changing.

Fixed-income markets are more difficult to analyze because of these distortions. But equally, if you believe these distortions are not going to go away, you just need to get on with the job and invest. Just look at the European bond markets in April and May. German 10-year rates dropped to five basis points in mid-April, then shot up to 75 basis points in mid-May. Is there value at 75 basis points? If you believe that negative interest rates are here for some time, then the market is probably getting close to being fairly valued. What is difficult to work out is the amount of selling (flow) that could occur. You get these sharp tensions and moves in the market, making it a somewhat uncertain environment for investors.

P&I: Does liquidity or the lack of liquidity impact bond markets now?

Paul Brain: The bond markets have changed because market-makers hold smaller order books and have less balance-sheet capacity than before. So the general liquidity of the market is not as good, but equally, low yields have encouraged governments and companies to issue bonds, so the size of the bond market has increased. Fewer market-makers and more investors distort the market and that's why you get these dramatic yield movements.

Default rates have been low since 2008 because covenants are stronger and leverage lower than before the credit crisis. But as you look forward two or three years, we think they may not stay so low. Credit risk at the individual company level is high because some issuers have gone back to the pre-credit crisis practices of weaker covenants. Business models are being stretched in the high-yield space, so we believe that some individual companies will go bust. At the same time, we think overall market conditions are supportive of credit because there continues to be positive growth. However, some forward-looking econometric models suggest that the economy will be rolling over in the second half of 2016.

P&I: What macroeconomic issues most concern you?

Paul Brain: It's almost frustrating how long the Fed is taking to raise rates. The general economic background in the U.S. today is pretty mixed, with some of the positive trends looking a bit tired to us. U.S. corporate profits could be rolling over and there's been a general lack of investment, which is quite surprising given how far along we are in the cycle. But wages are creeping up, as you would expect in the second part of an economic recovery. I think that the Fed will have a mandate to raise rates in the second half of the year, but the window to push up rates appears fairly narrow.

We've been talking about the European economies turning around since the beginning of the year and now there's clear evidence that that is happening. The caveat is Greece. If Greece is forced out of the euro or has to go through a significant restructuring of its debt, it will cause uncertainty. But the rest of Europe, places like Spain, Ireland and Italy, have reformed parts of their economies and we see them recovering quite nicely. European growth is unlikely to be anywhere near that of the U.S. or Asia. At best, we think it's going to be 2% to 3%, but that it's more likely to be 1% or 2%.

P&I: Does the slowdown in Chinese growth concern you?

Paul Brain: The Chinese authorities are going their own way, although I believe they have enough firepower to sort out their problems. There's been an immersive credit explosion, manifested particularly in the real estate market, but also through states and companies. It's intriguing to see how that debt has been swapped into bonds. While it's not a nice experience for bond investors, it's a neat way of solving one of China's problems. China is a massive economy going through a huge transition, so it's difficult to come to any logical conclusion about the outcome from the numbers.

That said, the economy is transitioning from being export-led to being more balanced. It will probably involve holding less in reserves, which has implications for other markets — in particular, U.S. Treasuries. Aside from this, China is also planning a new wave of infrastructure spending, including the development of a Silk Road and maritime link through India and Pakistan to Europe. It's a 10- to 15-year project, so I don't think we'll see a significant slowdown. Cutting interest rates and restructuring debt should keep the economy moving along at 5% to 7%, rather than the 7% to 10% we saw before.

P&I: Where do you see opportunity in the near future?

Paul Brain: If you look out over the next six to 12 months, and with the assumption that the Fed will raise rates, we think the curve will flatten, with the front end setting off the long end. Once investors realize that there isn't an inflation problem, we think yields will start to stabilize and come back again. So we see the long end of the Treasury market as a place to seek opportunity and, at the moment, I would balance it with some short positions at the front end. That's a position that looks more attractive to us now than it has for some time. At some point, you could take the hedges off and just hold the long bond.

When it comes to credit, we see some idiosyncratic company risk, but generally view the market as okay. Right now we expect there to be some volatility in both high-yield bonds and equities through the summer months, given the likelihood the Fed will raise interest rates and corporate profits will decline. So credit is not a market we would rush into right now. But as the market becomes affected by volatility, it may become cheaper and then we'd look to get involved.

Right now, it's probably wise to batten down the hatches, which is what we've done. We've taken off quite a lot of interest-rate risk and credit risk. In the second half of the year, the long end of the Treasury market and high yield may be more attractive. If you don't mind some volatility, owning euro-denominated assets could be an opportunity as the European Central Bank is set to buy more bonds than are issued, leading to a squeeze. ❖

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Newton Global Dynamic Bond Strategy

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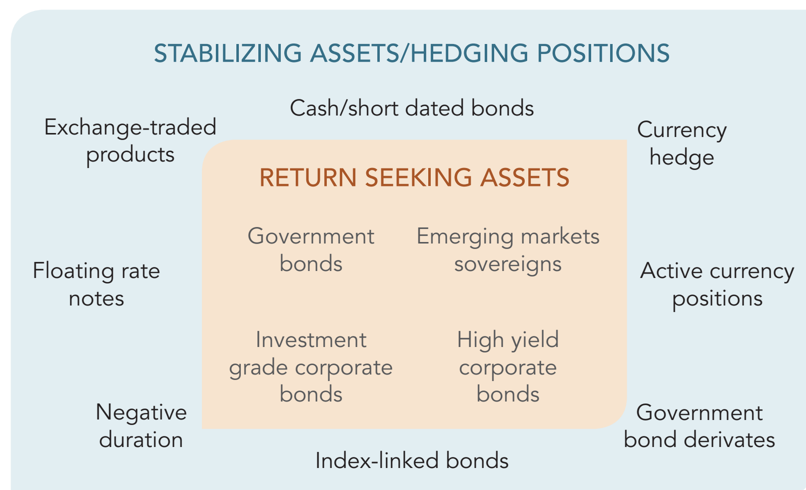
NEWTON
The Power of Ideas
A BNY MELLON COMPANY℠

- Newton manages **$14.1** billion in fixed income securities across the firm
- Unconstrained, global approach based on our view of the world and not dictated by index weightings
- Stable and experienced team that has worked together since strategy launch and which has delivered positive returns every year since launch.

Conceptual representation

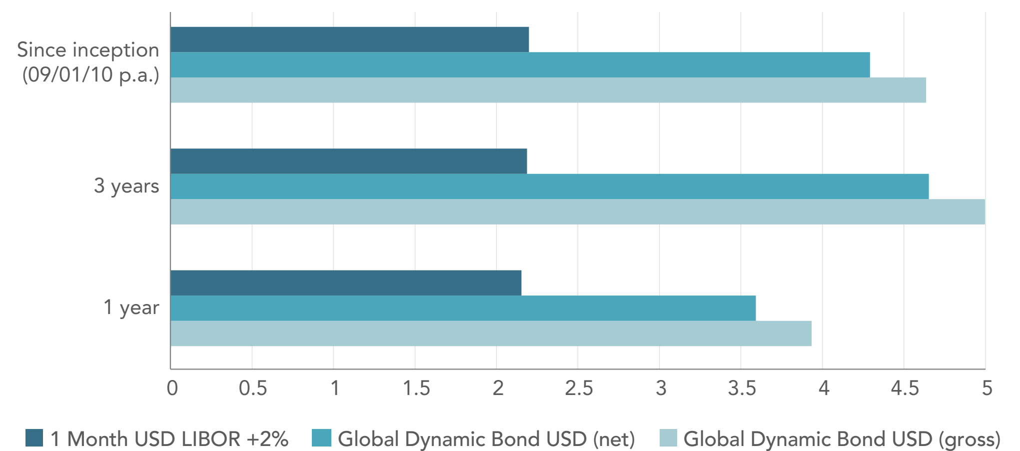
Transparent, single portfolio of direct investments, backed up by fundamental analysis.



Source: Newton, 2015

Global Dynamic Bond Strategy performance

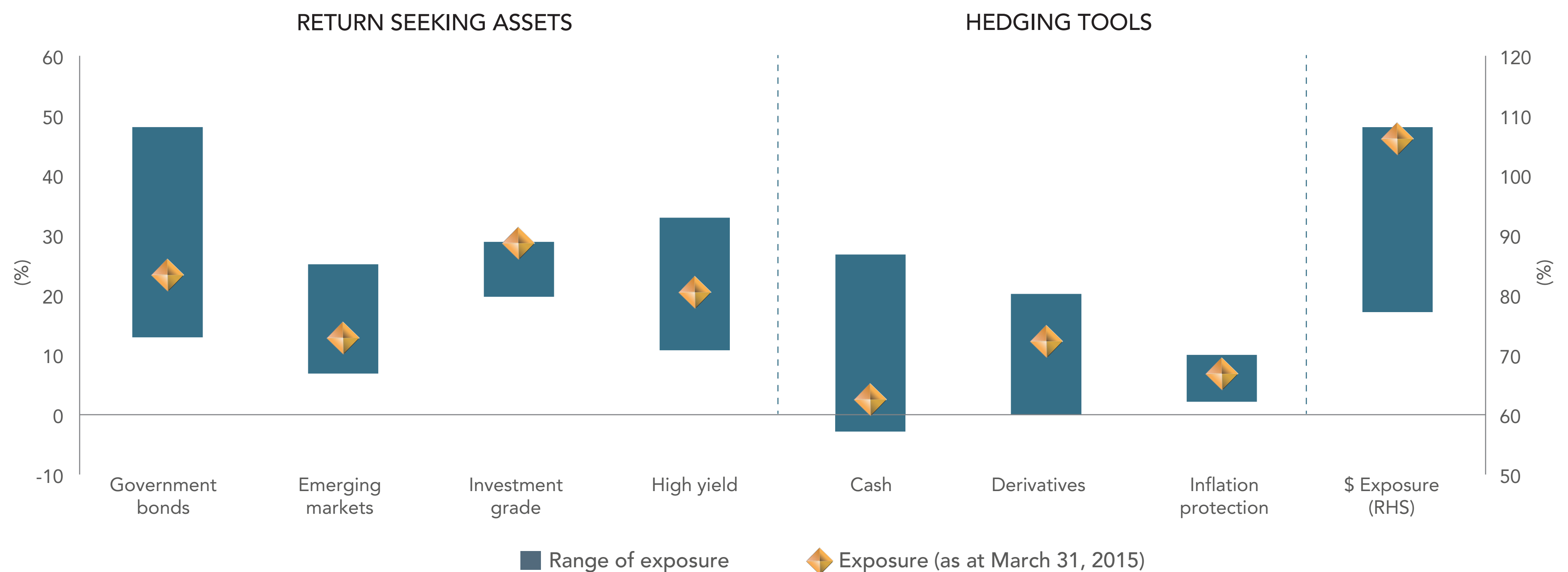
We believe flexibility to invest dynamically has been key to the strategy's success.



Source: Newton, Global Dynamic Bond USD strategy as of March 31, 2015
Past performance is not a guide to future performance.

Strategic positioning - since launch

A strategy seeking to navigate changing market conditions through dynamic asset allocation.



Source: Newton, launch September 1, 2010, positioning as at March 31, 2015

Vehicles Offered

MUTUAL FUND[1] SEPARATE ACCOUNTS COLLECTIVE TRUST[2]

[1]*Offered through The Dreyfus Corporation and is not available to Canadian investors.*
[2]*Not available to Canadian investors.*

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