

INSIGHTS

INVESTMENT

Finding value in the corporate bond market



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Investment-grade bonds have historically offered a safe haven for institutional investors when the market starts swinging, but this year, the sector hasn't fared much better than other asset classes. In fact, investment-grade bonds are poised for one of their worst years since the financial crisis.

There are plenty of factors contributing to the losses. In addition to dealing with continued interest rate increases by the Federal Reserve, which have pressured yields, bond investors have also faced supply-related pressures from repatriation issues created by tax reform in the first quarter, continued mergers-and-acquisitions activity and an increase in BBB-rated bonds.

All of that has created a volatile market that has some market watchers predicting that the end of the bull market in bonds is near. But for smart investors and those willing to take on some risk, opportunities are out there, according to Manulife Asset Management bond fund managers.

"It hasn't been the easiest of markets, but we're a bottom-up manager, so we're able to find things that work," said Howard Greene, head of the U.S. core and core-plus fixed-income strategies at Manulife Asset Management. "The 10-year Treasury yield is at the highest level it's been since 2011. You take that factor, along with some wide spreads, and it's not the worst time to be putting money into fixed income. There is value relative to other asset classes."

CYCLE MAY HAVE 'A FEW MORE YEARS'

There are signs that the cycle is closer to its midpoint than its end, said Jeff Given, a senior managing director and senior portfolio manager at Manulife Asset Management. While the Fed funds rate has been moving upward, the trajectory has been slow, inflation has held steady around 2% and unemployment remains low.

"We should still have a few more years, at least a few more quarters, of this cycle paying out," he said. "Maybe the earnings growth isn't as high as it was before, but you still have some good fundamentals supporting corporate credit and overall economic activity."

The current market is more of a "coupon-clipping" environment for smart corporate debt investors, Greene said, with the bulk of income coming from the carry rather than from spread compression.

But that doesn't mean that it's going to be a smooth ride. There is likely to be heightened volatility in the markets

across all asset classes, especially compared with the low-volatility markets of the past few years.

"It's important to keep that longer-term view of things, so you're not getting whipsawed around as markets change on a day-to-day basis," Given said.

COMPARISON TO 2003-2007

The higher yields and wider spreads of today's market feel similar to the market of late 2003 to mid-2007, when the Fed pushed the Fed funds rate from 1% to 5.25% but investment-grade credit spreads oscillated in a fairly narrow band, according to Greene, who said it's unlikely that the interest rate will go that high. Indeed, Greene said he feels comfortable with the cost of investment-grade debt today, expecting that credit spreads will be similar to that earlier period after adjusting for the higher percentage of BBB-rated corporate bonds in the current market.

"We can typically discern between credit that's at real risk of a downgrade versus a credit spread that's widening and take advantage of the market."

- Jeff Given

"Looking at that market [from 2003 to 2007], valuations seem to be appropriate for this point of the cycle," Greene said. "We've been trading in that band all year, and we expect it to continue. It will likely ebb and flow on perceptions of valuation."

Of course that market led into the Great Recession, but Greene said he believes that "can't and won't" happen this time around for several reasons. The cost of debt is much lower, companies are generally in better shape to handle the debt loads they have and many have opted for longer-term debt. In addition, many companies have strengthened their balance sheets in recent years.

Bank balance sheets, in particular, are much stronger than they were a decade ago, and there are financial reg-

ulations and guardrails in place now that didn't exist then. Plus, hedge funds, have derisked significantly, and many of those that took the largest risky bets have closed up entirely.

"We also don't have that identifiable bubble today that we had leading into 2008," Greene said. "There's no housing bubble. There's no excessive valuation in the equity market. There's no huge piece of the economy that's been over-levered and over-valued and securitized across the whole spectrum."

When the next recession does come, it is likely to be more of a traditional recession, like the one that occurred in 2002, rather than a systemic recession that shuts down the entire system, Given added.

LIMITED RISK FROM RISING RATES

With that backdrop, Greene suggested that institutional investors should not be too concerned about rising rates, particularly as they relate to corporate bonds.

"For a value- or a yield-based investor, we should be much happier with the 10-year at 3.10 or 3.15 than when it was sub-2%," he said. "We're getting a better real rate of return, and there's better valuation out there. If you look at the yield for the corporate market, it's at 4.38%. That's the best yield we've seen since mid-2010. You're getting a much better return profile now than we've seen for a long time."

While they anticipate a December rate hike, Greene and Given said they believe there's a chance the Fed will pull back on the expected hikes next year. Still, the volatility in the market makes it even more vital to find managers who know what they're doing and where to look for value.

While declining to cite specifics, Given said they continue to like the financial space and they're taking another look at mortgages. They've been underweight in mortgage investments in recent years, but that could change as the Fed continues to unwind or reduce its balance sheet.

"There are certain sectors where we see a steep yield curve," Given said. "You can find opportunities. This is where the active management can add some value. It's not as easy to just blindly allocate to investment-grade credit going forward, but we feel you can add some incremental revenue from active management. We can typically discern between credit that's at real risk of a downgrade versus a credit spread that's widening and take advantage of the market." ■

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