Search for stable income continues in 2020

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With a precarious stability priced into markets as optimism about economic growth is balanced against fears of further weakness, we see value in focusing on the yield that can be captured with minimal volatility and by seeking diversified sources of return.

Key Takeaways

- Today, a precarious stability is priced into markets as optimism about economic growth is balanced against fears of further weakness. While credit markets are likely to remain supported, above-trend growth will be necessary to realise another strong year of credit market returns.
- The recent divergence of CCC and BB rated credits in the high-yield market showcases the importance of strong company fundamentals in below-trend growth environments. Selectivity in pharmaceuticals, healthcare and energy will be particularly important given that 2020 is a US election year.
- Given the uncertain landscape, we see value in focusing on the yield that can be captured with minimal volatility and by seeking diversified sources of return to further mitigate portfolio volatility.

The swift correction in bond markets in the last quarter of 2018 set the stage for strong performance in fixed income in 2019. After that short-lived but precipitous decline, concern over trade disputes and potential slowing of the US economy led 10-year Treasury yields to fall steadily for much of the year, boosting total returns across many fixed income markets. And after its about-face and three 25 basis point rate cuts in 2019, the US Federal Reserve appears to have been successful in engineering a 'soft landing' for the US economy – or at least stayed the market's fears that a recession is likely in 2020. This sentiment supported riskier assets for much of 2019, and high yield spreads, in aggregate, are trading well through long-term averages and once again approaching the tightest levels of this credit cycle.

Credit markets hang in the balance

Today, a precarious stability is priced into markets as optimism about economic growth is balanced against fears of further weakness. The outlook for US GDP is unclear and will be subject to an effective resolution to international trade disputes. To realise another year of strong credit market returns, we believe investors will need to see indications that the US will return to above-trend growth in the latter half of 2020. But that is not today's expectation. Even still, it is difficult to be outright bearish on corporate credit, because a growth rate wobbling around 1.5%–2% may not be enough to fuel strong growth in equity markets, but it is sufficient to support many corporate capital structures.

Slower growth reveals corporate mistakes

The recent divergence of CCC and BB rated credits in the high yield market showcases the importance of strong company fundamentals in below-trend growth environments. Over the summer of 2019, the gap between the spreads of higher- and lower-rated bonds accelerated dramatically as the latter was dragged wider by a tumultuous energy sector. The BB sector of the high yield market has returned nearly 15% in 2019, a stark contrast to the CCC segment, which has returned almost 5%. While current CCC valuations may appear ‘cheap’, we are not optimistic about their recovery. The CCC market has been shrinking and deservedly so. After a decade of economic expansion, companies still in the CCC category are being justifiably vetted by the market. Strong economic growth can mask many mistakes, while slower economic growth tends to unmask them.

Seeking yield without the volatility

Given the uncertain landscape, we see value in focusing on the yield that can be captured with minimal volatility. In the high yield market specifically, striking a balance between holdings with the potential for high total return and those with more stable prices and steady income seems prudent.

As we look into 2020, we do not anticipate significant spread tightening or widening and thus expect returns to be driven by the yield on those more stable, though lower-yielding, credits. Identifying steady sources of income with the potential to withstand volatility will be particularly important given that 2020 is a US election year, with selectivity in pharmaceuticals, healthcare and energy paramount.

Seeking diversified sources of return should further serve to mitigate portfolio volatility. We expect the strength of the US consumer to lend a hand as it creates demand for higher-rated asset-backed securities and collateralised loans, as well as mortgage-backed securities. In our view, considering both total return and steady income opportunities across all segments of fixed income will be critical in navigating an uncertain 2020.

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