Janus Henderson
INVESTORS

MARKET GPS

FIXED INCOME PERSPECTIVES

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OUR FIXED INCOME CAPABILITIES

JANUS HENDERSON FIXED INCOME PROVIDES ACTIVE ASSET MANAGEMENT SOLUTIONS TO HELP CLIENTS MEET THEIR INVESTMENT OBJECTIVES.

Over the past four decades, our global investment teams have developed a wide range of product solutions to address clients' varied and evolving needs. From core and multi-sector investing to more focused mandates, we offer innovative and differentiated techniques expressly designed to support our clients as they navigate each unique economic cycle. The capabilities of these teams are available through individual strategies or combined in custom-blended solutions.

GLOBAL HEAD OF FIXED INCOME
Jim Cielinski

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While shared knowledge across teams and regions encourages collaboration and the debate of investment ideas, each team retains a defined level of flexibility within a disciplined construct. Our portfolio construction processes are governed by a rigorous risk management framework with the intent of delivering stronger risk-adjusted returns. Further, we believe transparency is the foundation of true client partnerships; we seek to earn and maintain our clients' confidence by delivering robust and repeatable investment processes and by providing firsthand insights from our investment professionals.

A LETTER TO THE FED FROM A CONCERNED FRIEND

Source: Getty Images

GLOBAL BONDS

Head of Global Bonds **Nick Maroutsos** expresses concern that monetary policy focused on financial markets will do little to ignite the growth needed for the economy to recover from recent weakness.

KEY TAKEAWAYS

- The Federal Reserve (Fed) has proven it can support financial markets, but there is scant evidence of its basket of ultra-accommodative policy tools spurring economic growth.
- The Fed's recent relaxation of its 2% inflation target is an implicit admission that inflation is of little concern and more initiatives are needed to create a pro-growth environment.
- With interest rates suppressed, bond investors have limited choices when seeking securities that offer the characteristics they have come to expect from a fixed income allocation.

Dear Fed,

I've been meaning to write for a while but recognizing how much you've had on your plate during this tumultuous year, I did not want to distract you from the Herculean tasks you've been assigned. Over these past months you have proven your good-heartedness as you've made great efforts to support families, small businesses and employers – you know, the components of the real economy that underpinned your charter more than a century ago. With magnanimity to spare, you also lent a helping hand to vulnerable souls like Apple, Citigroup, AT&T, Ford, United Airlines and many other Fortune 500 stalwarts.

Yet, I believe your same propensity to give may leave you exposed to being taken advantage of. Due to this concern, I believe that I must speak up. I'm referencing your relationship with financial markets, which I fear has grown increasingly one-sided, to the point of becoming dysfunctional. The writing is – if not on the wall – at least in this year's corporate bond issuance data. It's the highest level on record as your programs that were initially created to thaw markets have allowed corporations to binge on low borrowing costs, sidestepping legitimate concerns about depressed earnings.

I can understand your desire to have given markets a helping hand during the Global Financial Crisis (GFC). Yet, so often these "project" relationships end badly as some partners are just incapable of change. The promise was there; I get it. A school of thought was that rock-bottom interest rates and bond purchases would lower the cost of capital, leading to an investment boom that would increase productivity and wages. It didn't happen. Instead, companies gorged on cheap credit to fund a wave of share buybacks. Then, you hoped that rising asset prices would lead to a wealth effect as frothy equity prices spurred a consumption boom that would permeate the economy. While benefits may have been felt by electric vehicle dealers, Bay area wineries and fortuitously located realtors, this "rising tide" promise fell flat across much of the country. Forgive me for being cynical, but I have my doubts that large corporations' recent feast on cheap funding will result in shiny new factories or large-scale job creation.

I'd like to say that you're faultless in this situation, but the hard truth is that you're enabling the market's rash behavior. Now the proverbial camel's nose is under the tent and any attempt to instill responsibility and moderation on the market inevitably is met with petulance, à la 2013's taper tantrum and autumn 2018's normalization convulsion.

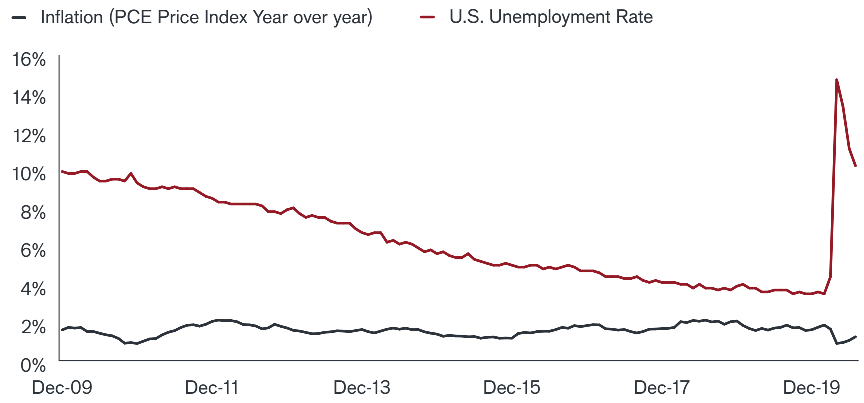
A LETTER TO THE FED FROM A CONCERNED FRIEND (cont.)

I cannot help but think how much happier you appeared when the real economy commanded your undivided attention. That relationship seemed so much healthier. The economy would weaken, you'd lower rates and a credit impulse would spur investment and consumption. Granted, the relationship wasn't without its missteps; often you were slow to control accelerating inflation, but that's an error that likely won't be repeated in the future. Both you and I know that inflation is not a clear and present danger.

While your recent relaxation of the definition of full employment is welcome as it should support job creation in underserved communities, it's your expectation of perpetually mild inflation – if not disinflation – that's allowed you to take this step without fearing any inflationary consequences. It's a shame that markets seem to be calling the shots now because your updated views on employment and inflation mean that you've finally jettisoned the Phillips Curve, which has proven to be an ineffective tool in managing the economy during the post-GFC era.

SO LONG, MR. PHILLIPS

Over the past decade, core inflation barely budged – averaging 1.6% – despite the Fed keeping interest rates low and unemployment steadily declining, all of which indicate a breakdown between the purported inflation-employment relationship espoused by the Phillips Curve that has been a central tenet of Fed policy.



Source: Bloomberg, as of 11 September 2020. The personal consumption expenditures price index (PCE) is a measure of the prices that people living in the U.S., or those buying on their behalf, pay for goods and services. The index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

The neediness of markets – especially of riskier assets – has led to misplaced priorities. Healthy financial markets should be a reflection of a vibrant economy. Inventions deployed to artificially support asset prices do nothing to ignite growth on Main Street – the past dozen years have proven that.

The U.S. is endowed with robust capital markets, but the irony is that your recent decision to implicitly allow asset bubbles while seeking to shore up the real economy may actually inhibit growth in the long run. The primary function of capital markets is to steer funds toward the most attractive investment opportunities, thus facilitating growth. The current distortions caused by hyper-accommodative policy leads to the opposite: bad investment decisions that do nothing to channel funds to their most promising use. Case in point are low-quality "zombie" corporations surviving by continuously unloading new debt onto yield-starved investors.

A LETTER TO THE FED FROM A CONCERNED FRIEND (cont.)

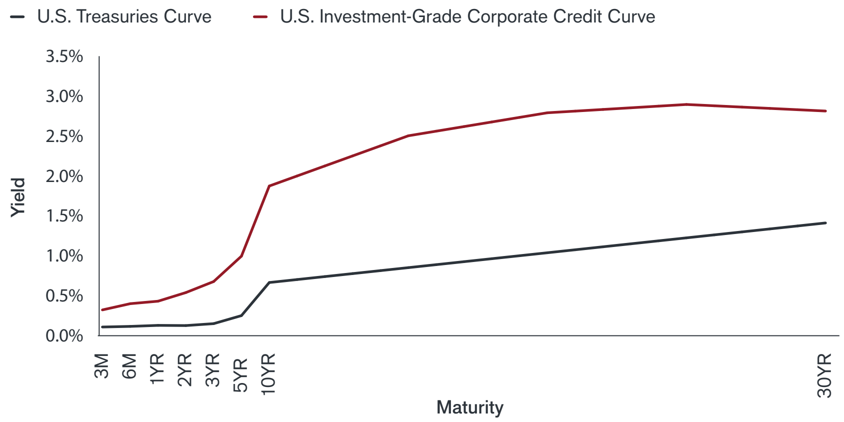
Caught in the middle are prudent investors. Attempting to navigate markets where company fundamentals are secondary to policy means the traditional approach to asset management has been turned on its head. Riskier assets are risky for a reason. That's why stocks typically command an equity risk premium and bond yields a spread above those on risk-free securities. If you always have the back of markets, there is little reason to account for these risk premia, and putatively risky securities are free to run exuberantly upward.

Given the primacy you've place on buoyant markets, there would seem to be little reason to own bonds given their miniscule yields. But while many stocks can return more in one day than the 10-year U.S. Treasury does in a year, the early-September sell-off sends a reminder that short bouts of volatility are possible.

The selection of a potential hedge against this volatility has also been influenced by your unwavering support of markets. With the yield on longer-dated Treasuries barely above those on shorter maturities, the front end of the curve is one of the few segments of financial markets where logic seems to prevail. The risk/reward of these securities look to be even more like a refuge of last resort given your commitment to not raising rates.

U.S. TREASURIES AND INVESTMENT-GRADE CREDIT CURVE

With interest rates suppressed across all maturities – and likely set to stay that way – one of the few pockets of the bond market that offers an attractive term premium is shorter-dated, investment-grade credits, which have the potential to generate income as securities "roll down" toward maturity.



Source: Bloomberg, as of 11 September 2020. Investment-grade corporate bonds are those issued by companies perceived to have a relatively low risk of defaulting on their payments. The higher quality of these bonds is reflected in their higher credit ratings when compared with bonds thought to have a higher risk of default.

A LETTER TO THE FED FROM A CONCERNED FRIEND (cont.)

Years of flawed policy assumptions have backed you into a corner and now the market is calling the shots. The real economy is the victim here. If you are honest with yourself, you know this fealty to markets won't give you what you truly desire – and were statutorily mandated to pursue. You pin your hopes on possible help from fiscal authorities, but we know how undependable they are.

It would take a reckoning to extricate yourself from this predicament. The market needs to be shown tough love. It must accept risk is part of life and that it cannot free ride on your largesse without having to share your attention with the real economy.

Extracting yourself from this destructive situation is easier said than done and the longer it continues, the more painful the reckoning is likely to be. A world in which never-ending dovish policy and Fed backstops keep asset valuations high may seem like one where everybody wins, but in actuality, everyone will eventually lose.

A LETTER TO THE FED FROM A CONCERNED FRIEND

Glossary

Taper tantrum: Markets' reaction following the U.S. Federal Reserve Chairman's comments in May 2013, which suggested that the U.S. was considering tapering (slowing down) the rate of its bond buying program (quantitative easing).

Phillips Curve: A single-equation economic model describing an inverse relationship between rates of unemployment and corresponding rates of rises in wages that result within an economy.

Risk premium: The additional return over cash that an investor expects as compensation from holding an asset that is not risk free. The riskier an asset is deemed to be, the higher its risk premium.

Yield: The level of income on a security, typically expressed as a percentage rate.

Spread/credit spread: The difference in yield between securities with similar maturity but different credit quality. Widening spreads generally indicate deteriorating creditworthiness of corporate borrowers, and narrowing indicate improving.

Maturity: The maturity date is when a debt comes due and all principal and/or interest must be repaid to creditors.

THE FED'S NEW POLICY, INFLATION AND ITS IMPLICATIONS FOR U.S. BONDS

Source: Getty Images

U.S. FIXED INCOME

Head of U.S. Fixed Income **Greg Wilensky** and Portfolio Manager **Michael Keough** discuss their outlook for U.S. inflation after the Federal Reserve's policy change, and its impact on U.S. bond markets.

KEY TAKEAWAYS

- The U.S. Federal Reserve (Fed) announced a new average inflation targeting regime where it aims to push inflation above 2%, but we do not foresee a significant rise in inflation in the near term.
- While the yield curve may steepen modestly, we believe the low interest rate environment will persist as the Fed continues to provide significant accommodation to the markets and economy via near-zero policy rates and large-scale asset purchases.
- We continue to see value in diversified bond portfolios and favor exposure toward high-quality credit that will likely benefit from central bank actions, progress on a vaccine and persistent need for yield across the globe.

Chairman Jerome Powell recently introduced the Fed's new monetary policy strategy with a renewed commitment to achieving an average inflation target. The policy will require allowing inflation to run above 2% to make up for persistently missing that goal in the prior economic cycle. For the current recovery, this means the Fed is committing to a more dovish path forward where it will not preemptively hike rates based on low unemployment or the first signs of inflation, but rather wait to confirm sustained inflation has taken hold. This is an important policy shift, but it is one thing to set a goal and another to deliver on it. Given the Fed's actions and statements have been the primary factor in the performance of financial markets since the outbreak of COVID-19, a change in its approach to managing inflation warrants a fresh look at the implications for bond portfolios.

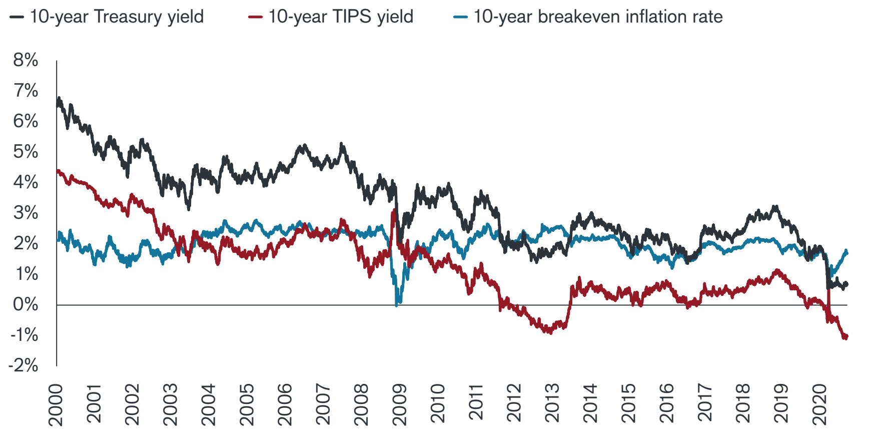
WILL INFLATION RISE?

With the large amounts of monetary and fiscal policy unleashed into the economy to combat the COVID-19 pandemic and market-based levels of inflation expectations on the rise, many investors are starting to wonder if rising inflation and higher yields will become a headwind for returns across the fixed income markets. True money supply is at historic highs as the Fed's balance sheet has exploded due to its asset purchase programs at the same time massive fiscal stimulus programs were enacted. But for all the money that has been pumped into the U.S. economy by the Fed and Congress, the stimulus does not look likely to turn into sustained inflation anytime soon. Unemployment remains high, spending is constrained, and while growth is turning positive there is still a significant amount of repair and healing that needs to occur in many parts of the economy. The persistent and continued spread of COVID-19 has also delayed the reopening of the economy on a larger scale.

THE FED'S NEW POLICY, INFLATION AND ITS IMPLICATIONS FOR U.S. BONDS (cont.)

IMPLIED INFLATION EXPECTATIONS

Inflation expectations are rising, as demonstrated by the difference between the U.S. 10-year Treasury (nominal) yield and the 10-year TIPS (real) yield.

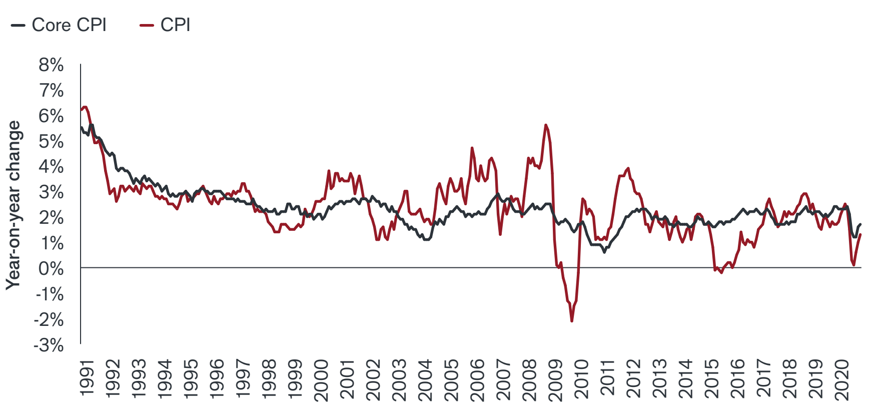


Source: Bloomberg, as of 11 September 2020. Treasury Inflation-Protected Security (TIPS) are a type of Treasury security issued by the U.S. government that is indexed to inflation in order to protect investors from a decline in the purchasing power of their money. As inflation rises, TIPS adjust in price to maintain its real value. Nominal yield is the yield of a bond before considering the effects of inflation. Real yield is the nominal yield of a bond minus the rate of expected inflation.

We believe the Fed would like to see higher inflation in the U.S. because it has drifted lower across the recent business cycles and has not averaged 2% in some time. To the extent there is fear of a Japan-like stagnation occurring in the U.S., rising inflation would not only confirm the economy has recovered but would also reduce concerns about the Japanification of the U.S. and any doubts about the Fed's ability to achieve its policy goals. In the current environment, we believe the Fed is more focused on raising the expectation of eventual inflation and so far Fed policy has been effective in keeping nominal U.S. Treasury yields anchored at low levels while inflation expectations have risen. Currently low nominal yields and negative real yields are supportive of economic growth and investment while also providing firm support for asset prices, as we have seen coming out of the crisis.

U.S. CONSUMER PRICE INDICES OVER THE PAST 30 YEARS

Inflation has generally remained below the Fed's 2% target since the Global Financial Crisis.



Source: Bloomberg, as of 31 August 2020. The Consumer price index (CPI) is a measure that examines the price change of a basket of consumer goods and services over time. Used to estimate inflation, headline CPI is a calculation of total inflation in an economy, and includes items such as food and energy, in which prices tend to be more prone to change. Core CPI is a measure of long-run inflation and excludes transitory/volatile items such as food and energy.

THE FED'S NEW POLICY, INFLATION AND ITS IMPLICATIONS FOR U.S. BONDS (cont.)

WHAT WILL HAPPEN TO THE YIELD CURVE?

We believe that interest rates at the front end of the U.S. Treasury yield curve will remain low for the foreseeable future. The Fed's new stance on inflation only increases the probability that its policy rate remains lower for longer than we have been accustomed to. Typically, the Fed raises rates when they think inflation is at risk of rising. This time, it has stated it will wait to see sustained higher inflation before raising rates. As progress is made on a vaccine and it is administered across the world, we would expect to see an uptick in economic activity and cyclical inflation from depressed levels, but we would not mistake that with a more significant shift of inflation requiring the Fed to withdraw accommodation and raise rates.

In terms of the back end of the yield curve and 30-year interest rates, it is imperative to remember the Fed was early and aggressive in its policy support. After lowering policy rates to zero, the Fed also began large-scale asset purchases with quantitative easing (QE) to support the stabilization of the financial markets and facilitate many borrowers' access to much-needed liquidity. In a recent speech, Fed Governor Lael Brainard repeated that "in coming months, it will be important for monetary policy to pivot from stabilization to accommodation." As a result, we will be listening for any additional details related to forward guidance and changes to the asset purchase program where it may increase purchases at the long end of the curve to help keep long-end rates in check. Meanwhile, we expect additional demand for longer-dated bonds to come from investors as they look to access the yield available in U.S. markets amid a large swatch of negative-yielding global debt. As long as the yield curve remains positively sloped, the historically low level of yields incentivizes investors to take longer-dated risk to achieve their objectives. This incentive will only increase when and if longer-term yields rise. Between investor demand and the Fed's desire to stimulate the economy through low long rates (both real and nominal), we expect any rise in longer-dated yields to be modest.

THE OUTLOOK FOR A DIVERSIFIED BOND PORTFOLIO

The benefit of a fixed income strategy that can invest across multiple sectors is the flexibility and tools to position for dynamic markets such as the one we find ourselves in today. For investors who can allocate between Treasuries and credit markets, low Treasury yields are not compelling compared to the opportunities across credit sectors that offer attractive yields and potential upside as the economy recovers. This is not to say that U.S. Treasuries don't have value in a diversified portfolio. Even at current yields, the long end of the curve should still be a diversifier of risk – and a source of potential capital appreciation should the economy weaken and risk assets, such as equities, sell off. But low yields in government bonds are creating an incentive to take credit risk. Indeed, we think the Fed wants to create conditions where investors allocate to these sectors and keep borrowing costs low for consumers and corporations, reversing the flight-to-quality that occurred in the first half of the year to help fund the private sector.

THE FED'S NEW POLICY, INFLATION AND ITS IMPLICATIONS FOR U.S. BONDS (cont.)

While the Fed has a new stance on inflation, we continue to believe it will take time for the economy to recover and prices to move sustainably higher, so, in our view, diversified bond portfolios offer value to investors. There are always risks that investors must navigate, such as election risk or a resurgence of COVID-19 as we enter the winter months, but we believe that investors will be best served by remaining flexible and continuing to align with Fed policy. As central banks continue to proactively support the recovery and reduce tail risks, we expect credit should remain well supported.

THE FED'S NEW POLICY, INFLATION AND ITS IMPLICATIONS FOR U.S. BONDS

Glossary

Yield: The level of income on a security, typically expressed as a percentage rate.

Money supply: The total amount of money within an economy. The narrow definition of money supply includes notes and coins in circulation and money equivalents that can be converted into cash easily. The broader definition includes various kinds of longer-term, less liquid bank deposits.

Nominal yield: The yield of a bond before considering the effects of inflation.

Real yield: The nominal yield of a bond minus the rate of expected inflation.

Quantitative easing (QE): An unconventional monetary policy used by central banks to stimulate the economy by boosting the amount of overall money in the banking system.

STRATEGIC FIXED INCOME: THE PREDICTABLE JAPANIFICATION OF US CORPORATES

Source: Getty Images

STRATEGIC FIXED INCOME

Jenna Barnard, Co-Head of Strategic Fixed Income, discusses how the suppression of volatility in interest rates by major central banks has spread the Japanification phenomenon to the US.

KEY TAKEAWAYS

- In early March I wrote that "as a result [of the COVID-19 crisis we] would not be surprised to see even lower yields on quality corporate bonds by the end of the year than where we started", given the predictable policy response from central banks. Hence, "the coronavirus provides us an opportunity" as corporate bond investors to lock in attractive income for years to come.
- This bullishness on quality corporate bonds was unusual as the consensus was an opposite view: that corporate debt had turned into a multi-year bubble about to burst, and the volume of BBB rated debt (bonds issued just one notch above high yield) was extremely high in particular, raising fears of disorderly moves in bond valuations as a result of an external economic shock.
- While the Japanification of Europe has been in play for a few years and only recently became more of a consensus view, the US had remained an exception. Events have proven otherwise and our Japanification thesis is now a reality in the US, with US investment grade yields at 2% on average as compared to 2.9% at the beginning of 2020.

In an article published early March in the UK (Coronavirus update from the Strategic Fixed Income Team) I wrote "When we do come out of the coronavirus 'recession' we will be in a world of 'zero interest' rates across the entire developed world; central banks buying even more investment grade corporate bonds via quantitative easing, a stumble towards fiscal stimulus and a cleansing of the 'value' areas of the credit markets that have been zombies for years (high yield energy being the most obvious example). As a result, I would not be surprised to see even lower yields on quality corporate bonds by the end of the year than where we started." This view was rooted in the experience of the European and UK corporate bond markets in recent years and follows the experience of Japan decades ago.

'Japanification' is a loose term to explain the fact that many of the challenges that face the economies of the developed world today were first present in Japan twenty years ago. As weak growth, ever lower interest rates and negative bond yields have spread to the rest of the world, Japan has become the lens through which markets view these economies. Over the last year or so, the term 'Japanification' has appeared many times in the financial media. Much has been written on the 'Japanification' of Europe. We have referred to the Japanification trend repeatedly since 2012 when we began talking about Nomura economist Richard Koo's theory of balance sheet recession in Japan.

JAPANIFICATION SPREADS TO THE DEVELOPED WORLD

After the 2008 Global Financial Crisis (GFC), central banks, regulators, and policymakers were forced to take extraordinary measures to prop up their economies. Despite their efforts, growth and inflation remained stubbornly low in the developed world, while the extended period of accommodative monetary policy resulted in ever decreasing interest rates and bond yields, at times into negative territory (Europe), with the US remaining an exception.

Falling government bond yields and interest rates, some into negative territory, over the last few years, were to us clear indications of the Japanification of Europe. We have long spoken of the failure of mainstream economics, which has repeatedly over forecast growth and inflation in the developed world and looked to focus on long term thematic factors instead, which weigh down bond yields such as demographics, excess debt and the impact of technology.

STRATEGIC FIXED INCOME: THE PREDICTABLE JAPANIFICATION OF US CORPORATES
(cont.)

As a result, between 2014-18, most countries in the developed world only cut interest rates. North America was an exception with the Bank of Canada and US Federal Reserve (Fed) pushing on with modest interest rate hiking cycles. This interest rate divergence had already come to an end with modest rate cuts from the Fed in 2019 and was accelerated in 2020 as a result of the pandemic. The significant emergency measures taken by major central banks to combat the crisis, and the Fed in particular, slashed government bond yields in the US and elsewhere. As government bond yields declined further, investors looked to the corporate bond markets, specifically in the US.

THE JAPANIFICATION OF VOLATILITY

Similar to the experience in Japan, in the COVID 19 crisis central banks succeeded in suppressing volatility through various extraordinary stimulus measures including lowering rates, quantitative easing, yield targeting, and forward guidance. Thus, as a result, policymakers dampened interest rate volatility and reduced systemic risk, creating an idyllic environment for investing in corporate bonds.

In the US, the Fed's programmes of support for investment grade and, to a lesser extent, some high yield default risk (through purchases of high yield exchange traded funds) further dampened volatility in the bond markets. The end result was predictable enough: for investors in need of income, the exceptionally low and stable government bond yields made investment grade bonds an attractive alternative.

INVESTMENT GRADE CORPORATE BOND YIELDS' MULTIPLE OVER US TREASURY YIELDS

Source: Janus Henderson Investors, ICE Bank of America indices, Bloomberg, daily data, as at 31 August 2020.

STRATEGIC FIXED INCOME: THE PREDICTABLE JAPANIFICATION OF US CORPORATES

(cont.)

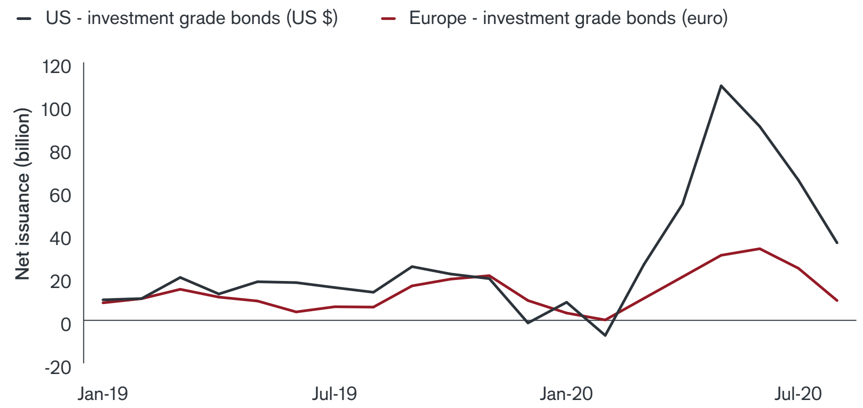
THE ERA OF 'NEW SOVEREIGNS'

According to a research paper by Bank of America, around two thirds of the global fixed income markets currently yield less than 1%. European sovereign bond yields fell dramatically in the years post the GFC, and in 2010-11, when the yield on 5 year bunds fell below 1%, bond investors rotated out of government bonds into the credit markets.

Similar to the experience in Europe, the US corporate bond market has seen increased demand and large inflows of capital in recent months. Catalysed by the actions of the Fed, the primary market (issuance market) for US corporate bonds reopened quickly in the crisis – the floodgates opened for investment grade issues in March and the high yield market reopened with a bang the following month. Borrowers took advantage of the lower borrowing costs to procure sufficient funds for their operations in the difficult months ahead and/or extend the maturity of their debt by selling longer- and longer dated bonds to yield hungry investors.

With low levels of inventories for trading in the secondary market, demand for new issues has been huge in the primary bond market with many deals oversubscribed, despite a record breaking pace of supply ($1.4 billion in investment grade issuance through to 8 September, compared to $0.8 billion for the whole of 2019).

FLOODGATES OPENED FOR INVESTMENT GRADE ISSUES IN MARCH



Source: BNP Paribas, Bloomberg, Janus Henderson Investors, monthly data, as at 31 August 2020. Net issuance volumes less fallen angels and buybacks. A fallen angel is a bond that has been downgraded from an investment-grade rating to sub-investment-grade status, due to a deterioration in the financial condition of the issuer. A bond buyback occurs when a company approaches the open market and repurchases its bonds from holders.

Flows into the investment grade and high yield markets have continued well into August. They have been further boosted by a resurgence in overseas buyers, given that the cost of hedging back to local currencies have come down with the decline in interest rates.

Interestingly, given the paltry returns on government bonds, investment grade corporate bonds have now become the alternative source for potentially 'safe' yield, as the search for yield has left little choice but to buy bonds from quality companies. Thus, wellknown, quality, 'sensible income' generating companies are almost the new sovereigns, and their bonds, almost the new benchmark reference rates.

For the rest of 2020, we expect to see lower net corporate bond issuance, as companies, having raised sufficient funds in the first half of the year, will likely be more aggressive in managing their credit ratings and borrowing levels through bond buybacks and repayments.

STRATEGIC FIXED INCOME: THE PREDICTABLE JAPANIFICATION OF US CORPORATES (cont.)

LOWER VOLATILITY IS A BOON FOR CORPORATE BOND MARKETS

Lower volatility helps to improve the risk/return profile for fixed income assets despite lower yields. In Japan, corporate bonds have, perversely, delivered solid risk adjusted returns over the years, despite offering lower yields and credit spreads, compared to their equivalents in Europe and the US. A historical analysis by Bank of America has shown that over the past two decades, Japanese investment grade corporate bonds, with an average credit spread of around a quarter to one fifth of their equivalents in Europe and the US, have delivered a much higher risk adjusted return, helped by the tailwind of lower volatility.

So long as central banks can maintain a credible commitment to low interest rates for years to come, based on their new economic models of 'economic scarring' from the COVID-19 crisis and too low inflation, this idyllic environment can continue as it has done in other countries. However, US 10 year sovereign bond yields now look about 50 basis points too low relative to our models of the rate of change of economic data[1]. The 'easy money' has been made in investment grade corporate bonds as the predictable Japanification theme has played out in months, rather than years.

STRATEGIC FIXED INCOME: THE PREDICTABLE JAPANIFICATION OF US CORPORATES

[1] As at 18 September 2020.

Glossary

Yield: The level of income on a security, typically expressed as a percentage rate

Investment grade corporate bonds: Bonds issued by companies perceived to have a relatively low risk of defaulting on their payments. The higher quality of these bonds is reflected in their higher credit ratings when compared with bonds thought to have a higher risk of default.

High yield bond: A bond that has a lower credit rating than an investment grade bond. Sometimes known as a sub-investment grade bond. These bonds carry a higher risk of the issuer defaulting on their payments, so they are typically issued with a higher coupon to compensate for the additional risk.

Balance sheet recession: An economic climate where high levels of private sector debt cause individuals and/or companies to focus on saving, by paying down debt rather than spending or investing, which in turn results in slow economic growth or even decline.

Systemic risk: The risk of a critical or harmful change in the financial system as a whole, which would affect all markets and asset classes.

Maturity: The maturity date is when a debt comes due and all principal and/or interest must be repaid to creditors.

Primary Market: A primary market issues new securities on an exchange for companies, governments, and other groups to obtain financing through debt-based or equity-based securities.

Secondary Market: The secondary market is where investors buy and sell securities they already own.

Spread/credit spread: The difference in yield between securities with similar maturity but different credit quality. Widening spreads generally indicate deteriorating creditworthiness of corporate borrowers, and narrowing indicate improving.

Basis point (bp) equals 1/100 of a percentage point. 1 bp = 0.01%, 100 bps = 1%

Risk-adjusted return: A risk-adjusted return is a calculation of the profit or potential profit from an investment that takes into account the degree of risk that must be accepted in order to achieve it.

WILL THE HUMP IN DEFAULTS BE A HILL OR A MOUNTAIN?

Source: Getty Images

CORPORATE CREDIT

Seth Meyer, Corporate Credit Portfolio Manager, and **Esther Watt**, Client Portfolio Manager, explore the default outlook for high yield bonds and the risks and opportunities this presents.

KEY TAKEAWAYS

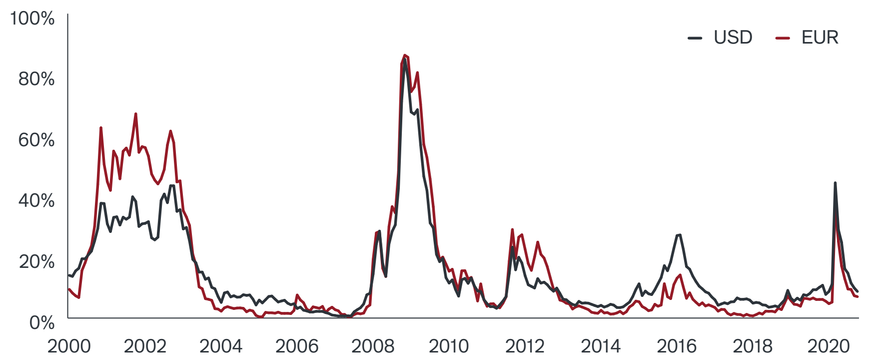
- Current expectations are that the default rate will be less severe than in the Global Financial Crisis, thanks to monetary and fiscal stimulus permitting refinancing and an economic rebound.
- Differences in the composition of high yield markets mean the default outlook is not uniform and at the sector level investors may be surprised by the areas that are outperforming.
- How economies navigate a rise in COVID-19 infection rates will ultimately drive the default outlook but selectivity by investors can help mitigate risks and extract value.

Considering the global economy has faced one of the most disruptive economic events in its history, asset markets have staged a remarkable recovery. Equity markets have rallied and corporate bond spreads have tightened on prospects that the global economy can bounce back quickly from the coronavirus-induced downturn. Within the high yield corporate bond market, expectations are that the default rate will rise but be less severe than that experienced after the 2008 Global Financial Crisis (GFC). Monetary and fiscal stimulus, combined with supportive technicals, frame this outlook but are markets right to be sanguine about defaults?

The distressed ratio measures the level of bonds with elevated spreads. It provides a useful barometer of stress within the high yield market. If the distressed ratio is high it is suggestive of an increased likelihood of defaults. While the spike in the distressed ratio back in March heralds a rise in defaults, it was significantly below the levels of the GFC and the fallout from the dot-com bubble.

DISTRESSED RATIOS HAVE DECLINED TO ALMOST PRE-COVID-19 LEVELS

Distressed ratio = % of bonds trading with spreads above 1,000 basis points



Source: Deutsche Bank, ICE Indices, Markit, 31 January 2000 to 8 September 2020. Spreads reflect the additional yield of a corporate bond over an equivalent government bond. In general, widening spreads indicate deteriorating creditworthiness of corporate borrowers, tightening spreads are a sign of improving creditworthiness. Basis point (bp) equals 1/100 of a percentage point. 1 bp = 0.01%, 100 bps = 1%.

A DEFAULT BY ANY OTHER NAME

What constitutes a default? This might sound like an inane question – surely when a bond issuer fails to meet their obligations to bondholders – but definitions can be tricky. For holders of credit derivatives in Novo Banco, the Portuguese bank, in 2016 it was a very real question. A decision not to classify a retransfer of assets as a 'governmental intervention', which would have triggered protection payments to holders of credit derivatives, meant that creditors were on the hook for losses.

WILL THE HUMP IN DEFAULTS BE A HILL OR A MOUNTAIN? (cont.)

Filing for bankruptcy, defaulting on a payment and restructuring debt are the most common credit events defined by the International Swaps and Derivatives Association (ISDA), the trade organisation of participants in the market for over-the-counter (bespoke) derivatives. However, legal definitions and bankruptcy processes vary considerably from country to country, which can make direct comparisons difficult. Furthermore, differences in regional constituents and index weights further complicate the picture.

For example, bankruptcy in the US is a relatively straightforward and more timely process than in Europe where state aid and loan guarantees typically play a bigger part in the credit markets, sometimes postponing the inevitable. The US can also be seen to be the riskier market with a greater exposure to the energy market and high proportions in the 'single B' and 'CCC' ratings buckets.

DIFFERENT COMPOSITION OF REGIONAL INDICES

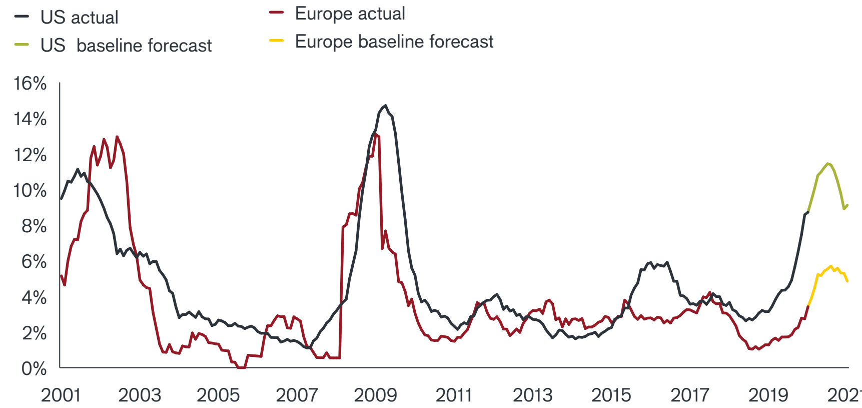
% weight in index	US	Europe
BB weighting	56.2	71.1
B weighting	32.3	21.8
CCC weighting	11.5	7.1
Energy sector	12.9	5.0

Source: Bloomberg, ICE BofA US High Yield Index, ICE BofA European Currency High Yield Index, as at 9 September 2020. ICE BofA US High Yield Index (H0A0) tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. ICE BofA European Currency High Yield Index (HP00) tracks the performance of EUR and GBP denominated below investment grade corporate debt publicly issued in the eurobond, sterling domestic or euro domestic markets. Ratings agencies assign a credit rating to high yield borrowers based on the borrower's creditworthiness. The credit rating progresses down through the alphabet such that a BB rated borrower is deemed better quality than B, which in turn is better quality than CCC. A CCC rating indicates the borrower is deemed higher risk and more vulnerable to default.

As such, it comes as no surprise that the US has seen a higher number of defaults relative to Europe this year and over recent years, in both cash bonds and derivatives. As the following chart shows, the high yield trailing 12-month default rate, compiled by Moody's, the credit rating agency, has risen to 8.7% in the US, more than double Europe's 3.4% as at the end of August.[1]

SPECULATIVE GRADE (HIGH YIELD) DEFAULT RATES

High yield default rates expected to peak lower than during the Global Financial Crisis



Source: Moody's default report, Trailing 12-month default rate, issuer weighted, 31 August 2000 to 31 August 2020. Baseline forecast as at 9 September 2020. Baseline is the most likely outcome between optimistic and pessimistic scenarios. The forecast is an estimate only, may vary and is not guaranteed.

[1] Source: Moody's default report (August 2020), 9 September 2020.

WILL THE HUMP IN DEFAULTS BE A HILL OR A MOUNTAIN? (cont.)

Given the equal weightings applied to credit default swap (CDS) indices a direct comparison does not make sense, but the latest iteration of the Markit CDX NA HY Index (North America high yield) provisionally sees eight companies leaving the index due to defaults versus only two in the Markit iTraxx Crossover Index (Europe).[2]

BRIDGING THE DIVIDE

Despite the unprecedented cessation of activity in some areas of the economy, default expectations have not rocketed. This is because many companies have been able to refinance at increasingly attractive levels thanks to the quick and unprecedented level of fiscal and monetary response that followed the coronavirus-related sell-off in March. To put this into context, in August, Ball Corp., an aluminium container maker rated BB+, set a record for the lowest coupon on 10-year bonds issued by a US junk-rated company – at 2.875%[3].

Investors should therefore not be overly alarmed by a near term deterioration in credit metrics. It is this successful 'bridging' of the revenue gap with temporary borrowing that will broadly see corporate credit metrics weaken over the next year or so before balance sheet repairs begin to take place. Investors, however, need to be discriminatory. Amid the high levels of issuance, good money will be thrown after bad and it is important to identify those issuers for whom structural changes have permanently impaired the business model.

SECTOR DISTINCTION

Unlike a more typical credit cycle, both companies with strong business models and those more fundamentally challenged are having to adapt to the COVID-19 environment. The nature of this crisis, with its restrictions on social activities, means retail, travel, and leisure are suffering alongside energy. We also need to be cognisant that these sectors are more likely to be exposed to the economic fallout from a second wave of COVID-19 infections. Some will already have used unencumbered assets to raise senior secured financing. A prolonged period of low revenues means this may have to be restructured further out.

Healthcare and technology are among the top performing sectors within high yield year to date[4] but investors may be surprised to learn that media, consumer goods, and autos are too, which highlights idiosyncrasies specific to credit and the composition of the high yield market. COVID-19 has accelerated usage of home entertainment, bringing a boost to the subscriber base of Netflix, the media group and significant high yield borrower. In autos, Ford became a so-called 'fallen angel' after it was downgraded from investment grade to high yield. Yet the high yield market was able to comfortably absorb the US$36 billion of debt and the spread on Ford's bonds subsequently tightened, illustrating that fallen angels can offer potential return opportunities for high yield investors.

WILL THE HUMP IN DEFAULTS BE A HILL OR A MOUNTAIN?

[2] Source: Morgan Stanley, CDX/iTraxx Roll Update, 11 September 2020, Markit news 16 September 2020. IHS Markit CDX NA HY Index is a tradeable credit default swap index comprising the most liquid North American high yield (sub-investment grade) entities. IHS Markit iTraxx Crossover Index is a tradeable credit default swap index that comprises the 75 most liquid sub-investment grade entities.

[3] Source: Bloomberg, 10 August 2020.

[4] Source: Bloomberg, ICE BofA Global High Yield Index, total return in US dollars, 31 December 2019 to 31 August 2020. ICE BofA Global High Yield Index (HW00) tracks the performance of USD, CAD, GBP and EUR denominated below investment grade corporate debt publicly issued in the major domestic or eurobond markets.

WILL THE HUMP IN DEFAULTS BE A HILL OR A MOUNTAIN? (cont.)

THE VIEW FROM THE TOP

The outlook remains uncertain in the absence of a proven COVID-19 vaccine. The ability to navigate a second wave in the northern hemisphere through winter without a marked pickup in hospital admittance will be crucial to keeping economies open and the recovery sustained. With announced fiscal support programmes coming to an end over the next couple of months on both sides of the Atlantic, the level of unemployment will be a key metric to watch as we go into the US election at the beginning of November and a potential 'no deal' Brexit at year end.

Continued high levels of new issuance, fallen angels (previously investment grade names that have been downgraded), identifying potential rising stars and 'avoiding the losers' are all areas where an active manager can add value. Alongside defaults, zombie companies (those which can service interest payment on their debt but lack sufficient funds to repay the capital or grow the business) are another area of concern for investors, but while we recognise the long-term impact of a misallocation of capital on productivity and growth, at the right price these too can be a source of returns for high yield investors while they remain creditworthy.

Ongoing nervousness means average spreads on high yield bonds remain above their three and five-year averages[5] and an effective yield of 5.5% for the ICE Global High Yield Bond Index (at 9 September 2020) means the asset class is likely to continue to attract investors prepared to accept some risk in the search for income. The default rate over the coming year may lack the height of previous episodes but we are mindful that the strength of the economy will determine whether the hump in defaults has a rapid descent or a more prolonged period of corporate challenge, underscoring the need for careful credit analysis.

WILL THE HUMP IN DEFAULTS BE A HILL OR A MOUNTAIN?

[5] Source: Bloomberg, ICE BofA Global High Yield Index, Govt option-adjusted spread (OAS), 3-year and 5-year periods to 9 September 2020 inclusive. Option-Adjusted Spread (OAS) measures the spread between a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option.

Glossary

High yield bond: A bond that has a lower credit rating than an investment grade bond. Sometimes known as a sub-investment grade bond. These bonds carry a higher risk of the issuer defaulting on their payments, so they are typically issued with a higher coupon to compensate for the additional risk.

Investment grade bond: A bond typically issued by governments or companies perceived to have a relatively low risk of defaulting on their payments. The higher quality of these bonds is reflected in their higher credit ratings when compared with bonds thought to have a higher risk of default, such as high-yield bonds.

Spread/Credit Spread: The difference in yield between securities with similar maturity but different credit quality. Widening spreads generally indicate deteriorating creditworthiness of corporate borrowers, and narrowing indicate improving.

Credit derivative: A financial asset in the form of a privately held bilateral contract between parties in a creditor/debtor relationship, which allows the creditor to transfer the risk of the debtor's default to a third party, paying it a fee to do so.

Credit default swap (CDS): A form of derivative between two parties, designed to transfer the credit risk of a bond. The buyer of the swap makes regular payments to the seller. In return, the seller agrees to pay off the underlying debt if there is a default on the bond. A CDS is considered insurance against non-payment and is also a tradable security. This allows a fund manager to take positions on a particular issuer or index, without owning the underlying security or securities.

Senior Secured Debt: Senior debt is borrowed money that a company must repay first if it goes out of business. The "secured" classification means the issuer is backing it with collateral.

Fallen angel: A bond that has been downgraded from an investment-grade rating to sub-investment-grade status, due to a deterioration in the financial condition of the issuer.

Rising Star: A bond that has potential to be upgraded once the company establishes an outstanding track record of paying back its debt.

Yield: The level of income on a security, typically expressed as a percentage rate.

FINDING FLOATING-RATE OPPORTUNITIES IN A LOW-YIELD WORLD

Source: Getty Images

SECURITIZED DEBT

The **Securitized Products team** discusses potential advantages of floating-rate products in a low-yield environment given their ability to act as a hedge against rising rates.

KEY TAKEAWAYS

- Low government bond yields make finding appropriate risk-adjusted returns challenging. While some investors may feel comfortable adding credit risk, it may be prudent for investors to consider their overall interest-rate exposure.
- Floating-rate products with high-credit ratings could be an attractive option in a diversified portfolio given their ability to act as a hedge against potentially rising rates.
- The floating-rate CLO market, which has nearly doubled in size in the last five years and where spreads remain attractive versus similarly rated corporate bonds, may deserve a closer look.

U.S. interest rates are near historic lows, but investors still want their bond portfolios to offer income in addition to the stability, and potential price appreciation, they have come to expect from bonds. U.S. Treasuries, given their AA+/Aaa credit rating, still offer more security and, despite low yields, diversity from equities. AAA rated corporate credit offers some additional yield over U.S. government bonds, but with similarly low absolute yields and increased interest-rate risk as borrowers issue bonds with longer maturities: The average maturity of the Bloomberg Barclays U.S. Corporate Bond Index has been steadily growing, with the current duration (a measure of interest-rate sensitivity) above 8.5 years.[1] While we remain broadly positive on the outlook for corporate bonds, investors may be well served diversifying some of their credit exposure into securities with less duration.

FLOATING-RATE SECURITIES MAY OFFER A HEDGE AGAINST RISING RATES

As more investors get comfortable thinking the worst of the current recession could be behind us, they may start to wonder if interest rates will rise as the economy recovers. The U.S. Federal Reserve's (Fed) recent statements about allowing inflation to rise, in the short term, above their 2% target adds to the fear that at some point U.S. interest rates could be significantly higher. We do not share the concern but recognize the risk. Given the low level of rates today, there is more asymmetric risk in U.S. Treasuries – rates can rise more than they can fall without turning negative, which we think is highly unlikely. One option for diversification could lie with floating-rate securities, where the coupon paid rises and falls with the prevailing interest rate, making their prices less sensitive to changes in rates.

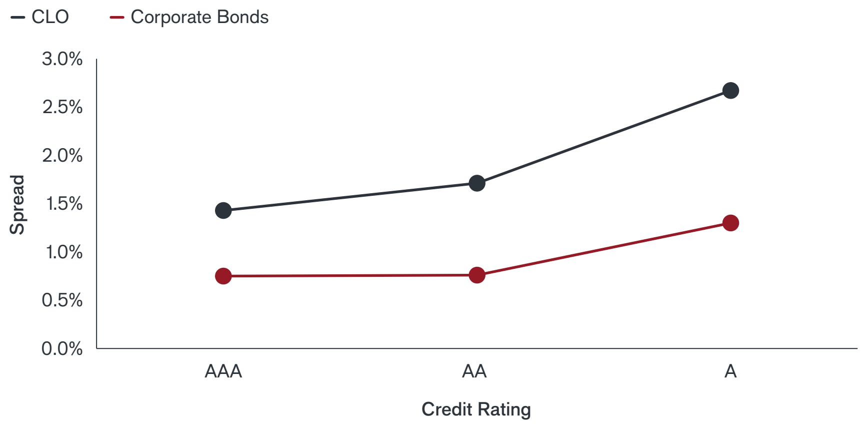
Securitized products have been a growing market since the mortgage market was established in the 1970s. Over the decades new offerings have been introduced such as commercial mortgage-backed securities (CMBS) and, more recently, collateralized loan obligations (CLOs) – the latter of which is the largest (and fastest-growing) segment of the securitized market offering floating-rate exposure. The collateral on these securities are pools of floating-rate bank loans issued to corporations that normally have a below investment-grade credit rating, but the pooled offerings span the ratings spectrum. Relative to the investment-grade corporate credit market, investment-grade CLOs at the AAA rating currently offer 0.67% of extra yield, while single A rated CLOs offer over two times the spread, as can be seen in the chart below.

[1] Source: Bloomberg, as of 10 September 2020.

FINDING FLOATING-RATE OPPORTUNITIES IN A LOW-YIELD WORLD (cont.)

CLO VERSUS U.S. CORPORATE BOND SPREADS

Relative to the investment-grade corporate credit market, investment-grade CLOs currently offer attractive spread over U.S. Treasuries.



Source: Bloomberg, as of 31 August 2020, J.P. Morgan CLO AAA Post-Crisis Discount Margin, Bloomberg Barclays Aaa Corporate Average Option-Adjusted Spread. Option-Adjusted Spread (OAS) measures the spread between a fixed income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option.

DISSECTING THE YIELD ON FLOATING-RATE CLOS

CLOs have offered a premium over both corporate bonds and many securitized products since the market began, over a decade ago.[2] One explanation is the relative newness of the market, including many investors' lack of familiarity with it. But this may be changing. The market has caught investors' attention, nearly doubling in size in just the last five years[3].

Concerns over a lack of liquidity could also be contributing to the yield premium, but we would argue the growth of the CLO market has been accompanied by increased trading volumes and improving liquidity. In March of this year, when bond market volatility was peaking and volumes in many fixed income markets fell, trading volume in CLOs surged, setting a new monthly record for the asset class.[4] Meanwhile, the number of CLO managers has grown steadily, more than tripling over the last decade[5], increasing both liquidity in the secondary market and more willingness on the part of broker-dealers to transact and hold the products.

Another, timely explanation for CLOs to pay comparatively higher yields could be the typical lack of demand for floating-rate securities during a period of falling interest rates. As floating-rate securities offer less capital appreciation potential in a falling rate environment, it would have been rational for investors to favor fixed-rate securities, like U.S. Treasuries and most corporate bonds and securitized product as the Fed cut interest rates. Particularly over the last few years, as CLO issuance has risen, lower demand for floating-rate products would contribute to higher yields. However, with the Fed's policy rate now at zero, and Treasuries out to the 10-year note paying less than 1%[6], perhaps floating-rate exposure warrants a closer look.

FINDING FLOATING-RATE OPPORTUNITIES IN A LOW-YIELD WORLD

[2] Source: Bloomberg, as of September 2020.

[3] Source: Bloomberg, as of September 2020.

[4] Source: Bank of America Merrill Lynch, as of September 2020.

[5] Source: Wells Fargo Securities, as of September 2020.

[6] Source: Bloomberg, as of 10 September 2020.

FINDING FLOATING-RATE OPPORTUNITIES IN A LOW-YIELD WORLD (cont.)

CAREFUL PORTFOLIO CONSTRUCTION INCLUDES SECURITY SELECTION

In an environment where interest rates are low, real yields (the yield paid after taking into account expected inflation) are negative, and the risk of higher Treasury yields has risen (while corporate bond durations have risen), we encourage investors to consider their portfolio construction carefully. To earn the yield they seek, investors can take additional interest-rate risk through buying ever-longer-term bonds. They could also take additional credit risk by extending into the investment-grade corporate bond market or even the high-yield market. Or, they can add additional exposure to securitized products, where yields often exceed the average for corporate bonds, durations are lower, and – in the case of CLOs – the coupons are floating rate, offering a natural hedge against potentially rising interest rates. But sector selection is only part of the process. Ultimately, we believe the value in active bond asset management comes from security selection within sectors that are identified as offering attractive risk/reward. Characteristics of individual securities can vary widely, and it is the role of the manager – ideally armed with decades of experience – to pick securities that offer better risk/reward and combine them into a portfolio with yield and risk targets that investors seek.

THE VALUE OF STRUCTURE

While the underlying collateral for the different segments of the securitized market varies, a few core ideas underlie them all.

- Different individual loans are pooled together in an attempt to create a more diverse offering.
- The product is structured into different classes (usually called tranches) to create higher-quality and lower-quality investment options across the ratings spectrum.

In the case of CLOs, which are collateralized by pools of loans, if there is a deterioration in the underlying collateral, the structure diverts cash flows to the higher-rated notes, which means that investors in a AAA tranche could be repaid sooner than expected, as opposed to later or less.

While no security is without some risk of loss, the amount of protection provided to the highest-rated tranches of a typical CLO has increased dramatically since the Global Financial Crisis, and today the protections are as stringent as any part of the securitized market. Indeed, through the COVID-19 crisis to date, the most severe liquidity crisis in over a decade, CLOs structures generally operated as expected, and in many cases better than the market expected.

FINDING FLOATING-RATE OPPORTUNITIES IN A LOW-YIELD WORLD

Glossary

Yield: The level of income on a security, typically expressed as a percentage rate.

Floating-rate bonds: Debt instruments with a variable coupon, where the interest paid equals a reference rate, such as the fed funds rate, plus a determined spread.

Collateralized Loan Obligations (CLOs) are debt securities issued in different tranches, with varying degrees of risk, and backed by an underlying portfolio consisting primarily of below investment grade corporate loans.

Spread: A measure of how much additional yield an issuer offers over comparable "risk-free" U.S. Treasuries. In general, widening spreads indicate deteriorating creditworthiness of corporate borrowers, tightening spreads are a sign of improving creditworthiness.

Bloomberg Barclays U.S. Corporate Bond Index measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

Duration: Duration is a measure a bond price's sensitivity to changes in interest rates. The longer a bond's duration, the higher its sensitivity to changes in interest rates and vice versa

Securitized Sectors: Refers to fixed income securities that pool financial assets together to create new securities that can be marketed and sold to investors.

Commercial mortgage-backed securities (CMBS): These are fixed income investment products backed by mortgages on commercial properties rather than residential real estate.

Investment-grade corporate bond: A bond typically issued by companies perceived to have a relatively low risk of defaulting on their payments. The higher quality of these bonds is reflected in their higher credit ratings when compared with bonds thought to have a higher risk of default, such as high-yield bonds.

Premium: When the market price of a security is thought to be more than its underlying value, it is said to be 'trading at a premium'. Within investment trusts, this is the amount by which the price per share of an investment trust is higher than the value of its underlying net asset value. The opposite of discoun

Volatility: The rate and extent at which the price of a portfolio, security or index, moves up and down. If the price swings up and down with large movements, it has high volatility. If the price moves more slowly and to a lesser extent, it has lower volatility. It is used as a measure of the riskiness of an investment.

Janus Henderson
INVESTORS

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