JANUS CAPITAL Group

INVESTMENT INSIGHTS SERIES

Are We Headed for a Hangover?

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It's late, and the punch bowl is half full.

With central banks around the globe still in accommodative mode, the threat that the Federal Reserve (Fed) will pull away the punch bowl sets up the markets for some real disruption. Until then, let the party continue.

Many investors have been drinking from the punch bowl. The punch leads them to believe that interest rates are still heading lower, will remain low for a long time, and that corporate spreads will follow suit. They've convinced themselves of a never ending fixed income rally.

Most of us know the effects of drinking too much, and the impact it has on decision making. Before casting judgment, however, drinking this "Lower for Longer" punch can be hard to resist. After several rounds, you may end up calling the drink "Lower Forever." Just look at the ingredients:

First, inflation remains contained globally, with some countries still in jeopardy of disinflation. The deleveraging cycle post the Great Recession continues to play out. In addition, the decline in oil prices, and in commodity prices more generally, have fueled a new round of concern. Then, add in the strong U.S. dollar, which makes imports to the U.S. cheaper and U.S. exports more expensive. This potentially hurts U.S. growth and further strengthens the lower for longer view.

More pungent is the stubborn economic slowdown abroad, not just in Europe but in China, which may be of greater importance. But, what really makes this cocktail stand apart? The powerful and unprecedented scale of monetary stimulus by central banks around the world that has sent rates plunging internationally.

A round of low yields for everyone

At this point, several developed market rates are far lower than the yield on the 10-year U.S. Treasury, which is hovering around 2%. The yield on the 10-year German bund is at around 40 basis points while some European rates are negative. If you like, you can pay the Swiss government 20 basis points per year to own their seven-year debt. This only encourages foreign investors to buy higher-yielding Treasurys, which in turn, keeps those yields lower.

Feeling dizzy?

Gibson Smith
CIO, Fixed Income
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Key Takeaways

- Many investors are complacent about U.S. Treasury rates remaining lower for longer, and this has clouded their investment judgment.
- In the low return environment, investors are stretching for yield and taking on risk.
- There remains opportunity in corporate credit, but greater selectivity is required.

I don't know when the party is going to end, and this party could rage on for some time, but I know for sure that the band has stopped playing and we have turned to the jukebox for our musical enjoyment.

No wonder. The "Lower for Longer" punch is flowing and the decision making in fixed income is becoming more and more blurred, with investors overly complacent about potential downside risks.

Why stop consuming? The market is flush with easy money that is being pumped by central banks around the globe, and there is no indication that it's going to stop any time soon. Fight it at your own peril as you might miss out on a few basis points of performance, and those few basis points could make or break your year from a competitive performance standpoint. We hear, "Don't be left behind in the fun." But, how much fun is it really?

Too much punch leads to complacency and risks

We see that lower for longer complacency is not only building in the sovereign bond markets, but also in the risk segments of fixed income. The central banks – monetary bartenders, really – allow investors to feel okay about continuing to take on risk even as corporate spreads remain historically tight. The commercial mortgage backed securities (CMBS) market has totally recovered from the lows of the financial crisis, and you can hardly see daylight between the yields of unsecured agency debt and 10-year Treasurys. Investors have been drinking the punch far too long.

With all the optimism about spreads tightening even further and rates heading lower, you would think that companies would hold off issuing debt until rates declined more. But, these sober patrons see opportunity, especially in debt with longer maturities. They're showing up in force to meet the insatiable drunken demand for even the anemic yield they're offering. Given the great deal these companies are getting, it makes them generous enough to issue the securities at a discount to thank the buyers for inviting themselves to their party.

We can hear the issuing company's leadership loudly saying: "Congratulations. You are one of the new owners of long duration, low coupon debt that holds paltry return potential. Thank you for your support." In other words, bonds with plenty of interest-rate sensitivity and downside risk that will be hard to sell if need be. Thank you for joining us. Have more punch.

The complacent get stuck holding the bag

This drinking analogy hopefully drives home the point around the complacency in the market today. We all know people that can drink all night and keep the party going. But, they can also overstay their welcome. I don't know when the party is going to end, and this party could rage on for some time, but I know for sure that the band has stopped playing and we have turned to the jukebox for our musical enjoyment.

Let's consider more facts.

It is always helpful to pull up a graph of the yield on the 10-year U.S. Treasury going back to 2007. Let's remember in that time that rates have had several periods of roughly 100 basis point moves in relatively short time frames. Five have been lower and three have been higher. Over the past eight years, 10-year Treasury yields have rallied from just over 5% to just beneath 2%. Getting the 100 basis point moves right, in either direction, can be key to investment success. But don't be wrong today as the outcome can cost you big in an already low return environment.

We've already seen this in the "taper tantrum" in 2013. We saw it at the end of 2014 in risk assets when owners of long-duration credit wanted to sell in order to stem losses. Given the credit market's low liquidity, especially in long-duration corporate debt, these investors were stuck holding the bag.

Restraint is needed to see the opportunities

I believe certain spread securities (those that are priced off Treasurys) can still be a solid investment for the extra yield and potential return. But, as I mentioned, the drinks are flowing and spreads are already tight. Year-to-date corporate debt issuance is up about 10% (and it's only gathering momentum) and CMBS issuance is up more than 35%.

Be selective. If we learned anything in the last four to five significant fixed income market corrections, it is that those pesky credit blowups become very costly. We also know that when there is a need and desire for more yield/return, investors go down in quality and extend duration to achieve their goals. This strategy can work for a while, but when the music stops and the lights get turned back on, you may realize you are dancing alone.

Be selective. If we have learned anything in the last four to five significant fixed income market corrections, it is that those pesky credit blowups become very costly.

It is a time for caution, and to be actively defensive with investing. The Barclays U.S. Aggregate Bond Index doesn't give you that, in my view. It gives you a lot of long-end Treasury-weighted duration, interest-rate sensitivity and potential volatility.

I hate saving the best for last, but the real story that exemplifies investor complacency is that so many are turning a blind eye to the lack of trading liquidity in the fixed income markets. Many investors have been handed warnings about this by the Fed, and now, the International Monetary Fund. But, they would prefer to dance and drink than read.

Gibson Smith
CIO, Fixed Income & Portfolio Manager

About Janus Fixed Income

Janus has been helping fixed income investors reach their financial goals for more than 25 years. Our team of investment experts is committed to delivering the stability our clients expect, with an unwavering focus on risk-adjusted returns and capital preservation. Today, we serve investors across a variety of markets by offering a diverse suite of fixed income strategies with highly complementary and distinctly separate investment approaches: a bottom-up, fundamental process led by CIO Gibson Smith, and a top-down, global macro process managed by Bill Gross.

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When bond valuations fall it is possible for both actively and passively managed investments to lose value.

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