JANUS CAPITAL Group

INVESTMENT INSIGHTS SERIES

Shut off the Noise, Hear the Risks

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The big surprise in 2014 was the sharp decline in long Treasury yields, with the total return of the 30-year Treasury exceeding 29%.

So, what's in store for the fixed income market in 2015?

Greater volatility!

Interest rates around the globe may remain low at least through the first half of the year. The reasons behind the 2014 rate decline have only intensified.

The world's economy is gloomier and deflationary pressures are building, especially with the plunging prices of crude oil and other commodities. China's slowing growth has become a greater concern as have the prospects of emerging market commodity producers. The "lower rates for longer" assumption has become a market consensus. But, don't expect these lower rates without a significant amount of volatility.

Global growth uncertainty to keep volatility elevated

We already saw increased market volatility in 2014 created by diverging growth trajectories between the U.S. on the one side and the eurozone and Japan on the other. Yet, global economic tailwinds are gathering as foreign central banks respond to global economic challenges with unprecedented monetary stimulus. Lower gasoline and food prices are also tailwinds for consumers. Any global economic recovery likely will be uneven as it unfolds because of different country dynamics. Thus, uncertainty about global growth should persist and keep market volatility elevated.

At this point in time, volatility in the fixed income market may represent a greater risk than the potential for a sustained increase in rates.

The U.S.'s strong economic foundation and the potential for foreign monetary stimulus to spur a recovery abroad are creating a spring beneath low interest rates. It feels like the spring is winding tighter and tighter. At the same time, complacency around low interest rates is building. Investors need to take note of this, especially those who have made excessive bets in their portfolios based on the lower rates for longer assumption. These have been expressed in significant overweights in long-end Treasurys or long-dated corporate debt. That lengthens a portfolio's duration, or its price sensitivity to changes in rates. Investors, watch out.

Increased rate volatility can generate negative returns for a portfolio skewed toward the long end of the curve.

Gibson Smith
CIO, Fixed Income
& Portfolio Manager

Key Takeaways

- Elevated volatility in the fixed income market poses greater downside risk, especially for those portfolios skewed toward the long end of the curve.
- Volatility is being created by divergences in economic growth and monetary policies around the world as well as lower liquidity.
- The fixed income market's return potential is challenged, and a disciplined, active approach is needed to find the most attractive risk-adjusted return opportunities.

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When rates reverse course, even for a short period, complacency about low rates could quickly turn to panic, and the rate rise could become fast and furious. We got a taste of this quick change in sentiment on October 15 last year when the long bond's price spiked upward intraday. We could see similar moves on the downside if sentiment were to change. While it's easy to understand why rates are declining and could hold at lower levels for a while, the decline has been met with increasing volatility, and with that, more risk.

Lower liquidity and currency moves creating choppy market

Besides global growth uncertainty, what else is driving increased volatility in the fixed income market?

First, as we have highlighted in the past, liquidity providers, like large banks, have reduced capital commitments to their bond trading business due to greater regulation. This comes at a time when the overall size of the market has been growing. That's created less liquidity, making prices more vulnerable to short-term spikes and plunges. Second, the world's central banks – namely the Federal Reserve, the European Central Bank and the Bank of Japan – have set the stage for a divergence in monetary policy for the first time in five years. The policy divergence should create more volatility in foreign exchange markets and that could set the stage for more broad-based market volatility. Historically, policy change has been a turning point for markets, and we expect nothing different this time around.

For example, the divergence of monetary policy has already sent the U.S. dollar on an upward tear against other currencies. The yen and the euro are more than 15% lower against the U.S. dollar over the past 12 months. We are watching other central banks break their pegs against currencies, surprising market participants. Growing uncertainty about monetary policy change has generated higher volatility in developed market currencies, and that's flowing into emerging market currencies. This volatility is intense enough to filter into the rest of the financial markets as the year progresses.

I think it's important to be more defensive in one's fixed income positioning at this juncture. With valuations stretched and yields low, there are risks that we have not seen in years. I also believe that avoiding large directional duration bets in the long end of the market can help limit exposure to volatility. A certain amount of Treasury exposure can be used to help buffer volatility of fixed income risk assets, like corporate credit. But, it's critical to first avoid the significant downside risk that long duration positioning courts while still sticking with a process that seeks out opportunities for investors to participate in the upside.

Volatility calls for active management

While Treasury market volatility has gathered increased attention, more attention needs to be paid to credit market volatility as it is creating downside risk.

Credit market volatility is being driven by several factors. Even though corporate credit spreads have widened over the last six months, we continue to have historically tight credit spreads. High valuations continue to make credit vulnerable to a sell-off. Given the uncertain global growth environment, many potential buyers of credit are not interested in adding to their positions. That exacerbates low market liquidity. The marginal buyer of credit we have seen over the last few years may not take much convincing to become a potential seller as we experience more volatility.

As it stands, we're now late in the credit cycle, marked by a significant increase in shareholder friendly activity, which is not bondholder friendly. Companies are releveraging their balance sheets through share repurchases, increased dividends and expensive acquisitions. In addition, it is now much more challenging to find attractive risk-adjusted returns in the credit market as it has priced in much of the corporate deleveraging that has occurred since the 2008 financial crisis.

Amid low rates and lower price return potential, many investors are stretching for yield and returns by loading up on lower credit quality bonds and taking big positions in longer duration securities. We believe this foolishly courts downside risk, especially amid the market's potential volatility.

Our core investing tenets are seeking attractive risk-adjusted returns and capital preservation. Quality is as important as ever in this market. *The fixed income market in 2015 will require sharpshooting, not casting a wide net – active management rather than passive investing.*

Patience and discipline are required to maintain an edge

With attractive risk-adjusted return opportunities harder to find, patience and discipline are required not to take on excessive risk and to be more defensive in one's positioning, especially when others are being rewarded for doing the exact opposite. We believe that giving up on generating solid risk-adjusted returns to pursue greater absolute returns would violate our growing belief that volatility is going to create some very undesired outcomes for many.

I always discuss the cost of being wrong with my team. We would rather stay defensive and wait for new opportunities at the first signs of a better global economic environment. As volatility increases and uncertainty takes center stage, we want to be in the position to take advantage of others' complacency and excessive risk taking.

Stay tuned, this is going to get more interesting . . .

Gibson Smith
CIO, Fixed Income & Portfolio Manager

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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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Past performance is no guarantee of future results.

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There is no assurance that the investment process will consistently lead to successful investing.

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Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

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

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