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Fixed income fund strategies for a post-QE world

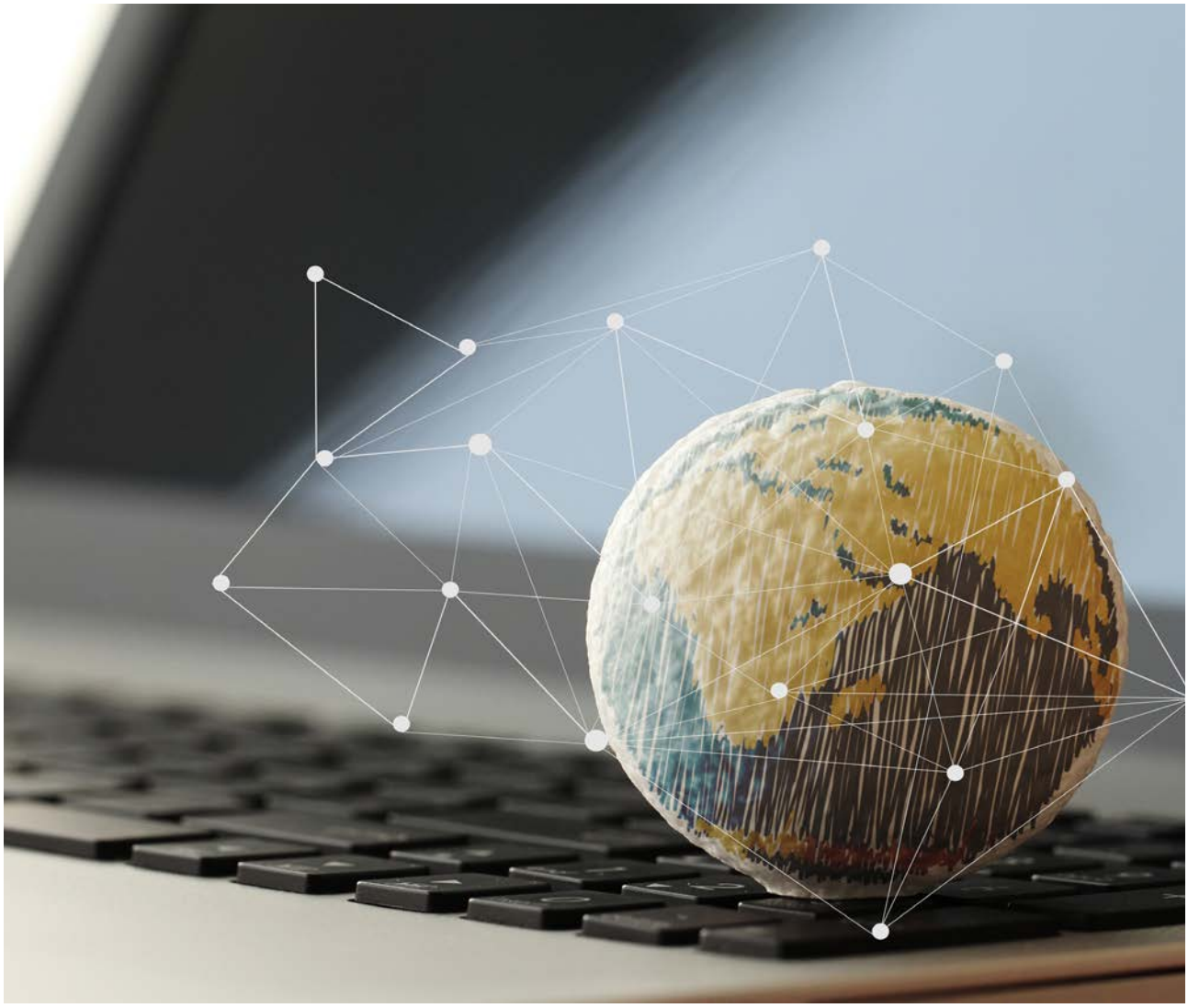
Nicholas Wall is the co-fund manager of the Old Mutual Global Investors' (OMGI) Strategic Absolute Return Bond Fund and manager of the Old Mutual Global Strategic Bond Fund. Hubbis arranged an exclusive briefing for OMGI – which was attended by 50 senior participants from private banks and multi-family offices - where Wall explained why Asian high-net-worth investors should consider buying into the strategy as well as into other OMGI fixed income funds, as the world of easy money dries up and an altogether more challenging environment emerges. Wall's views sought to merge his broad, global macro perspective and defined fixed income strategies.

Executive summary

The era of the world's leading central banks flooding the global financial system with liquidity is over. Wealth managers and high net worth investors in Asia must be mindful that carrying on familiar carry trade behaviour is becoming more and more risky, as is leverage in times of rising volatility. But adopting the right strategy for fixed income investment based on sound appreciation of global macro factors and risk should help reap solid returns.

Although inflation has been rising and yields on 10-year Treasuries have risen to around 3%, the US Federal Reserve is not rushing to hike rates further, as there is the ever-present fear of triggering recession, especially in an environment of geopolitical instability around the globe, as evidenced by North Korea, Brexit, Italy's sudden move towards populism and anti-European rhetoric, as well as President Trump's nascent global trade wars.

The markets are therefore finely poised, and far more difficult to predict than at any time in the past decade since the global financial crisis. Nicholas Wall, co-fund manager and fixed income macro expert at Old Mutual Global Investors, was in late June joined by Hubbis editors and a group of Asian wealth management experts as he gave his views on his macro outlook and the resultant portfolio strategy for fixed income portfolios that are unconstrained but the holdings of which are moderated by tight risk management protocols.



"**THE WORLD TODAY IS FAR** from the world it has been during most of the past decade since the global financial crisis," Wall stated. "There are mixed signals and being long risk assets is no longer the one-way street it was. For a decade or so, the combination of global quantitative easing (QE), a weaker dollar and a low developed market yields generated large amounts of liquidity that found its way into risky assets. Combined with austerity and banks recapitalising, money was not being recycled into the real economy, it was going back into assets propelling their performance year in year out."

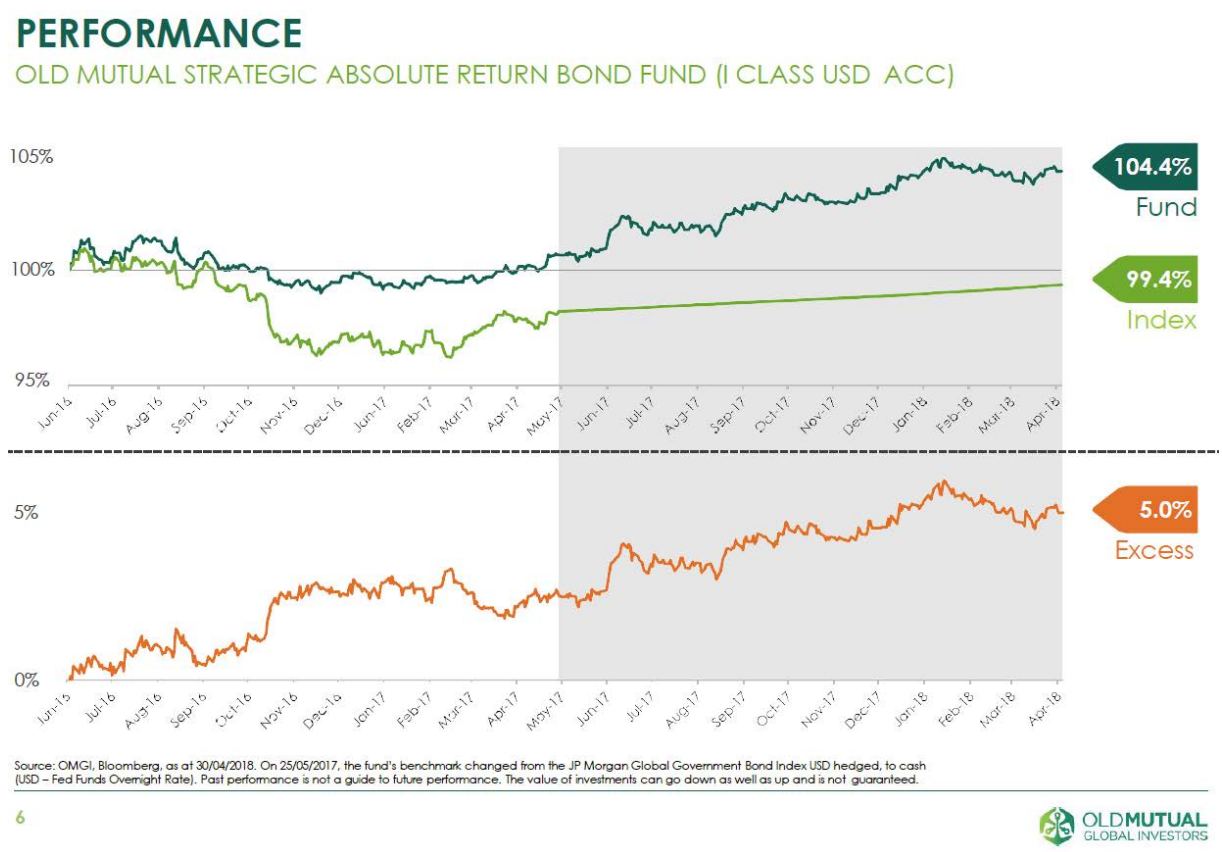
But rates have risen to around 3% at the 10-year maturity on the US Treasuries yield curve. And the Federal Reserve (the Fed) is expected to raise rates again, perhaps several times in the next 6 to 12 months.

The times they are a-changing...

"Times have changed on the liquidity front, and quite dramatically," Wall observed. "Central bank balance sheets are in retreat and QE is at an end. President Trump has really pushed back on the FX manipulation that has been going on in some countries, reducing purchases of US Treasuries from fx reserve managers. Stimulus plans such as those Trump is promoting will cost vast amounts of money, the funding of which will crowd out other investments. Banks will increasingly recycle funds into the real economy, removing liquidity from the market and repricing spreads. All these themes reduce liquidity and make the competition for capital fiercer."

"Inflation is the big one," he continued, "it changes everything as it would limit the Federal Reserve's ability to respond when stocks start to fall or when financial conditions tighten. We have seen global output gaps close, we have seen a huge explosion in fiscal spending, which is going to accelerate as austerity gives way to populism, we have seen oil prices rise - all of which lead to upside inflation pressures."

Highlighting to the assembled audience a graph tracking core CPI in the US versus the New York Fed's inflation gauge, Wall remarked how good an indicator it has been of future inflation trends. "The inflation move remains up-



wards, limiting the Fed's ability to react. That is why the Fed has continued to tighten policy, despite some disruption in markets; they have not made any effort to squash volatility like they have done in the past."

The carry trade, where an investor borrows at a low interest rate to buy bonds in a higher yielding region, is no longer the only strategy in town. "The return of volatility will present opportunities, but investors will need to be patient," Wall advised.

Funding the US deficit

Wall believes the dollar strength of late will reverse and the dollar should weaken in the medium term. "In the modern globalised era, the US has bought a huge amount of the world's exports, and it has run consistent trade deficits. At the same time, the quid pro quo there was that the rest of the world has bought US Treasuries. This kept US Treasury yields lower than they would have been otherwise. The trade deficit was offset by the capital account inflows, and that kept funding and credit cheap, powering the US consumer".

But Trump, says Wall, sees the trade balance as a weakness. He does not want to see the offset. He wants to reduce that balance, he wants trade to be more balanced in the US's favour rather than significantly out of balance as it has been for decades.

"At the same time," he said, "the US has just announced a huge fiscal deficit and that needs to be funded. Will it be the US households funding it? Unlikely given their low savings rate. Accordingly, if it is the rest of the world funding the US, then Treasury yields must increase or the dollar weaken significantly to attract those kinds of inflows."

Dollar strength temporary

That is why he sees longer-term weakness in the US dollar, but

Nicholas Wall: Macro Expert and Portfolio Manager

Nicholas Wall is manager of the Old Mutual Global Strategic Bond Fund and co-fund manager of the Old Mutual Strategic Absolute Return Bond (SARB) Fund. He joined OMGI in mid-2016, moving from Invesco Asset Management, where he worked with Mark Nash, currently also co-fund manager of the SARB Fund. Wall's expertise is macro analysis and his background includes managing the Invesco Bond Fund and the Invesco Euro Bond Fund. He has a Bachelor of Science in Economics from the University of York and is a CFA charter holder.

acknowledged in the near -term there are some factors supporting the USD. In a May macro report, Wall wrote that he is mindful that the vigorous hike in US yields has finally pushed up the US dollar.

"It is no coincidence that the greenback reasserted its relationship with domestic yields when data elsewhere started to flag," the report stated.

"We see this as temporary and are long-term US dollar bears. With yields pausing in their ascent this could encourage US dollar selling to return. However, we probably need some positive economic data outside the US to shove the market in this direction. If left to run, a stronger greenback could damage the recovery. So, owning front end US bonds is advised given what is priced in already."

Wall also said he anticipates several more rate hikes at the Fed before investment and consumer behaviour changes markedly. "The Fed wants more ammunition in case of a crisis, although not at the risk of triggering a recession," he observed, "so they will go slowly."

In the longer-run, however, the US running twin deficits, the fading impact of the fiscal stimulus package and better growth in the rest of the world should see the US dollar resume its weakening trend.

Rising term premium rising volatility

Some of the confusion over direction and volatility has been caused by conflicting signals in the yield curve versus growth expectations. "That is why we highlight the term premium as a gauge of potential volatility. The yield curve must normalise first and until then we think volatility will keep increasing".

In terms of the macro outlook in relation to the yield curve, Wall says as a fixed income fund manager he is quite happy to own the five-year and is short in the long end of the curve, which will be driven a lot more by term premium rather than central bank expectations. He expects term premia to rise as inflation pressures rise and QE ends.

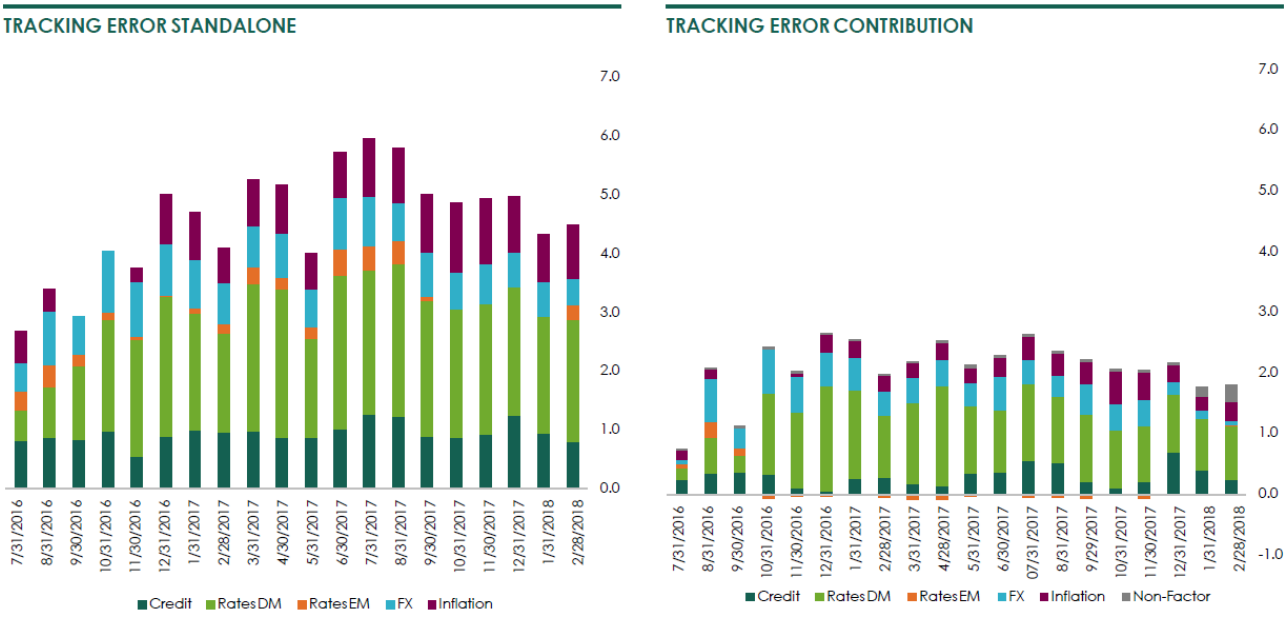
He then expanded on asset allocation. "I do not really see the evidence in the US that households and businesses are over-leveraged. The debt service cost is already low. House prices are not excessive, and they are rising. Borrowing from households has not been vast and it is still concentrated in the most creditworthy borrowers. The debt to asset ratios are still low. Therefore, I do not see signs of a recession. The Fed chairman is cautiously raising rates and will probably pause when they think they are near neutral."

Powell is not afraid to admit the Fed does not have all the answers, so they will not likely be overly dogmatic.

There is also some uncertainty in the labour market and growth has fallen off in the rest of the world, so the Fed will not risk pushing the economy into recession.

Wall observed that there is a little too much optimism about the growth that emerged late in 2017. "We think the central banks will move very slowly and keep liquidity conditions fairly robust. Whereas we had held out of emerging markets and credit towards the end of last year and the beginning of this year, we have been reallocating our funds towards emerging markets, because the spreads are there now."

RISK CONTRIBUTION SINCE MANAGER CHANGE



Source: Bloomberg as at 28/02/2018.
Past performance is not a guide to future performance. The value of investments can go down as well as up and is not guaranteed.

OLDMUTUAL GLOBAL INVESTORS

One-way bets are over...

Wall explained that he and his colleague Mark Nash joined OMGI's fixed income fund management team from Invesco in August 2016. "We believed that the one-way bet on fixed income would come to an end and we wanted to run the fixed income portfolio differently; we have launched some strategies off the back of a new process that we have driven. We have put risk management at the heart of the investment process to try to avoid some big drawdowns."

Wall explained that the OMGI fixed income team today comprises 11 investors across the 12 fixed income funds the firm runs. Based in London, the team cross-fertilises information, ideas and strategies. "We believe this is the best way forward, with expertise dedicated in one location. But we want to be small, centralised, agile, and reactive to these fast-changing and challenging market conditions."

Wall explained that, within the fixed income absolute return strategy, the focus is on total return, not on yield. "We do not promise a certain income, which we believe is the correct approach in this environment, coming off years of excessive liquidity in the market. Bond yields have been crushed and yet lots of strategies, mandates and policies have been sold with a fixed yield in mind. This forced fund managers further out to long maturity bonds and further down the credit spectrum. Fine in a 2017 and before type situation, but risky now and especially if volatility rises sharply."

Investing without constraints

Wall explained that OMGI invests across the panoply of opportunities - in developed market rates and FX, emerging market rates and FX, as well as credit. "With this, we can more easily find opportunities to go long and short and thereby outperform. Our constraint is simply risk management, which is at a heart of the investment process."

Wall highlighted how risk management is not an afterthought, it is a core element of the investment decision. "As portfolio managers at OMGI, we own all the risk in the funds, we are completely accountable, we do not abdicate our risks to a committee or another team. Instead, we use our expertise, we build up the best ideas in the funds, but we own all the risk. Mark Nash and I have a strong track record at Invesco, where we performed in the top quartile of investment bond funds."

Turning to the asset return funds, a long/short strategy, Wall explained that they invest across the entire fixed income universe.

"We are completely unconstrained in terms of what markets we can invest in, we aim to make 4% per annum gross of fees on this strategy. With our rigorous risk management focus, we have a risk target of an annualised volatility of around 4% to 5% in this fund. We can go net short for this fund, so it can go from minus five years duration to plus five. It is designed to make money in a rising yield or a falling yield environment, in high or low volatility scenarios. As long as we get the macro right, of course, and so far we have achieved encouraging results."

"The widespread expectation, or fear, then was that inflation was going to be low almost 'forever' in the developed markets."

Starting with macro perspectives

He noted that their portfolio selection and management process begins with the macro focus, helping to decide what will drive asset prices in the next six to 12 months, following which they focus on the best ideas.

"This is where Mark and I then work with our broader team, each of which has expertise in different areas, for example emerging markets, credit and across all asset classes. Overlaying these best ideas with our risk model then throws out suggested positioning sizes. In this way, we can avoid excessive correlation and overweight ideas that provide diversification."

Wall noted that they make decisions based on fundamental and macro. "We are driven by top-down, we are not so much driven by quantitative techniques. We take views on where we think rates are going, an inflation view, the output gap, also on the financial cycle, looking how levered the economy is and how much room is there for central banks to get credit into the economy. We take risk where our view of these macro fundamentals differs from the market's and isn't reflected in valuations."

Best ideas first, risk assessment follows

Wall then highlighted a model portfolio, explaining that the best ideas list is a collection of long and short ideas and their appropriate

THE BOND BEAR MARKET: IS THIS IT?

IT'S ALL ABOUT INFLATION

Source: Bloomberg as at 01/02/2018.

Diminishing spare capacity

Deficit spending explosion

Above trend growth

Wage pressures

Oil

conviction level related to those ideas. "It shows our confidence level for the ideas across different asset classes," he explained.

"We can then build a model portfolio with a view on risk and volatility as well, based on our target returns. What we are trying to do is manage on an unconstrained basis in terms of asset class diversification, but with the only constraint driven by our risk model and the total amount of risk we have in the fund. We aim to avoid excessive volatility and seek to achieve steady risk-adjusted returns."

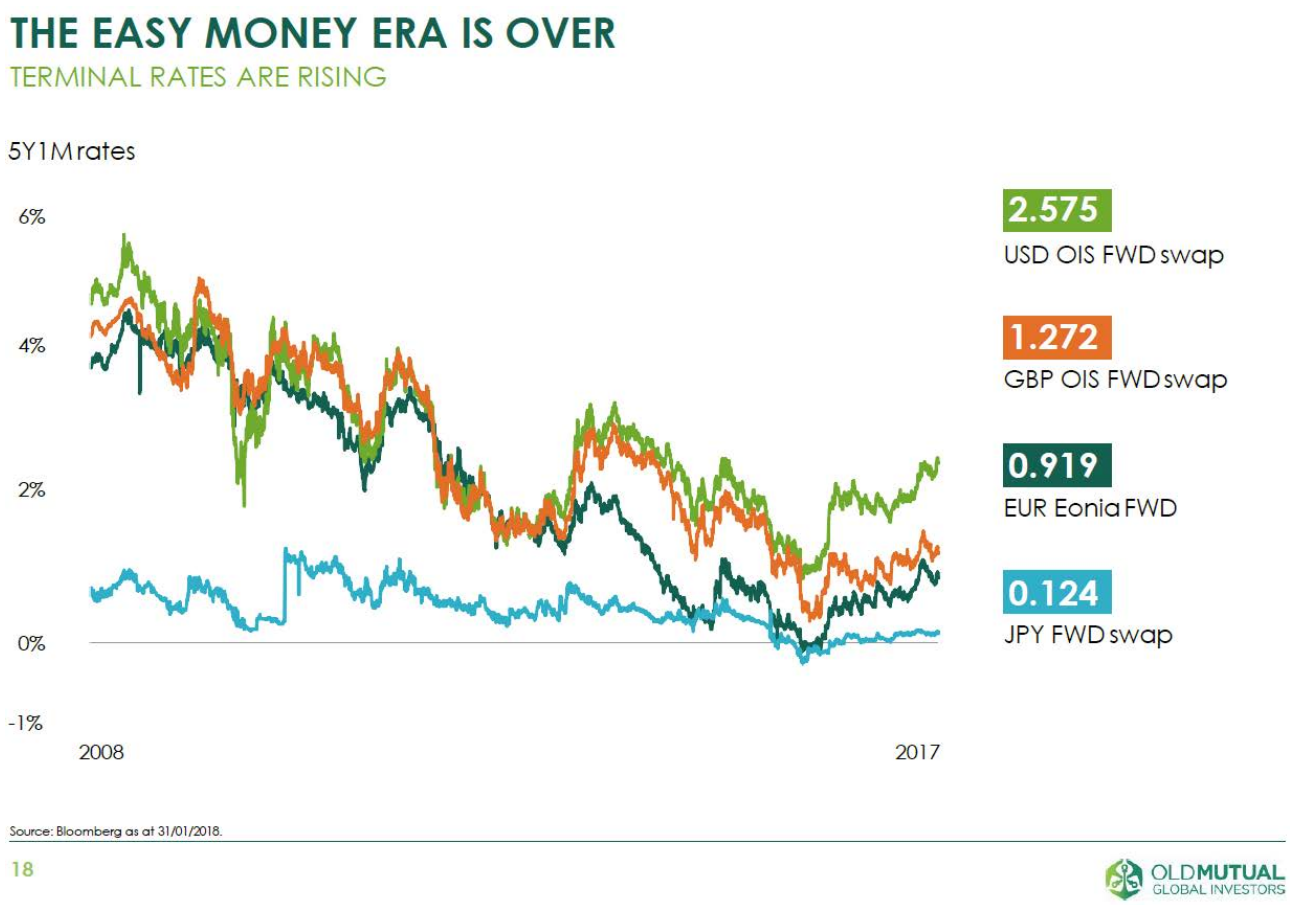
Wall explained that when he and Mark Nash joined in 2016 they were moving at what he termed 'peak secular stagnation' when everyone thought the world was destined to follow Japan's disinflationary path.

"The widespread expectation, or fear, then was that inflation was going to be low almost 'forever' in the developed markets." However, Wall and Nash went against that view. "Our emphasis since we joined has been on shorter duration and low credit exposure, which has worked out well," he reported. "We kept our credit exposure low throughout this time, and at times had negative credit exposure. We will not chase yield when spreads are tight, just because the rest of the market does. We did sacrifice some gains last year when financial conditions continued to loosen, but we stick by our conviction and this has helped limit volatility in the fund this year."

"One must remain patient and it is certainly a benefit of the total return approach, not being required to hold certain assets when they look overvalued."

Wall said that as the markets are now starting to see liquidity conditions tighten, there can be exaggerated moves in some sectors, for example in emerging markets in May/June and also in credit, especially high yield.

"In short," he reported, "one must remain patient and it is certainly a benefit of the total return approach, not being required to hold certain assets when they look overvalued." In conclusion, Wall believes that investors need to be mindful of how the market is positioned and be wary of what were



popular trades amidst benign liquidity conditions.

"The cycle is maturing which typically creates volatility, just at a time when the exit door has narrowed because of constraints on bank trading desks due to new regulations, the cost of capital constraints and automation," he elucidated. "Bank trading desks are now less able and willing to warehouse risk, particularly when volatility rises, and risk limits are hit," Wall added. "This means that when investor sentiment turns, as it did over the political change in Italy, price moves can be rapid and spread quickly to other markets."

So far, he noted, these episodes have been short-lived because it is hard to stay short European risk given the ECB's presence in the market. "But this is changing as the European central bank gradually removes its QE safety net." The risks around US Treasuries are also finely balanced now. Despite the heavy issuance of Treasuries, the yield on the 10-year bond has struggled to break through 3% and is met with consistent buying from domestic and foreign investors - the strong demand seen at recent auctions is a testament to this.

"The surge in US 10-year bond yields seen this year creates a great opportunity for us," Wall commented. "Since we arrived at OMGI we have been cautious on emerging market and corporate bonds. The spreads on offer only made sense in a QE world, that we believed was coming to an end. Carry is only one part of the total return on bonds and we will not chase it if the risk premium on offer is inadequate. With the spike in volatility in emerging market assets seen this year, however, buying opportunities have been created and, mindful of idiosyncratic risks, we have bought a basket of EM bonds and currencies."

Shifting positions - with good reason

Wall reported that OMGI's fundamental view on the outlook for markets has not changed - but that the risk/reward relationship has. "We are closer to neutral duration in the fund overall, but after the large sell-off seen in the last two years, this is now concentrated in the long end where there is more room for the term premium to reprice. Meanwhile, we have added to our emerging market position after this year's big sell-off in EM bonds and forex; we are well positioned to capitalise on any rebound. We keep the large US dollar short position and view the recent appreciation in the currency as a short squeeze." ■