

The imminent risk of rising yields and how investors can react

Bernd Hartmann, Head of Investment Research & Chief Strategist at VP Bank Group, cautioned the audience at the Hubbis Independent Wealth Management Forum of March 8 on the risk of rising yields and strategies to mitigate the downside.

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FALLING YIELDS AND LOW RATES have been the main driver for stock markets. Due to the loose central bank monetary policy and the absence of inflation, positive macroeconomic data has not been driving yields higher. This changed somewhat in January - after initially ignoring the re-pricing of interest rate expectations, stock markets reacted quite negatively in February.

“Good macroeconomic data could henceforth be accompanied by rising rate expectations,” Hartmann explained, “and good data no longer has to be good news for the equity markets as well. If we were already at that point it would be a major game changer, but although there is some cyclical pressure from the labour market on inflation in the US, structural forces like globalisation, demographics and digitalisation keep the lid on yields.”

Not yet at the tipping point

Therefore, Hartmann extrapolated,



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lated, while US core inflation will pick up, it will be constrained. “However, be aware that with extra fiscal stimulus from the US, already higher growth rates and a growing twin deficit these factors could increase the risk of mark-

edly rising yields.”

Record high short positions in US Treasuries currently signal that the market expects nothing to go wrong. On balance, Hartmann noted that risk premiums still currently favour equities over bonds.

Bernd Hartmann · Head of Group Investment Research, Chief Strategist · 8 March 2018

The underestimated threat of rising yields and how to cope with it

But inherent risks are growing

“However,” he said, “one of the main risks for 2018 will be that we have a change in this relationship, meaning that positive macroeconomic data leads to higher yields and also perhaps this then leads to the situation where good data is no longer good for the equity market. History indicates that after reaching a certain level, rising yields are a burden for equities. Historically, this tipping point was about 5% but we believe this will henceforth be considerably lower at around 3.5%.”

Hartmann noted that nobody yet knows when this tipping point will be reached. If higher yields cause a re-evaluation of corporate bonds and equities, there could be massive ramifications due to the excesses built into the system in the past decades.

Credit quality deterioration

“We do know the bond market has significantly changed its risk profile over the past few years,” Hartmann observed. “Loose monetary policy causes distortions, especially in the bond market. Credit quality has gradually deteriorated. The incentive for a higher credit rating has vanished because there is minimal cost differential between triple-A and triple-B paper. So, companies have leveraged up and are taking advantage of the low-interest environment to increase long-term

borrowing.”

To mitigate the risks of this environment, Hartmann advised investors to focus on single bond selection, on quality stocks, to follow hedge funds-style strategies, to look at low or uncorrelated asset classes, to focus on floating rate notes, and look at undistorted and under-represented asset classes, for example, private debt.

Adjust portfolios... and expectations

“What investors should not do is take on long-duration paper, poor credit quality paper or highly leveraged, rate-sensitive equities.”

Amongst the uncorrelated investments to consider, Hartmann highlighted insurance-linked securities. “The performance of Insurance Linked Securities (ILS) is primarily linked to natural events, and therefore largely independent from economic activity. Thus, even if not entirely risk-free, they offer above average diversification effects.”

Hartmann also explained that due to the high valuation levels prevailing, VP Bank considers hedge fund-style strategies as an interesting addition to traditional asset classes. This kind of solution has an interesting risk/reward profile for a low return environment. For example, Absolute Return funds are in a position to achieve better returns than the bond market. As are event-driven strategies that benefit from the M&A cycle, or arbitrage strate-

gies focusing on valuation discrepancies, both with low beta.”

Private debt – not only for HNW portfolios

Hartmann zoomed in on private debt. “These are individually negotiated loans outside the banking system. As these loans are not publicly traded, prices are not directly distorted by central banks’ bond purchasing programmes. They are long lasting contracts with no interest rate risk, as these loans are based on a fixed spread over the short-term rate, i.e. Libor.”

VP Bank currently prefers what it terms the Middle Market segment, which currently offers higher spreads than junk bonds, but with substantially higher recovery rates of 85%. Investor returns also include an illiquidity premium as investors have to commit for a few years,” Hartmann added. “The risk profile compared to high yield bonds is quite conservative and these are attractive figures with IRRs of between 7% and 9% for European private debt, perhaps 1.5% or so higher if in the USD terms. However, Hartmann did admit that to play in the private debt game requires substantial investment funds of some \$5 to \$10 million, as well as a specialised manager. To address these issues VP Bank has set up a fund with an experienced private debt company as manager. Due to the fund structure investors can participate also with smaller amounts. ■