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Access expert insights on fixed income:
Is a change in market dynamics afoot?

Fixed Income Survey Q1 2019



Fixed Income Survey 2019

Is a change in market dynamics afoot?

Throughout the year we ask leading bond and currency managers to consider valuations, expectations and outlooks for the coming months. This quarter's survey included 60 responses from managers with fixed income specialisms from all over the world.

In this survey, we outline the highlights and overall conclusions from each of the eight fixed income sectors below:

1. Global rates
2. Global investment grade credit
3. Global leveraged credit
4. Securitised non-agency credit
5. U.S. municipal bonds
6. Developed currencies
7. Emerging markets hard currency
8. Emerging markets local currency debt.

Please note:

The views from managers in this survey are as at the 31st of January 2019. Russell Investments' analysis and commentary was compiled over February and March.

Changing global market dynamics

Over 2018, it was clear that our fixed income manager survey respondents were anticipating ongoing market volatility. Throughout the year, we continued to highlight the incongruous views of bearish interest rate managers versus credit managers, who have been more bullish. We also saw broad optimism for emerging markets foreign currencies overall, with particular favour for the Mexican peso.

In 2019 however, there has been a clear shift in sentiment and the results from our survey suggest that our respondents have a very different outlook for the next 12 months. As we will see, the abrupt change in direction by the U.S. Federal Reserve (the Fed) has had an effect on many of our managers' views versus last year

The 'Fed put': Genuine comfort, or mistake?

Against the backdrop of the strong rally we have experienced since the turn of the year, market sentiment has been buoyant, and participants are very much risk-on.

As such, many are recalling Fed action from the 1990s and are hailing this market environment as a resurgence of the 'Fed put' – i.e. an expectation by the market that the Fed will pause rate hikes (or even lower rates) if we experience a downturn of any sort. And typically, we see elevated market confidence buoyed by the comfort of this expectation. Indeed, after the results of this survey were finalised, we have since received further guidance from the Fed that perhaps rate hikes in 2019 are off the table.

However, critics are concerned that:

1. Markets may be relying too heavily on the prospect of a Fed bail out.
2. The Fed and markets may be discounting fundamentals such as wage inflation and unemployment or risks such as Trump's increased U.S. fiscal spending.

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Global rates survey

Highlights

- Managers have tempered their views on rate hikes (in line with market pricing). However, the weighted average of the current expectation is 1.5 hikes – greater than the market is pricing.
- There has been a material reduction in the expectations of a flattening curve, with it no longer being the consensus view. 30% of the survey expect to see the yield curve steepen, 30% do not foresee a material change. Meanwhile 20% expect a parallel movement, and another 20% expect it to flatten.
- The U.S. breakeven market continues to be considered the most attractive globally, followed by Japan, Germany and the UK.
- In line with reducing inflation expectations, core CPI consensus has tempered as well.
- The majority of managers expect the Fed funds rate to peak at 2.86% in this cycle.
- The 10-year U.S. Treasury spot interest rate in 12 months' time is expected to be 2.92%.
- The 10-year German bund spot interest rate in 12 months' time is expected to be 0.54%.

10-year Treasury demand and supply: Overall lack of concern

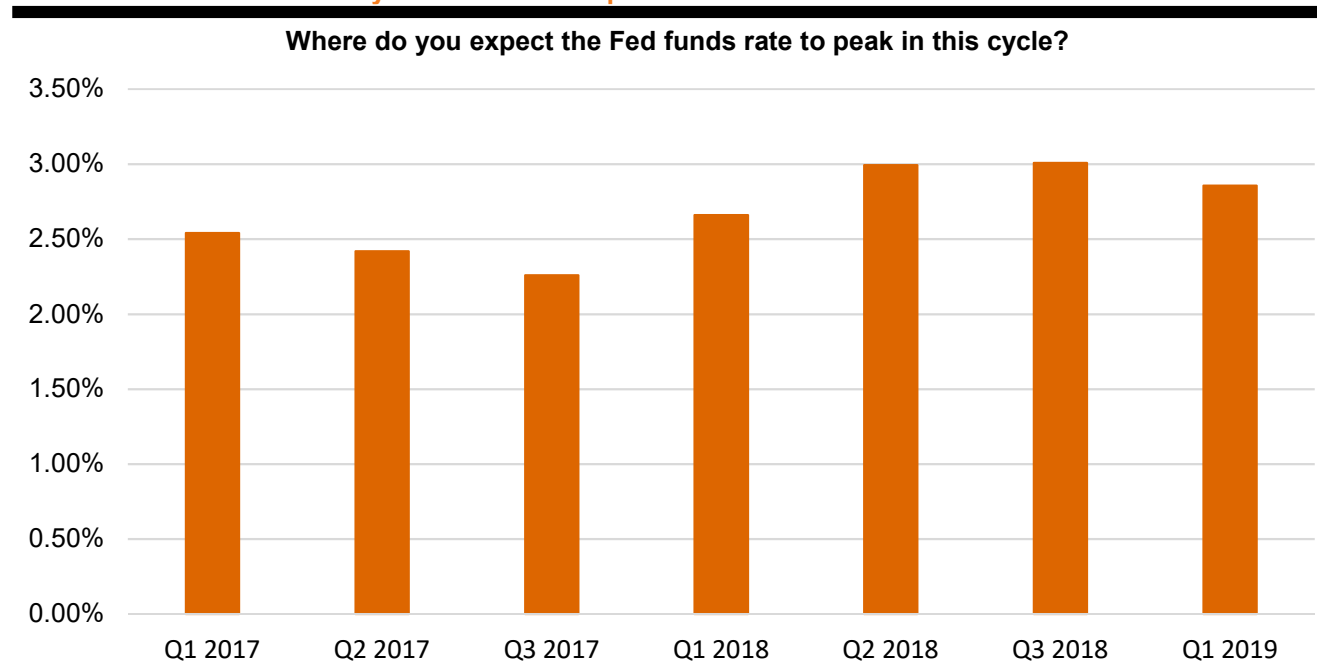
In line with markets at that time of the survey,¹ managers did not appear worried about a threat from rising rates, given that they predicted an increase of less than 0.03% in 10-year U.S. Treasury yields over the next 12 months. Indeed, the same could be said for their concern about the demand required to meet the increased supply of 10-year Treasuries

¹ The views from managers in this survey are as at the 31st of January 2019. Russell Investments' analysis and commentary was compiled over February and March.

(issued to fund the U.S. government's spending). In light of the recent move down in Treasury markets since the 20th of March 2019, the market's fear of growth has evidently provided adequate demand for any increases in supply. The question now is, where will rates go next?

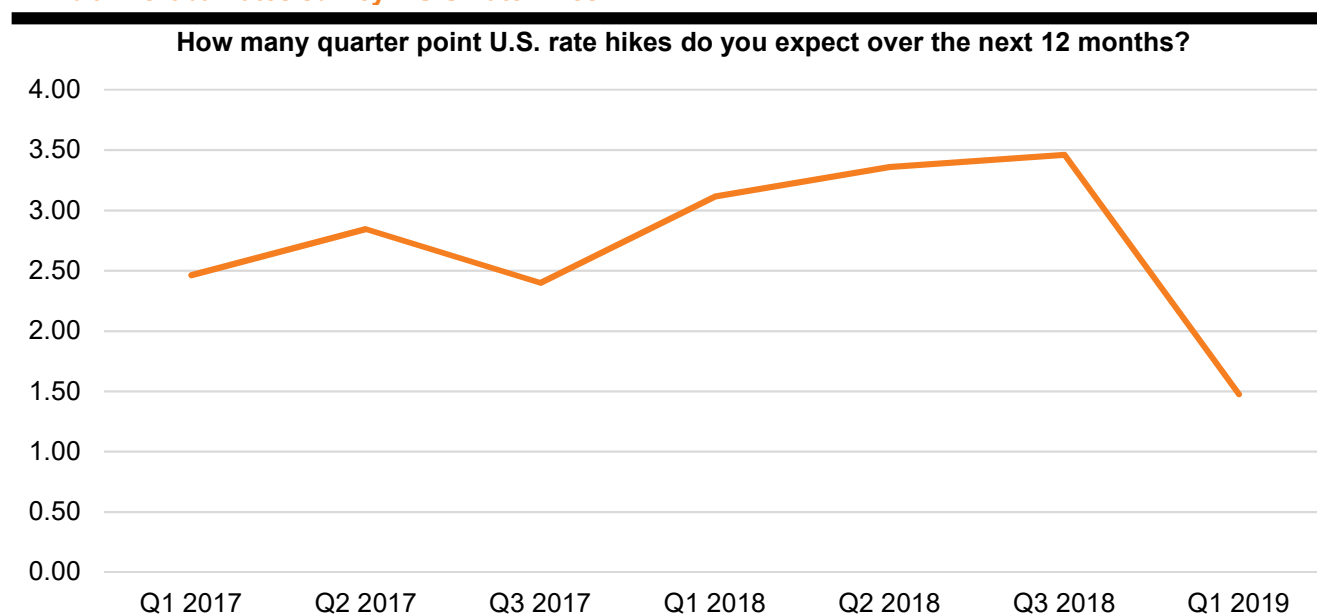
It seems as though our interest rate manager respondents do indeed feel genuine comfort from the Fed put, but are growing cautious on their outlook for global growth.

Exhibit 1: Global rates survey – Fed funds rate peak



Source: Russell Investments' Fixed Income Survey, Q1 2019. Weighted average.

Exhibit 2: Global rates survey – U.S. rate hikes



Source: Russell Investments' Fixed Income Survey, Q1 2019. Weighted average.

Market versus managers: Fed hikes – where to now?

Survey projections for the Fed funds rate however, are at odds with the market. As a result of the Fed's January announcement, the market is currently no longer pricing in any more rate hikes. Whilst we have also seen a drop in the expected number of hikes from our survey respondents, the weighted average is still higher than the current market view.

Survey respondents have moved from anticipating an average of 3.5 hikes over the next 12 months down to now only 1.5 times. This does beg the question – if active fixed income managers are not fully responsible for the current market pricing of zero hikes, who is?

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Credit surveys

Global investment grade highlights

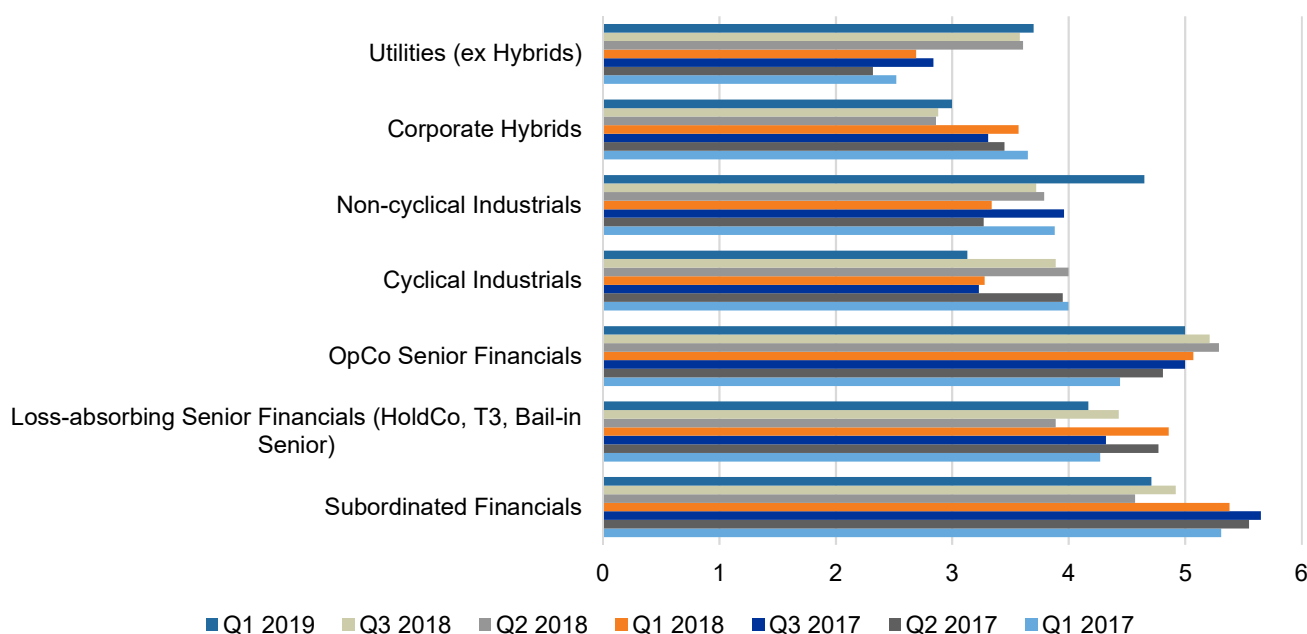
- Managers remains cautious on credit spreads over 12 months (51% expected spreads to widen, whilst 23% expect them to tighten).
- However, managers have become more positive in their view for investment grade credit over the short term, compared to their 12-month forecast –the average credit beta is 1.1 times.
- Emerging market corporate credit is now considered the most attractive region on a 12-month horizon, taking over from Europe ex-UK. The U.S. was a close runner up.
- Operating company (OpCo) senior financials remain the most favoured sector within investment grade credit, closely followed by subordinated financials and non-cyclical industrials.
- Many of our investment grade credit survey respondents also manage high yield credit. These managers have grown more optimistic in their 12-month view and now consider high yield credit to be the top asset class in terms of expected excess return potential (over Treasuries).

Credit beta

The average credit beta is 1.1 times

Exhibit 3: Global credit surveys – Investment grade credit sectors

Which sector is currently most attractive in global investment grade credit?



Source: Russell Investments' Fixed Income Survey, Q1 2019.

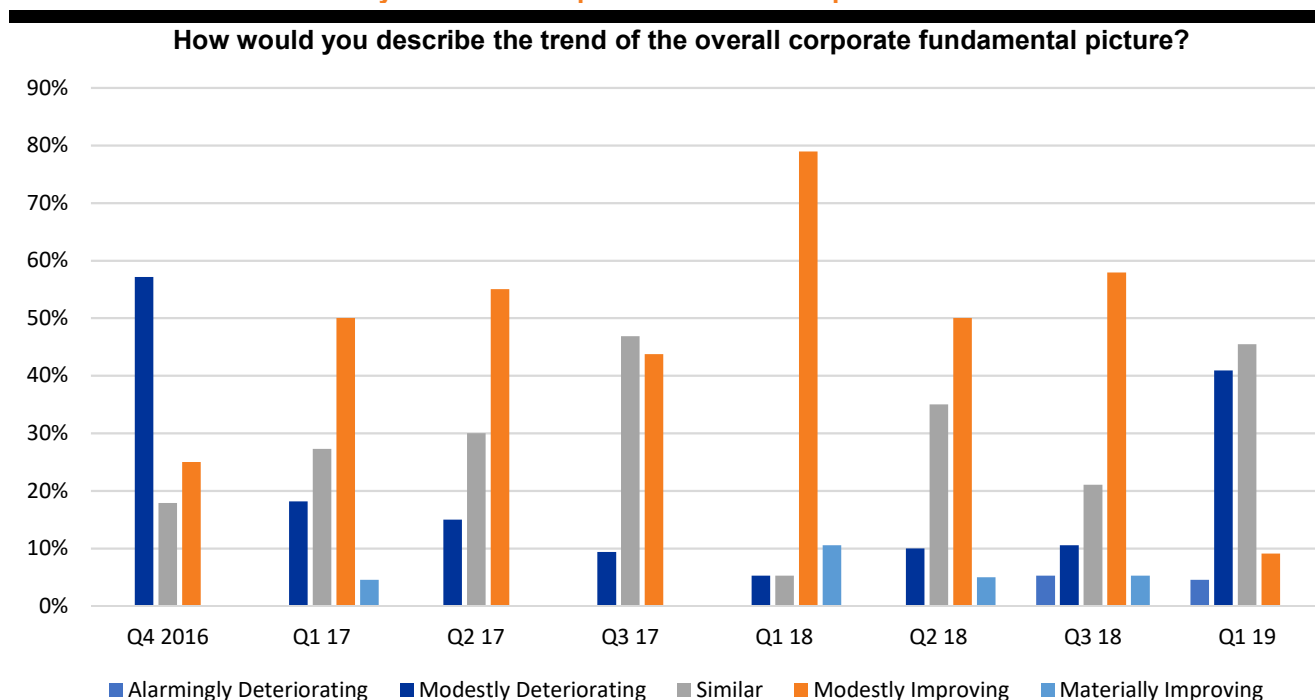
Global leveraged credit highlights

- 45% of managers surveyed expect U.S. high yield corporate credit spreads to widen, the most since we started this survey in Q4 2016.
- 50% of managers forecast 12-month returns of over 5%, suggesting that spread widening expectations are still modest.
- Once again, very few managers plan to add risk in the foreseeable future – consistent with all surveys since Q4 2016.
- U.S. high yield credit is once again the favoured asset class, having previously lost the top spot to leveraged loans, European high yield, and collateralised loan obligations (i.e. CLOs) over the past few surveys.
- 45% of managers expect the overall corporate fundamental picture (including leverage, interest cover and the quantity of cash flow generation) to stay similar to how it is now, whilst 41% expect it to modestly deteriorate. This is a significant shift from our end of 2018 survey, which saw 58% of managers anticipate modest improvements and 20% expect it to stay on a similar trajectory.
- The majority of managers think that the second half of 2019 onwards will see the peak of default activities in the U.S. high yield market for this cycle.

Adding risk

Very few managers plan to add risk in the foreseeable future – consistent with all surveys since Q4 2016.

Exhibit 4: Global credit surveys – Overall corporate fundamental picture



Source: Russell Investments' Fixed Income Survey, Q1 2019.

Securitised non-agency credit highlights

- 33% of managers are planning to add risk to return-oriented securitised portfolios, the most since the survey started in Q1 2017.

Momentum shift for credit managers?

Overall, the momentum for corporate credit including high yield and investment grade has deteriorated in contrast to credit managers' bullish outlook throughout 2018. Whilst sentiment has shifted somewhat, 50% of credit managers still expect 5% or greater returns in U.S. high yield overall for 12 months – which suggests they are not overly concerned

about spreads more broadly. Only 5% of survey respondents expect a negative return. If they were truly bearish, we would expect that return expectation to be much lower.

Interestingly, the momentum shift has moved from corporate credit to securitised credit – with 33% planning to add risk here, which is the most since this survey started. Emerging market debt has also grown in favour, which is somewhat at odds with the declining outlook for corporate credit given that these two risk assets are typically correlated. 51% of managers expect a total return of 6% or more over the next 12 months in emerging market debt, up from 18% a year ago – and not one manager expects a return of less than 2%.

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U.S. municipal bonds survey

Highlights

- The balance of views across the U.S. municipals bond managers is evenly mixed – with some managers expecting spreads to widen, some expecting spreads to remain range bound while others expect some tightening.
- Overall, the majority of managers expect municipal bonds to outperform high yield credit.
- Tobacco is no longer viewed as positively as it was previously, with 45% of survey respondents expecting a muted performance of between 0-2% over the next 12 months.

Munis remain attractive

- Overall, U.S. municipal bonds remain an attractive alternative to corporate bonds, especially in light of their supply/demand dynamics and superior quality profile.

Dedicated currency manager survey

Highlights

- 44% of managers now predict an ex-U.S. dollar G10 currency to be the top performing currency over the next 12 months.
- However, we continue to see the majority of managers (53%) expect a basket of emerging market (EM) currencies to perform best overall.
- The Japanese yen and sterling are the most favoured currencies in the G10.
- The Turkish lira is the most favoured currency in emerging markets.

Favourite currencies

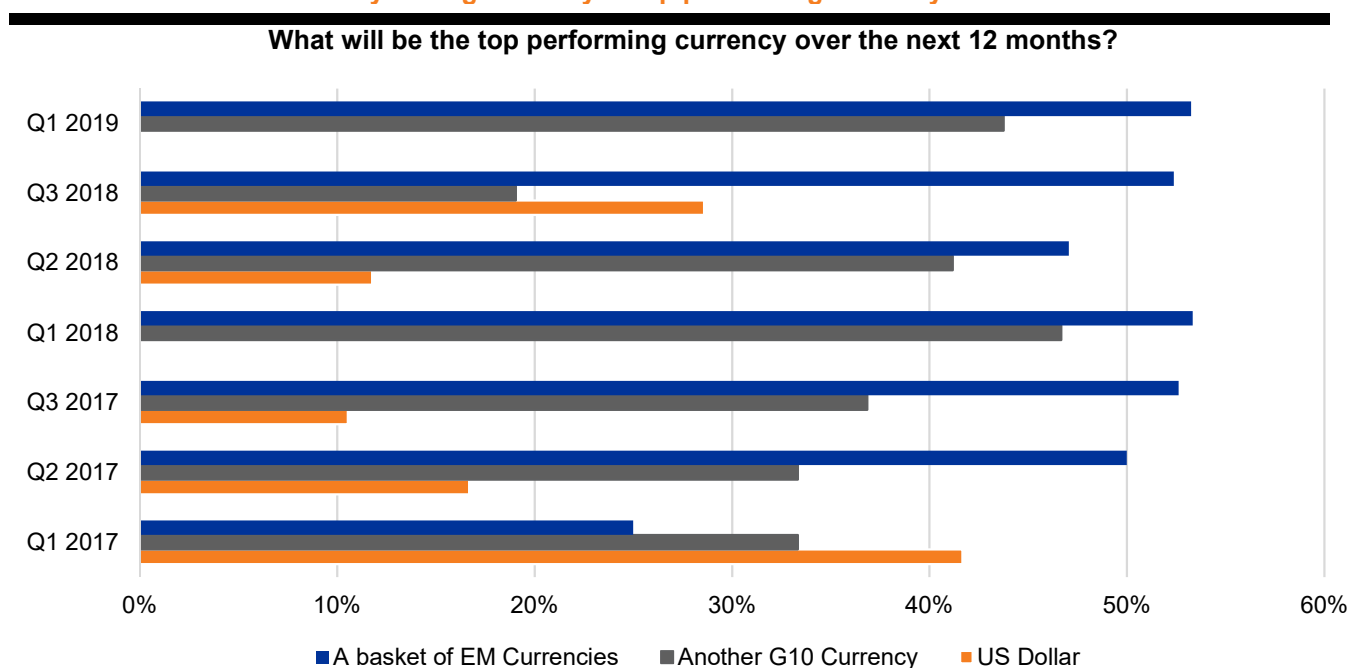
- Yen
- Sterling
- Turkish lira

U.S. dollar falls out of favour

One of the biggest shifts that we have seen in this survey is the complete reversion in favour for the U.S. dollar. When we asked dedicated G10 foreign exchange managers to predict the best performing currency over the next 12 months, none of our survey respondents selected U.S. dollar (for the first time since Q1 2018).

Given that the outlook for the U.S. dollar is highly linked to Fed action, this shift in favour is likely due to the change in direction from the Fed.

Exhibit 5: Dedicated currency manager survey – Top performing currency



Source: Russell Investments' Fixed Income Survey, Q1 2019.

Emerging markets surveys

Hard currency survey highlights

- Managers expect the hard currency emerging markets spread to modestly lower (20-50bps) over the next 12 months.
- This translates as an expectation of positive total return to be in the mid-single digits.
- This quarter, managers prefer to have an off-index allocation to (hard currency) emerging markets corporate debt, whereas last quarter it was local currency sovereign emerging markets debt.
- With the Fed softening its stance on rate hikes, the slowdown in China is now the top concern.

Local currency emerging markets debt survey highlights

- Once again, managers are bullish on local emerging markets debt.
- 73% of managers expect a 6% or better return in local emerging market debt over the next 12 months, versus 47% last survey and 64% previous to that.
- The only time managers were more bullish was in February 2018 – which turned out to be incorrect.
- The Mexican peso has fallen out of favour.

Peso is no longer the favourite

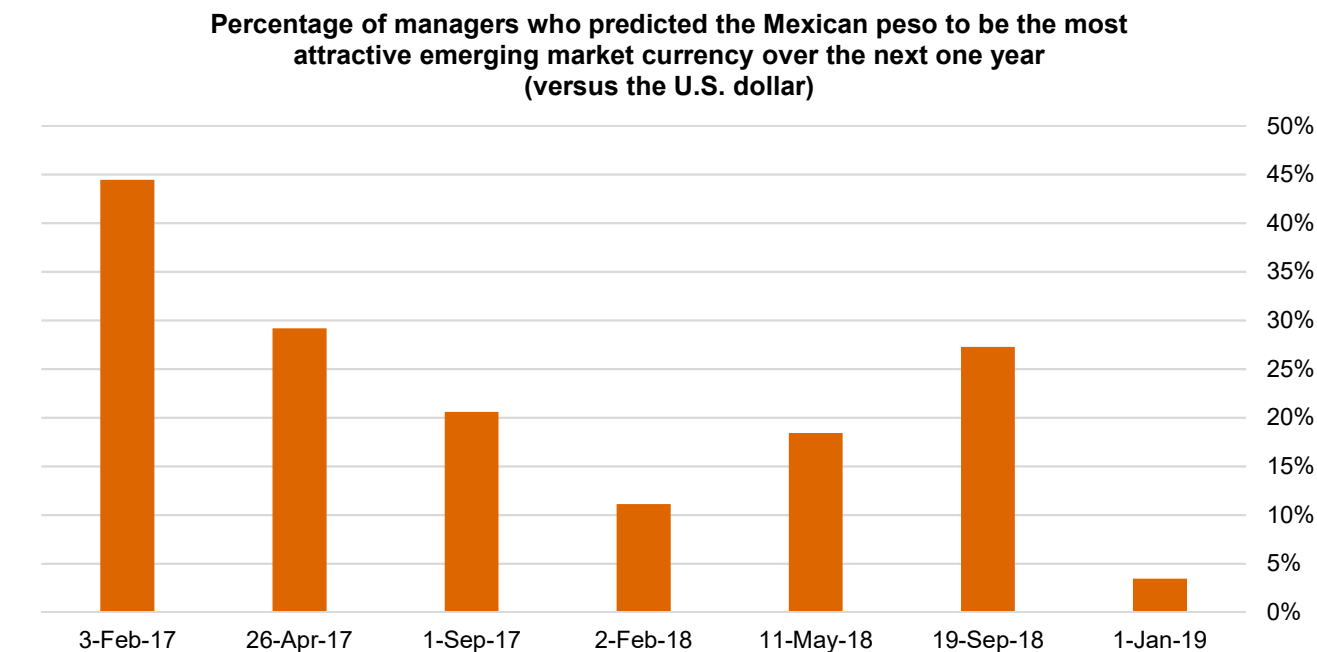
The Mexican peso spent the vast part of 2017 and 2018 as the most favoured emerging markets currency against the U.S. dollar. In this latest survey however, only 3% of managers predicted it to be the most attractive over the next year – the lowest number since the peso was first highlighted as one to watch in March 2017.

Attention has shifted to the Brazilian real with 28% of managers selecting it as the most attractive currency. This top spot was closely contended by the Argentinian peso, which

With the Fed softening its stance on rate hikes, the slowdown in China is now the top concern.

despite experiencing a significant drawdown in 2018, has 24% of managers selecting it as their favourite currency for 2019. This is a big shift from our end of year survey, which saw only 14% and 5% favour the Brazilian real and the Argentinian peso respectively.

Exhibit 6: Emerging markets surveys – Mexican peso



Source: Russell Investments' Fixed Income Survey, Q1 2019.

Navigating today's market environment will be critical for bond managers

The main takeaway from this survey has been the clear change in views on interest rates and the U.S. dollar, impacted by recent guidance from the Fed that they would be more accommodative in the face of slowing economic data. Whilst this is a notable change, the government bond market has priced in a weaker economy than the survey would imply.

On the other hand, there has been only marginal deterioration in the credit outlook. Credit spreads have retraced much of their weak performance from the fourth quarter of 2018, and thus are more in alignment with survey views.

The dichotomy of opinion between credit and interest rate managers that we have highlighted for some time now, started to show signs of unwinding last year in the third quarter, with rate managers adjusting their views progressively higher to align better with the benign views of credit managers. This survey has once again shown that the opposition in views of credit and interest rate managers is set to continue.

Only time will tell, but navigating this market environment will certainly be critical for bond managers over the next few months.

Three questions to ask yourself:

1

Are market participants now relying on monetary policy once again to support credit spreads?

2

If so, how will credit markets react if recession becomes a reality, given policy makers have not made significant progress towards rate normalisation?

3

Or, will rates once again shift gears and trend higher?

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