December 2015

News & Views

For Professional Clients and, in Switzerland, qualified investors

BNY MELLON

WHY FLEXIBILITY MAY NOW BE THE KEY TO BOND MARKET RETURNS

Newton's Paul Brain says the ability to dynamically allocate bond exposures will limit downside in the coming years, while allowing investors to capture the upside when markets improve.

A focus on liquid and transparent holdings could be paramount for investors anticipating future bond market stress, according to Paul Brain, lead manager of Newton's Global Dynamic Bond strategy.

Speaking at the Newton annual investors' conference in November, Brain noted how his Dynamic Bond strategy currently has a conservative asset allocation stance, with a historically high level of exposure to government bonds, often viewed as a 'safe haven' asset (around 44%) and investment grade corporate debt (around 32%).

In contrast, the allocation to assets with what Brain sees as higher risk are at historical lows. Emerging market sovereign debt accounts for just over 8% of the strategy portfolios, for example, while high yield debt stands at just 5.5%. Duration also remains historically low at 3.3 years, while currency risk taken within the strategy stands at just 1% (compared with around 45% as of April 2008, for example). [1]

The aim of his conservative strategy positioning, he said, was to avoid drawdowns and to protect capital for future reinvestment. While the energy sector "could throw out some opportunities" in both the high yield and investment grade space given current attractive valuations, the investment team is "not ready to reallocate capital just yet", he added.

Twist, hold or fold?

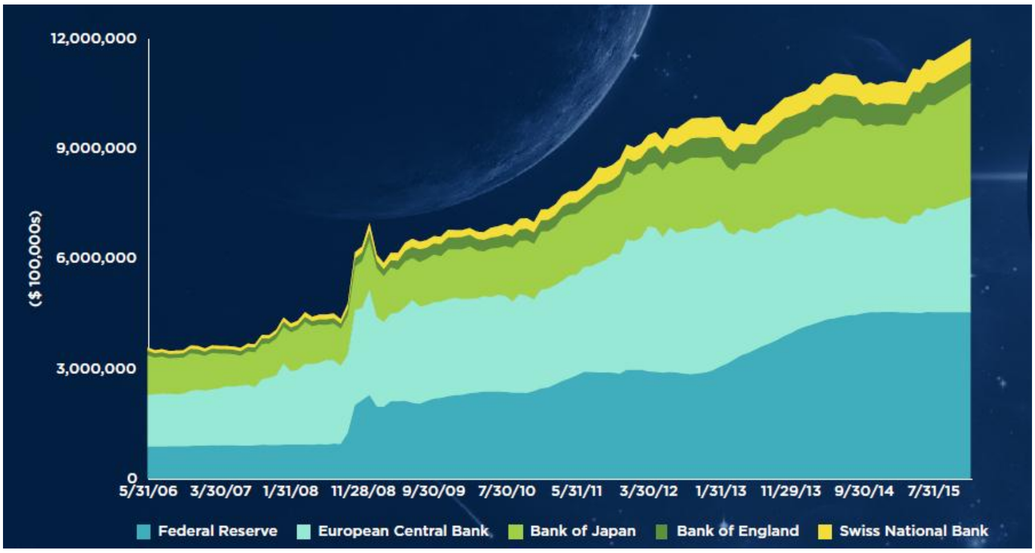
Looking forward, Brain pointed to three paths the global economy could take in the medium term: rising interest rates coupled with higher inflation; flat interest rates coupled with inflation that stays "more or less the same" or stagnant growth coupled with deflation. In each case, the ability to dynamically allocate bond exposures could limit the downside while allowing investors to capture upside when markets improve, he said.

For the first scenario – that of rising interest rates – Brain noted how so far, and despite widespread adoption of QE in the world's developed economies, central banks have struggled to generate inflation (see Figures 1 and 2). The next development, he said, could be a move to fiscal expansion.

"The next logical step given the failure to generate inflation could be a transition to fiscal expansion and there has been a growing call for change. Elections in Canada, Portugal and Poland have all been won on an anti-austerity platform. In the UK, 'Corbynomics' – or an increase on deficit spending – has also been touted."

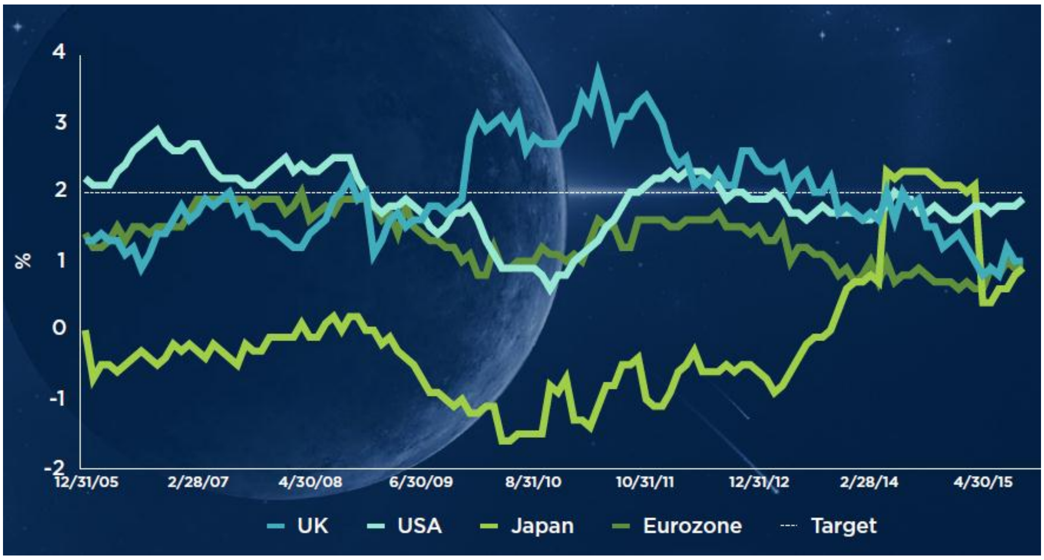
[1] As at 30 September 2015. .

Figure 1: Central banks continue to add liquidity…



Source: Bloomberg, National Central Banks, July 2015 (Forecast August 2015 onwards)

Figure 2: But underlying inflation remains well below central bank targets



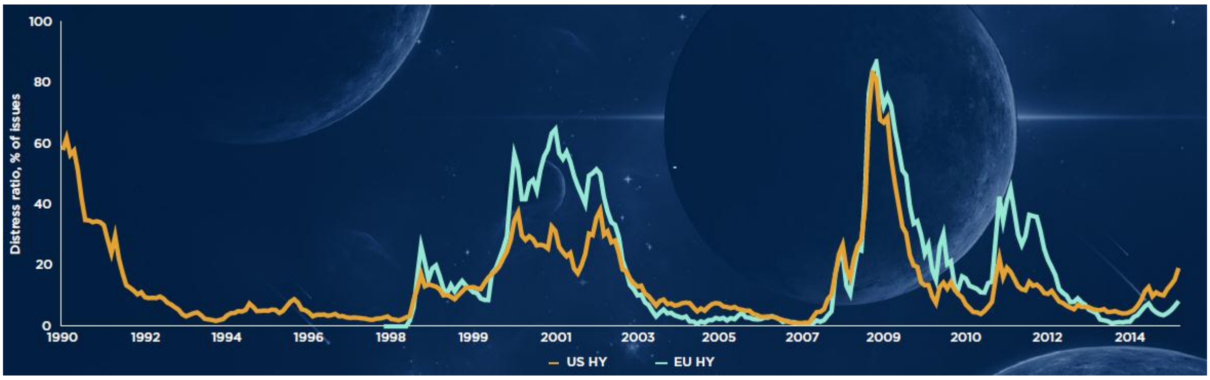
Source: Bloomberg, September 2015

Potentially this kind of fiscal expansion could translate into higher inflation but for Brain, the most likely outcome is “more of the same”. “It will take a lot to move from anti-austerity policies, to fiscal expansion and from there to fully fledged inflation,” he said. “Our view is for the continued debt burden to be the defining factor in creating a low interest rate, low growth environment of the kind we saw in the years immediately following World War II.”

This is not to say the current environment is free from risk. Leverage has been building up in the corporate bond market as the appetite for yield coupled with cheap borrowing costs has made it easy for companies to increase their debt. Said Brain: “Often the capital raised has been used to pay dividends, create unnecessary capacity or to buy back shares – and this worries us. Now we're looking at a scenario where many commodity or oil and gas producers are facing weaker profitability because of falling prices. This means their debt ratios are climbing which in turn is pushing them closer to default.

"One positive is that defaults are relatively low for the time-being, particularly when compared to the credit crisis. Nonetheless, there are growing signs of discomfort and the number of companies with distressed ratios is rising rapidly in both the US and EU high yield space" (see Figure 3 below).

Figure 3: Credit in distress: a pick-up in distressed ratios is usually a leading indicator of defaults

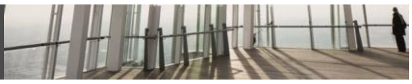


Source: Bank of America Merrill Lynch, 30 September 2015

Here, Brain drew a parallel with previous periods of bond market stress, which, he said, led even the most sophisticated of bond strategies into periods of drawdown. Against the current background, the most sensible approach for investors would be to maintain a flexible approach to allocation, he said, with a focus on simplicity, liquidity and sustainable investment.

He concluded: "As ever, current market conditions are unpredictable and returns are likely to be volatile. There are a variety of fixed income options available but we think a flexible approach is essential to generate returns and protect capital."

In the nine-and-a-half years since its launch in May 2006, Newton's Global Dynamic Bond strategy has returned 7.2%, with a 1.0 sharpe ratio over that time (As at 30 September 2015).



Important Information

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements. When investments are sold, investors may get back less than they originally invested.

This is a financial promotion for Professional Clients. In Switzerland, this is for Qualified Investors only. This is not investment advice. In Germany, this is for marketing purposes only. Any views and opinions are those of the investment manager, unless otherwise noted. Investments should not be regarded as short-term and should normally be held for at least five years. Portfolio holdings are subject to change, for information only and are not investment recommendations. This material may not be used for the purpose of an offer or solicitation in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or not authorised. This material should not be published or distributed without authorisation from BNY Mellon Investment Management EMEA Limited. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation. BNY Mellon Investment Management EMEA Limited is ultimately owned by The Bank of New York Mellon Corporation. BNY Mellon Investment Management EMEA Limited, and any other BNY Mellon entity mentioned] are all ultimately owned by The Bank of New York Mellon Corporation. Issued in the UK and Europe (ex- Switzerland) by BNY Mellon Investment Management EMEA Limited, BNY Mellon Centre, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorised and regulated by the Financial Conduct Authority. Issued in Switzerland by BNY Mellon Investments Switzerland GmbH, Talacker 29, CH-8001 Zürich, Switzerland. Authorised and regulated by the FINMA. Issued as at 08/12/2015. CP16607 – 08-03-2016 (3M).

本情報提供資料は、BNY メロン・グループ（BNY メロンを最終親会社とするグループの総称です）の資産運用会社が提供する情報について、BNY メロン・アセット・マネジメント・ジャパン株式会社が審査の上、掲載したものです。当資料は情報の提供を目的としたもので、勧誘を目的としたものではありません。当資料は信頼できると思われる情報に基づき作成されていますが、その正確性、完全性を保証するものではありません。ここに示された意見などは、作成時点での見解であり、事前の連絡無しに変更される事もあります。

BNY メロン・アセット・マネジメント・ジャパン株式会社
BNY Mellon Asset Management Japan Limited

金融商品取引業者：関東財務局長（金商）第 406 号
〔加入協会〕一般社団法人　投資信託協会
　　　　　　一般社団法人　日本投資顧問業協会