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QE AND FIXED INCOME

The trouble with bonds

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Quantitative easing and its effects on fixed income markets are here to stay. Investors ignore that at their peril.

Quantitative easing has turned the fixed income world upside down. But even though central banks are starting to reverse their emergency policies, QE isn't going away completely. For investors, this means adopting new rules.

In many ways, bond investors have been guinea pigs over the last 10 years of QE. They were part of a massive experiment, one in which central banks expanded balance sheets to provide liquidity to the market and have ended up owning more than 20 per cent of outstanding global bonds. Throw in tighter regulation, and the effect has been to change the structure of the financial system, leaving banks a significantly less important source of credit.

In 2007, 61 per cent of debt instruments in non-financial firms were bank loans. Last year that figure was 45 per cent.

> “ Bond managers and investors have felt like guinea pigs over the last 10 years of QE. ”

And investors are stuck with QE. Not only is it now an essential part of central bankers' toolkits for supporting economies when interest rate cuts aren't likely to be effective, but high government debt levels – they're touching 120 per cent of GDP among G-7 countries – make QE an important backstop for when the markets struggle to absorb fresh bond issuance.

That's the first and most important of the eight lessons that I believe will help us navigate this new world of QE: **QE is here to stay.**

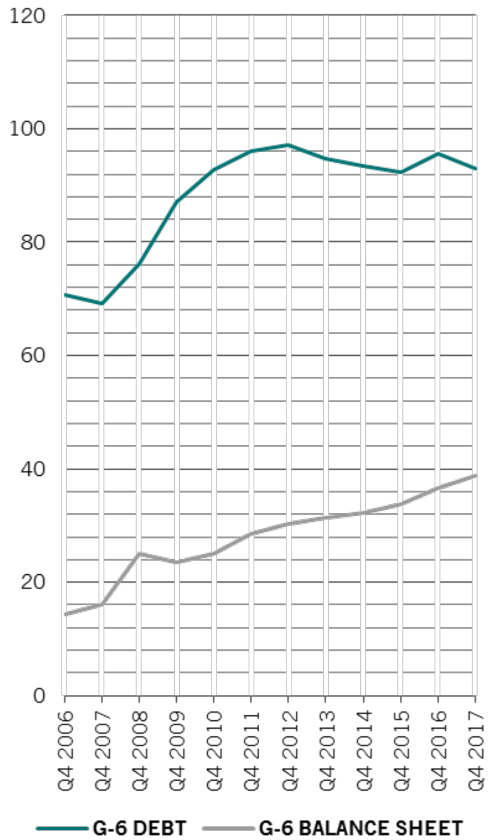
Next is that **even with QE, the law of diminishing returns holds**. Early rounds of stimulus are more effective than later ones. Which is a worry if the next crisis rolls around before central banks have been able to restock sufficient monetary ammunition.

What is more, given QE's permanent, if variable, role, it's important for investors to forget about GDP forecasting when talking about the credit cycle. Instead, they should **pay attention to what's happening to central banks' balance sheets** and to their guidance. That's necessary because QE has disconnected the credit cycle from the economic cycle.

It's also **important to retain plenty of flexibility**. Investors shouldn't just rely on market liquidity to satisfy their investment needs. By trying to shore up banks' balance sheets, central banks reduced liquidity in markets. It means investors have to be prepared to absorb more shocks in future.

KEEPING PACE WITH DEBT

G6 central bank balance sheets and national debt as % of GDP



G6 comprises US, Switzerland, euro zone, UK, China and Japan. Source: National central banks, Thomson Reuters Datastream, Pictet Asset Management. Data as at 30.06.2018.

Fifthly, it pays to **think a bit differently** by taking a contrarian stance or buying out-of-favour assets. Ugly can be beautiful. Before QE, investors would have done well by investing in the previous year's best performing sectors. After QE, the strategy that worked best was to buy the 'losers', assets that are out of favour but still have value.

The sixth lesson is that **the yield curve matters**. As an investor, the most important decision you're going to make is duration, or whether to raise or lower your portfolio's sensitivity to changes in interest rates. Before the crisis, curve positioning and duration decisions went pretty much hand in hand. Back then, investors had two basic curve strategy options, depending on how they saw central bank policy unfolding.

If they expected rate cuts, they'd use bull steepeners, under which shorter dated bonds are expected to outperform long-dated ones. Or, if investors envisaged rate rises, they'd set up bear flattener trades, which are designed to benefit from a sell-off in shorter-maturity debt. But since the crisis, other types of yield curve strategies are just as common as a result of central bank bond buying.

Then there's the matter of changes in the relationship between different fixed income assets. There have been several instances in which assets that usually move in lockstep with one another failed to do so for long periods, and vice versa. In other words, **bond investors cannot rely on historic market correlations** .

Before the crisis, investors could rest assured that they would achieve a decent amount of diversification by combining safe government bonds and credit in their portfolios. And that the correlation of returns between the two was relatively stable. But after the crisis, this correlation has fluctuated. This is a new risk and it's not going to go away.

And finally, **zombies can be opportunities**. Once upon a time, companies that struggled to pay the interest on their debt would fail. But with low interest rates and investors willing to refinance these companies, there has been a fairly gradual increase of the number of such zombie firms globally. Before the crisis, credit managers would do their credit work and make their selections only from among companies that could actually pay their interest costs. But after QE, that probably was not the right answer. You had to pick some of the zombies to outperform.

By the same token, investors need to be aware that as central banks remove liquidity from the system, as they try to reverse QE, credit markets are likely to be most vulnerable. That's where the rubber hits the road.

Ultimately, investors need to bear in mind that the fixed income markets' transformation since the financial crisis is here to stay.

We need to face reality and think that maybe the lessons we've learned over the last 10 years will also apply over the next 10.