

# The monetary policy squeeze

What should investors make of rising yields, higher volatility and wider credit spreads?



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In our 2018 credit outlook<sup>1</sup>, we outlined two potential scenarios for the year ahead as the economic cycle matures and central banks tighten monetary policy. The first was the consensus benign outcome of modestly higher government bond yields being offset by tighter credit spreads. However, we believed a second scenario was underestimated, one where the removal of central bank support would undermine demand for credit, leading to higher volatility and wider spreads. Given tight valuations and unresolved global structural problems, the benign consensus outlook seemed complacent, arguing for cautious credit portfolios.

So how have things played out so far? It's fair to say that the benign scenario is being tested, with credit returns having generally been negative during the first four months of the year (Figure 1). While the main driver

of this has been higher government bond yields, credit spreads have moved wider in addition, with emerging markets under particular pressure. That said, there have been pockets of resilience, with high yield credit spreads managing to move modestly tighter.

Faced with such evidence, it's understandable that investors lose confidence in the first scenario. However, they are yet to abandon the prospect of positive returns for the year, with both surveys and fund performance analysis suggesting that many active managers remain overweight credit risk.

In contrast, we believe the second, more disruptive, scenario is even more compelling than at the start of the year, arguing for defensive credit portfolios.

Figure 1: Fixed income returns in 2018 (as at 14 May)

	Total return	Excess (credit) return
Global investment grade credit	-2.5%	-0.4%
US dollar investment grade credit	-3.4%	-0.6%
Euro investment grade credit	-0.6%	-0.1%
Sterling investment grade credit	-2.1%	-0.5%
US high yield	0.1%	1.4%
Emerging markets sovereign debt (EMBI)	-3.9%	-1.3%

Source: LGIM, Bloomberg Barclays Indices, JP Morgan Indices

1. <http://www.lgim.com/uk/en/insights/our-thinking/market-insights/credit-outlook-2018.html>

**DEMAND FOR CREDIT HAS BEEN DISAPPOINTING**

Since the initial volatility spike in February, the steady widening of investment grade credit spreads suggests that few investors have the firepower to step in and provide support (Figure 2). Mutual fund flows have been weak, expensive hedging has reduced the demand for US credit from Asian buyers, while the appetite for shorter-dated credit has fallen as US offshore investments are liquidated and repatriated following US tax changes.

The only significant demand has come from US pension fund contributions, which is also a function of tax reform. But this has not been enough to counterbalance the negative flows. Moreover, secondary markets have been weighed down by another year of heavy corporate bond supply, with the busiest start to a year for M&A promising a bloated pipeline.

**Figure 2: Investment grade credit spreads (bps) have widened steadily since the end of January**



Source: LGIM, Bloomberg Barclays indices

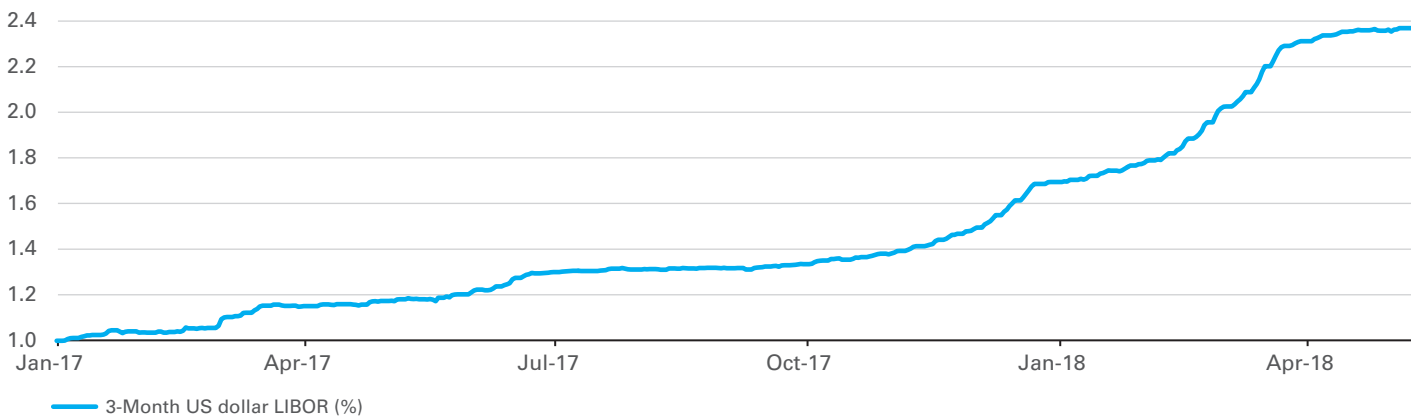
Emerging markets have been similarly impacted by much-reduced mutual fund demand, mixed with heavy new issuance. High yield fund flows have also been weak, but at least supply has been less pronounced, explaining the relative resilience of this market year-to-date.

In general, we don't expect the drivers of this difficult technical situation to change materially in the coming months.

**MONETARY CONDITIONS ARE TIGHTENING**

While numerous reasons have been given for market weakness, from trade wars to Russian sanctions, we think the underlying cause has been a gradual tightening of monetary policy. As the Fed's balance sheet reinvestment is reduced and as the European Central Bank (ECB) dials down quantitative easing, there is less easy money cascading down into risky assets. In addition, we have seen bond yields and funding costs steadily increase, with the sharp move in LIBOR grabbing headlines (Figure 3).

**Figure 3: US dollar LIBOR has increased significantly in 2018**



Source: Bloomberg L.P.

Years of cheap funding and easy liquidity has driven a global carry trade where investors bought high yielding assets using dollar liabilities, but this is starting to unwind. We expect this pressure to build throughout 2018 as central banks continue to remove their support.

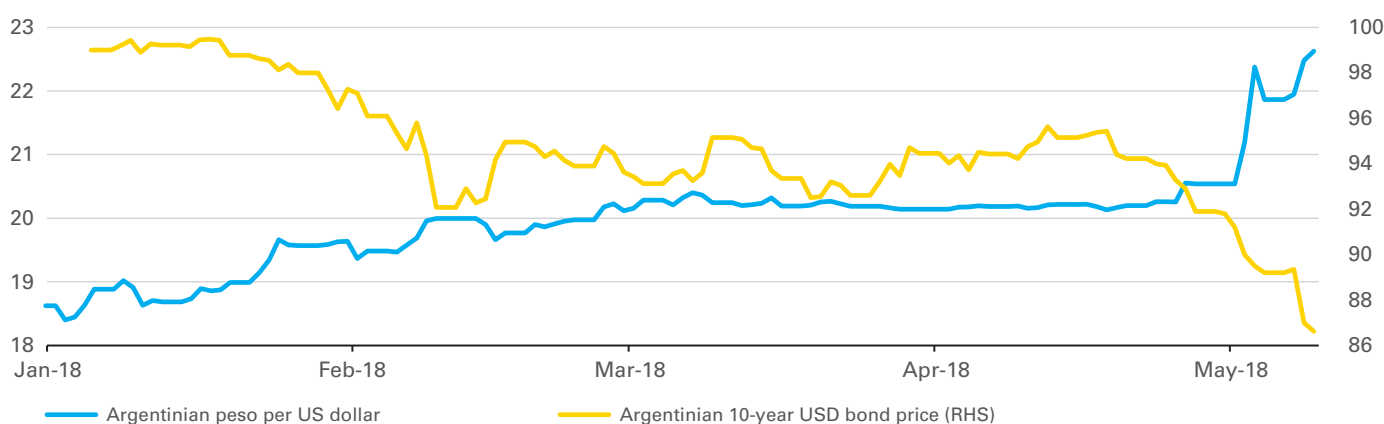
**FOCUS ON THE US DOLLAR**

Our asset allocation colleagues have [discussed](#) how US dollar strength is a key barometer for [risk assets](#). As tighter monetary policy increases dollar funding costs, we'd expect carry trades to unwind, sending the dollar higher as investments are liquidated and

repatriated. Of course, this is a vicious cycle with dollar strength increasing funding costs, encouraging further liquidation.

We think this unwind will have more influence in the near term than the downward pressure on the dollar from the massive US current account and fiscal deficit. Indeed, we have already witnessed some sharp moves across emerging markets in recent weeks – a number of local currencies and bond markets have seen precipitous declines (Figure 4). We'd expect this weakness to spread to other asset classes over time.

**Figure 4: Argentinian assets have been under significant pressure in 2018**



Source: Bloomberg L.P.

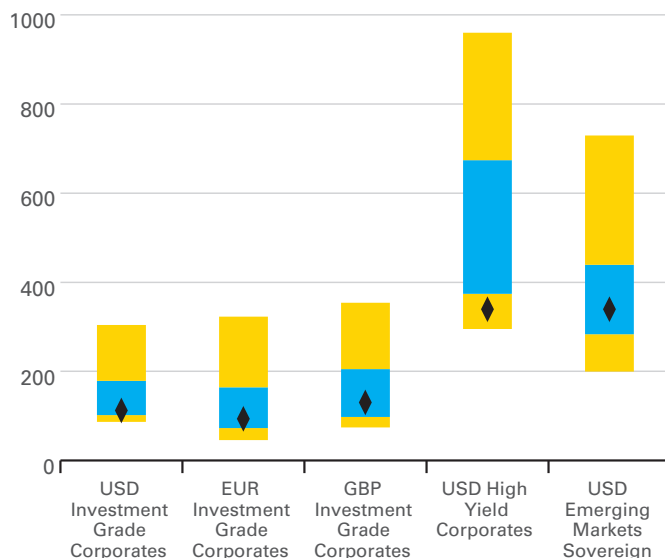
**A RETURN TO BENIGN CREDIT MARKETS? WE THINK NOT**

Our confidence in a scenario of higher volatility and wider spreads has increased, but this does not exclude the possibility of a return to the more benign first scenario. For this to happen, economic activity needs to remain robust while inflation pressures would have to fall (otherwise central banks would be inclined to carry on tightening).

In effect, we'd have to see a significant boost to productivity. Business investment is expected to accelerate thanks to corporate confidence and US tax changes, but this shouldn't impact productivity for a while yet. So we'd need to witness an unlikely reversal of the long-term trend of lower productivity.

Importantly, we don't think credit spreads and yields have corrected enough to make a compelling case for taking a chance on this scenario (Figure 5). Our base case is therefore for wider credit spreads.

**Figure 5: Credit spreads (bps) versus history (current diamond versus both 5%-95% and inter-quartile range)**



Source: LGIM, Bloomberg Barclays indices, historical ranges from January 2001, as at 9 May 2018

Current level versus 5%-95% (yellow) and inter-quartile (green) ranges

## MIXED OUTLOOK FOR GOVERNMENT BOND YIELDS

The outlook for government bond yields is more balanced. Simplistically, rate hikes from the US Federal Reserve and less bond buying from the ECB argue for higher yields, but higher volatility suggests investors will increasingly look to hide in government bonds. So far, this dynamic has resulted in a bearish flattening of the yield curve as central banks dominate the short end of the curve while investor flows support the long end.

Such a move has historically correlated with a deteriorating economic outlook as central banks eventually tighten too far. We believe that most credit investors would be caught out if this pattern emerges in the coming months.

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