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Henderson Research
THINK/Bonds

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Wanted: Buyer for US fixed income

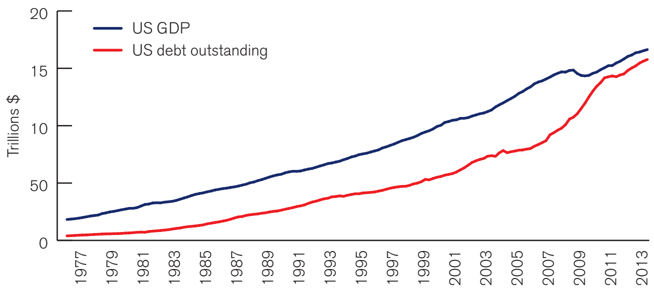
Since the financial crisis, US government borrowing has increased at a pace unseen since the Great Depression. At the same time, bond yields have fallen to unprecedented lows. In this edition of THINK/Bonds, we look at the flow of funds in the US fixed income market.

While fundamental indicators suggest that yields are now closer to fair value (eg, 10-year yields broadly in-line with nominal gross domestic product (GDP)), imbalances between supply and demand can lead to market prices overshooting. Our analysis of previous cycles suggests that yield curves can remain steep as official rates rise, with term premia remaining elevated.

Looking at commonly used metrics, US fixed income supply has ballooned in recent years thanks to the onset of the financial crisis and the swelling of the fiscal deficit. Conventional wisdom suggests that in a world of high (and increasing) supply, higher yields (lower prices) typically result. However, supportive fundamentals including low inflation, sub-trend growth, continued deleveraging, and significant investor support have kept yields at subdued levels so far.

At the end of 2008 the size of the US bond market stood at just over 10 trillion (tn) dollars. Since then it has grown to almost $17tn. The jump is even more pronounced if we compare this with growth in nominal US GDP.

The supply of US fixed income has grown significantly in context of history

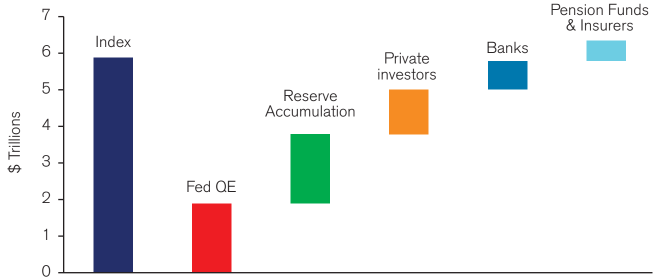


Source: Barclays; Barclays US Universal Index plus Treasury Inflation-Protected Securities (TIPS) as at 30 August 2013.

A significant quantity of the total new issuance from the past four years (c.80%) has been bought by a very narrow investor base consisting of:

1. The US Federal Reserve (Fed), through quantitative easing (QE)
2. Foreign central bank reserve accumulation
3. Private investors, through mutual funds, ETFs etc

Growth in the Barclays US Universal Index (+TIPS) between January 2009 and December 2012



Source: US Treasury; Flow of Funds report, as at 31 December 2012.

We will take a closer look at these investors and discuss how this behaviour may change going forward.

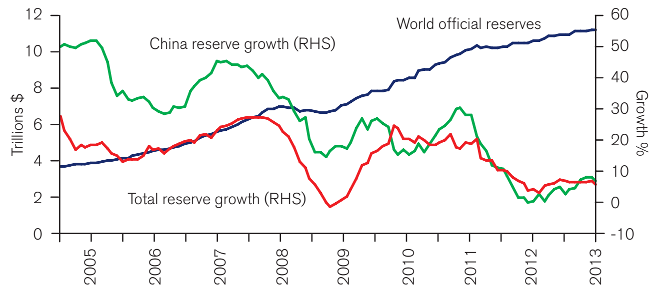
1. The US Federal Reserve — in conducting their policy of quantitative easing they have provided significant demand/support for fixed income markets. As a result, they have more than doubled their balance sheet and are currently purchasing $85bn of US Treasuries/mortgage-backed securities (MBS) per month. The Fed have stated that as growth and unemployment numbers improve they will 'taper' asset purchases, with some seeing this as a first step towards hiking interest rates. We assume the Fed will not unwind existing purchases (instead leaving them to run off), but will no longer be buying new issues or reinvesting proceeds from existing holdings.

2. Foreign central bank reserve accumulation — from a technical perspective we have witnessed a number of trends in emerging markets (EM), the reversal of which could paint a difficult picture for US fixed income. In aggregate, the 'current account surplus' (exports minus imports) across EM countries has been declining for some time. More recently, this has been offset by larger gains in the capital account as these economies experienced significant inflows from increasingly less stable portfolio flows. In defence of export orientated growth models, their central banks have intervened to limit associated currency appreciation and as a result have grown large foreign currency (FX) reserves*. Indeed, since joining the World Trade Organisation (WTO), China alone has accounted for a third of the increase in global central bank reserves, which have increased from $2tn to $11tn, the majority of which has been invested into US fixed income securities.

This dynamic is now shifting with rising Treasury yields and dollar strength prompting a reversal in fund flows as carry trades (borrowing at cheap interest rates in one country to invest in higher yielding assets from another country) are unwound. This is a worrying situation for countries in deficit, or with high funding requirements that rely on these inflows to finance their economies. Furthermore, many EM central banks have recently become sellers of US fixed income assets, selling down foreign exchange reserves in defence of weakening currencies.

*The central bank buys foreign currency securities (eg, US Treasuries) funded by selling the domestic currency.

Reserve growth stalling



Source: Bloomberg, Henderson Global Investors, as at 30 August 2013.

3. Private investors — have had a difficult time with two large equity drawdowns over the last decade. The resultant risk aversion towards equities has driven demand for bond-like assets from both retail investors and pension funds. A combination of inflows to fixed income, along with Fed buying (as part of their QE programme) has driven up returns, creating a virtuous circle and further inflows from private sector buyers. As a result, these investors now hold in excess of a trillion dollars more of fixed income assets than historical long-run trends would imply.

As you can see from the next chart, we now have higher duration (or interest rate risk) embedded in traditional fixed income assets, while yields are lower. This means there is less of a yield cushion to offset capital losses should bond yields rise. We have already seen negative absolute returns in US aggregate bond indices and resultant outflows in recent months, which could persist if returns deteriorate further.

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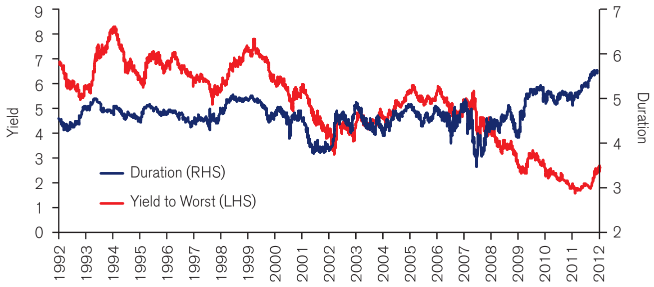
Negative real returns did not stem demand but negative nominal returns have historically resulted in a step change in investor behaviour

Duration (interest rate risk) has been increasing while yields (expected return) have fallen



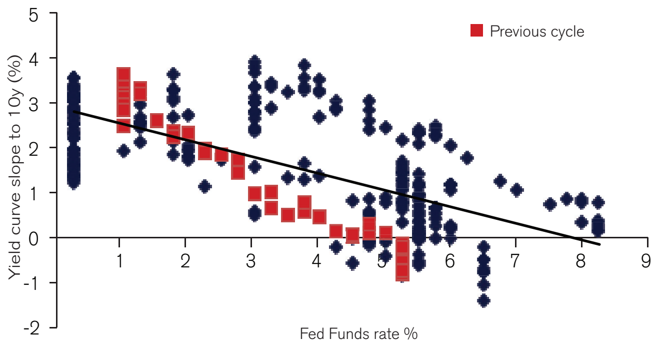
Source: Barclays, Global Aggregate Bond Index, as at 30 August 2013.

The common theme across these investor groups is that they are slowing and potentially reversing bond purchases. While we are unlikely to see wholesale selling across all investor types, the market will need new buyers to maintain issuance at pre-2008 levels. Prospective buyers could stem from:

- Pension funds' demand for longer maturity bonds, especially given the desire to derisk into an improving solvency position and assuming continued equity strength. (Note that changes to US pension funding requirements may slow the pace of derisking).
- Overseas QE: as the Bank of Japan's version of QE gathers momentum Japanese buyers may diversify into foreign bonds. Evidence from HSBC suggests that if non-official buyers allocated 5% of assets overseas, it would be equivalent to c.$700bn over the next two years. However, there is little to suggest a meaningful allocation so far.
- Changes in legislation? American corporations have considerable quantities of offshore capital that they do not want to repatriate for tax reasons. A political solution similar to the Homeland Investment Act could see almost $1tn return to the US capital markets.

A reverse of the bond conundrum

As a result, US bond yields could move significantly higher, with the US yield curve remaining steeper than expectations for some time (certainly compared to the previous cycle). This would represent a reversal of the 2005 'bond conundrum', former Fed chairman Alan Greenspan's description of how long-dated yields did not respond to tighter monetary policy. The chart below shows the relationship between the slope of the yield curve on the vertical axis against the level of central bank rates (Fed funds). There is a negative relationship between the two: higher levels of Fed funds is consistent with a flatter yield curve as longer maturity bond yields are less affected by the movements in short-term rates. Importantly, the long-term relationship is not stable (and in particular, there is significant variation around the line of average fit). Many investors point to the last Fed tightening cycle in 2004 (highlighted in red), when base rates rose from 1% to 5.25% and 10-year yields rose moderately from 3.5% to 4.5%, as a template for the next cycle. In our view, these relationships merely underline the lack of control that central banks can exert over longer maturity bond yields (without QE), particularly for longer maturity bonds where the 'flow of funds' impact can be most pronounced. With today's starting conditions, there is pressure on the yield curve to remain steep even as central bank rates are increased.



Source: Bloomberg, Henderson Global Investors, as at 30 August 2013.
Note: Yield curve slope to 10y=10-year US Treasury yield minus Fed funds rate. Monthly data since 1990.

Visit http://research.stlouisfed.org/wp/2012/2012-036.pdf to view the St. Louis Fed paper on Alan Greenspan's bond conundrum

In a world where bond supply is high and demand is more constrained, the level of long maturity yields relative to central bank rates can remain wide as rate hikes come through. While locking in funding levels and sponsor tolerance for risk are critical to liability driven investment trigger levels, from a pure investment perspective, we continue to expect pressure on the long end of yield curves in the US, and to a lesser extent in the UK (in spite of the degree of institutional demand). As a result, we have purchased options on longer-term interest rates in our unconstrained bond funds to provide protection against this scenario.

From an asset allocation perspective, the headwind of rising rates requires a reappraisal of how to access fixed income opportunities. Traditional bond portfolios focused around broad market indices are most heavily dominated by duration risk. Going forward, refocusing exposure on asset classes or strategies that can isolate or blend together a wider range of risk premia is likely to better meet bond investors' needs for income whilst retaining bond- like volatility.

New generation bond strategies seek to access multiple drivers of return:

Duration/term premia
Inflation
Credit spread
Illiquidity
FX
Skill

Summary

While some fundamental factors suggest that bond yields are now closer to fair value, the forward looking demand and supply dynamics for the US Treasury market will continue to exert pressure on longer-term bond yields. We like to characterise this thought process by making a distinction between the shorter term waves (or oscillations in yields) around a longer-term trend (the tides). Higher market volatility is likely to create shorter-term waves in both directions, but the tide is one of structural upward pressure.

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