Psigma
Investment Management

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Brief View from Psigma

"Fixed Interest – Have I Missed It?"

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Introduction

We are not sure we will ever again see a year in financial markets such as we have experienced, endured and, at times, enjoyed so far in 2020. Outbreaks of panic, followed by outbursts of unbridled enthusiasm has led to a rollercoaster for investors, which has forced us to keep focussed on the long-term investment landscape and, at times, hold our nerve. Equally, there have been several times this year when we have had to reassess the potential for favoured investments and recognise that their valuations were becoming excessive, leading to above-average levels of portfolio activity. Our assessment is that such a strategy will continue to be vital in the years ahead.

The market environment this year has been so extreme that we can easily make the case that we have seen two equity market bubbles and one crash in the same year (and we are only two-thirds of the way through 2020!). Fixed interest markets have been similarly volatile, even if the rises and falls have not been quite so extreme. As we described at the end of the first quarter, the heavy falls that we saw in the miserable month of March afforded investors an excellent long-term recovery opportunity across medium to higher risk fixed interest markets. Like many of the events in 2020, we have been surprised by the speed with which fixed interest markets have healed, with most investments having made healthy positive returns and our fixed interest portfolio in positive territory this year. This has led to a change in the discussions with our clients on the subject from "will there be further falls and a better entry point present itself?" to "have I missed it after the recovery?"

Paradoxically, the answer to "have I missed it?" is both "yes" and "no". We have seen an almost unbelievable recovery in bond prices over the last few months, which has meant that the chances of further capital appreciation are now limited. Certainly, some of our selected investments offer the prospects for further recovery in prices, but for the most part it is a case of generating attractive levels of income. The risk and reward characteristics have also shifted markedly in the last five months; when we were discussing "generational" buying opportunities across selected fixed interest opportunities at the start of the second quarter of 2020, the prospects for defaults and bankruptcies were significantly higher than they are now and that dynamic was reflected in the extremely high yields on offer. Fast forward to today and we believe that those companies and emerging countries that were likely to default have done so and that further damage on that front will be limited, therefore justifying the lower yields that investors can now achieve by comparison to the turbulent times of the spring of this year.

Another strong argument in favour of selected fixed interest markets are the direct and indirect supports put in place by the governments and central banks of the world. 2020 has been a year when we have seen targeted intervention in to corporate and consumer credit markets by many major central banks, including the omnipotent US Federal Reserve, who themselves are now buying many forms of private credits for the first time. The long-term consequences of such actions are debatable but the clear message to investors from the authorities is that they want to limit defaults and they are firmly on the side of investors. This has been a "game changer" for existing investors and given extra confidence to those wanting to invest in such markets. In addition, we have seen the commitment from all major central banks around the world to keep interest rates as low as possible for a very long time into the future. As regular readers will know, we struggle to envisage an interest rate rise in the next five years in any of the major developed world economies (the truth is that it could be much longer). This reality and the likelihood of further asset purchases by central banks will lead to an ever-increasing extinction of income-generating opportunities, in a world where the yields on cash, government bonds and the highest quality corporate bonds are already zero. Indeed, we live in an extraordinary investment world where there is now $15 trillion dollars' worth of negatively yielding government and corporate bonds. For those who understandably cannot rationalise the concept, this is a situation where you pay borrowers to hold your cash for you.

The basic intention of the central banks is to reduce borrowing costs as far as possible, helping all borrowers to refinance their debts cheaply and mitigate default risk, and to encourage investors with cash to deploy it into financial markets. This has proven a "successful" strategy over the last few months and we expect the central banks to repeat this strategy again and again in the coming years, for as long as necessary. From a "moral hazard" perspective we find this philosophically challenging, but the reality is that central banks know that there are a lot of assets "on the sidelines" sitting in cash and they want them moved in to asset markets. It is increasingly obvious that many investors are anxiously awaiting a pullback to invest further. There is clear evidence for this in the persistent flows in to fixed interest funds, despite the lower yields on offer, and in the fact that in the oversubscriptions for new bond issues is very high.

Conclusion

Our core message is to find specific fixed interest opportunities where we can still find attractive yields with low default risks and hold on to them tightly. The good news is that we can find a diverse, global opportunity set of specific fixed interest opportunities that can afford investors both positive returns in both nominal and real (adjusted for inflation) terms. This approach is both relevant to our core multi-asset investment portfolios and our fixed interest strategy. We believe that the inflation-proofing mentality will become increasingly important in the coming years, as we will discuss in our next View in this series. The obvious risks are that we see either a further decline in economic activity, most likely caused by governments' treatment of COVID-19, and a spike in default risk, which could lead to investor panic and a broad market liquidity mismatch such as was experienced in the last two weeks in March. Whilst these concerns are real and should be respected, the more likely outcome is that central bankers continue to offer unprecedented levels of support to fixed interest markets and make the life of investors seeking a steady investment income increasingly miserable. The days when investors could place their portfolios in a range of cash and high quality fixed interest markets and live off the income are long gone and we recognise that investors must think differently and work harder than ever to find solutions in the "income desert".

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For further insights from our CIO Tom Becket check out the Psigma Voice, our communication platform providng you with a variety of investment and market commentary.

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