

Turning the coin over on negative bond yields with yield enhancing solutions

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German government bond yields just above 3 percent in the front end with 10 year yields near 3.9%, as was the case on 1 January 2007, almost seem like a distant memory now. European investors have had to manage portfolios on the basis of the European Central Bank keeping deposit rates at 0% or negative 0.40% since 2012. Depressed government bond yields have caused investors to look for greater returns in more volatile assets and delay de-risking. To make matters more challenging, investors are confronted with low yields even in the long end of the yield curve partially as a result of Central Bank quantitative easing programmes, which have kept long end yields low relative to historical averages even after the US Federal Reserve and the European Central Bank ended their quantitative easing programmes. Notably towards the end of March 2019, the US yield curve inverted between 3 months and 10 years for roughly five business days leading some investors to consider positioning portfolios for an upcoming US recession. While an inverted yield curve has been a good indicator of an approaching recession, the yield curve today is being influenced by factors that differ from those of the last fifty years. Quantitative easing in the US has impacted the steepness of the US yield curve, making the hurdle to reach an inverted yield curve today much lower than it has been in the past.

Where does that leave fixed income investors today?

From a macroeconomic standpoint, growth figures are being revised lower across Europe tied to core inflation printing below 1% in April 2019. These figures do not lead us to believe that the European central bank is in any hurry to raise rates to combat inflation concerns. Taking the most recent ECB monetary policy meeting as an indicator, the ECB indicated that they expect not to hike rates through the end of 2019 as they see risks to the Euro area tilted to the downside especially for the manufacturing sector which has experienced a slowdown in external demand. While the pace of rate hikes in the US was high in 2017 and 2018, the Federal Reserve's March Dot plot of interest rate projections have now signalled the likely scenario that the Fed will also be on hold for 2019 unless US inflation prints significantly above the 2% range.

Given the current market environment, with the unlikely scenario of a rate hike in the US or Europe and a gradual slowdown in the horizon, we believe investors are starting to increase their allocations to core fixed income solutions and tactically invest in lower rated bonds to gain higher yields within their fixed income portfolios. Most investors continue their hunt for yield whether investing in asset classes that offer a high coupon distribution and/or the potential for a higher total return.

There are different ways to play this environment:

- **For Core Fixed Income:** Most European government bond yields in the 1 to 5-year maturity bracket are offering negative yields with German bunds in the extreme at negative 58 basis points for bonds within this maturity bracket as indicated in Table 1. Investors that have traditionally been benchmarked to the Bloomberg Barclays Euro Treasury Bond Index (ticker: LEATTREU) now have 42% of their core fixed income assets in negative yielding bonds. With overall European government bond yields at depressed levels, a strategy that aims to achieve a higher yield than the Bloomberg Barclays Euro Treasury Bond Index using the bonds within the index while respecting pre-defined risk and liquidity targets / constraints could be a useful solution for core allocations within European fixed income portfolios.

Table 1: Yields within the Bloomberg Barclays Euro Treasury Bond Index

Source: Bloomberg, WisdomTree. Data as of 29 March 2019.

Historical performance is not an indication of future performance and any investments may go down in value.

- **For Tactical Allocations:** Adding to corporates that have a strong issuer rating but going lower in the capital structure could provide higher yields meanwhile maintaining exposure to issuers that generally have healthy balance sheets. Issuers with stronger balance sheets may be better placed to withstand margin pressures driven by a weaker economic backdrop and may benefit from spread compression as investor appetite for better fundamentals increase.

Chart 2: Yields and duration across different corporate asset classes: Yield-to-Worst/Effective OA duration profile

Source: WisdomTree, Markit. Data as of 01 April 2019 to reflect post-rebalance figures. Yield is yield-to-worst, Effective OA duration is effective option-adjusted duration. AT1 CoCos is the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index, US HY is the iBoxx USD Liquid High Yield Index, EUR HY is the iBoxx EUR Liquid High Yield Index, US Corps is the iBoxx USD Liquid Investment Grade Index, EUR Corps is the iBoxx Euro Liquid Corporates Index, Short-term EUR HY is the iBoxx EUR Liquid High Yield 0-5 Index, Short-term US HY is the iBoxx USD Liquid High Yield 0-5 Index, EUR IG Financials is the iBoxx EUR Liquid Financials Index, EUR HY Financials is the iBoxx EUR Liquid High Yield Financials Index, US HY Financials is the iBoxx USD Liquid High Yield Financials Index.

You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.

Some solutions to consider for tactical fixed income allocations

1. **Yield to worst versus duration:** Chart 2 highlights that investors who are looking for bond yields above 6% from corporate issuers with approximately less than 4 years duration may want to consider US high yield bonds or AT1 Contingent Convertibles (AT1 CoCos) issued mainly by European banks.

2. **Credit quality:** While US high yield bonds have a longer history and as such a deeper investable universe of bonds than AT1 CoCos which have recently celebrated their 5th birthday, high yield bonds are issued by companies that are typically at higher risk of default. On the other hand, AT1 CoCos are hybrid securities issued by Global Systemically Important Banks and Domestic Systemically Important Banks (GSIBs and DSIBs) that are generally rated investment grade by the rating agencies. Using Markit indices as a measure for the asset class, nearly a quarter of the AT1 CoCo market is composed of bonds rated BBB by the rating agencies with approximately 63% rated BB, the higher part of the non-investment grade rating scale. AT1 CoCos sit at the bottom of the banks capital structure just above the bank equities and as such they provide investors with a yield-pickup over the banks more senior debt.
3. **Common equity tier 1 ratios:** AT1 CoCos can be converted to equity or written-down if the banks common equity tier one (CET1) ratio is triggered. Therefore, healthy fundamentals within the asset class are an important element to consider before investing. As of 29 March 2019, the CET1 ratio of issuers within the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index were above their trigger levels, 5.125% for low triggers and 7% for high trigger CoCos. A majority of the index had a CET1 ratio between 12% and 15% with Nationwide who only issue in GBP and ABN AMRO who only issue in Euro both with CET1 ratios of 18%.

For European fixed income core portfolios that are benchmarked to European government or European aggregate indices, solutions that seeks to enhance income and yield potential using the bonds within the index but shifting exposure across sectors, levels of interest rate risk, and credit risk meanwhile maintaining pre-defined risk constraints could be a useful solution given the negative yield environment present in European government bond markets. On the tactical side, considering a vehicle that provides exposure to a diversified universe of AT1 CoCos that can limit individual issuer exposure, exclude emerging market issuers and only include bonds that are rated by one of the rating agencies as could be the case with an exchange traded fund that aims to track the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index could provide a unique way to gain access to this asset class. Such a solution can be interesting even for investors who are considering allocations in European AT1 CoCos over European bank equities.

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