Bonds still solid in today's tricky markets

Bonds are still a good investment, despite expected US interest rate rises

Bonds remain a competitive asset class, despite expectations of US interest rate rises. So argues Robert Tipp, senior portfolio manager of US-based PGIM Fixed Income, a global investment management business of Prudential Financial, Inc.[1] and winner of *AsianInvestor*'s 2016 award for 'global fixed income, unhedged'.

Q *AsianInvestor*: PGIM believes interest rates will stay ultra-low– why, and what does that mean for bond investors?

A Robert Tipp: In our view, rates will stay ultra-low for several reasons. First, there's a huge amount of leverage in the system. Over recent decades, countries' net debt to GDP has risen from 100% to 200%, 300%, 400% and even 500%. It's a global phenomenon, and in turn the equilibrium level of interest rates that can be supported as a result has declined.[2]

In addition, inflation is below target, and global growth has downshifted. People are still wrapping their minds around that and the implication that most of the decline in long-term interest rates is, for all practical purposes, permanent.

As investors come to grips with the new reality, the search for yield will continue. Despite rock-bottom yields, bond returns may still be higher than investors expect, thanks to the return advantages of spread product, the non-negligible return boost from rolling down the yield curve, and active management.

Q But won't ultra-low rates – indeed negative in Europe and Japan – and more stimulus in those two countries, boost equity investments?

Robert Tipp, PGIM Fixed Income

A That's possible, but seems unlikely – you pass a point of diminishing returns to lower discount rates, where effectively expectations for lower growth dominate, and equities perform poorly. In Europe and Japan, we may be seeing not only that phenomenon at work, but also a corrosive impact from the negative short-term rate policy and aggressive QE purchases – they've damaged the outlook for savers and investors in two of the world's principal capital-surplus zones.

Q What are the investment implications of this?

A If you accept that the European Central Bank [ECB] and Bank of Japan [BoJ] persist with these policies, it increases the likelihood that rates are going to stay incredibly low for longer than they would otherwise. So again, yields may be low, but in a slow-growth environment where you can earn yield, incremental spread from non-government sectors, and the boost from rolling down the curve, returns may still average in the low-to-high single digits, depending on the fixed income sector. Furthermore, given the high degree of confusion in the markets, excess returns for active management – or alpha-generating opportunities – may be above average.

Q How are investors reacting to this environment?

A The substantial bond buying by the BoJ and ECB is squeezing domestic fixed income investors out of their local markets, so they are becoming more global. To a lesser extent, the same is true in the US, where some investors are more willing to look globally for opportunities.

Q How are you investing your global bond portfolio?

A The biggest opportunity at present is in the higher-yielding sectors – high-quality structured product, medium-grade hard-currency emerging markets, European peripherals, investment grade and to some extent, high-yield corporates.

We are maintaining a long-duration posture across a range of countries. In terms of foreign exchange, we see the dollar in transition from rising to falling, and therefore our positioning is imminently more tactical.

Q Is it time to raise allocations to emerging-market debt?

A Hard-currency EM debt has proven to be a return generator over the years, and remains attractive.

Local-currency EM is a tougher call. The Fed's intention to raise rates has weighed on the sector and may continue to do so. To the extent the Fed trims its rate hike intentions, local EM may get its day in court in the coming quarters and years. ■

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1 Prudential Financial, Inc. of the United States is not affiliated with Prudential plc, which is headquartered in the United Kingdom.
2 For more details, visit pgimfixedincome.com for the white paper, The Totally Mad World of Low Rates.