TwentyFour
ASSET MANAGEMENT

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Protecting a bond portfolio from rising rates

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Vontobel

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For the first time in a decade, fixed income investors face a rising rates environment.

The US Federal Reserve raised interest rates a further quarter point in March, its sixth hike since the global financial crisis, and there could be two or three more before the year is out. Other central banks are further behind in the tightening cycle, but the days of easy money are clearly numbered.

Global rates markets sold off sharply in early 2018 as investors saw the 'great reflation' trade that proved elusive through much of 2017 moving closer to reality. The yield on 10-year Treasuries hit a three-year high of 2.95% in February, a level most analysts didn't expect it to reach until at least the end of this year. Bunds and gilts have recovered some of their losses in the weeks since, but USTs have since broken new ground above 3%, a full 60 basis points above where they started the year.

We all know rising yields are typically bad news for bonds, whose prices fall as yields rise, but the problem is made more acute this time around by the significant increase in the duration of the fixed income market since the global financial crisis.

As central banks have held official interest rates at historic lows, and compounded the effect in the bond market with trillions in quantitative easing, fixed income yields have collapsed, while bond issuers taking advantage of lower borrowing costs have pushed the average maturity of the asset class longer and longer.

As a result, the duration of the fixed rate bond market – or its sensitivity to interest rates – has increased sharply in recent years.

Investors need a strategy to protect their portfolio from this risk.

WHY HAVE RATE EXPECTATIONS CHANGED?

Inflation has been one culprit. Surprisingly strong US inflation of 2.1% in January[1] was one of the triggers for the global rout in bonds, while recent rhetoric from the Bank of England and European Central Bank has also signalled increased confidence that inflation will run closer to target.

Wage growth has been another. One of the most alarming data releases for rates investors in January was a 2.8% leap for average hourly earnings in the US[2], while major unions in Germany and the UK have agreed strong pay deals for their members already this year.

And there are reasons why rates could rise more steeply.

A change to the Fed's interpretation of its inflation mandate, a big increase in Treasury supply in 2018, and the coordinated global economic recovery could all accelerate the rise in yields.

There is also the lingering prospect of a global trade war, sparked by protectionist policies being implemented by US President Donald Trump's administration. Any escalation from the US or its major trading partners could add to global inflationary pressures.

HOW BAD COULD THINGS GET?

Pretty bad, if you don't have a clear plan for mitigating the duration risk in your portfolio.

The average duration of the Barclays Multiverse index – a good proxy for the overall investable fixed rate global bond market that many investors will allocate to – is now 6.83 years, having risen some 35.8% since the year 2000 (as of August 2017). At the same time, the average yield of that index has been cut by two thirds to around 2%.[3]

The yield fixed income assets pay per unit of duration risk is a fraction of what it used to be. Dividing the Barclays Multiverse's average duration by its average yield, you get a multiple of 3.64. In other words, a portfolio invested in a similar way to the index would lose 3.64 years' worth of income for every 100 basis point rise in yields.[4]

There are of course ways to mitigate this interest rate risk, such as limiting the duration of your portfolio and buying assets with extra yield that offer a bigger buffer against income-eroding rate rises. More enlightened bond investors – such as those running our Multi-Sector Bond and Outcome Driven funds – are already employing these to good effect.

But that is just the interest rate exposure. If there is a reversal of appetite for fixed rate bonds as investors begin to anticipate poor performance, then the asset class could also suffer short-term spread widening on top of the duration pain.

The broad sell-off across global risk markets in the first quarter neatly demonstrated the adverse impact just a brief combination of rising yields and widening credit spreads can have on your typical fixed rate bond portfolio.

The yield on 10-year Treasuries – a decent proxy for the market's future interest rate expectations – rose from 2.62% to 2.85% between January 25 and February 9. In that period the Barclays Multiverse mentioned above returned -3.06%[5], a performance perhaps reasonably familiar to equity investors but anathema to traditional bond buyers. The 10-year UST yield has since punched through 3%, heaping more pain on fixed rate holdings.

Across the first quarter, the spread of the US investment-grade corporate bond market jumped from 95bp to 113bp, while the UK equivalent rose from 122bp to 136bp.[6]

The Multiverse actually recovered to achieve a marginally positive return in Q1, but that level of volatility and short-term mark-to-market losses is not what we're looking for when we invest in fixed income.

Sterling denominated corporate bonds – a sector with a particularly high duration – suffered losses of 2.31% in Q1 and was down by 4.67%[7] at its lowest point, showing how big a risk duration can be to a primarily fixed rate portfolio in the context of rising rates.

1, 2 Bureau of Labor Statistics, Feb 2018
3,4,5,6,7 Bloomberg Barclays Indices, Apr 2018

WHAT ELSE COULD BE DONE?

One possible solution is to remove interest rate duration with a swap, but as with most things in life, there are costs involved. Swapping away the 8.5 years of duration in the UK investment-grade corporate bond index right now would cost around 150 basis points, cutting the credit spread from 2.64% to just 1.14%.[8] Reducing the interest rate duration is eating into the income you are trying to protect from rising rates. In addition, exposure remains to potential spread widening if other investors rotate away from fixed rate bonds, and a net spread of 1.14% isn't a great reward for holding that risk.

The second could be to switch fixed rate bonds in the portfolio for floating rate notes, where coupons are set at a pre-determined level over an interest rate benchmark like Libor or Euribor, making them far less volatile in a rising rate environment.

EUROPE'S FLOATING RATE UNIVERSE – WHAT'S OUT THERE?

Banks are the most prolific users of floating rate notes (FRNs). They issue floating rate senior unsecured bonds, as well as secured debt in the form of covered bonds and asset-backed securities (ABS). Investment grade corporates also have a decent volume of outstanding FRNs, though a sizeable portion of their €76 billion is effectively privately placed and trades infrequently. In all, a grand total of €353 billion is a very limited market when you consider the global Barclays Multiverse fixed income index stands at some €46 trillion.[9]

At just over €427 billion, European ABS accounts for well over half the investable floating rate bond universe in Europe, and €200 billion of that alone is rated triple-A.[10]

ABS are virtually all floating rate, with near-zero interest rate risk, and valuations there will be far less volatile than in other assets as central banks tighten the screws. Their performance across a tumultuous first quarter of 2018 proves this. While the investment-grade fixed rate market was suffering the ill effects mentioned above, the European ABS market experienced precious little volatility and spreads continued to tighten.

Table 1: European floating rate bonds

Sector	No. Issues	Size (€bn)	WA Maturity	WA Spread*	WA Rating
SSAs**	23	21	2.61	8	A
Covered Bonds	126	113	4.54	11	AA
Senior Unsecured Banks	234	142	2.42	27	A-
IG Corporates	127	76	2.03	15	BBB+

*versus Libor/Euribor (bps)
**Sovereign, Supranational & Agency
Source: TwentyFour, Apr 2018

Table 2: Investable European ABS universe by rating, €mm

	RMBS	Consumer	CMBS	Auto	CLOs*	Other	Total
AAA	98,105	10,798	2,902	33,003	51,200	3,474	**199,483**
AA	37,974	4,808	2,645	5,619	14,400	6,439	**71,885**
A	22,671	2,673	4,691	1,402	9,400	9,866	**50,703**
BBB	9,903	498	3,669	107	7,900	8,133	**30,210**
Non-IG	14,233	365	7,033	26	12,000	4,183	**37,841**
Unrated	6,092	2,810	10,934	4,279	-	13,251	**37,365**
Total	**188,979**	**21,952**	**31,874**	**44,436**	**94,500**	**45,346**	**427,087**

Source: JP Morgan, Citivelocity, TwentyFour, Apr 2018
*non-AAA totals derived from typical CLO tranche sizing. Excludes equity.

8 TwentyFour, Apr 2018
9 Bloomberg Barclays Indices, TwentyFour, May 2018
10 JP Morgan, TwentyFour, May 2018

ABS also tend to offer more yield for a given rating or maturity. The weighted average rating of the floating rate bonds shown in Table 1 is 'A', and their weighted average spread is just 15 basis points over Libor/Euribor. That is significantly smaller than the very tightest spread on offer in the European ABS market, where only the highest quality triple-A tranches of two-year Auto ABS go for around 20 basis points.

In addition, there is a wide range of spreads on offer within ABS itself, since each transaction is structured with several rating levels. The investment grade UK residential mortgage-backed securities (RMBS) market, for example, offers spreads from 40bp over Libor for a triple-A rated bond out to a handsome 180bp for a triple-B rated bond.

ABS provide more yield than other floating rate bonds of the same rating because there is a complexity premium attached to the market, which is still under-researched and poorly understood. The product is generally higher rated than the rest of the floating rate bond universe because it features a number of structural protections for investors, which you can read more about in our whitepaper '**Demystifying Asset Backed Securities**'.

Protecting a portfolio from rising rates by removing interest rate risk with floating rate bonds is good, but buying the floating rate bonds that offer the highest yield for the remaining market risk is better. The two biggest risks facing the fixed income market today, namely rising yields and the tightening of monetary policy by global central banks, make ABS a market that no investor can afford to ignore.

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