COLUMBIA THREADNEEDLE INVESTMENTS

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David Oliphant,
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What has happened in the first half of the year in your area?

It has been a challenging first half of the year for fixed income. Returns are more negative than they are positive, that is to say those areas that produced a positive rather than a negative are very much the exception.

Why is this the case? First, bond yields were driven higher by expectations that the US Federal Reserve would tighten rates (which it subsequently has done) and fears that the European Central Bank would reverse its extraordinarily accommodative policy over the next year or two. Second, spreads in risk markets (including investment grade, high yield and emerging market debt) had a tough time in the second quarter, in part driven by political uncertainty in the eurozone (Italy), and due to fears over rising trade tensions and possible trade wars. Also, within emerging markets risk in specific countries became elevated in, among others, Turkey, Argentina, Brazil and Mexico.

Drilling into EM further, spreads were below 300bps in January before widening by about 100bps; however, they have come back in somewhat. The market was probably a little overly complacent, while a stronger US dollar and specific country issues did not help.

In high yield and investment grade credit, we started the year with a fairly restrained outlook, and we were running risk that was around that of the benchmark; moreover, as part of our sector rotation we had reduced exposure to more risky sectors.

What was expected and what surprised you in the first six months?

We are not particularly surprised that returns have been low as we started the year thinking they would be in the low single-digits across fixed income, and we certainly weren't feeling overly optimistic. We are aware that interest rates, despite the fact they have risen somewhat in the US, remain pretty low globally, and bond yields are also low.

In credit, spreads widened in May and, while we didn't necessarily expect that to happen, we had positioned ourselves in case that did occur. The reasons for that spread widening were, again, not

necessarily factors we had predicted; it is very difficult, for example, to predict a tie-up between two very different political parties in Italy, or to predict what might happen in terms of trade rhetoric or indeed Brexit. That said, we were expecting the UK economy to have a tougher time of it.

We ended 2017 feeling that the global economy was in a good place and was accelerating, and optimism about the economy was reasonably high. What has been very evident since is that this optimism has not been met with reality in terms of economic data as we have gone through the year. As it stands, we have probably gone from excess optimism at the end of last year to excess pessimism today, and there are some signs that economic data is coming through better than consensus. This is true of both the hard and soft data – in both cases data in aggregate had been weakening and consensus views had been dropping, but we are bottoming out now, particularly in the eurozone.

What do you expect to happen in your area in the next six months?

It is still going to be a challenging environment for fixed income. Yields remain low, and your starting point in terms of yield has often been a reasonable predictor of subsequent returns, so we believe returns could be quite low.

What we are more encouraged by is that credit spreads in both investment grade and high yield have widened a little in the wake of the above factors, and we feel that the valuation argument, while not shifting us from neutral to bullish, is tilting in that direction.

The tone in our internal meetings about markets has been more constructive in recent weeks (centred on valuations looking more promising), but we are mindful, especially when we look at credit investment, that we are at a very mature phase in the credit cycle. We are seeing ongoing M&A activity, and even though we expect to see companies post decent earnings in the next earnings season, that will likely benefit the shareholder rather than the bondholder.

When it comes to emerging markets, we have a backdrop in which commodity prices are quite high and the global economy is performing reasonably well, but there are still some specific areas to worry about (Turkey, Argentina, Brazil etc). That global growth backdrop is encouraging, while the valuation argument that was absent in January is probably more helpful now (with spreads today about 370bps over US treasuries, whereas they were below 300bps in January). With this in mind, we are invested with a bit of an overweight in EM risk across our EM portfolios.

As for geo-politics, all we can say is that if the global trade rhetoric (which seems to change daily) ends up in a full-blown trade war, we would expect global growth to be reduced. In some senses this reduces inflation pressure, and in others reduces the need for interest rates to go up.

What are the key opportunities and challenges for investors in the second half of the year?

The global economy continues to look reasonable in terms of growth, and we have still not seen the pass-through from global growth and low unemployment rates into wages and actual inflation – that would be pivotal for fixed income and other markets. If we see inflation picking up, then the idea (particularly in Europe) that we have ongoing QE and negative interest rates would seem fairly ridiculous, but as yet we have not seen that, and we are not seeing a big pick-up in productivity either. The reasons for this could include a mixture of globalisation, use of robots, technology, ageing populations and deunionisation – whatever the real reasons are, inflation is not yet coming through. So as long as there is a lid on inflation, bond yields are not going to normalise.

Within investment grade and high yield our success will be down to active management. We believe we have a better probability of success in picking the right issuer and the right security than we have in, say, predicting the outcome of Brexit or making bold duration decisions – we are just going to stick to our knitting, and expect to generate most of our excess returns from doing just that.

We have had a pretty good start to the year and have a good track record of generating relative and risk-adjusted relative returns over the course of the cycle.

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