Don't panic!

Alistair Wilson casts a calm eye over the current events causing concern for fixed income investors

There was a lot of speculation in the press as to what might happen if and when we have a 'Grexit', if and when we have 'lift off' in rates, and if and when investors mass panic and sell all their bonds. As such we thought we should add our own observations and, hopefully realistic, thoughts to the debate that is clearly creating some concern for investors.

So we have three major factors that investors are concerned about: Greece, FOMC and liquidity. One affects rates, one affects credit and one determines how many bonds will need to trade to shift yields. Three very different dynamics. Every fixed income manager will be alive to all three, but I would like to briefly comment on each one separately.

I would begin by saying don't panic - we are not panicking. In fact each of these drivers may present us with an opportunity to improve our portfolios. The drivers that we face here today are a lot less scary than some of those that we have navigated in recent years! Once you sell an investment it is often very difficult to get back in; look at what you may have missed if you had panicked in 2011 in the sovereign debt crisis, or in 2013 in the taper tantrum, or in October 2014 in the volatility spike.

Let's start with rates, the Fed and lift off. The transition has been well flagged by the Fed and Janet Yellen has already been talking up Treasury yields. Back in February the yield on the 10 year was 1.65%, and we recently touched 2.50%, so a lot of the move has already happened. Investors need to ask themselves how much of a term premium over base rates and over the inflation target do they need, especially as this cycle is very likely to remain a low rate cycle. Having said that, long dated, highly rated, low yielding, rates sensitive securities are the ones that I would be avoiding currently, and also the ones where the largest bond funds are concentrated. These risks can be avoided, but should yields overshoot, say to 3%, I would expect a lot of traditional fixed income investors to be allocating more money to the market.

Greece, on the other hand, is irritating markets in a completely different way. Representing just 1.3% of EU GDP (and just 0.4% of global GDP) even a total default should not have a destabilising effect on the rest of the European or global economy. However, commentators continue to focus on the possibility of major contagion sweeping through the Eurosystem, creating long-term uncertainty. Greek politicians in many cases have been the source of a lot of these stories to further their cause, and the contagion effects do make great stories, however a lot has happened since the previous sovereign crisis in 2011 to mute that contagion.

We believe that more is to come from the EU. For example Mario Draghi recently brought up the 'road map' for greater European union integration that his team are drafting. Eurozone jitters will be a great excuse to get a lot closer a lot quicker, just as in 2011. Additionally the QE programme is committed to run its course until at least September 2016. So our take on the Greece situation is yes, it is an uncertain situation that understandably weakens market sentiment but once it is resolved (whether or not this ultimately results in 'Grexit') the determination of the EU and the ECB to contain the fracas should not be underestimated. As we get close to the pivotal point in this unfortunate scenario we expect volatility will increase and bond prices may still weaken further, but this should be viewed as an opportunity for investors (for all non-Greek product), not a source of panic.

Lastly, liquidity. We should be concerned, because low liquidity means fewer bonds can trade within a given price range. Expensive bonds will become cheaper quicker, but once cheaper, I strongly suspect that the selling will stop, after all there is still an insatiable demand for income out there. Everyone heading for the doors regardless of price is about as ridiculous as the ECB running out of bonds to buy.

I don't want to be blasé about liquidity, but managers generally do factor this into their portfolios. Hats off to Pimco for example, they have lost nearly $200 billion from their flagship fund and managed it. Right now we are keeping portfolios very liquid. Firstly so that we have the ability to be opportunistic if and when one of these three drivers gives us the chance to improve the portfolio, and secondly of course because we are running open ended funds. Liquidity is simply part of our portfolio construction.

Our overriding advice is not to panic but to try and be opportunistic, should the occasion present itself.

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