Approaches to navigating global tapering

Balance sheets appear to be reaching their peak and some central banks have started to announce tapering. Antoine Lesné reveals how ETFs can help investors navigate this changing landscape

SPDR's new report* outlines three potential investor goals and the asset classes that could help for each of these aims.

1. Absolute performance return
• EM local currency bonds
One of the fundamental long-term attractions of local currency emerging market (EM) debt is the yield pick-up over developed market (DM) sovereigns. The prospect of EM local currency yields continuing to fall may concern some investors. However, EM policy rates are expected to move lower in 2018 in response to current low levels of inflation, which could support bond prices.

Other positive considerations for EM local currency debt include improving economic growth forecasts, better fiscal balance, and positive current accounts. The IMF expects that the pace of EM expansion may trend modestly higher during the coming years, as growth stabilises in China and recovers in other economies. Moreover, the expectation is that this growth could be achieved without undermining the steady drift lower in inflation, which has featured in these markets during the past few years.

• Convertible bonds
Traditionally, convertible bonds have been used to extract value in rising stock markets. This attribute, coupled with a need for regular cashflows to lessen drawdowns during times of high volatility, has attracted investors.

Given our positive outlook for equity markets, we believe current conditions provide an interesting opportunity for investment into convertible bonds, as they could help with equity market upside capture. At the same time, the steady stream of coupons provides a degree of potential downside protection (sometimes known as a 'bond floor') if the issuer's stock declines.

2. Carry trades
• Euro high-yield bonds
This sector has been relatively robust, weathering potential geopolitical events such as the Dutch, French and German elections. Whilst acknowledging that valuations are high, we believe that the economic environment supports current spread levels. Future central bank tapering is expected to be orderly and well communicated, which may mitigate the chance of a significant spread widening.

Default rates in the European high yield market are also expected to fall in Q1 2018, according to Moody's Investors Service. With euro treasury yields forecast to rise gradually, we expect continued support for the euro high yield market and our near-term carry argument.

3. Seek excess return over treasuries
• US, euro and sterling corporate bonds
The synchronised global recovery has supported the gradual tightening of investment-grade corporate bond spreads. Whilst spreads are tight, having analysed the historical option-adjusted spread level of US and European investment grade corporate bonds, it is apparent that the distribution of excess returns starting from lower spreads does not necessarily translate into negative excess returns 12 months later.

SPDR's analysis looked at US data for the period May 1993 to August 2016 (with excess returns as of end-August 2017) and European data for the period August 1999 to August 2016 (with excess returns as of end-August 2017). The analysis suggests that the average excess return 12 months later when US investment grade spreads are below 75bps is 0.26 per cent, whilst for European investment grade it is -0.01 per cent.[1] Further economic recovery may help to keep spreads at low levels.

Written by Antoine Lesné, head of SPDR ETF strategy and research EMEA, SSGA

*spdrs.com/fixedincome

1 Source: State Street Global Advisors, Bloomberg, as at 29 September 2017. The US universe is Bloomberg Barclays US Corporate Bond Index; European universe is the Bloomberg Barclays Euro Corporate Bond Index.
Investing involves risk including the risk of loss of principal. Past performance is not a guarantee of future results.