Watching the cycle

Janus Henderson Investors global head of fixed income, Jim Cielinski, speaks to *Pensions Age* about trends in the fixed income market

How did the Covid-19 pandemic affect, and continue to affect, fixed income markets?

It is what will continue to affect markets that is critical. The impact of Covid-19 was unexpectedly positive because it reshaped the policy response framework. By creating more debt and lower rates, it hasn't made debt service levels get out of control. It's implicitly given us as investors a contract with central banks that they can't unwind the debt overhang in an orderly way any longer. So, they really have no choice but to support credit markets.

So, we have a pretty friendly market for credit for corporate borrowers, and then through financial repression I think it's forced rates down.

That's where you start to argue, is it good or bad for pensions?

It's not only the pandemic affecting fixed income markets. What other macro trends are affecting fixed income investments?

It has set off a number of other macro trends. ESG and inflation ones are two big ones.

I thought 80 per cent of the inflation would come from transitory factors. So, you had base effects and then you had the reopening premium. Early on, that was about 80 per cent of the inflation we saw, and then the more cyclical inflation was the remaining 20 per cent. I was thinking, as that first 80 per cent faded, we'd be back into low inflation. What's happening now is that 20 per cent is getting worse, and the bottlenecks don't look as temporary as they did.

I still think that the ultra-high price pressures that we've seen of late can still be traced to the reopening premium, and as that fades you're going to get inflation of 2-3 per cent, which is higher than it was obviously pre pandemic, but it's actually the right number I think for central bankers and markets as well.

Central bankers don't really trust their models that much because there's no similar historic environment really. I think what they're going to worry about is when the output gap is closed and if they see private credit creation. They also had to worry about wage pressures, but I'd argue that they've already seen those.

Has the credit cycle moved back as expected, or are we seeing a 'new normal'?

I think it's a new normal. Defaults have been at their peak successively lower with each credit cycle. I think that real rates are so low, and policy can be turned on so quickly to allow companies to gain access to markets, that I think that will preclude defaults from ever going as high as they used to, say, in 2000 or even 1997/98. Those old cycles I don't think are what we're going to see a repeat of.

Ultimately, the debt super-cycle ends when even policymakers can't control it anymore, but we're not there yet. They've kept rates and spreads low enough so that we shouldn't worry about corporates' ability to through their cashflow service debt. So, I do think defaults will be permanently lower, and I think that is a new normal. I think direct policy intervention in markets is the new normal.

ESG is the other megatrend that is not going away, particularly for big asset owners like pensions, either DB or DC. This is one of their primary objectives now in Europe and the UK. Most pensions are on the journey of trying to establish what carbon-friendly policies are best for them and how to best design a long-term programme from an ESG perspective.

Europe has designed a structure that does not work very well for transition companies, mainly in that if you wanted to hit the Paris Agreement or have less than 2 degrees warming, the way to really go about that is to make all the bad polluters today clean up their act. But to buy bad polluters right now in an ESG framework, particularly under Sustainable Finance Disclosure Regulation (SFDR) and things like that, it's really difficult. What *[regulations]* are effectively saying is that it has to be good now, but if we all disown oil companies and own a bunch of tech companies instead, that's not changing anything.

The question of whether I should be doing ESGs has definitely been answered. You must be doing ESG. The question of how to do it I think is the next big trend, and how to do it better, because a lot of the early solutions are not precisely what I think will drive the change.

We would expect most fixed-income and pensions to have some kind of ESG element as we go forward. The bulk of it will, and certainly the core parts of their assets, like credit, core investment grade credit, will have to be carbon friendly.

Are there any other changes or trends that you expect to see within fixed income?

I think the continued search for yield will take people higher in risk, lower in liquidity. As that happens and yields and yield spreads get lower, we're priming the fixed-income markets for a disruptive change, where more direct lending for example starts to take hold. The old style of financing companies is pretty obsolete. In the new world, there's no reason why companies should be going through all the hassles of borrowing money that they are. So, I suspect that you'll see more in private debt, but it won't just be your higher risk stuff; I think it will be high-quality, low-quality, different sources of risk.

Then I think short duration in many areas is probably where people will hide out because they don't think they're being compensated for risk. The extension of that for a pension scheme is some type of LDI or CDI where you take advantage of what has happened and you try to hedge your liabilities. Beyond that, you're going to probably be looking for your alpha and for your returns by going shorter duration down in liquidity.

How can institutional investors such as pension funds keep track of the latest risks and opportunities within fixed income markets? For instance, Janus Henderson produces regular credit risk monitor videos. How can they help?

What we try to do for our clients is not do a running play by play of markets, because for pensions you can't move that quickly. Also, for most pension schemes, they don't want to know if there's a little correction coming, they want to know if there's a 2008 coming or something like that.

The monitor is set up to say, if you're going to get a crisis in credit, three things have to be present. You have to have a lot of debt in the system, over-leveraged; you then need something to limit or preclude access to capital for companies; and third, you need something that causes a shock to earnings or cashflow.

So, we would note that in March of last year, it was a big worry because companies were losing access to capital. I think the one box that is clearly ticked is that we have a lot of debt, but the other two are clearly not ticked and in fact they're bright green.

Companies have really easy access to capital, and earnings and cashflow have just undergone the biggest year-on-year increase ever. That was after they plummeted in March and April of last year, but it's more than made it all back. Credit quality is now better than it was pre pandemic. Earnings globally went down; in the G7 I think they went down about 33 per cent in the 12 months ending in December. But as of right now, they're up about 70 per cent year on year.

So, you've had the most explosive increase in earnings and cashflow ever. You've had credit quality now completely retrace the pandemic and is now better and it's improving.

So, valuations won't look very attractive to any of us, because they're just not historically. But the point is, in my career I've seen people sell three years early because they didn't think valuations were attractive. That's not the way for a DB scheme to think, because they need credit, they need yield, they need income. They have to look at these elements of what drives a cycle.

For me, if I'm managing a pension, I'm focusing on when the end of the cycle hits me, not when the next small correction hits me. And right now, the cycle actually looks good.

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