

Strategic credit: A nimble approach for an uncertain world

What are the advantages of active credit allocation in portfolios now that government bonds no longer serve their traditional purpose?

Governments have launched massive efforts to underpin their economies in the wake of the Covid crisis: what are the most important implications for bond investors?

Investors need to rethink the role of bonds in their portfolios, because government bonds no longer fulfil their historic role. They don't provide a steady and secure income, nor are they a safe store of value, or, indeed, a source of diversification to equities. In fact, if central banks are successful at pushing up inflation and then return policy to more normal levels, including raising interest rates, investors run the risk of suffering losses on both their bond and equity holdings. So, they need to rethink how they construct portfolios.

Is it really reasonable to fear inflation? After all, major central banks have consistently been undershooting their 2 per cent inflation targets for most of the past decade.

In considering this, it is worth bearing a few things in mind. First, although central banks introduced QE and other emergency measures after the 2008 financial crisis, their response was largely focused on underpinning the banking sector. Second, that intervention was considerably smaller than what they've done this time. Finally, and maybe most crucially, governments implemented austerity in the years after the credit crisis in an effort to fix their balance sheets. This time, deficits have blown out massively and governments have shown no indication that they intend to

claw back their generosity as yet. Then, investors need to factor in that the US Federal Reserve this summer altered its monetary policy framework to put unemployment and social fairness front and centre and said it would be much more willing to allow inflation to run hot if in earlier parts of the economic cycle it was too low.

So whereas monetary and fiscal policy were pulling in opposite directions 10 years ago, this time they're working in tandem. As long as economic activity is continually interrupted by lockdowns and Covid guidelines generally, all this stimulus is only ever likely to mitigate the consequent fall in demand. But a return to normal social interaction could see these huge infusions of both fiscal and monetary stimulus start to feed through to the prices of goods and services – and possibly faster than many people think.

Longer term, all this stimulus also raises risks for social stability. Central banks' approach to monetary policy has already created disharmony by favouring capital over labour. This disharmony is likely to have profound consequences for bond investors.

If government bonds are no longer the safe haven they once were, what's the answer?

If we accept the traditional cycles of the economy and credit have largely been replaced with a volatility cycle, driven by counter cyclical monetary policy, it is important to work with this cycle and to be both contrarian and value driven in your search for returns. It makes sense to

look for value after there's been a market panic – in other words when the credit markets deliver equity-type returns at bond-type risks. Of course you need good, penetrating analysis to avoid the value traps.

And then, when investor confidence gets ahead of itself, when credit starts to deliver bond-type returns for equity-type risk, it's important to rebalance and retrench until the next cycle hits. People forget volatility can return very suddenly, but these cycles are much more frequent than investors seem to recognise.

There are opportunities for investors that work with the cycle to take advantage of these periods of volatility, delivering attractive income and/or matching longer-term liabilities, but in a way that uses both common sense and a contrarian mindset with a low correlation to wider risk assets. Essentially an approach that avoids the vagaries of fear and greed caused by central bank herding of market risk appetite.

Unconstrained investors can roam the markets to find sources of value. Of course, they have to be nimble and must have clear insights into what's driving a particular asset as well as the market as a whole. But get this right and they can help to give investors what government bonds no longer can. Which is a reasonable, steady return, with controlled downside and as little correlation to equity like risk as possible.



Written by Jon Mawby,
Head of Investment
Grade Credit, Pictet Asset
Management

In association with

 **PICTET**
Asset Management