2018 Global Market Outlook

Investment Ideas

Don’t Bet Against Bonds as Inflation and Growth Stay Moderate

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Interest Rates
With moderate growth and inflation, and interest rates likely anchored around 2.5%, remain tactical and look for relative value opportunities across countries.

Credit
Not all credit is created equal, so continue to look for opportunities while reducing overall risk.

Emerging Markets
Stay invested in EM local currency debt, assess which countries offer better risk/return trade-offs and tilt toward quality.
Over the past eight years, investors have positioned their portfolios for the end of the bond bull market in expectation of higher interest rates. But so far those calls have been wrong and most investors have been disappointed.

While we are unlikely to see the bond bull keep charging in 2018, we do think the bears will probably be proved wrong for another year, even as the Fed is expected to raise rates and other major central banks begin tapering their accommodative policy.

We suggest that investors position their broad fixed income portfolios with a reasonable level of yield, but help make them more resilient to the risks of various potential outcomes.
No Breakout on Rates

Will 2018 be the year when we finally see a breakout in interest rates? On the face of it, coordinated growth around the world and the winding down of quantitative easing might suggest a positive answer. But while we expect the global economy’s cyclical upswing to continue in the short run, secular forces suggest growth and inflation will remain slow and steady over the medium term. Putting interest rates in that context suggests modest upward pressure, but well anchored around a lower level. Plotting the actual path of the US federal funds rate against the classic Taylor Rule estimate demonstrates as much (see Figure 1).

Figure 1
US Fed Funds Rate vs. Taylor Rule Estimate

Source: CBO as of September 29, 2017. Taylor Rule Estimate uses Laubach-Williams estimate for the neutral real rate, Core Personal Consumption Expenditure (PCE), and Congressional Budget (CBO) estimate for non-accelerating inflation rate of unemployment (NAIRU). Past performance is not a guarantee of future results.

The same dynamic is at play in most of the developed world, as highlighted by the weighted average of G6 rates relative to underlying nominal growth, which includes inflation (see Figure 2). By these macro measures, interest rates seem marginally rich, but hardly egregious.

Figure 2
Interest Rates and the Economy

Source: Barclays as of September 29, 2017.
What can investors do to enhance return in the face of continued low interest rates? First, recognize that carry is likely to be rewarded in this environment. Second, stay tactical around a range of naturally vacillating yields. Third, assess relative value across different developed countries. For example, consider a basic heat map of important factors that tend to drive total returns in government bond markets (see Figure 4). Each factor plays out over various time horizons and changes frequently, but this framework can highlight current conditions.

Expectations that ending QE will cause interest rates to rise also merit a counterintuitive reminder. When the Fed was engaged in QE, interest rates rose and credit spreads narrowed (see Figure 3). So as QE unwinds, it is possible we get the opposite—namely, lower rates and wider spreads.

![Figure 3](https://via.placeholder.com/150)

**Figure 3**

Reaction of 10-Year Treasury Yields and Option-Adjusted Spreads (OAS) to Quantitative Easing

- **10-Year US Treasury Yield**
- **Investment Grade OAS**
- **Periods of Quantitative Easing**

Source: Bloomberg Finance L.P., as of September 29, 2017. Past performance is not a guarantee of future results.

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![Figure 4](https://via.placeholder.com/150)

**Figure 4**

State Street Proprietary Scoring Across Developed Country Government Bonds

<table>
<thead>
<tr>
<th>10-Year Interest Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type</strong></td>
</tr>
<tr>
<td>Germany</td>
</tr>
<tr>
<td>UK</td>
</tr>
<tr>
<td>US</td>
</tr>
<tr>
<td>Australia</td>
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<td>Japan</td>
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<tr>
<td>Canada</td>
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</tbody>
</table>

If there has been any place where investors have been right and rewarded for it, credit has been that place. Any credit sector—investment grade, high yield, emerging market hard currency debt and particularly structured credit—has posted tremendous returns over the past three, five and eight years. However, current spreads relative to government bonds are extremely tight.

Take high yield (HY) for example. With option-adjusted spread levels hovering around 3.5% in late October 2017, excess returns relative to Treasuries have often been negative over the subsequent 12-month period—implying that taking on more risk is not always rewarded and sometimes even punished. Most credit sectors are in similar territory. So from a pricing perspective alone, we think it makes sense to reduce risk for 2018 relative to the positioning coming into 2017. Nevertheless, we see a number of positive fundamentals underpinning current pricing.

First, flows into credit have been extremely strong from almost every channel, with little chance of slowing as long as investors are still searching for higher returns. Second, the economic and policy backdrop looks broadly supportive. Third, we just went through a default cycle in energy and healthcare. Less than two years ago, HY spreads were over 8% and investment grade (IG) spreads rose above 2%, while defaults spiked to 6%. We are still seeing some remnants of this cycle, but we suspect the worst has already been washed out. Last, with rates so low, call options on most bonds warrant only a modest premium. Combined, this has decreased duration and increased quality within the HY universe, justifying a lower spread than history would suggest.¹

The balance of risks indicates to us that BBB/BB-rated corporate bonds are the sweet spot, as AA/A pays too little to bother and there are still traps in lower-quality credits. Within the IG universe, banks and high-quality energy are attractive. HY security selection is critical amid structural changes in many industries—retail, telecommunications, media and technology, to name a few. Emerging markets hard currency debt offers diverse underlying risks, adding a favorable profile to a multi-sector portfolio. We see some signs of excess in the leveraged loan market and BBB commercial mortgage backed securities (CMBS) are at risk of re-rating. In short, be selective.²

² See glossary for ratings definitions and calculations.

What do we expect from the US dollar? In 2018, most major central banks are likely to pursue some form of monetary tightening—except the Bank of Japan, which will stay on hold until economic growth translates into inflation. Under those conditions, the dollar should remain largely range-bound, especially if strength in Europe continues to offset the potential stimulus from tax cuts in the US.³

Emerging market (EM) local currency debt was one of our top investment calls for 2017, and we got that right. The argument was simple and compelling: real yields were high, inflation was peaking, currencies were dirt cheap and momentum was building in the asset class. That call has paid off handsomely, with a nearly 15% gain in local EM debt over the course of the year.

For 2018, valuations have certainly become less attractive. Real yields have declined by around 100 basis points and inflation seems to have found a floor. Our models indicate that EM currencies are only 3% undervalued. That said, momentum is strong, flows remain healthy and investors still have appetite for risk. Even perennially troubled Argentina can raise 100-year debt in today’s environment.4

Of course, not all EM issuers are the same, so knowing how much a sovereign bond returns relative to the risks involved is critical. Comparing real yields to our proprietary issuer scores can provide a snapshot of which markets look relatively attractive (see Figure 5). We would lean toward quality, while also keeping an eye on China, which may get added to major bond indices next year.5

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5 SSGA Blog, “China’s Bond Connect: A Game Changer for Investors” by David Furey and Bruce Zhang, July 31, 2017.

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Add it all up and many fixed income sectors still look attractive. Interest rates remain well anchored, selective opportunities can be found in the credit markets and the favorable backdrop for emerging markets persists, particularly as a range-bound US dollar takes currency risk off the table. Not a charging bull but not a bear.
Glossary

**Carry**
A strategy in which an investor borrows money at a low interest rate in order to invest in an asset that is likely to provide a higher return.

**Credit rating**
An assessment on the likelihood of an entity to default on its debt or financial obligations. Ratings are performed by agencies such as Standard & Poor’s (S&P), Moody’s or Fitch. The ratings are listed as letter designations. Standard & Poor’s uses D (in default) to AAA (highest). Fitch uses DDD (in default) to AAA (highest). For S&P and Fitch, BBB- and above represent investment grade while BB+ and below represent non-investment grade or junk. Moody’s uses ratings from D (default) to Aaa (highest). For Moody’s, Baa3 and above represent investment grade while Ba1 and below represent non-investment grade or junk.

**Duration**
A measure of a bond’s price volatility, expressed in terms of the weighted average term-to-maturity of all the bond's remaining cash flows.

**Gross Domestic Product (GDP)**
The monetary value of all the finished goods and services produced within a country’s borders in a specific time period.

**Group of Six (G6)**
Refers to the US, UK, Germany, France, Italy and Japan.

**Nominal Growth**
A measure of GDP using current prices that is not adjusted for inflation.

**Option-adjusted Spread (OAS)**
Removes the effect of the embedded options and shows the average spread the investor will actually earn over a comparable Treasury security.

**Quantitative Easing**
An expansionary monetary policy method in which a central bank purchases government bonds and other securities in an effort to lower interest rates and maintain liquidity in the market.

**Real Yield**
A measure of yield that has been adjusted for inflation.

**Taylor Rule**
An equation introduced by economist John Taylor in 1993 that forecasts the federal funds rate based on values of inflation and estimates for the level of slack in the economy.
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