Challenging the Consensus View in Fixed Income

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Wellington Management Company, LLP
What Is the Consensus Trade?

Clients are expecting higher rates – short duration relative to their benchmark.

Clients expect credit to produce better returns than Treasuries – long Credit, including Corporates, MBS, CMBS and High Yield.

Client Surveys Corroborate

**Treasury Client Survey**

- Net Long Duration Positions

Source: JPMorgan

**Credit Client Survey**

- (OverWt+Neutral)/(UnderWt+Neutral)

Source: JPMorgan
Real Yields Are Rich?

30-Yr Real Yield (Nominal – CPI Y/Y)

US 30-Yr Tsy Yield
25th Percentile
50th Percentile
75th Percentile
Low Yields May Persist

- Slower global growth
- Uncertain policy
- Stealth tightening from regulation
- Contagion risk from Europe

Sources: Datastream, JPMorgan
All Eyes Are on Europe

CDS Spreads (Basis Points)

- Spain
- Portugal
- Italy
- France
- Ireland
- UK
- US

Source: Bloomberg
# Direction of Financial Conditions: Stealth Tightening

<table>
<thead>
<tr>
<th></th>
<th>Monetary Policy</th>
<th>Fiscal Policy</th>
<th>Financial Regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>Accommodative</td>
<td>Tighter</td>
<td>Tighter</td>
</tr>
<tr>
<td>Eurozone</td>
<td>Tighter</td>
<td>Tighter</td>
<td>Tighter</td>
</tr>
<tr>
<td>UK</td>
<td>Accommodative</td>
<td>Tighter</td>
<td>Tighter</td>
</tr>
<tr>
<td>Japan</td>
<td>Accommodative</td>
<td>Looser</td>
<td>–</td>
</tr>
<tr>
<td>China</td>
<td>Tighter</td>
<td>Looser</td>
<td>Tighter</td>
</tr>
<tr>
<td>Latin America</td>
<td>Tighter</td>
<td>Tighter</td>
<td>Tighter</td>
</tr>
</tbody>
</table>

Source: Wellington Management
Post Financial Crisis Yield Experience

10-Year Yield Change (Percentage Points)

- Norway, 1987 (5)
- Finland, 1991 (6)
- Sweden, 1991 (4)
- Japan, 1992 (17)
- US, 2007 (2)

<table>
<thead>
<tr>
<th>Crisis Beginning Year</th>
<th>Duration in Years</th>
<th>Crisis Ending Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Norway</td>
<td>1987</td>
<td>5</td>
</tr>
<tr>
<td>Finland</td>
<td>1991</td>
<td>6</td>
</tr>
<tr>
<td>Sweden</td>
<td>1991</td>
<td>4</td>
</tr>
<tr>
<td>Japan</td>
<td>1992</td>
<td>17</td>
</tr>
<tr>
<td>US</td>
<td>2007</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: Datastream
## Is Credit the Answer?

### Option-Adjusted Spreads (bps)

<table>
<thead>
<tr>
<th>Category</th>
<th>31 Aug</th>
<th>YTD Change</th>
<th>Percent Rank</th>
<th>Current Z Score*</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABS</td>
<td>76</td>
<td>-4</td>
<td>53</td>
<td>-0.25</td>
</tr>
<tr>
<td>CMBS</td>
<td>344</td>
<td>93</td>
<td>83</td>
<td>0.58</td>
</tr>
<tr>
<td>MBS</td>
<td>72</td>
<td>30</td>
<td>60</td>
<td>0.18</td>
</tr>
<tr>
<td>Corporates</td>
<td>208</td>
<td>54</td>
<td>90</td>
<td>0.86</td>
</tr>
<tr>
<td>• Financials</td>
<td>279</td>
<td>91</td>
<td>93</td>
<td>1.20</td>
</tr>
<tr>
<td>• Industrials</td>
<td>169</td>
<td>36</td>
<td>77</td>
<td>0.50</td>
</tr>
<tr>
<td>• Utility</td>
<td>173</td>
<td>26</td>
<td>78</td>
<td>0.54</td>
</tr>
<tr>
<td>High Yield</td>
<td>708</td>
<td>193</td>
<td>81</td>
<td>0.68</td>
</tr>
<tr>
<td>EMD**</td>
<td>321</td>
<td>80</td>
<td>72</td>
<td>0.15</td>
</tr>
</tbody>
</table>

*Current Z-Score = (current spread – mean spread)/standard deviation of spread

**Period selected for EMBI+ history captures average index quality that is comparable to current levels (BB+ and higher)

Sources: Barclays Capital, JPMorgan

Different Sectors Behave Differently

Relative Performance by Economic Environment

Strong
- Equities
  - Public/private
  - Long-only
  - Long/short Hedge funds
- EMD

Growth
- Agency MBS
- US Treasuries
- IG Corporates
- US Aggregate

Weak
- Falling
- Inflation
- Rising
- Commodity
- Inflation-sensitive equities
- Timber
- Oil/gas partnerships
- Real estate (?)
- High Yield
- CMBS
- TIPS
- Gold/Precious Metals

For illustrative purposes only.
Different Sectors Behave Differently

History of fixed income sector total return performance since index inception

Sensitivity to changes in inflation and growth

US Treasuries, IG Corporates, US Agg and MBS do best in falling growth/falling inflation

CMBS, HY perform best in rising growth/rising inflation

TIPS perform best in falling growth/rising inflation
Different Sectors Behave Differently

FI Sectors Environment Analysis

Sources: Barclays, JPMorgan, Datastream, Wellington Management
IG Corporate Total Returns Are Usually Dominated by Rate Movements

US IG Corporate Year-Over-Year Returns

Source: Barclays
## MBS Have Attractive Return Features

- More "efficient" returns
- Fewer drawdowns
- Less refinancing risk due to credit constraints
- Highly liquid

<table>
<thead>
<tr>
<th></th>
<th>Barclays Capital US MBS Fixed Rate Index</th>
<th>Barclays Capital US Corporate Investment Grade Index</th>
<th>Barclays Capital US Aggregate Index</th>
<th>Barclays Capital US Treasury Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Std Dev of Annual Returns</td>
<td>3.13</td>
<td>5.46</td>
<td>3.85</td>
<td>4.64</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>1.05</td>
<td>0.69</td>
<td>0.85</td>
<td>0.65</td>
</tr>
<tr>
<td># of Pos Months</td>
<td>210</td>
<td>191</td>
<td>193</td>
<td>185</td>
</tr>
<tr>
<td># of Neg Months</td>
<td>60</td>
<td>79</td>
<td>77</td>
<td>85</td>
</tr>
</tbody>
</table>
Liquidity has been impaired since financial crisis

Higher capital requirements for banks means less inventory will be carried

Bid-offers widen quickly and dramatically during financial stress
Liquidity in a Normal Environment

FI Sectors Environment Analysis & Liquidity – Current

Increasing Growth

Decreasing Growth

Decreasing Inflation

Increasing Inflation

Sources: Barclays, JPMorgan, Datastream, Wellington Management
Liquidity in a Stressed Environment

Sources: Barclays, JPMorgan, Datastream, Wellington Management

FI Sectors Environment Analysis & Liquidity – Stressed

Increasing Growth

Decreasing Growth

Decreasing Inflation

Increasing Inflation

Sources: Barclays, JPMorgan, Datastream, Wellington Management
Putting it Altogether

Macro backdrop is precarious – yields could stay low, credit could be volatile

Take a more granular approach to fixed income

Increase allocations to sectors with liquidity and diversification, like MBS, TIPS

Stay defensive on higher-beta sectors like CMBS and HY
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Post Crisis Ten Year Nominal Yield Levels

Norway, 1987 (5)

Finland, 1991 (6)

Sweden, 1991 (4)

Japan, 1992 (17)