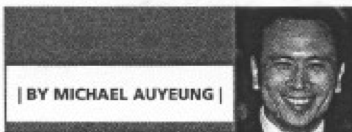
Preparing for higher interest rate regime



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We are again approaching that part of the economic cycle where investors in the fixed income markets may see return prospects pressured for a prolonged period. However, there are enough uncertainties that we could yet see yields bounce all over the map before the trend to higher rates sets in for good.

Invariably, the interest-rate cycle will turn and bond prices will feel the heat, meaning returns could be very weak, possibly even negative for a spell to come. What exaggerates the turnaround in the return prospects is that, generally, such a turn in the cycle comes after a fairly protracted period of stellar performance in fixed-income investments.

The recent period is no exception as the potent combination of record low benchmark rates and flight to quality saw government bond prices soar during the recent financial meltdown. Subsequently, astute fund managers reaped additional rewards on the first signs of reversal as spreads on progressively riskier bonds were compressed back towards neutral levels.

Funds able to apply leverage did even better, given that borrowing (if you could find a lender) was nearly free. Clever positioning on foreign exchange (forex) carry trades could further amp repatriated returns. Combined with insightful trading stances, this explains how some bond funds were able to generate upwards of 50% returns in 2009 alone.

In November 2009, US bond fund management giant Pimco reported its holdings in US government debt to be at its highest in over five years. Yet by early January this year, Pimco and other mega bond fund managers were all starting to pare back their government (mainly US and UK) bond exposures. An overload of issuances and rising government debt levels, hardly breaking news, were cited as primary reasons. Look a bit deeper and the spectre of the US Federal Reserve stopping its mortgage securities buyback programme as well as other central banks pulling back on quantitative easing (QE) would have been nice timing catalysts.

The broad fate of global bond markets going forward will take the lead from a few key factors or their subsets.

Economic recovery

Increasingly, the view is that the world economy will stage a full-blown recovery in the short term. That is already playing out in bonds and stocks. However, near-term economic outperformance driven by a low base y-o-y effect and government stimuli may yet yield to a weaker continuance further out as ample impairments in the financial system are unmasked. Growth may still falter once the transition is made from policy drivers back to the private sector being the load bearer.

Financial sector recovery

The flood of TARP (US government funds injected into banks to bail them out) repayments suggest that the US banks are regaining their health — how much incentive to repay was due to the banks wanting the freedom to dole out unrestricted remuneration can be left to debate. Yet by recent estimates, banks globally have only written down US$1.7 trillion out of a bad asset pool that totals some US$3.4 trillion. Should capital markets stutter, the ability to further absorb such losses may again bring credit channels to a standstill and raise renewed doubts on the sustainability of economic recoveries.

The financial sector is key to mending the general business environment. Despite massive capital injections, lending flows in developed countries have remained constricted even in the money markets. To date, central banks have stayed active to keep these markets lubricated. Again, the real test will come when regulators step back, which could have a massive influence on market lending rates.

Housing/real estate recovery

Historically low mortgage rates have been instrumental in generating some modest stability in the US housing market. Any removal of the QE or accommodative monetary policy could unravel the precarious rebound, and this critical base to the economy could restart a cascade of erosion that unravels the healing of the past couple of quarters.

All in, central banks and policymakers have already initiated exit strategies. However, it is not an absolute that all programmes can be unwound in a straight line, as uncertainties abound over whether economies can recover in a straight line. Shifts in policy stances could still cause steep gyrations to market rates and bond prices.

In Asia, China has indicated that excessively loose monetary policy is coming to an end. In other Asian countries, concerns have been voiced over asset bubbles, meaning higher rates are in the offing.

In Malaysia, the threat to higher policy rates is less immediate as growth and financing of pump-priming activities will be prioritised. However, as global rates move up, local market interest rates will trend up despite benchmarks holding steady.

From the recent past, the frailties of the local PDS market have been exposed under such conditions. Illiquidity remains a problem when herd mentality kicks in and all are trying to sell to fend off capital erosion. Price movements are exaggerated as buyers quickly drop bid levels for easy pickings.

Losses beget more losses as retail bond fund investors see mark-to-market values of funds dip day after day, driving them to kick redemptions up a notch and aggravate the selling. The long end of the yield curve rises far quicker as the short end gets anchored by the rebalancing of durations, leading to misguided suggestions that the market is pricing far greater "inflation and policy rates" to come. That hardly helps sentiment.

For investors in local fixed income funds, a well-managed portfolio that has sacrificed some near-term yields by holding duration (generally reflective of maturities) short would be extremely well positioned to capitalise on a yield curve that continues to shift higher, rolling over maturities into longer dated instruments offering higher yields. In fact, near term, such funds could benefit as others seek to shift their exposures to the short end, causing prices to actually rise.

Longer term, certainly the odds favour structurally higher interest rates as the world returns to a more normalised expansionary environment and risk premia are brought back in line. For conservative local fixed income investors, that perspective should be a focal point. Specifically, that means not locking in marginally higher near-term returns at the risk of potential painful loss of capital down the road, especially at times like now when the rate structure has been so artificially compressed. On the current outlook, there will be a better time to lock in higher yields with lesser downside threats to your money. ■

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A sold sign stands outside a newly completed Centex home in Clayton, North Carolina, US. Historically low mortgage rates have been instrumental in generating some modest stability in the US housing market.