

How can bond investors generate returns in a low rate, post-Brexit world?

Bond investors seeking stable returns face an increasingly difficult task, but there are options available.

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Unstructured Learning Time

Brexit burden

What the UK's June decision to leave the EU will mean to regional – or global – economic viability is still a matter of heated debate. What most investors agree on is that Brexit only adds to the already elevated level of market uncertainty, and has made life even more difficult for bond investors.

Interest rates across the world remain at historic lows and liquidity is compromised by central bank buying activity. Yields have fallen, again, and the lack of liquidity has led to bouts of extreme volatility. However, bond investors are not without options.

The current level of monetary policy accommodation is unlikely to dissipate in the short or medium-term. Indeed, unconventional policy responses from the world's major central banks are only likely to increase in coming months.

On the bright side

To date, actions from these central banks have squeezed developed market yields in both government and corporate bonds to historic lows. We expect the hunt for yield will remain a driving force here for some time. The silver lining is that with central banks content to remain accommodative, or become even more so, emerging markets have again become a viable source of returns. The fact that the Federal Reserve has grown more dovish in 2016 has proved a boon so far this year for emerging market debt, given that it is more sensitive to US dollar strength. To mid-July, cumulative inflows into emerging market debt had reached \$13.7 billion. This compares with an outflow last year of \$14.4 billion and an inflow over the whole of 2014 of \$11.1 billion.

In particular, Schroders' fixed income team has grown more interested in Latin America, which looks increasingly business-friendly after years of structural vulnerability. As political uncertainty rises in the US, the UK and the eurozone for various reasons, political reforms in Latin America are making the political landscape a great deal clearer.

Of course, bond investors should not generalise about emerging markets or treat them as homogeneous. Not all emerging economies are on an equal footing, but we believe that diligent investors can find a number of opportunities to exploit.

The carry trade

Investors who want or need to retain much of their bond exposure in developed markets face a sterner challenge, but still we believe there is a route to stable returns.

In our view, the most prudent approach to take is to focus on “carry”. Carry is perhaps the most traditional component of bond returns and refers to the combination of coupons gathered and price appreciation as a bond draws to maturity.

In our unconstrained strategies we have the ability to combine exposure to select corporate bonds with derivative positions to isolate carry. Our derivative positions aim to limit or offset interest rate sensitivity and credit risk, allowing us to reduce exposure to an unpredictable market while still potentially benefiting from some stable total returns. Most benchmark constrained strategies will not be able to implement such an approach, but more flexible, unconstrained bond funds, do not have the same constraints.

It is clear that bond investing is more difficult now than at any point since the global financial crisis. The outlook for the global economy is murky. Yields are negative in a widening pool of global government bonds, which already amounts to \$13 trillion. Political risk is high. However, with a careful, strategic approach, we think investors could still secure positive total returns until greater clarity is restored.

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