RBC BlueBay Asset Management

Q&A: Bonds are for the bold?

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"Now we think bonds are for the bold, with yields much higher than they were."

Bond yields have continued to rise in recent months, but the time to buy has arrived, argues Kaspar Hense.

Are we now at the top of the rate cycle and do you think investors should be looking to increase duration?

Three years ago, yields around the world had been close to zero and we had three years of consecutive negative returns in US Treasuries, which we have never seen before. Now we think bonds are for the bold, with yields much higher than they were.

The path to lower rates is still rocky, and huge returns in fixed income are still rather for the second half of next year. But yield compensation is already high, and we think from an asset allocation perspective, it is the time to buy. We expect most central banks to cut rates next year, starting with EM and then followed by developed markets.

Fiscal spending is rising in the US and there have been concerns about the level of treasury issuance that we require to fund it. Who's going to buy all these bonds?

The US budget deficit is certainly ballooning and indeed concerning. We think that interest rate payments will be one of the largest expenses of the US budget over the next years. They will rise up from $1trn to $2trn and increase by 10 percentage points as a share of overall tax receipts.

There is hardly any room left for discretionary spending as an automatic stabiliser, either. Discretionary spending really will become marginal to support growth.

On the other hand, though, we think the market has now adjusted to these very high issuance level. Even though we think issuance will rise from roughly $1trn to $2trn next year.

You also have to have in mind that there are ample of domestic savings parked in money market and in bank deposits and also in stocks. Money markets have grown to $5.5trn. Fund deposits are currently at $17trn. And domestic stocks or stocks, which are hold mainly domestically, of $45trn, give you some buffer for the supply to be absorbed. Indeed, we expect some crowding outs at these higher yield levels.

How does leverage look for investment grade companies, and does the extra spread that investors get paid to hold these bonds over government bonds look attractive versus possible default risks?

Overall, we think that the clouds of a recessionary outlook will continue to darken the investor sky, but we think it will be rather a slow process of continuous deleveraging and low demand. Sufficiently strong or healthy labour markets and demand should keep economies afloat.

Investment demand is also high in Europe and will continue to support growth, which indicates a somewhat better fiscal outlook. That means we are indeed optimistic for investment grade credit overall, though careful on sector selection.

We like European banks with solid balance sheets and in our view, very manageable increases of non-performing loans. But we are still cautious on cyclicals and capital-intensive sectors such as autos.

Looking at the different sectors that make up of the investment grade world, which ones do you and your team think are attractive?

We like some emerging market local debt, where yields are still double digit but inflation is already close to target and fiscal policies has not been exuberant. We also like, as I said, European banks on the corporate side, and we think that next year US agency mortgage-backed securities will be quite interesting, with yields up to 6.5% and falling rates volatility. Nonetheless, with refinancing rates high, we are focusing more on a bottom-up analysis than on asset allocation.

We do not like emerging market hard currency debt because overall valuations are not very attractive. But we like Romania, which has low government debt and trades twice as wet as the index, to give an example of our stock picking at this current juncture.

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