

## US fixed income: Buying opportunity or a falling knife?

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10 year US Treasury yields crossed the psychologically important 3% threshold in the 2<sup>nd</sup> quarter, the highest level in four years - buying opportunity or a falling knife? Given these critical levels and an uptick in US inflation, investors are justifiably worried about spiralling rates. But the recent yield rise mostly results from *cyclical* factors. The *structural* macro backdrop hasn't changed much. The long term case for low yields is intact. Even cyclically speaking, the support for higher yields is already weakening as global economic momentum is in a peaking process. **While it is notoriously difficult to call the peak in yields, this suggests to us that the bulk of rate move is behind us.** At the same time, valuation and return potentials improved significantly.

### The macro case for US fixed income: Cyclical moves vs. structural shifts

Investors often confuse short term cyclical moves with long term structural shifts. For recent yield rises to transform into a lasting upward trend, the drivers need to be structural. More concretely, the nominal growth trend needs to improve. For this to happen, two conditions have to be met: Real growth potential has to rise and low inflation need to belong to the past.

1. On growth: Low productivity and ageing continues to keep a lid on real growth. Fewer new hands available on the labour market and no sign of technological progress transforming into higher productivity dampens growth potential. The "amazonification" has not made people more productive *in aggregate*. Hence, **stronger growth recently is mostly cyclical of nature - not a structural quantum leap out of the low growth environment.** Weakening leading indicators already point towards downside risks to interest rates stemming from the growth front.
2. What about inflation? An ageing population also keeps wages low via a negative effect on productivity. On top, high debt levels and technological progress limit inflation. **Hence, the recent rise in inflation is mostly cyclical of nature.** Case in point, wages are still lacklustre. But in order to see a sustained rise in inflation, wages need to rise.

**From a top-down perspective, the upside to yields is therefore limited by fundamentals, as low growth and low inflation shouldn't allow them to rise much from here.** From an investor perspective, current yield levels present attractive entry levels.

### Asset allocation perspectives: (Real) return potential & safe haven appeal combined

Rising yields over the last months clearly improved the absolute and relative attractiveness of US bonds. **Whether the aim is to maximise real returns or simply safe haven considerations: It's hard to ignore US fixed income.**

On an absolute return basis, it is clear that rising yields equals cheaper valuation and hence higher expected returns. Importantly, real returns have improved as well – despite rising inflation. At the cyclical lows, 2 year US Treasury yielded -2.1 % in real terms. Today, the real yield stands at +0.6%. Long term yields have not risen as much. There's no need to increase duration risk too much on order to harvest positive real returns.

On a relative basis, the spread between German and US government bonds is at the highest level since the 90's, so a significant yield mark-up awaits for Euro investors willing to accept some US Dollar risk. As the global economy transforms from synchronised recovery in 2017 to desynchronised slowing in 2018, Europe is decelerating while US growth should stay around current levels. This – together with rising political risks in the Euro Area - implies that extreme monetary policy divergence between the Fed and the ECB is here to stay. It also means that interest rate divergence between the US and Europe will stay elevated, underpinning the relative attractiveness of core US fixed income.

How does the asset class fare in various risk scenarios? First, US core fixed income continues to prove its safe haven appeal and diversification merits. Recall that US government bonds outperformed both credit and equities during the market turmoil in February. Secondly, even in a rising yield scenario the downside is limited in absolute terms. A quick sensitivity analysis helps putting things into context: 2Y US Treasuries yields (currently at 2.5%) have to climb around 150 basis points over one year before price declines wipe out coupons. It takes a very hawkish Fed outlook to erase this "yield buffer". And even if the Fed were to hike that aggressively, riskier assets are likely to suffer even more.

**So the case for US core fixed income is not only supported by improved expected returns. Its safe haven appeal is very much alive as well.** This results in an attractive risk-reward profile in times of rising volatility, even if this is caused by rising rates. Importantly, the appeal of US core fixed income is not only about Treasuries...

### **The sweet spot: As the credit cycle turns, yield hungry investors need alternatives**

Although often overlooked, agency mortgage backed securities (MBS) stand out in terms of their risk-return profile. Over the last 20 years, their Sharpe ratio is 1.04, while overall US core fixed income stands at 0.82<sup>1</sup>. They offer a yield pick-up relative to Treasuries but still enjoy the same credit rating. Relative to investment grade credit, agency MBS have both less credit risk and less duration risk. **Amid signs that the credit cycle is turning and volatility is past its lows, especially yield-hungry investors seeking to scale down their risks might find agency MBS are a better solution than corporate bonds.**

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<sup>1</sup> Data Source: ©2018 Morningstar, Inc. All Rights Reserved as of (05.05.2018). Index: Bloomberg Barclays US Aggregate Bond Index, Bloomberg Barclays US MBS Index. Time period: 01.05.1998 – 30.04.2018

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*\*Source: Nordea Investment Funds, S.A., 31.03.2018*

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