

Shades of grey in quest for yield

Global landscape remains challenging with low rates and liquidity conditions further distorting asset prices

BY JASSLYN YEO

THE search for yield is now taking place in an evolving global landscape that is shrouded in shades of grey. Lines are becoming increasingly blurred between fundamentals, valuations and technicals. As a result, asset allocation has become more challenging, with interest rates staying at historically low levels, and global liquidity conditions further distorting asset prices.

The 2015 global landscape is a “two-speed” world. On a faster speed, we see the US growth recovery further normalising, and the Federal Reserve about to embark on interest rate hikes. On a slower speed, both the European and Japanese economies appear to be turning around, with the European Central Bank (ECB) and the Bank of Japan (BOJ) engaging in quantitative easing (QE) to fight off deflationary risks. In Asia, China growth continues to slow with structural reform implementation, and the People’s Bank of China is responding with interest rate cuts.

Overall, we expect global GDP (Gross Domestic Product) growth to improve to 3.4 per cent this year from 3.2 per cent last year. Liquidity conditions will remain accommodative, with the ECB and BOJ QE providing counterbalance effects to the Fed raising rates. Against this macro backdrop, the search for yield and risk-taking are set to continue. Investors will be further incentivised to climb the risk ladder, and deploy their low interest-bearing cash deposits into higher-yielding assets, such as equities and high yield bonds. (See Chart)

Our tactical asset allocation for the next three to six months, however, is to underweight US Investment Grade (US IG), overweight US High Yield (US HY), and be neutral on Equities, Emerging Market High Yield (EM HY), Emerging Market Investment Grade (EM IG), and cash. In today’s context, we need to look at each asset class on both a relative and absolute basis when allocating assets.

Having a relatively high yield or risk premium alone is not sufficient for an asset class overweight. There are now growing risks of asset bubbles, with low interest rates and excess liquidity distorting asset prices. Therefore, considering each asset class in relation

to its inherent risks is a must: Are we being adequately compensated for the interest rate risks and default risks of the bonds that we buy, and growth risks of the stocks that we buy?

The following questions should be asked:

- Do IG and HY bond yields adequately compensate us for taking on the interest rate risks and default risks? With improving US growth and inflation, as well as a likely rate hike by the Fed in June or September, we see the 10-year US Treasury (UST) bond yield rising to the 2.25 per cent to 2.75 per cent range over the next three to six months. This is negative for the fixed income asset class in general, all things being equal.

US IG has been a big beneficiary of the ECB and BOJ QE liquidity. This is because of its relatively more attractive yield (with potential US dollar appreciation), when compared to its European IG and Japanese IG counterparts. However, the US IG current yield is already at a low of 3.1 per cent, and the credit spread has tightened to near pre-crisis levels. Valuations are clearly expensive. Therefore, even as US IG may offer some yield pick-up over cash, returns can become negative if UST bond yields rise higher than our forecast. In light of this interest rate risk, we recommend to underweight US IG.

US High Yield

Compared to US IG, US HY has a higher current yield of 6.8 per cent and is trading at a significant spread to US IG. Recent inflows have been strong, despite some deterioration in US HY corporate fundamentals. However, even with earnings growth falling (largely due to the fall in energy sector earnings) and leverage ratios rising, there are modest refinancing needs until 2017 (as much of the recent issuance has been used to refinance loans and extend maturities). Therefore, default rates are likely to stay low this year.

US HY sold off late last year, largely on the back of the sharp drop in oil prices, given its large energy sector concentration (12 per cent). Given our view of bottoming oil prices, and improving US and global growth, we see potential for credit spread compression. Coupled with the relatively high carry, US HY has a decent buffer against higher UST bond yields and expected default risks. Given this attractive risk-reward, we recommend to tactically overweight US HY.

For EM bonds, valuations are more attractive than their US bond counterparts. EM IG has a current yield of 4.8 per cent and is trading at a reasonably wide spread over US IG. EM HY has a current yield of 7.5 per cent and a significant spread over US HY. However, technicals have been mixed, and sovereign credit fundamentals are weakening.

We recently saw Russia being downgraded to sub-investment grade, and Brazil is struggling to avoid a recession and credit downgrade, with the Petrobras corruption scandal in focus. Therefore, despite the higher carry and potential credit spread buffers against higher UST bond yields and default risks, we recommend a neutral positioning on both EM IG and EM HY in the near term.

- Do Equities adequately compensate us for taking on its growth risks?

Global equity indices have hit new highs, and are

now trading at very expensive multiples (for example, the S&P 500 NTM P/E is at 16.6x and the MSCI Europe NTM P/E is at 15.2x, both more than two standard deviations above their respective 10-year historical averages). This is despite earnings per share growth having fallen significantly and global earnings revisions rolling over, although largely as a result of analysts downgrading the energy sector earnings.

And while equity markets may overshoot in the near term due to favourable technicals (for example further rotation of fund flows from cash in search for yield, given the low interest rate environment) and earnings growth is steady, we prefer not to chase this rally.

This is especially as Fed rate hikes are on the horizon, which are historically associated with more equity volatility.

The search for yield may be on – as historically low interest rates and abundant liquidity drive investors up the risk ladder, into higher-yielding assets such as equities and high yield bonds – but we should not

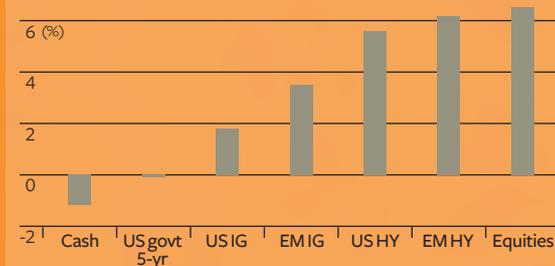
blindly chase for yield, as there are growing risks of asset bubbles in today’s world of grey. Each asset class has to be examined in relation to its inherent risks.

For tactical asset allocation over three to six months, we recommend investors to underweight US IG and overweight US HY. We see the former vulnerable to interest rate risks, and the latter offering the best risk-reward among the suite of asset classes that we cover. We are neutral cash, EM IG, EM HY and Equities.

We look to overweight Equities when volatility over the Fed rate hikes subsides, earnings growth improves, or better entry levels arise. We look to move to overweight EM HY when the EM macro and default outlook stabilises. **W**

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Equities and high yield bonds offer the highest yields



* we use real yields, or yields adjusted for the effects of inflation. This is why cash is giving a negative yield.

* we use current yields for IG and HY bonds and earnings yield for equities.

* US IG is proxied by the Bank of America Merrill Lynch US Broad Market index, US HY is proxied by the Bank of America Merrill Lynch US High Yield index, EM IG is proxied by the JP Morgan CEMBI Broad High Grade index, EM HY is proxied by the JP Morgan CEMBI Broad High Yield index and Equities is proxied by MSCI World Equity Index.

Source: Bloomberg, BOS