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Fixed-Income Outlook: Three Themes We're Watching in 2019

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by Douglas Peebles
of AllianceBernstein

We began 2018 expecting a rough ride—and we got it. Global growth was strong in the first half of 2018, but eased in the second half. More importantly for investors, the era of easy money was ending, and with it came a likely end to the nearly uninterrupted rise in risk assets. Trade protectionism and other political threats also justified caution.

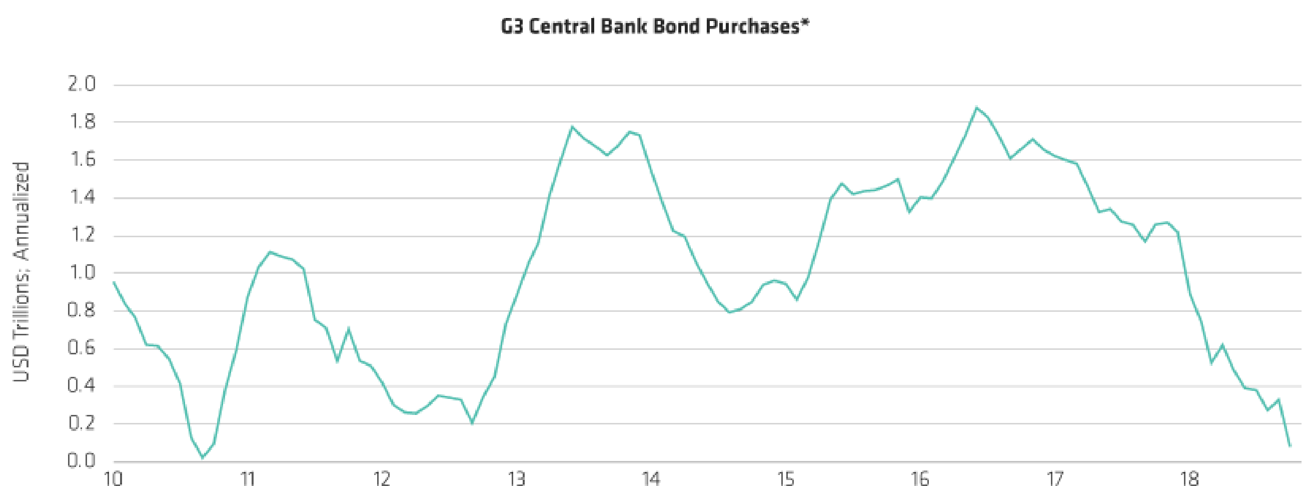
Even forearmed, it's been difficult at times to navigate the increasingly turbulent investing conditions, particularly during the last quarter, when markets staged a prolonged sell-off encompassing nearly every major asset. Bond fund redemptions increased as credit spreads widened in the US and Europe, and part of the US yield curve inverted, leading many investors to worry that a recession is around the bend.

Will 2019 deliver more of the same turbulence? Very possibly. Financial markets are transitioning from an unusually supportive environment to a more volatile one of slower growth, reduced liquidity and heightened political risk. In other words, investing will remain challenging.

We are focused on three major themes to help us navigate today's market environment.

A Slowdown—Not a Recession—Ahead

Global growth remains positive, and central banks around the world continue to unwind what has been a very accommodative monetary policy. The Federal Reserve has raised key interest rates nine times since late 2015, while simultaneously shrinking its balance sheet. And the European Central Bank (ECB) ended its quantitative easing program at the end of 2018. Net balance sheet purchases by the Bank of Japan (BoJ) have also slowed to a crawl and are likely to remain low this year (*Display*).



Through October 31, 2018
*Three-month rolling average of monthly net purchases. G3 is the US, the euro area and Japan.
Source: Bloomberg and Haver Analytics

In response, US Treasury yields have risen across the board, though less so at the longest maturities. The resulting flatter yield curve is often read as an indicator of an upcoming recession. It's true that, historically, inversion of the yield-curve slope between two years and 10 years has predicted a recession. And while this differential has not yet turned negative, it has flattened dramatically.

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But in this case, we don't see a recession around the corner—for the US or the world. We think the shape of today's US yield curve reflects investor worries that the Fed has tightened too much for global economies and financial markets, while being "just right" for the US economy. Even when the two- to 10-year slope does invert, as it is likely to do sometime in 2019, the lag between inversion and recession can be as much as two years.

In addition, the Fed is better positioned now than at the start of 2018 to engineer a slowdown rather than a hard landing. That's because the markets have done some of the Fed's work. In the US, faltering capital markets have effectively tightened financial conditions, allowing the Federal Reserve to notch down its growth and inflation forecasts and giving it the flexibility to hike rates more slowly.

As a result, we've cut our forecast to two rate hikes for 2019—in line with the Fed's median forecast. That's still more than the market expects, as most investors are more pessimistic about the American economy than we are. But the US labor market and consumers are still in good shape, inflation is hovering around 2%, and overnight rates are only slightly higher. The recent decline in the price of oil is likely to keep inflation below the Fed's 2% target for the near term—and allow the central bank to be less hawkish than it otherwise would have been.

Furthermore, we don't think a global recession is near. The world economy is likely past its cyclical peak, and we do expect major economies to slow in 2019 as interest rates rise and trade tensions erode business confidence. But we are expecting a retreat to trend levels of economic growth, rather than a contraction.

Heed Systemic Risks

Nonetheless, we can't ignore key risks to the outlook.

A change of course incentral bank policy regarding Fed rate hikes and/or Fed, ECB or BoJ balance sheets could hurt or help. For example, the market responded positively to Fed Chair Jerome Powell's November comments in which he characterized interest rates as "just below" neutral. That was a walk back of his previous characterization as "a long way" from it. But the Fed will need to walk the talk to keep the goodwill flowing.

Another risk: The US fiscal position is unsustainable. In a growing economy at full employment, a $1 trillion deficit—the projected budget shortfall for fiscal 2019—is an anomaly that could, in classic boom-and-bust fashion, lead first to overheating and then to recession. Worse, a slowdown in the economy would drive this figure much higher. Historically, periods of economic growth have been used as opportunities to shrink, not grow, the deficit. We view the untimely ramp up in deficit spending—largely the result of record military spending combined with tax cuts—as a mistake.

We are also keeping a wary eye on the impact of theUS-China trade war on US businesses (as well as on trade-sensitive economies around the world) and hoping for a positive resolution in terms of trade negotiations before earnings season is well under way.

In addition, a worsening trade war could weaken China's economy and sour the global growth outlook. Our current forecast is for Chinese growth to slow to 6.2% this year from 6.5% in 2018. But it will require substantial and timely policy stimulus to prevent a sharper slowdown. If this doesn't come, China's growth may fall well short of expectations, sending a deflationary impulse through the global economy and commodity markets—especially if it's accompanied by a substantially weaker yuan.

Uncertainty surrounding Brexit and the fiscal standoff between Italy and the European Commission also bear watching. These two issues could become deeply intertwined. If the UK decides to leave the European Union without a deal, for example, the shock waves will be felt across Europe, adding to concerns about Italy's debt sustainability.

Lastly, market liquidity—already strained by the Fed's reduction of its balance sheet—will probably worsen as the ECB ends quantitative easing and gears up for a rate hike of its own in late 2019.

In sum, financial conditions are tightening, and macroeconomic and political risks are likely to keep overall market conditions volatile in 2019. In this environment, investors should stay invested but be selective.

Looking to Buy: Stay Tuned (In)

With yields now higher for both government debt and credit, the return potential for fixed income is bigger than it's been in quite a while. Not only is it rare for credit sectors to experience negative returns for two consecutive years, but history has shown that overall returns tend to be strong following a period in which both government and credit sectors have underperformed.

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It’s important to “hold duration” in bond portfolios—that is, to have exposure to the risk that interest rates will rise or fall—in an environment in which both volatility and potential returns are high. But investors shouldn’t hold just government bonds. They should also take advantage of dislocated credit sectors and look for more opportunities to add exposure when prices dip.

This requires caution, as selling momentum remains strong, necessitating a careful, case-by-case approach to adding credit exposure. For example, US investment-grade credit spreads have widened over the past year, making them more attractively priced. But average credit quality has declined and gross leverage of BBB-rated industrial issuers has increased. In a rising-rate environment, that could depress forward returns on some securities, even at current valuations. We will continue to watch for catalysts that could justify increased exposure.

Yields in the high-yield market are also much higher than in 2017. It’s critical, though, to invest selectively in below-investment-grade companies with strong fundamentals, without the downside volatility we see in the CCC market. High-yielding credit-risk-transfer (CRT) securities—a kind of bundled residential mortgage debt—also remain attractive, as we expect US home prices to continue to rise in the coming months, albeit at a slower pace.

As with other risk assets, there are still headwinds buffeting emerging-market debt (EMD). Interest rates are rising, the US dollar is strong and market liquidity is declining. In these conditions, investors can’t afford to chase high yields while ignoring an asset’s underlying fundamentals.

Happily, fundamentals in several parts of the EMD universe are still strong, leaving the sector well insulated against external shocks in 2019. And after last year’s sell-off, valuations are attractive—both historically, and relative to other risk assets.

Putting It All Together

With volatility likely to stay high, investors must continue to do their homework. It’s important to carefully manage overall portfolio risk—economic, political and otherwise. That means staying active and taking advantage of market downturns to pick up assets at attractive prices. Investors who follow this approach will find themselves navigating 2019 with confidence.

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