Uncovering value in fixed income

October 2009

The recent credit crisis has had tremendous impact on all sectors of the fixed income markets. As Chief Investment Officer of J.P. Morgan Asset Management's Global Fixed Income and Currency Group, Bob Michele shares his view on finding value in today's bond markets and explains how pension funds can best capitalise on these opportunities.

Robert Michele, managing director, is the Global Chief Investment Officer within J.P. Morgan Asset Management's Global Fixed Income and Currency Group. In this role, he is responsible for overseeing the activities of our New York and London fixed income investment teams. Prior to joining the firm in 2008, Bob was at Schroder Investment Management for ten years, most recently serving as the global head of fixed income. He also previously served as the head of Schroder's U.S. Fixed Income Group, based in New York.

Bob Michele Managing Director
Global Chief Investment Officer
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Q. How should pension funds approach fixed income in the current market environment?

Bob Michele: The last two years have seen high volatility in the global bond markets as the credit crunch and the global financial crisis sparked a significant revaluation of asset prices – the extent of which had never been seen before. As a result of this volatility, parts of the global bond markets have become heavily oversold, creating significant opportunity for investors to search for and buy fundamentally sound assets at very low prices.

Of course, identifying these opportunities, while avoiding the risks, will take considerably more skill than in the past. Strong fundamental research and a disciplined investment process are vital in uncovering value in today's market. As I believe asset prices will continue to recover over the coming months and years, pension schemes should move to capture these opportunities by meaningfully adding risk back to their bond portfolios today.

Q. So where do the best opportunities currently lie?

Bob Michele: We expect global economic growth and inflation to remain low as the financial system heals and companies repair their balance sheets. Under such an outlook, government yields should remain low thereby highlighting compelling opportunities in other parts of the global bond markets. In particular, three areas stand out: securitised debt, high yield corporate bonds, and emerging market debt.

The securitised debt markets remain cheap following the collapse in home prices. Despite this distress and the resulting increase in defaulted securities, these assets should further recover as home prices begin to stabilise. In particular, parts of the residential non-agency mortgage-backed securities market offer good value. Of course, intense credit research is needed to find those assets in the non-agency market that will perform and avoid those that will default. Much of the work we do involves stressing each transaction at the individual loan level under different scenarios of housing recession and depression. Most securitisations will 'break' under our scenarios, but we do manage to find many that remain stable and will return full principal.

Although having narrowed substantially this year, high yield spreads over Treasuries remain well above their long-term average. At these still distressed levels, high yield valuations do not reflect what we believe to be a more stable outlook for the global economy whereby deleveraging will be the primary focus of borrowers. Companies have already become far more fiscally prudent as they have cut dividends, suspended share buy-backs and reduced expenses to the bare minimum. As long as their focus is on their balance sheets rather than accelerating earnings growth, credit spreads should halve from where they currently are over the next year. Our credit team is focussed on finding those issuers that remain committed to their balance sheet and can withstand a prolonged period of little or no economic growth and inflation.

Finally, I continue to find good opportunities in emerging market debt, particularly in Latin America and Asia where local debt and currency markets have only moderately recovered. For example, while Mexico has cut interest rates substantially as inflation expectations have moderated, bond yields remain relatively high. One of the key attractions of local market Asian or Latin American sovereign bonds is the currency. As deficits have ballooned in the UK and US, sterling and the dollar could come under pressure. The currencies that would benefit the most are in the emerging markets where expanding current account surpluses signal the need for appreciation.

Q. Is there still value in investment grade corporate bonds?

Bob Michele: Investment grade corporate bond markets performed very strongly earlier in the year, leaving valuations looking less attractive. After a quiet summer, I expect these markets to continue to trade sideways, further highlighting that better relative opportunity to add risk exists in the securitised, high yield and emerging debt markets.

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Nevertheless, we remain constructive on the sector over the long term. Our credit analysts are tasked with scoring the investment grade credit market and, at the moment, all scorecards are marked positive-to-neutral. Financials, in particular, offer the biggest opportunities, given the wide spreads relative to industrials and utilities. I expect financial spreads to continue to narrow and eventually converge with other sectors.

Q. Given the risks associated with credit markets, how can pension schemes best capitalise on the opportunities you've identified?

Bob Michele: I believe that unconstrained 'best ideas' funds, taking a dynamic approach to sector allocation, are a particularly good way to capitalise on the broad opportunities that currently exist in global bond markets.

Because many UK pension schemes have traditionally invested predominantly in the sterling bond markets, trustees would need to extend mandates to allow schemes to invest in non-sterling bonds to adequately capture today's opportunities.

Of course, mitigating risk is a key concern for many pension scheme managers today. To mitigate this risk, choosing experienced fund managers with disciplined investment processes and large research resources is vital.

We have dedicated sector teams globally covering government bonds, investment grade corporate bonds, mortgage and asset-backed securities, high yield bonds, and emerging markets debt. Moreover, our fixed income team can tap into the full global resources of J.P. Morgan, including our equity analysts (who can provide a different perspective on corporate fundamentals), our real estate team, our investment bank and our commercial bank.

I have long said that the strength of an investment process depends on the quality of the research inputs and the strength of the team making investment decisions. Particularly when analysing credit markets, a strong team of credit analysts are a necessity in identifying value in today's bond markets. That's why I've been adding resources to our credit, emerging markets and securitised debt teams.

Q. What is your main message to UK pension schemes?

Bob Michele: The revaluation of credit over the last two years has provided significant opportunity for fixed income investors, with many areas of the fixed income universe offering value. Now is the time for UK pension schemes to explore them. Those opportunities are global, but will not last for long.

Complacency is not an option. Considerable risk still remains in bond markets and further volatility could lie ahead as the global economy struggles to recover. Fixed income managers that think globally, have invested in strong fundamental research capabilities and run disciplined investment processes will prevail in identifying value in these challenging market conditions.

For further information please contact your usual J.P. Morgan Asset Management representative or visit **www.jpmorganassetmanagement.co.uk/institutional**