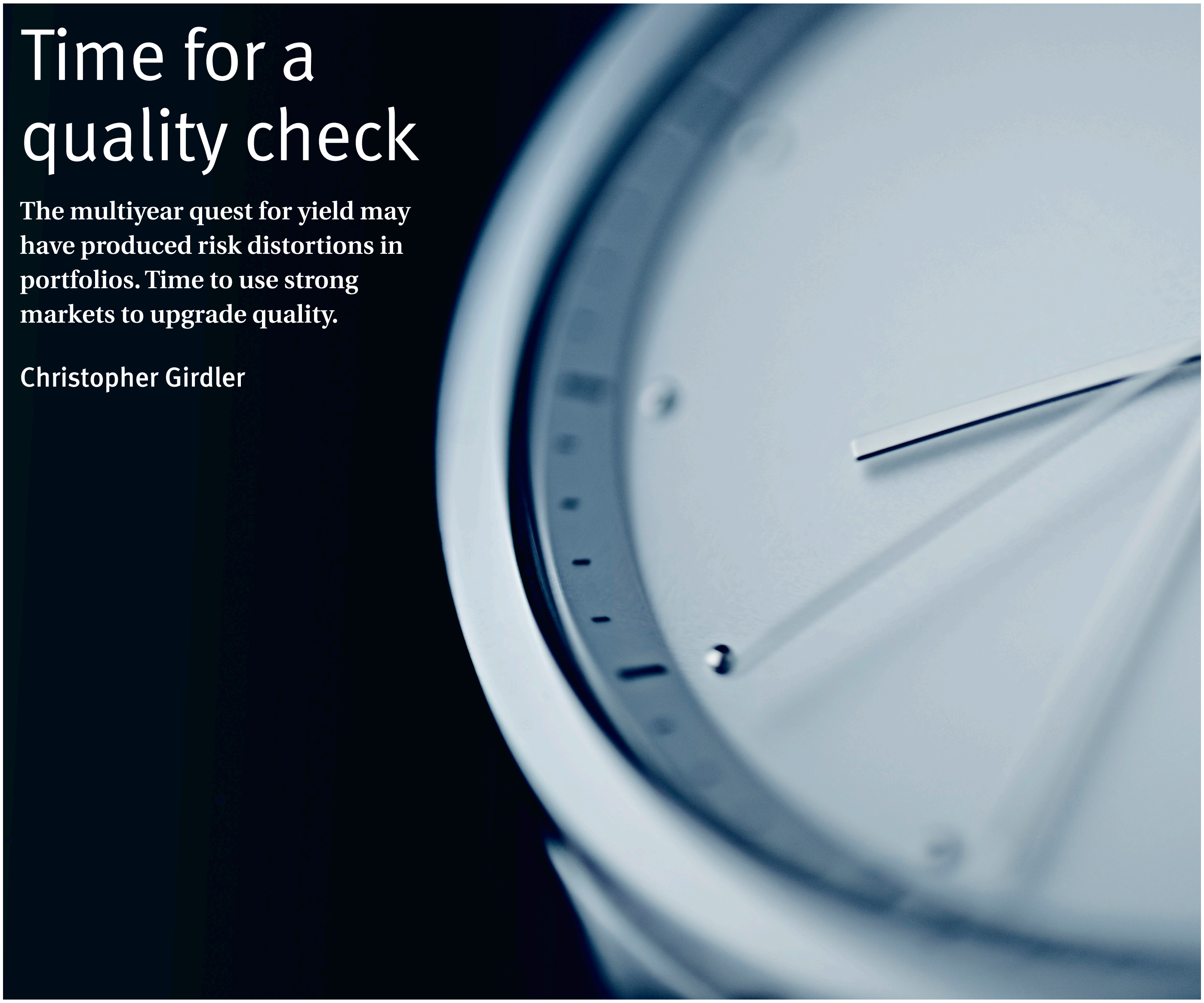
RBC WEALTH MANAGEMENT

Global Insight

Focus Article



Time for a quality check

The multiyear quest for yield may have produced risk distortions in portfolios. Time to use strong markets to upgrade quality.

Christopher Girdler

For important and required non-U.S. analyst disclosures, see page 7.

All values in U.S. dollars and priced as of May 31, 2017, market close, unless otherwise noted.

RBC Wealth Management

Focus article

Time for a quality check

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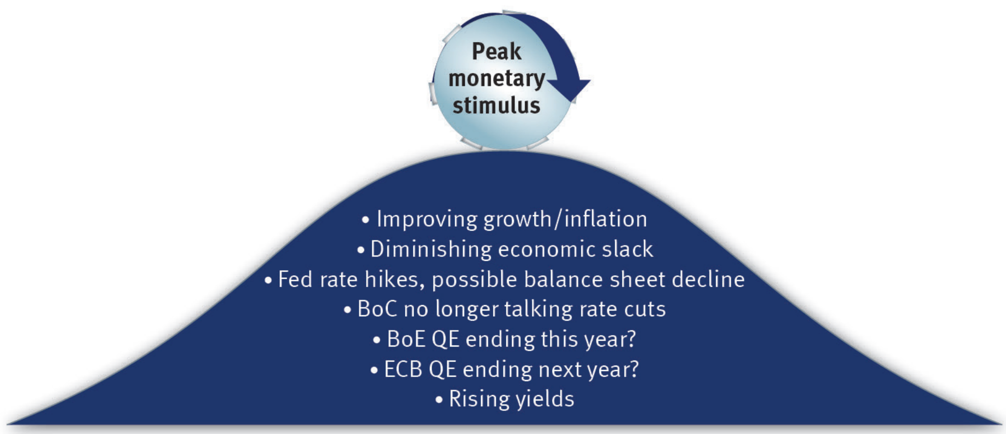
– Gradual "sea change" approaching for global monetary policy and interest rates
– Time to assess risks taken on during the long search for yield

Major central banks have been running intensely accommodative monetary policies since the financial crisis began. Excluding the Federal Reserve, for the most part they still are, but to us it appears the period of peak monetary policy stimulus could soon be behind us. We foresee a long unwinding process during which time government and corporate bond yields could gradually increase. In our opinion, it's time for investors to do a quality check on their portfolios to make sure they haven't inadvertently increased risk in search of higher yields. We believe corporate credit still offers selective yield opportunities, but with stretched valuations now is the time to upgrade portfolio quality.

Monetary stimulus is passing its peak



Source - RBC Global Asset Management

Opportunities as interest rates rise

As central banks gradually move toward a more balanced policy stance, government bond yields are likely to rise at a similarly deliberate pace, reflecting improved growth prospects and receding risks of deflation.

When bond yields go up, bond prices fall. Faced with this, conventional wisdom would say an investor should remain in cash and very short maturities, waiting until higher rates have arrived before re-investing. However, in this case that means accepting a very low coupon return perhaps for several years. For the buy-and-hold investor, in our view, this is a heavier cost than the current circumstances would justify.

Time for a quality check

Investors holding bonds to maturity will naturally see the path of returns altered by interest rate changes, but their overall return, set when they bought the bond (the yield to maturity) will remain in place. Over the life of the bond, assuming the issuer remains solvent, the investor will continue to receive regular interest payments as well as principal at maturity. Rising interest rates could actually improve the buy-and-hold investors' realised returns thanks to the reinvestment of coupon and any principal repayments at progressively higher interest rates.

Too much of a good thing?

Massively accommodative monetary policy across most major developed economies since the financial crisis has pushed government bond yields down to exceptionally low levels. Investors looking to maintain the level of income in portfolios have increasingly chosen to assume additional risks in search of better yields. Typically that has pushed them towards corporate bonds where the risk of default is higher than for governments and liquidity much lower, especially during periods of market stress.

Corporate credit has provided solid returns with limited volatility over the past three years

	Annual equivalent return (%)	Volatility of returns (%)
US Treasury Total Return Index	2.38%	4.49%
US Corporate Total Return Index	3.90%	5.40%
US High Yield Total Return Index	4.57%	5.23%
European Treasury Total Return Index	4.04%	4.76%
European Corporate Total Return Index	3.43%	2.59%
European High Yield Total Return Index	4.99%	4.54%

Source - RBC Wealth Management, Bloomberg

Corporate credit has recently demonstrated a superior risk-return profile compared to Government bonds.

Moody's BBB Corporate Bond spread

Source - RBC Wealth Management, Bloomberg; data through 5/19/17

Corporate credit spreads (BBB-rated) have narrowed to the tightest levels in a number of years.

As business conditions have improved over the past several years, this appetite for corporate credit has grown steadily. During last year's episode of ultra-low, even negative, government bond yields, this preference for corporate credit became so pronounced that the differential (spread) between the yield on corporate bonds and government bonds narrowed to the tightest level in a number of years.

But we now ask ourselves, was this spread compression justified? Credit fundamentals for both investment-grade and high-yield borrowers, as measured by financial leverage, have worsened at the same time as compensation for assuming credit risk has fallen. It's true the current interest rate environment keeps borrowing costs for corporate issuers at an affordable level, but the large pile of debt that has made its way onto most balance sheets over the past several years—to fund expansion plans or large share buy-back programs—could prove a headwind to corporate bonds as interest rates rise.

Correlation risk: Out of sight, out of mind

The correlation of different financial assets is a topic usually discussed at portfolio construction but is often forgotten thereafter.

In addition to providing reliable income, the fixed income component of a portfolio is supposed to act as a countervailing force when the equity component is under pressure.

In addition to providing reliable income, the fixed income component of a portfolio is supposed to act as a countervailing force when the equity component is under pressure. Government bonds and high-grade corporates usually do just that. When the economy heads into recession, earnings and share prices fall. Funds looking for a safe haven often flow into high-grade bonds pushing bond prices higher, taking some of the sting out of equity losses and giving the investor the financial and psychological staying power to hang in through the downturn.

But the worse the credit characteristics of a particular bond or preferred, the less it acts like a high-grade bond during periods of economic duress and the more it behaves like a stock. As the multi-decade search for yield has pushed investors toward lower-quality credits, it has simultaneously exposed portfolios to more equity-like volatility than intended. So far there has been no discernable cost to investors: they have enjoyed higher incomes than government bonds would have provided, and spreads are pretty well as low as they have been in the past seven years.

Counting on that continuing indefinitely seems to us to be an unreasonable assumption.

Corporate bonds, especially high-yield, display positive correlation to equity markets

	Correlations** vs. Equities*
U.S. Treasury market	-0.37
U.S. corporate bonds	-0.27
U.S. high-yield bonds	0.48
European Treasury market	0.01
European corporate bonds	0.08
European high-yield bonds	0.69

* For U.S. equities, we use the S&P 500 Index and for Europe we use the STOXX Europe 600 Index. ** Correlations are calculated using daily returns over three years. Source - RBC Wealth Management, Bloomberg

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Time for a quality check

It would be prudent at this point, when yields and spreads are both so low, to assess portfolios to ensure investors are being fully compensated for taking the risks that are present as well as making sure fixed income holdings offer appropriate portfolio diversification.

... the recent strength in credit markets provides an opportune time to lock in well-earned gains ...

While we feel that select corporate bonds still offer worthwhile yield advantages and that spreads have the capacity to remain at current levels or tighten in some cases, the recent strength in credit markets provides an opportune time to lock in well-earned gains and reduce exposure to positions more susceptible to suffering in a bond market pullback. Reinvesting proceeds into higher-quality bonds would have the natural benefit of increasing credit quality of the total portfolio as well as improving its liquidity profile.

Research resources

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			Investment Banking Services Provided During Past 12 Months	
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