

No Better Alternative

Stockholm (HedgeNordic) – Fixed-income investments are a mainstay of institutional portfolios, not because institutional investors really want to, but because they have to. And with high-quality bonds yielding close to zero or even negative returns, investors have been forced into riskier high-yield bonds.

“All institutional investors are suffering from the low-rate environment and even the negative interest rate environment in the euro area,” says Kari Vatanen (*pictured*), the chief investment officer of Finnish pensions insurer Veritas. “During the last ten years, investors hunting for yield have been forced to go into the higher-risk segments of the fixed-income space,” he elaborates. “They have been going for higher credit exposure, high-yield debt, emerging market debt, even collateralized loan obligations (CLOs) or any illiquid debt. The hunt for yield will continue as long as interest rates stay at a low level.”

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Despite higher-quality fixed-income securities offering “return-free risk,” according to Vatanen, institutional investors such as Veritas need fixed-income assets in their portfolios to meet solvency regulations. “We are forced to be invested in fixed-income securities for several reasons, one of which is that we face solvency capital requirements,” explains the CIO of Veritas. “High-yield bonds are requiring less solvency capital than equity-type investments or some other alternatives, so we are forced to stay in fixed income, at least some allocation should be there for solvency reasons,” he elaborates. For that reason, riskier, higher-yielding bonds are more attractive than safer fixed-income securities.

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“At the moment, the views on the high-yield space are not that good,” acknowledges Vatanen. “There are two aspects of my views on high-yield markets, one is absolute and the other one is relative,” he continues. In absolute terms, yields in the high-yield space are suppressed and close to the historical lows that had been prevailing before the onset of the Covid pandemic. “We are at a low level of both yields and spreads, which means that tactically, it is not the best possible time to go into the high-yield market,” considers Vatanen. “If we are going to see any kind of turbulence in the market, it is probable that high-yield spreads will start to widen and that is bad for holders of high-yield bonds.”

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The yield levels of high-yield bonds in the euro area are hovering between 2.5 and 3 percent at an index level, “which is really low for investors, especially for those with some return targets to meet for the longer run,” according to Vatanen. “On absolute terms, high-yield bonds are not very attractive at the moment, but the problem is that on a relative basis, the other asset classes within fixed income are not attractive either,” he emphasizes. “In a relative sense, if you need to be in fixed income, high-yield bonds provide at least some positive yield over time, especially if we are expecting inflation to rise at least mildly.”

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With higher-quality bonds exhibiting negative expected returns in a rising rate environment, “high-yield bonds might be the only place to stay in that kind of environment if you are forced to be in fixed income,” considers Vatanen. “Maybe the worst possible place to be at the moment is investment-grade credit because this segment has higher duration risk, i.e., higher interest rate risk and credit risk embedded in the same package,” argues the CIO. “If rates are rising and at the same time credit spreads are widening, you have only risk embedded in investment-grade fixed-income portfolio where the expected yield return is zero or even negative.”

Better Positioned for Rising Inflation

With inflation expectations rising as investors anticipate a fiscal stimulus- and vaccine-fueled economic recovery, high-yield bonds may be better positioned than safer, lower-yielding fixed-income securities. “First, duration or interest rate sensitivity is typically lower on the high-yield side,” says Vatanen. “If interest rates are rising, high-yield bonds are getting less hit compared to investment-grade bonds,” he continues. “But if the rising rate environment comes from rising inflation, which is typically driven by improving economic conditions, high-yield bonds are a better alternative than investment-grade securities.”

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“There is no inflation without economic growth and if economic growth continues, then credit spreads should not suffer in that kind of environment,” explains Vatanen. “But if rates are rising and at the same time, economic growth is suffering, then holders of high-yield bonds will suffer,” warns the CIO. “The hunt for yield will continue if the economic environment stays positive,” considers Vatanen. “Investors will continue to look for higher-yielding asset classes. Within the credit spectrum, investors are still going towards illiquidity, towards opportunistic credit and even CLOs, especially if central banks are expected to continue their support and prevent any collapses in the credit market.”

Defaults and Different Market Dynamics

The coronavirus pandemic could have forced many struggling businesses to go bankrupt or default. Still, extensive monetary, fiscal and regulatory measures appear to have helped many companies go through the period of quasi-suspended economic activity. “Defaults will probably increase slightly,” considers Vatanen. “In Europe, for instance, there has been supportive legislation to help businesses

avoid defaults so far.”

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“That cannot continue forever,” says the CIO. “It is only natural that there will be a little bit more defaults than what we have seen in the last months,” he continues. “But as long as the support from central banks and governments continues, we do not expect to see a huge increase in defaults,” argues Vatanen. “Perhaps the default rates will be higher than we have seen in the last 12 months, but not extraordinarily high.”

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While the high-yield universe may seem homogenous, “the market dynamics are quite different in various markets,” explains Vatanen. “Varied exposure to different high-yield markets can give some support from a diversification perspective,” he emphasizes. “It is clear that there are higher growth and inflation expectations in the United States,” says Vatanen. “Higher growth expectations can be good for any kind of illiquid or opportunistic credit strategies,” he adds. “In Europe, we have a bit different story, as growth is not expected to be as high as in the United States,” according to Vatanen. “We do not expect rates to rise as fast as in the United States and economic trends in Europe tend to be more stable, which means that investors face less uncertainty and volatility. The dynamics are different in different markets, at least as long as the stimulus policies continue.”