FIXED INCOME

Where Might Credit Risks Exist? Follow the Supply

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In 2017, corporate credit—including high yield—saw a resurgence in interest within a longer-term trend of increasing supply. In recent weeks, however, it has shown some cracks. Roger Bayston, senior vice president and director, Fixed Income, Franklin Templeton Fixed Income Group, weighs in on why he sees reason for caution amid changing market dynamics—but also where opportunities appear to be opening up.

While we are bottom-up investors, we still must recognize the big-picture macro themes or events that may affect our investments. I'd like to outline a few of these themes we see affecting the markets today, including the changing dynamics of the credit market and how technology has brought disruption and potential to various sectors.

As an investor, you have to understand where potential risks exist as well as potential returns. One of the potential risks we see relates to supply. Over the past 10 years, the US investment-grade debt market (corporate bonds), has grown by about $4 trillion.[1] This pace of growth has actually outstripped US gross domestic product growth over that period.

Why has this tremendous growth in credit occurred? Look to the central banks.

Since the Global Financial Crisis, global central banks have been providing easy money. Investors have been given incentives to invest in longer maturities and take on more credit risk across the credit spectrum. It makes sense. Why would an investor settle for historically low Treasury yields when there is a plethora of potential corporate bond opportunities that offer a more attractive proposition? However, I think there is a lesson here investors need to heed. To look for potential issues in the fixed income markets, in my view, you have to follow the supply. We have a lot of it right now in the corporate credit markets.

We have seen similar periods of heavy supply that didn't end well. In the late 1990s, telecom companies were issuing a lot of debt into the marketplace to finance digital-age projects, and many weren't able to fulfill their promises. Then in 2007, we saw issues surface with non-agency mortgage-backed securities that led to a sweeping financial crisis. And more recently in 2015-2016, we saw volatility in the energy sector amid a glut of supply. When global oil prices were high, and US shale oil held a flood of promise, oil and gas companies issued lots of debt. Oil prices plummeted, and paying back that debt became a problem.

Therefore as it relates to credit markets, we think it is critical to perform fundamental research at the issuer level when selecting securities. In addition, analyzing these broader trends and potential catalysts will play an important role in managing fixed-income portfolios going forward.

Technological Innovation Disruption

The supply situation today may not be a problem in and of itself, but we also have to consider that we are in a period of tremendous and rapid technological advancement—often times disruptive.

Companies—and entire industries—have quickly disappeared. When there is tremendous change combined with heavy supply, there are going to be winners and losers. I think we are likely to see an increase in idiosyncratic risk in the marketplace going forward. I'd label this technological innovation disruption.

Autonomous driving vehicles offer an example of technological innovation disruption. Traditional US automakers are in the game, but they may not be at the forefront. A number of companies in China in particular are dedicated to the business proposition of building an autonomous driving network.

Because of the low-interest-rate environment in the United States, traditional US automakers can issue debt to build their own mobility networks. But would you as an investor want to own that debt with a 10-year maturity? That's the question. Businesses are changing, they will be restructured and the bondholders may not be happy. Will all the companies in the race to develop and support these vehicles even exist in 10 years?

Another example is in the retail space. We know how internet-based retailers have caused massive disruption to the traditional brick-and-mortar outlets. While that may be good for the investors who get it right, it may not be great for many bond holders.

This technological disruption is not all bad news, however. There are positive things about innovation. It creates efficiencies, it helps control costs. But we are going to see winners and losers.

In June-July 2017, The Economist Intelligence Unit (EIU) conducted a global survey of 571 institutional investors about how they have been adapting to changing market conditions.[2] I found it interesting that respondents across the globe cited volatility as a big concern—and that the survey recognized "technological disruption" as a factor.

The survey's global findings summary stated that in light of long-term trends like climate change and technological disruption, investors identified correlation risk (49%)[3] and non-financial risks such as geopolitical risk (45%) as the top challenges to achieving long-term targets—closely followed by liquidity risk (43%) and short-term volatility (40%).[4]

We've had this rising tide with credit-related investments performing well in recent years, so we are aware that we could see somewhat of a pullback given the significant supply in the market and the disruptions that are taking place. Markets have been in a prolonged period of exceptionally low market volatility and I expect there could be heightened volatility in the coming year. We are already seeing a few signs of it in the high-yield credit market. During bouts of increased volatility, it's important to focus on what is driving the movement. Is it short-term market movement driven by headlines that can expose opportunities or is there a fundamental shift that presents principle-loss risk?

One area that has garnered a lot of attention and headlines is US politics. While political issues create shock-worthy headlines—and contribute to market volatility—in our view, they are mostly just noise and don't change the fundamental investment landscape that much. While they may create some of the short-term gyrations that seem to worry investors, we take a longer-term view of the situation. We think there are bigger trends in the global economy that likely will have a greater impact on investments and that short-term volatility should not obscure the solid underlying fundamentals of the US economy.

So when I'm thinking about our strategies, I look at the macro trends, including supply and disruption, idiosyncratic risk, where winners and losers might be, and how we can bring our wisdom to generate alpha.[5] We are trying to find opportunities our clients might not be able to source themselves.

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What Are the Risks?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in the fund adjust to a rise in interest rates, a fund's share price may decline. Changes in the financial strength of a bond issuer or in a bond's credit rating may affect its value. Lower-rated, higher-yielding instruments are subject to increased risk of default and can potentially result in loss of principal. These securities carry a greater degree of credit risk relative to investment-grade securities.

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1. Source: Morgan Stanley Research, Dealogic, as of November 2017.

2. Source: Survey of 571 institutional investors from North America, EMEA and Asia-Pacific conducted by The Economist Intelligence Unit (EIU) in June-July 2017. The EIU had final editorial control of the Survey, and, for avoidance of doubt, was not obliged to comply with any input from Franklin Templeton Investments which sponsored the Survey.

3. Correlation measures the degree to which two investments move in tandem. Correlation will range between 1 (perfect positive correlation where two items have historically moved in the same direction) and -1 (perfect negative correlation, where two items have historically moved in opposite directions).

4. Source: Survey of 571 institutional investors from North America, EMEA and Asia-Pacific conducted by The Economist Intelligence Unit (EIU) in June-July 2017. The EIU had final editorial control of the Survey, and, for avoidance of doubt, was not obliged to comply with any input from Franklin Templeton Investments which sponsored the Survey.

5. Alpha is a risk-adjusted measure of the value that a portfolio manager adds to or subtracts from a fund's return.

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