"Great Rotation?" How About "Selective Rotation?"

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A few months ago there was a lot of buzz about a so-called "Great Rotation," used to describe an investor exodus from fixed income and into equities, conjuring up images of a massive herd of wildebeest on the African plain racing for greener pastures. Oftentimes, when investors react to the market with a herd mentality, they can wind up losing sight of where they are going, and why. Eric Takaha, senior vice president and portfolio manager for Franklin Strategic Income Fund, says what he's seen is more of a "selective rotation." He notes that some areas of fixed-income have done well this year and could continue to provide compelling opportunities for investors willing to do some independent thinking.

Takaha doesn't see real-world evidence of the "Great Rotation," also noting that the choice between fixed income and equities is not an all-or-nothing affair—and shouldn't be.

"We've certainly seen flows into the stock market, and that's helped equity performance in 2013. If you look across the fixed income market, we have seen money coming out of some money market instruments and some of the government-related instruments. On the other hand, bank loans have had over a year of positive inflows, week after week.[1] Even high-yield corporate bonds have seen money coming back in of late. I think investors in general are distinguishing between short-term money markets and the very low yields in government bonds versus some of the other fixed income sectors that can offer a bit higher income stream. So while we have seen money going into equities and money coming out of certain fixed income products this year, overall we haven't seen a great rotation out of all of fixed income. We think that's going to be the case going forward, where investors look to pick up yield and income by investing in select instruments that they think might be slightly less sensitive to interest rates, while still being comfortable with where we are in terms of the credit cycle and some of those fundamentals."

Focusing on Corporate Credit and Global Bonds

Takaha points to corporate credit as an area of particular interest to him right now, including high-yield corporates, leveraged bank loans and investment-grade credit.

"The credit fundamentals, as we see them today, are relatively positive. Default rates have been very low for both high-yield and bank loans for the last couple of years. The overall credit quality for investment-grade companies is relatively strong. Companies have used the last few years to pay off debt maturities, push out the refinancing needs, and build up liquidity. Although we have seen some recent actions by companies to get a bit more aggressive, to buy back stock, to do some M&A, in general the environment in terms of credit fundamentals remains relatively intact.

"If you were to see some sort of a major dislocation in the macro economy, such as a much more significant slowdown in China, Europe going back into recession, or US growth really slowing, that would cause pressure on some of the areas that we're invested in, if risk aversion were to rise up again. But frankly, if we have slow growth, which is the environment we've been in, that's actually fine for corporate credit. Many companies can still deleverage their balance sheets and service their debts."

Besides corporate credit, Takaha also says investors need to think globally in the fixed income space. And for US investors—municipal bonds look attractive, despite being maligned recently.

"We continue to like global bonds. In some cases they offer not only higher yields, but also the potential for currency appreciation. There are many different countries, yield curves, and currencies out in the marketplace, and our global bond specialists are focused on finding what we think are the most attractive opportunities.

"Municipal bonds have really been beaten up over the last several months; there have been a lot of headlines regarding Detroit and Puerto Rico that have spooked some investors. Valuations in the muni market look fairly attractive to us, even without the potential tax benefits they can offer some investors. We've been buying some of those securities, because we think the longer-term return potential appears fairly attractive. We have a great group of analysts here that are evaluating those opportunities for our portfolios."

Meanwhile, Takaha isn't keen on interest-rate sensitive areas within US markets.

"We don't favor the more interest rate-sensitive areas within the US market, namely Treasuries, agencies and mortgage-backed agency securities. However, that's not because we necessarily think rates will move dramatically higher in the near term. If you look at just the nominal yields and the return potential in the government bond market in the US, we think it's pretty limited. Even though rates are up a bit from their lows, in general, they're still near historical lows. Relative to some of these other sectors where you can pick up some spread, you can pick up potential currency appreciation, we think the overall return potential in the government-related markets seems fairly limited." [php function=1]

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What Are the Risks?

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