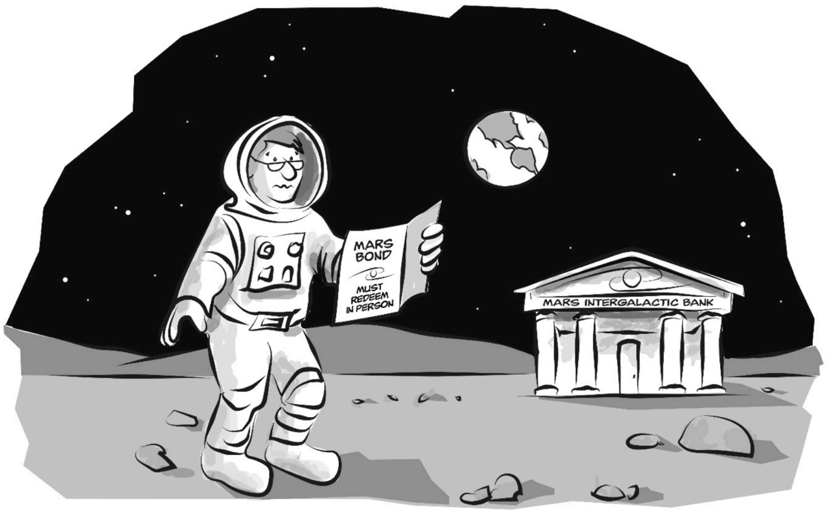
Fixed **income** insights

Hiding in plain sight: Dancing gorillas in the bond market

Since U.S. Treasury yields hit an all-time low in the beginning of the third quarter, the so-called hunt for yield has been a major topic for investors. Yet the search for yield reminds us of the famous psychology experiment and later YouTube sensation of The Invisible Gorilla. In that video, observers are asked to closely watch players and count how many times they passed a ball back and forth. As the observer focuses on the number of passes, a person in a gorilla suit walks through the middle of the screen. As comically obvious as this sounds, about half of viewers have no awareness of the gorilla whatsoever.

As we repeatedly hear the accepted orthodoxy that there is no yield in fixed income and investors continue to look to alternatives either within or across asset classes, we ponder if the answer is right in front of us, hiding in plain sight, but we are too focused on what we know to see it. As we examine the fixed income landscape, we try not only to count the number of passes, but to see the gorilla as well. We examine four of these invisible dancing gorillas that offer investors yield, but are hidden to those focused elsewhere.



Umm . . . I'm not sure the extra yield was worth it.

Taplin, Canida & Habacht (TCH) is an institutional fixed income boutique within The Bank of Montreal and part of the BMO Global Asset Management group. TCH manages over $10 billion of assets and is a subadvisor for multiple open-end mutual funds. We are dedicated to investing on behalf of our clients and servicing them to the highest standards. For more information about TCH, please visit tchinc.com.

Contact us

1-844-266-3863

bmofunds.com

bmo-global-asset-management

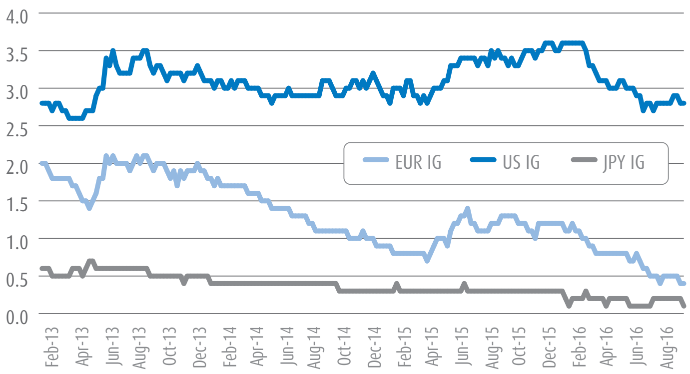
Gorilla #1: What if the grass isn't greener

As we have discussed in previous pieces, the U.S. yield environment remains quite attractive in a global context. The yield differential between the U.S. and other developed markets remains large and that has drawn international capital to U.S. markets. This substitution effect, whereby international investors buy U.S. high quality fixed income assets in place of their local market assets, has provided support for U.S. yields in recent years. From the non-U.S. perspective, it is important to note, these purchases are not a trade-off of liquidity for yield, they are in fact a trade up in both.

While often a search for investment alternatives takes one beyond the boundaries of their domestic market, no such travel is necessary for American investors as global yields remain below American ones and the U.S. market remains the largest and most diverse available.

Global corporate debt yields

Percent



Sources: Bloomberg L.P., TCH, LLC

Gorilla #2: Apples to apples

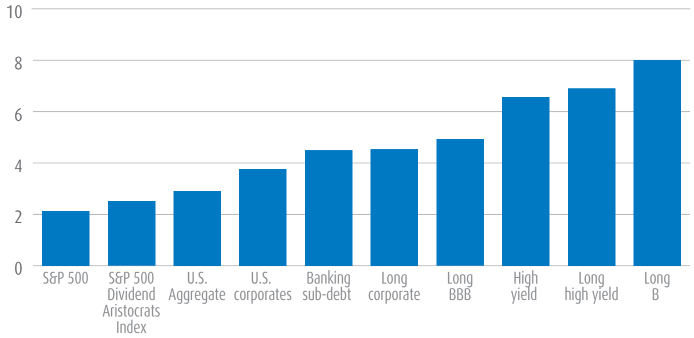
A major topic continues to be high dividend paying equities and the seeming oddity that equities are paying comparable or at times a higher dividend than bonds are paying. The much touted high dividend equities approach (as measured by the S&P 500 Dividend Aristocrats Index) offered a dividend yield of 2.5% at quarter-end, above the yield-to-worst (YTW) for the Bloomberg Barclays U.S. Aggregate of below 2%. On a current yield basis and a more comparable methodology to dividend yield, however, the Bloomberg Barclays U.S. Aggregate offered a 2.9% yield at quarter-end. Since the quarter has ended and rates have drifted higher, fixed income yields have only become more attractive. The 10- year Treasury ended October at 1.83%, approximately 30 basis points higher than September, a trend which has continued in November.

Further, the U.S. fixed income market does contain pockets of the yield that investors are seeking, but many of these opportunities are obscured by the overall index averages. For example, the U.S. Aggregate yield is largely driven by the 40% of the index that is U.S. Government securities and a 10-year Treasury yield of 1.59% at quarter-end. As is typical, the non-government sectors within the index offer higher yields including U.S. corporates offering 3.8% current yield at the end of September. In this more apt comparison, equity dividend yields fall below the yield of U.S. corporates, while of course adding higher equity risk to a portfolio than would U.S. corporates.

Active equity portfolios may be able to create even more attractive dividend yields, a point we would echo for active fixed income portfolios.

Current yield / dividend yield

Percent



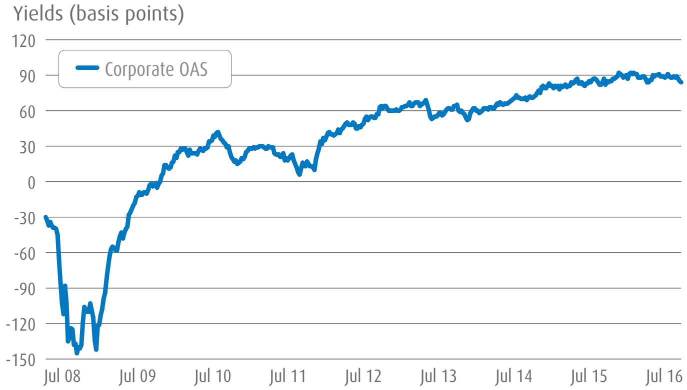
Sources: S&P Dow Jones Indexes, Bloomberg Barclays, TCH

Gorilla #3: Missing the trees for the forest

Examining overall corporate yields excludes the various pockets of yield within this 5,900 security index. For example, BBB securities are the largest quality cohort within corporates (48%) and offered a 3.3% YTW at the end of October. Further, the 10+ year component of U.S. corporates is the largest maturity segment of the index, comprising over 31% of corporate market value, and offers a YTW of 4.2%. Credit curve steepness is an important consideration – though it is important to observe how much the yield curve has flattened in the past three years in the U.S., credit curves remain steep offering meaningful premia to investors.

U.S. corporate OAS steepness (bp)

Yields (basis points)



Sources: Bloomberg L.P., TCH, LLC

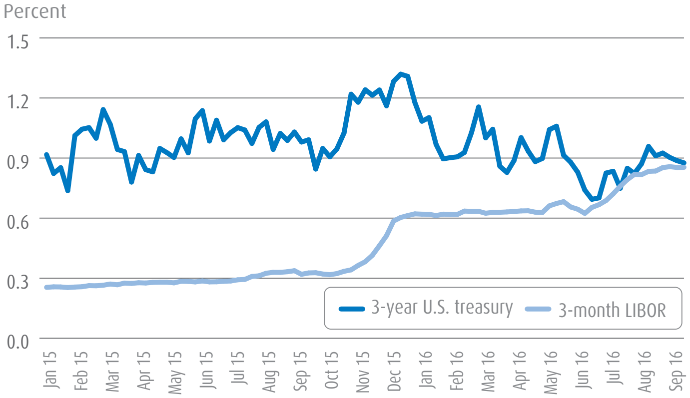
When yield alternatives, notably private credit and infrastructure, are juxtaposed to their traditional counterparts with comparable maturities and credit risks, the yield pick-up is much less than one might anticipate. In effect, the biggest difference is the illiquidity premium. The lack of pricing for these assets due to illiquidity creates a liquidity/volatility paradox, as less frequently priced securities appear to show lower volatility. The liquidity of public debt, with the option to exit the position daily or hold to maturity, seems the more favorable risk of the two in our estimation.

Gorilla #4: The rising tide

It is not only the long end that is offering value. Leaving the confines of the standard index, but remaining rather conventional, we examine investment grade floating rate notes, which have had an interesting and significant change in yields of late.

In this case, the shift in yields comes from the regulatory changes in money market funds where (to simplify a complex set of regulations) government securities will now be treated more beneficially than corporate ones for purposes of ensuring a daily NAV of 1 in money market funds. The result has been a marked increase in LIBOR rates versus short-term Treasuries, thereby increasing yields for securities with coupons that have a component tied to LIBOR, such as floating rate notes. It is also important to distinguish between investment grade corporate floaters and bank loans, another popular instrument. By contrast to bank loans, corporate floaters are highly liquid, investment grade instruments with no LIBOR floors, so the impact of the increase in LIBOR benefits the holder as soon as the reset date of the instrument.

Short-term interest rates



Source: Bloomberg

Outlook & Positioning

The increase in yields in the beginning of the fourth quarter has strengthened the case for the availability of yields in traditional fixed income. Contrary to long-standing expectations of significantly rising rates, the recent increase comes on the back of a significant decline in rates year-to-date in 2016 and in our view is a healthy bounce from the all-time lows set in the beginning of the third quarter. On balance, we view the more likely drift of rates to be higher, but this is against a backdrop of long Treasuries having returned nearly 15% in the first three quarters of the year.

With the continued focus on the Federal Reserve (Fed) and the second rate hike in this cycle expected in December, short-term volatility may escalate if Fed messaging is muddled regarding expectations for 2017. Particularly following the market reaction to their September 2015 statement, the Fed is keenly aware of potential consequences of its actions (or inactions) and is likely to tread lightly on policy and messaging. The possibility of short-term disruptions do not shift our expectation for the fixed income landscape and our focus remains on the underpinning of the U.S. economy, the differences between global monetary regimes and the specifics of each investment that will have the greater impact to markets and client portfolios.

As fixed income markets have been returning to a more fundamental and nuanced pricing of risk, we have viewed that as an opportunity to exit positions that we either maintained or added opportunistically during bouts of volatility in the third quarter of 2015 and the first quarter of 2016. We have either replaced these with new mispriced assets as available or with more liquid, high quality assets when spread differentials were not justified.

Conclusions

In our view, a closer examination of traditional fixed income markets reveals opportunities to find the yield investors seek, but they may not realize is available. Investors' expectations and consensus opinion on investment options may be blinding us to that which is often times right in front of us. Further, many attractive options for investors are masked by the overall market, leading to different perceptions of the trade-offs investors are undertaking.

While most investors recognize the inherent risks when so many market participant are seeking the same objective, it has not yet deterred more exotic approaches to yield generation. These take many forms, but by and large can be summarized as a trade-off of liquidity, quality or both for yield. We continue to see opportunities in traditional fixed income and view the relative yields from other sectors as less than meets the eye when placed into the proper context of maturity, quality and liquidity.

There are indeed many balls in motion and it is easy to be distracted by them and focus only on the task of counting the number of passes. While counting the passes, we are also attempting to find the dancing gorilla in our midst. To illustrate the difficulty, the video can be found titled as "The Monkey Business Illusion."

Portfolio positioning

Interest rates/duration: Maintain positioning for a flatter term structure while holding overall duration towards the lower end of relative benchmark range given low absolute yields; Underweight Treasuries, favoring non-government sectors instead

Credit: Global growth concerns have led to a dearth in positive global sovereign bond yields and furthered the demand for U.S. fixed income; U.S. corporate balance sheets have managed the credit cycle well; U.S. IG credit will likely recognize further support from global yield substitution effect

Mortgages: U.S. agency MBS to realize continued support from Fed reinvestment despite potential for increased supply; While the total return potential appears limited relative to cross-sector opportunities, they remain a relative safe haven during periods of uncertainty

High yield (HY) and emerging markets (EM): For higher yielding opportunities, market volatility has created bottom-up opportunities in the wake of macro concerns; however, by the numbers, the risks appear more balanced in investment grade