Fixed Income Outlook 2016: Have Rising Interest Rates Been Priced Into Bonds?

With the Fed finally raising rates — and more hikes likely to come — we look at the opportunities and dangers in fixed income in the New Year

The markets yawned when the Federal Open Market Committee raised its target by 25 basis points for the federal funds rate on Dec. 16, since the widely anticipated move had already been priced into the market. When the Third Avenue Focused Credit Fund halted redemptions from its high-yield fund in early December, there was much consternation but no contagion into other junk bond vehicles.

In a November interview, Kathy Jones, chief fixed income strategist for the Schwab Center for Financial Research, pointed out that the markets had already priced in the Fed rate hike. "Look at two-year notes," she said, "they're yielding almost 90 bps; a year ago they were yielding 22, 23, so clearly the market has discounted a couple of rate hikes at the short end."

However, the pace of further Fed increases in 2016 and the prospects for more volatility, especially in the currency markets, along with more quantitative easing by the European Central Bank and its counterparts in Japan and China, may well affect yields next year.

As for the Fed itself, in a Dec. 22 note to investors, George Rusnak, co-head of global fixed income strategy for Wells Fargo Advisors, pointed out that in its Dec. 16 statement, the Fed "included the word 'gradual' twice when referring to the path and probability of future rate hikes. The addition of this word indicates that the Fed will be quite cautious before making future rate increases."

Just as the Fed communicated regularly before taking action on Dec. 16, Rusnak believes the Fed "will work to clearly guide the markets prior to rate hikes in order to avoid market disruptions."

As Treasuries are expected to fade, here's where the biggest money managers are finding value. Below, we look at the outlook for some specific fixed income sectors. As for the bigger picture for bonds, Timothy Paulson, fixed income investment strategist for Lord Abbett, said in a note to investors on Dec. 21 that the consensus in 2016 is for rising interest rates and a flattening yield curve, in which rates on shorter-maturity issues rise faster than those of longer maturity.

Despite that consensus, Paulson reminded investors that "markets move when expectations change, and those expectations could be volatile as we get more information on economic data" throughout the year. Paulson also reports that Lord Abbett has already seen "some increase in risk premium in asset classes like high yield, emerging-market bonds, and leveraged loans, where yield spreads widened meaningfully in 2015."

Wells Fargo's Rusnak said he expects the Fed to raise rates "only two to three times in 2016" and thinks it "very unlikely that the Fed will consider going back down to a zero interest rate policy (ZIRP) anytime soon."

Jones said Schwab's view on how fixed income investors should react to higher rates "is that if we're going to see a flatter yield curve and higher volatility, then we're cautious on credit — we're neutral on high yield, we're underweight EM bonds and international developed market bonds because we think the dollar will continue to go up."

So what does Jones like? "We're looking at the upper tranches of the credit quality spectrum," she said.

Moreover, she suggested that investors might want to use a barbell strategy, where you have some short-term paper — CDs, cash — that will adjust as short-term rates move up and add to the bond portfolio "some high-quality intermediate term bonds to generate the income" that clients need.

Municipals

Dan Solender, director of municipal bonds at Lord Abbett, is bearish on munis for 2016, arguing that "supply should remain on the higher side" but will be matched by "consistently strong" demand. Writing in a Dec. 21 note, Solender said he believes that "other than the few high-profile troubled issuers in the headlines, credit quality should remain on a positive trend, based upon tax revenue strength and the volume of upgrades compared to downgrades from the credit rating agencies." Munis from those "high-profile" issuers — Illinois and Puerto Rico — will "remain under pressure," he predicts, but "their issues should remain isolated and not affect the entire market.

Among the trends he thinks will continue in 2016 is that individual investors will decrease holding individual bonds in favor of managed products, while banks will decrease their municipal bond holdings due to regulatory pressure and to reduce their risk. Solender thinks Fed rate hikes could increase investor demand for munis and concludes that the muni market "has had a good 2015; we think it is well positioned for 2016."

Emerging Markets

Schwab's Jones says she is underweight EM bonds moving into 2016, and PIMCO analysts Richard Clarida and Andrew Balls agree, saying that "emerging markets remain a potential source of volatility." Writing in the firm's December Cyclical Outlook, Clarida and Balls say their "baseline view is there will be less macro spillover from China to the rest of the world, via commodity and trade channels, in the next 12 months compared with the past 12 months." They argue that China's slower growth trajectory "is now priced into macro forecasts and markets." They warn, however, that the Chinese government's policy, "especially foreign exchange policy, is a key source of risk."

Overall, the PIMCO analysts see fixed income opportunities not in EM debt, but "across investment-grade, high-yield, U.S. bank senior debt and bank capital in Europe."

High-Yield Bonds

Steven Rocco, high-yield portfolio manager at Lord Abbett, acknowledges that the high-yield space showed turbulence in 2015, "owing in large part to weakness in the energy and mining and metals sectors." For 2016, unless the U.S. economy heads into recession, which he calls "not a likely outcome," he is bullish on high yield. Should U.S. consumer spending continue to advance at a 3% clip in 2016, that would benefit "key high-yield sectors such as retail and restaurants."

As Treasuries are expected to fade, here's where the biggest money managers are finding value. Lord Abbett sees the default rate on high-yield issues "rising to about 4.5% during 2016, versus a level of around 2% in 2015, with most of the increase coming from energy and metals issuers." But even that development could yield "some buying opportunities within the high-yield market if the default number comes in below the expected level.” Rocco argues that “the real wild card in the market … will be demand for crude oil; any bounce in demand could help spark a rally in energy bonds in the late second half of 2016.”

Writing on Dec. 15, Anthony Valeri of LPL Financial says that “the origin of high-yield weakness has come from the lowest-rated tiers of the high-yield market but has infected the broader market.” While volatility will persist, he nevertheless believes the high-yield bond market “offers good value at current prices for suitable long-term investors but the near-term still looks challenging. Current default expectations in both the overall high-yield market and in the energy sector, 9% and 16%, respectively, are overly pessimistic, but they take a backseat to trading flow dynamics, which can overpower fundamental drivers in the short run.”

Russ Koesterich, BlackRock’s global chief investment strategist, sounds a cautious note. “While we believe high yield (outside of issues from energy and other natural resources firms) can stabilize in 2016, the reality is that we’re getting late in the credit cycle.” To Koesterich, that suggests that “U.S. stocks and bonds may continue to struggle, unless we see a more meaningful acceleration in the global economy.

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