


**FIXED INCOME:**

# BRACING YOUR PORTFOLIO FOR TOUGH CONDITIONS IN 2020

Bond yields are low, geopolitical risk abounds and the global growth outlook is uncertain. Can fixed-income allocations still generate solid returns in this late-cycle environment without forcing investors to take too much risk? With some careful portfolio repositioning, we think they can.

The global economy is facing numerous challenges. A trade war between the US and China has hurt global trade, causing business confidence to falter and manufacturing output to decline (*Display 1*). Washington and Beijing made some progress toward a trade deal late last year, but that could change with a single presidential tweet. And while some manufacturing indicators have stabilized, they have done so at levels consistent with contracting output.

And trade hostility is just one example of the geopolitical risks and the drift toward populist policies that have cast a cloud over the macroeconomic and investment landscapes. As 2020



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VP/Fixed Income Product Director



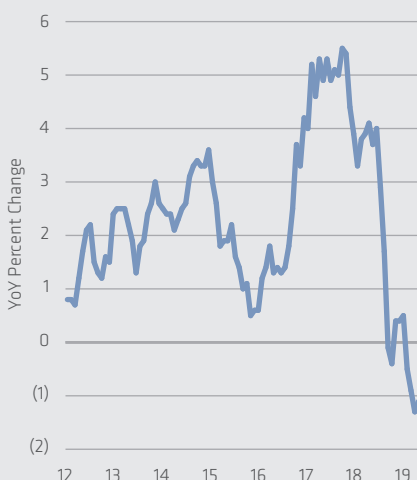
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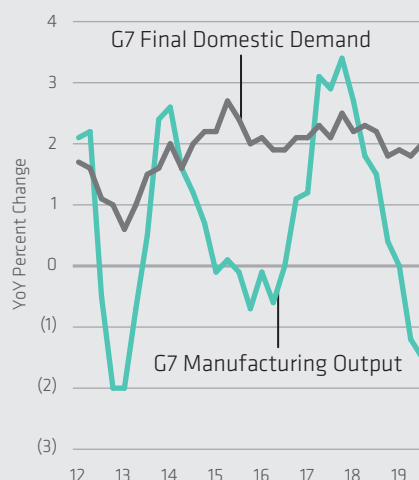
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**DISPLAY 1: WORLD TRADE IS COLLAPSING AND MANUFACTURERS ARE HURTING**

World Trade (Three-Month Moving Average)



Manufacturing Output and Domestic Demand



Historical analysis does not guarantee future results.  
Through September 30, 2019  
Source: Bloomberg Barclays, Haver Analytics and AB

began, markets were rattled and oil prices rose when the US killed a senior Iranian general in a drone strike and Iran threatened revenge.

It's not all doom and gloom, though. Developed-market consumers continue to spend and labor markets—particularly in the US—remain healthy. That's already prevented the manufacturing downturn from turning into a broader and more damaging economic slowdown, and it provides scope for optimism so long as weakness in manufacturing can be arrested, as now looks more likely.

For now, we think the case for urgent additional central bank stimulus has faded, but the risks are still tilted toward further easing. But it's not clear how effective additional easing will be in boosting global growth, particularly with interest rates already so low. Meanwhile, economic and political risks, including those tied to the 2020 US presidential election, remain high. In other words, we think it would be premature to declare that the economy has turned a corner.

We expect global economic growth to slow to 2.4% in 2020. That's better than we expected a couple of months ago but would still represent one of the weakest performances since the global financial crisis. And the risks are probably still skewed to the downside. So while recent developments have been encouraging, the outlook for the economy—and investors—remains highly uncertain.

### RAISING YIELDS, REDUCING VOLATILITY

Here's what does seem clear: bond yields are likely to stay low for some time to come, while market volatility should remain high. So how can institutions boost income and return potential in today's low-yielding, late-cycle world without taking on too much risk?

To start with, we think **US dollar–based investors should globalize their safety-oriented core fixed-income strategies—but hedge the currency exposure.** Even with the world economy losing momentum, this approach adds diversification, which can reduce volatility and increase return potential.

Next, investors may want to **consider stand-alone allocations to relatively new or overlooked sectors that offer an appealing mix of yield, quality and the potential to limit downside risk.** Two that we find attractive are **US securitized assets backed by commercial and residential mortgages** and **subordinated European bank debt.**

Let's take a closer look at how we think institutional investors can shape their fixed-income allocation to today's realities.

### IMPROVE YOUR CORE (BOND) STRENGTH

In our view, investors who have already globalized their core allocation have a distinct advantage in today's economy and capital markets. Going global widens the opportunity set, helping to provide the stability and income that investors expect from their core allocation—as well as diversification against their equity risk.

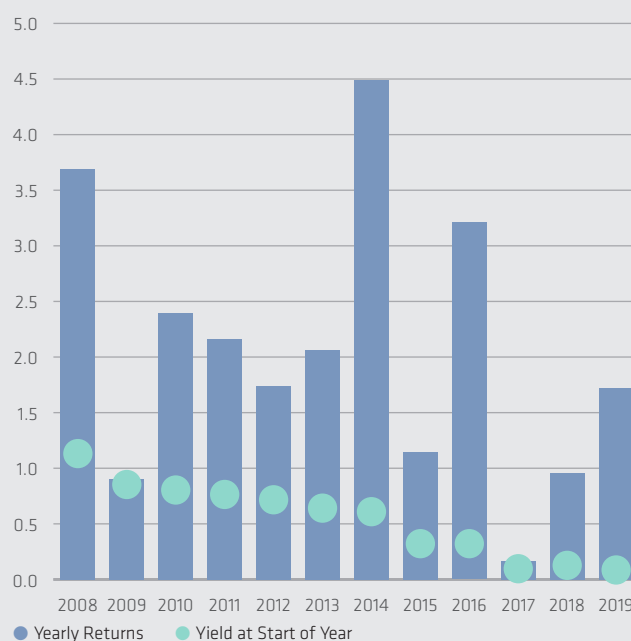
There are more than 24,000 bonds in the Bloomberg Barclays Global Aggregate Index, and varying business cycles, monetary cycles and yield curves around the world mean country-bond returns differ from year to year. Investors who stick to their domestic markets are leaving a lot of opportunity on the table—even in today's low-yield environment.

For instance, European government bond yields are far lower than those on comparable US Treasuries. But European yield curves are steep, so tactical exposure to longer-maturity eurozone debt can add return potential, capital appreciation, stability and diversification. And European Central Bank (ECB) easing is likely to keep euro-area yields from rising for some time.

Here's another thing to keep in mind: low yields don't have to mean negative returns. To see what we mean, let's look at Japanese government bonds, which have the longest recent history of very low yields. The 10-year Japanese government bond began the last three years with a yield near zero, and 11 of the last 12 years with a yield below 1%. But annual returns over this period averaged more than 2% (*Display 2*).

#### DISPLAY 2: LOW YIELDS DON'T HAVE TO MEAN NEGATIVE RETURNS

Case Study: Japanese Government Bond—Yield vs. Returns (Percent)



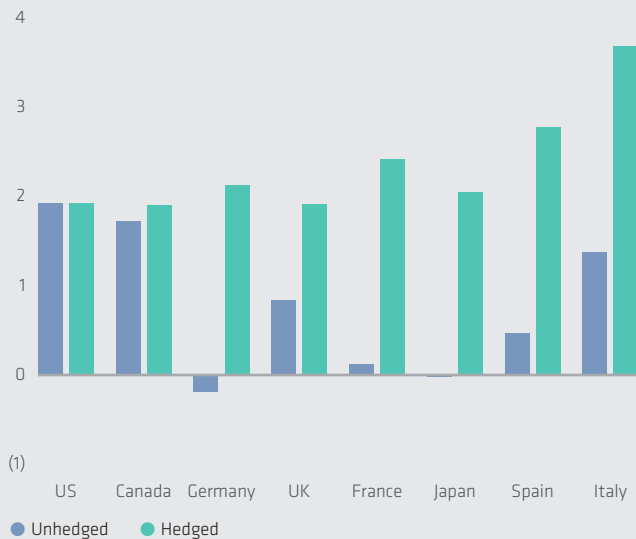
Past performance and historical and current analysis do not guarantee future results.

As of December 31, 2019

Source: Bloomberg Barclays, J.P. Morgan and AB

**DISPLAY 3: CURRENCY HEDGING CAN MAKE LOW-YIELD BONDS MORE ATTRACTIVE**

10-Year Bond Yield (Percent)



**Past performance and historical and current analysis do not guarantee future results.**

Hedge: A hedge is an investment to reduce the risk of adverse price movements in an asset, such as taking an offsetting position in a related security. As of December 31, 2019  
Source: Bloomberg Barclays and AB

It's been a similar story recently with European bonds, where falling yields have led to healthy capital appreciation. For instance, the yield on the Bloomberg Barclays Euro Aggregate Treasury Index, which includes government debt issued by the 19 countries that use the euro, began 2019 at 0.74% but by December 31 plunged to 0.21%. That amounted to a cumulative return of 6.77%.

**CURRENCY HEDGING: THE ANTIDOTE TO NEGATIVE YIELDS**

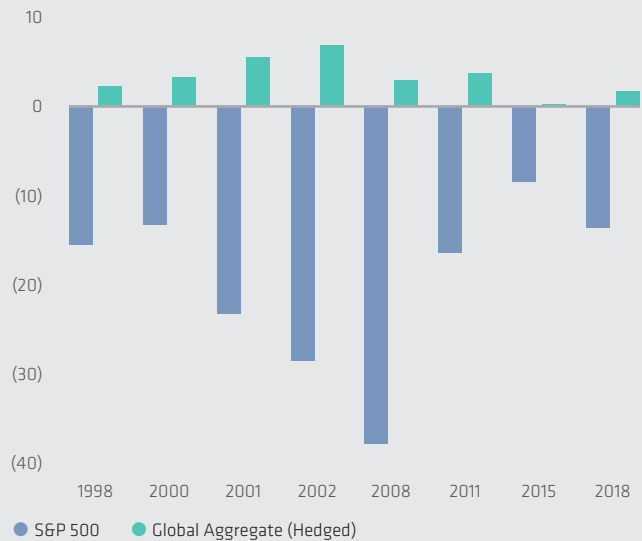
Of course, global yields aren't just low. Many developed-market bonds, including nearly half of the outstanding debt issued by eurozone governments, carry negative yields.

This is certainly a challenge. But for US investors, a group that has historically harbored a strong home-country bias in core strategies, and others with US dollar-based portfolios, it's also an opportunity—provided they hedge against currency risk.

For dollar-based investors today, hedged exposure to certain bonds not denominated in the US currency can also provide an attractive added yield. When hedging out currency exposure, investors are essentially selling the cash rate of the currency they are hedging from and buying the rate of the currency they're hedging to. So, depending

**DISPLAY 4: A VALUABLE OFFSET TO EQUITIES IN TIMES OF MARKET STRESS**

**Drawdowns: Equities and Global Bonds (Hedged to USD)**  
Return (Percent)



**Historical analysis does not guarantee future results.** Individuals cannot invest directly in an index. Global aggregate (hedged) represented by Bloomberg Barclays Global Aggregate hedged to USD. Return data correspond to the months when S&P 500 had its maximum drawdown for the year. As of December 31, 2019  
Source: Morningstar and AB

on the difference between short-term interest rates, hedging can either raise or lower a bond's yield.

While short-term US interest rates are low by historical standards they're considerably higher than the zero or negative rates that prevail in other developed countries. That's why hedging a euro- or yen-denominated bond to US dollars can raise yields considerably. As *Display 3* shows, the yield on a 10-year German bond jumps from (0.18)% to 2.12%. Ten-year French or Italian bonds offer even higher yields.

Our research has shown that a currency-hedged global core portfolio is often less volatile and can offer more diversified return streams than a US-only core portfolio. It's also less volatile than an unhedged global core allocation.

It's also important to remember that global bonds have provided a valuable offset to equity volatility. As *Display 4* illustrates, hedged global bonds held up well during the last eight large equity drawdowns, including during recent years when yields were low.

## US SECURITIZED ASSETS: HIGH RETURN POTENTIAL WITH LESS VOLATILITY

A well-designed global core strategy may help to boost return potential without requiring investors to assume undue risk. But it isn't enough. While many credit sectors, particularly in the US, are in the later stage of the cycle, abandoning return-seeking assets entirely isn't a viable option. At this stage in the cycle, it makes sense to focus on credit sectors exposed to the healthiest parts of the world economy, such as US consumer or banking.

In our view, two of the most attractive opportunities can be found in less traditional sectors of the global fixed-income market. First, we think **a stand-alone allocation to securitized products backed by US mortgages (commercial and residential) can boost income potential and dampen volatility—especially the kind caused by rising geopolitical risk.**

Commercial mortgage-backed securities (CMBS) offer a healthy yield pickup over corporate bonds, making them an attractive way to boost portfolio income. As of December 31, 2019, approximate loss-adjusted yields for a typical CMBS ranged from 3% to as high as 8%, compared with an average yield-to-worst in the US high-yield market of 5.19%.

This sector has been out of favor in recent years amid fear that the shift to online shopping will cause stores and shopping malls to default on their loans. This has driven down prices and pushed yield spreads wider on CMBX.6, a synthetic index tied to CMBS deals issued in 2012.

We think the worries about the retail sector are exaggerated, and that makes current CMBS valuations attractive. It's true that apparel retailers are retrenching and that as many as a third of American malls won't survive the upheaval in the retail sector. But that's only part of the story. When we dig deeper, we find that many mall owners across the country often support their assets, especially when the malls in question are regionally dominant. Such a mall has the power to consolidate tenants when other, obsolete competitors go out of business.

Even if the American mall were dying, avoiding CMBS altogether would be a mistake. Loans for shopping malls are just one of the many types (along with loans for apartment buildings, office parks, hotels, etc.) included in a CMBS, and they make up just a fraction of those in the CMBX.6, which has become a popular way for investors to bet against retail assets. (The way we see it, the index isn't even an efficient way to short shopping malls; these assets have just a 17% weight in the CMBX.6, and only 1% are considered Class C, as struggling malls at risk of closure are defined.)

Institutional investors may also want to consider exposure to credit risk-transfer (CRT) securities, residential mortgage-backed bonds issued by the US government-sponsored enterprises Fannie Mae and Freddie Mac.

CRTs benefit from a still-solid US housing market: home affordability has improved in most regions, and while minor corrections in some high-income areas of the country may slow home-price appreciation, they're unlikely to stop it outright. Reduced supply due to a lack of speculative building should also put a floor under home prices, as will demand from millennial buyers in their early 30s, the typical age of most first-time homebuyers in the US. And a strong US labor market means most borrowers can make their mortgage payments.

Unlike traditional agency bonds, CRTs do not come with a government guarantee. If many underlying home loans were to default, private investors would absorb a share of the losses.

Still, we think the risk-reward trade-off is an attractive one. Underwriting standards have been high—the majority of loans over the last five years have gone to borrowers with credit scores of 750 or higher—while realized losses have been below expectations. What's more, falling rates have meant faster prepayment as borrowers rush to refinance. Faster prepayments mean fewer borrowers in the loan pool who might default. Both of these factors explain why many CRTs have been upgraded to investment-grade status, yet still offer compelling yields.

There's another reason to consider exposure to US commercial and residential mortgages: these securities have been a good way to offset trade-war-related volatility. As *Display 5* shows, CMBS and CRTs have weathered the ups and downs of the US-China trade war better than US high-yield credit. Just as important, securitized assets are uncorrelated with government debt and exhibit low correlations to other fixed-income sectors, including US high yield and US equities.

### EUROPEAN BANK BONDS: DIGGING DEEP FOR VALUE

We also think investors can boost yield potential without taking too much risk by allocating to **subordinated financial bonds—especially those issued by European banks.**

These securities were issued to comply with the global Basel III banking regulations that required banks to build up equity capital

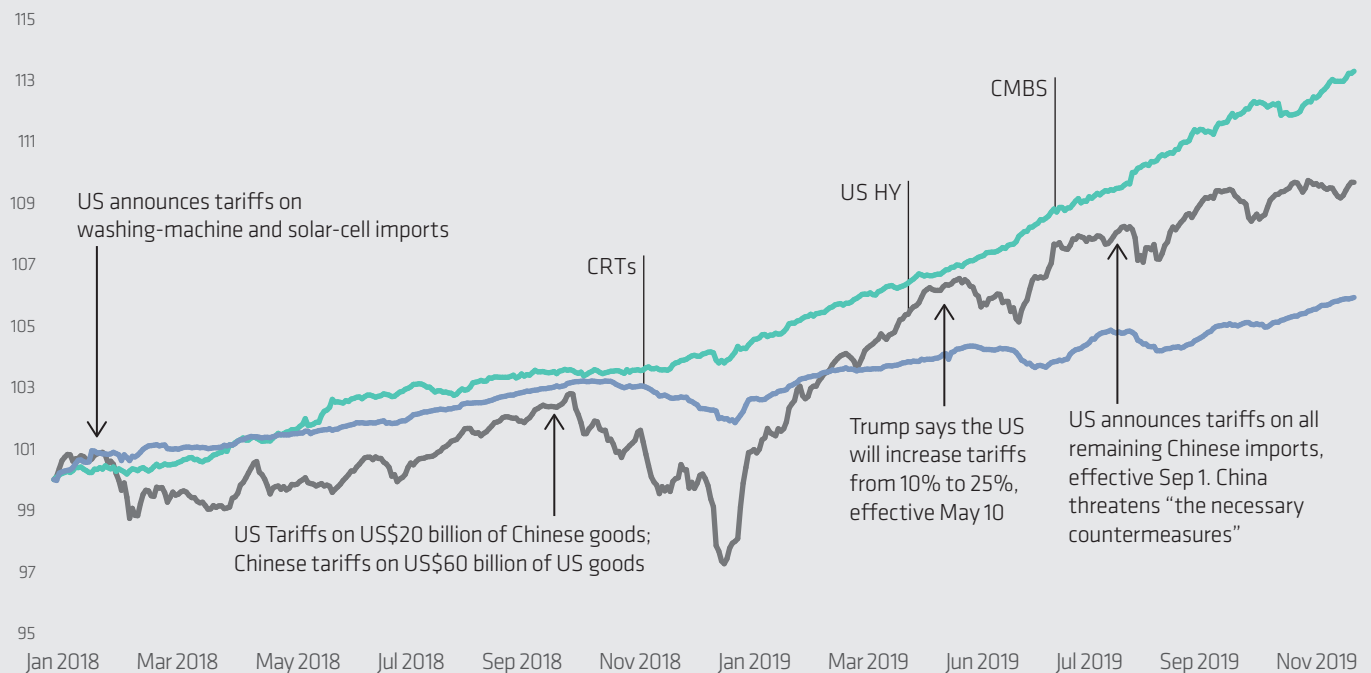
buffers, preventing taxpayers from having to foot the bill for bank bailouts as they did during the global financial crisis. Yields are attractive in this US\$237 billion market because the securities can be used to soak up losses if a bank's capital ratio should fall below a predetermined level. In extreme cases, issuers can suspend coupon payments, convert the bonds to common equity or write them off entirely.

The good news is that developed-market banks are broadly in good health today, making the risk-reward trade-off attractive. Following the global financial crisis, most went through a deleveraging cycle, improved capital ratios and now hold fewer nonperforming loans.

But because they're lower in the capital structure, subordinated bonds issued by banks with investment-grade ratings yield like

#### DISPLAY 5: SECURITIZED ASSETS—INSULATION FROM TRADE FLARE-UPS

CRTs and CMBS Have Held Up Well During Periods of Trade Tensions



**Historical analyses do not guarantee future results.** CRTs and CMBS are represented by the bonds (including CMBX.6 holdings) held in those sectors in an AB-managed fixed-income portfolio, and are therefore not intended to represent a generally accepted proxy/benchmark for these markets. For illustrative purposes only Through November 30, 2019  
Source: Bloomberg Barclays and AB

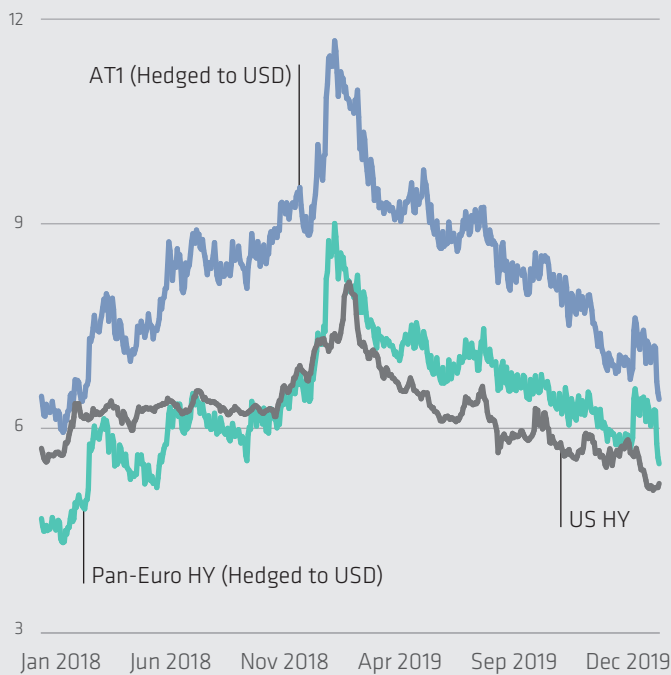
speculative-grade securities—even the bonds issued by European national champion banks. In recent years, yields on European additional Tier 1 (AT1) bonds, the first fixed-income securities that would take a hit if the issuing bank ran into trouble, have comfortably outstripped those on European and US high-yield bonds. And while low interest rates can hurt bank profitability, it's bank stocks—not bonds—that typically suffer as a result (*Display 6*). Bank bonds, on the other hand, benefit from solid balance sheets.

European bank debt, which makes up about half of the subordinated debt market, is particularly attractive for two reasons. First, European financials are in a slightly earlier stage of the credit cycle than their US counterparts. Also, future supply will be limited, since most Basel III-compliant securities have already been issued and future issuance will mostly be tied to refinancing needs. This should help to support prices.

**DISPLAY 6: AT1s HAVE ADVANTAGES OVER HIGH-YIELD CREDIT AND STOCKS**

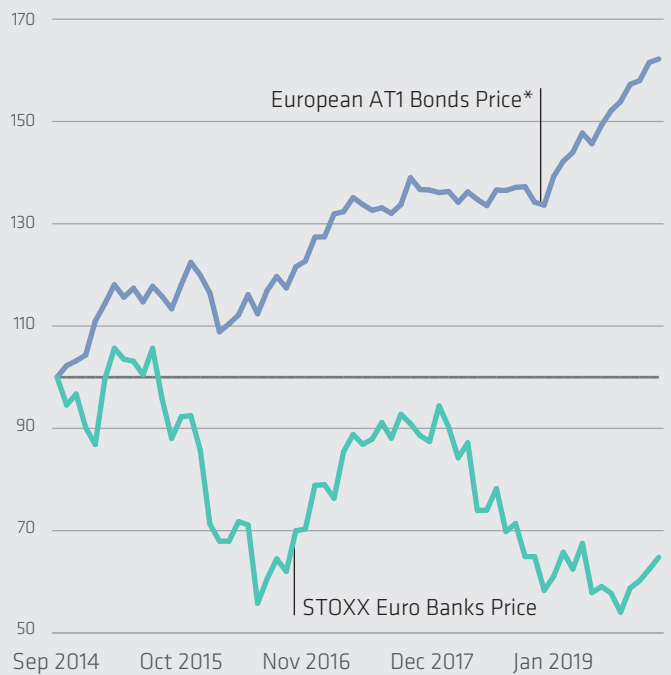
**AT1 vs. US, European High Yield**

Yield to Worst (Percent)



**Negative Rates Hurt Bank Stocks More than Bonds**

Growth of €100



Historical and current analyses do not guarantee future results.

CoCo: contingent convertible

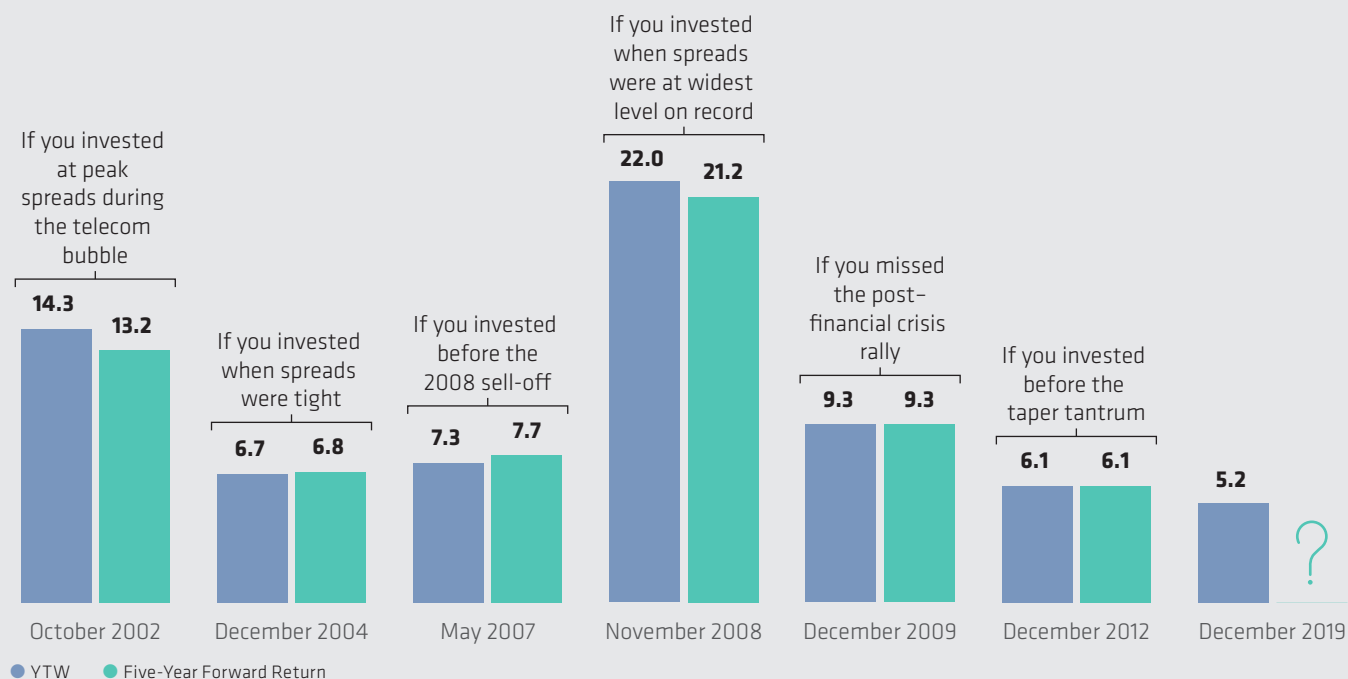
\*European AT1 Bonds is represented by the Bloomberg Barclays Euro CoCo Tier 1 Index.

Through December 31, 2019

Source: Bloomberg Barclays, European Banking Authority and STOXX

## DISPLAY 7: STARTING YIELD HAS BEEN A RELIABLE INDICATOR OF FUTURE RETURNS

Starting Yield to Worst and Five-Year Forward Annualized Return (Percent)



### Historical and current analyses and forecasts do not guarantee future results.

Global corporate high yield is represented by Bloomberg Barclays Global Corporate High-Yield (USD Hedged); US corporate high yield is represented by Bloomberg Barclays US Corporate High-Yield. Indices are used for comparison purposes only. An investor cannot invest directly in an index, and its performance does not reflect any fees and expenses or represent the performance of any AB fund.

As of December 31, 2019

Source: Bloomberg Barclays and AB

## PICKING THE RIGHT SPOTS

For investors looking for additional credit exposure beyond these areas, we recommend selective exposure to the following sectors, each of which can address specific portfolio needs and increase diversification.

**In US investment-grade credit, we see value in select BBB-rated bonds.** Leverage at many of these companies surged while borrowing costs were low, but we think the market has overestimated how many bonds are at imminent risk of becoming fallen angels, as bonds that lose their investment-grade status are known.

Many companies with BBB– ratings—the lowest rung on the investment-grade ladder—have prioritized debt reduction, with a corresponding decline in debt and an increase in interest coverage. And many still have healthy earnings. Caution is warranted in sectors with high exposure to global trade, high leverage metrics or both. Some issuers in telecom, healthcare and consumer goods may be at higher risk of downgrade. Still, we believe active investors can take

advantage of BBB bonds, which offer yields like those available in the high-yield market.

**We still see value in US high-yield bonds.** Because high yield is about half as volatile as equities, shifting some equity exposure to the high-yield market can end up lowering overall portfolio risk while only modestly curbing return potential. Focusing on shorter-maturity high-yield bonds, which tend to do better when the US Treasury and credit yield curves are flat, may dampen volatility even more.

Investors who have maintained exposure to high-yield debt across market cycles have been rewarded for it. As *Display 7* illustrates, the starting yield has been a remarkably reliable indicator of what investors can expect to earn over the next five years. This has held true even during the market's most stressful and volatile periods. With a current yield around 5.19%, the expected returns from high-yield bonds are not far below our expected forward equity returns.

**Finally, emerging-market (EM) debt can be a good diversifier for a fixed-income allocation, but selectivity is key.** Hard-currency high-yield sovereign bonds issued by EM countries still offer a substantial yield advantage over US high-yield corporate bonds (*Display 8*), and we see pockets of value in the sector. But with valuations since having tightened, the scope for broad-based returns in 2020 isn't as strong. Investors will have to be choosy about where they take their risk.

Overall, though, the dovish tilt by developed-market central banks should continue to support EM debt more broadly, and economic fundamentals in many EM countries have improved markedly in recent years.

### SUMMING IT UP

An increase in trade tensions and other geopolitical risks suggest that the global economy is still in some danger. A pivot by policymakers from monetary to fiscal policy would help support growth, but we're not convinced that governments will be able to move quickly enough to make much difference this year. For fixed-income investors,

this means one thing: the era of ultralow yields and the investment challenges they bring is not likely to end soon.

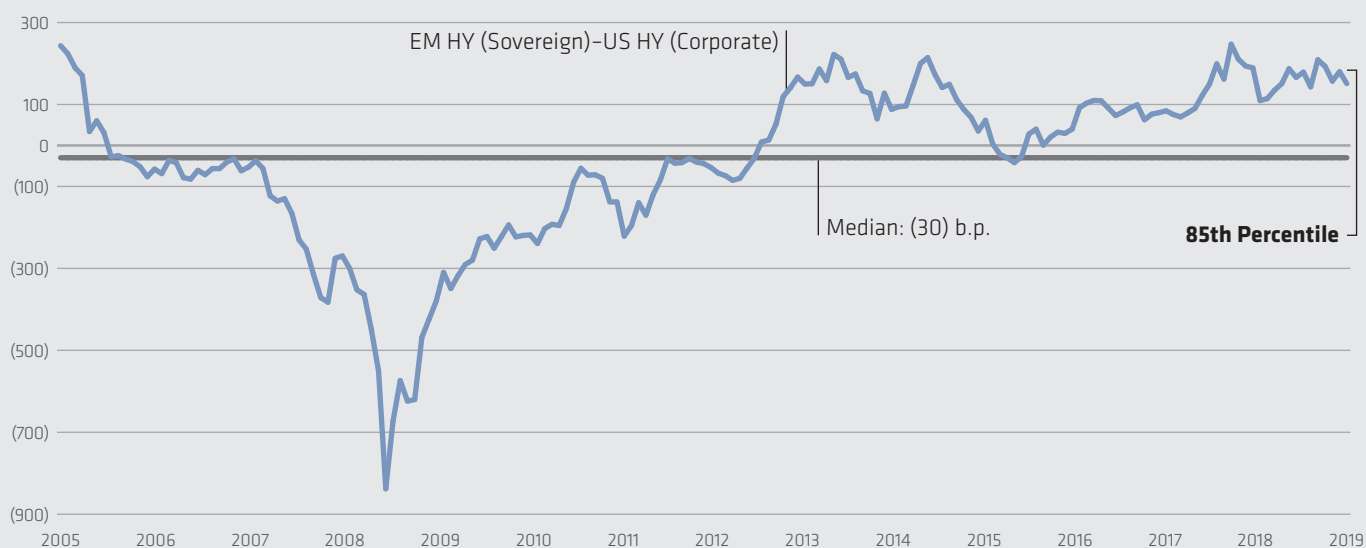
That doesn't mean investors should give up on earning a decent return in their fixed-income strategies. Investors who globalize and hedge their core bond allocations back to US dollars are likely to get better diversification and increase return potential by capitalizing on interest-rate differentials between the US and other regions.

It's just as important to seize opportunities in pockets of the market that offer an attractive mix of return potential and credit quality. We see that today in subordinated European bank debt and US commercial and residential mortgage-backed securities.

No matter the prevailing market and macroeconomic conditions, a robust and well-designed fixed-income allocation remains the anchor of investors' overall asset allocation. Institutions with long time horizons have an advantage in their ability to ride out periods of slow growth and high volatility. But the way we see it, building a fixed-income strategy that maximizes return potential without boosting downside risk can provide a smoother ride.

**DISPLAY 8: EM HARD-CURRENCY HIGH-YIELD SOVEREIGNS LOOK CHEAP VS US HIGH YIELD**

Spread (Basis Points)



**Historical analysis is for illustrative purposes only.**

EM HY (sovereign) is represented by J.P. Morgan EMBI (HY) and US HY (corporate) by Bloomberg Barclays US Corporate HY; spreads are option adjusted.

Through June 30, 2019

Source: Bloomberg, Bloomberg Barclays, J.P. Morgan and AB



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