



# The Future of Fixed-Income

## Niagara Institutional Dialogue

Philippe Lespinard



**Schroders**

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# Outlook for Fixed Income

## Agenda

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1. The Great Reflation
2. Policy outlook
3. Political outlook
4. Economic rebalancing
5. Market outlook
6. Conclusion

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# The Great Reflation

An unprecedented combined effort to combat recession

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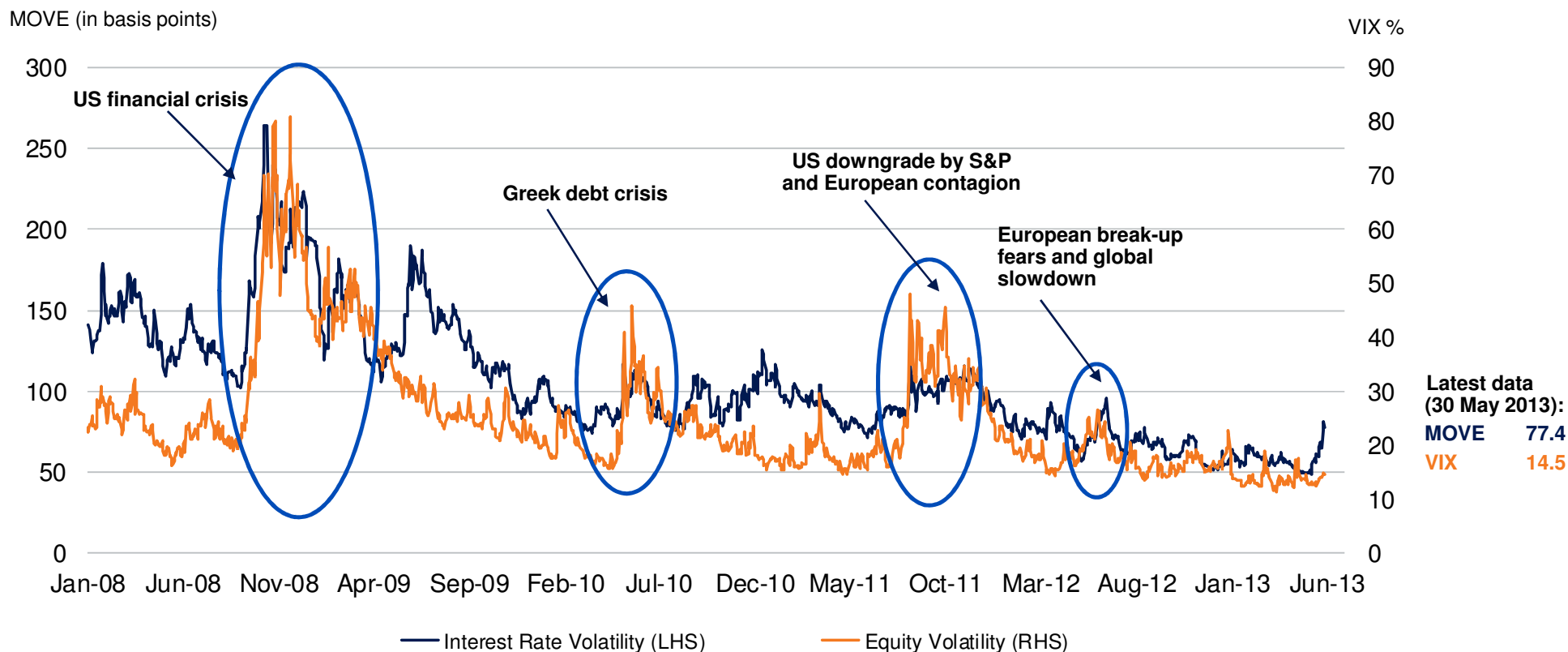
<b>2008- 2012 Cumulative USD trillion</b>	<b>Government Budget Deficits</b>	<b>Central Bank Balance Sheet Expansion</b>	<b><i>Central Bank Asset Purchase Program</i></b>
US	\$6.8	\$2.0	\$3.2
Japan	\$2.1	\$0.6	\$2.2
Eurozone	\$2.8	\$2.0	\$0.4
UK	\$0.4	\$0.2	\$0.6
China	\$0.6	\$1.8	-
<b>Total</b>	<b>\$12.7</b>	<b>\$6.5</b>	<b>\$6.4</b>

Source: Thomson Datastream, Schroders, 14 January 2013

# The Great Reflation

What do you get for \$20tn? Lower volatility

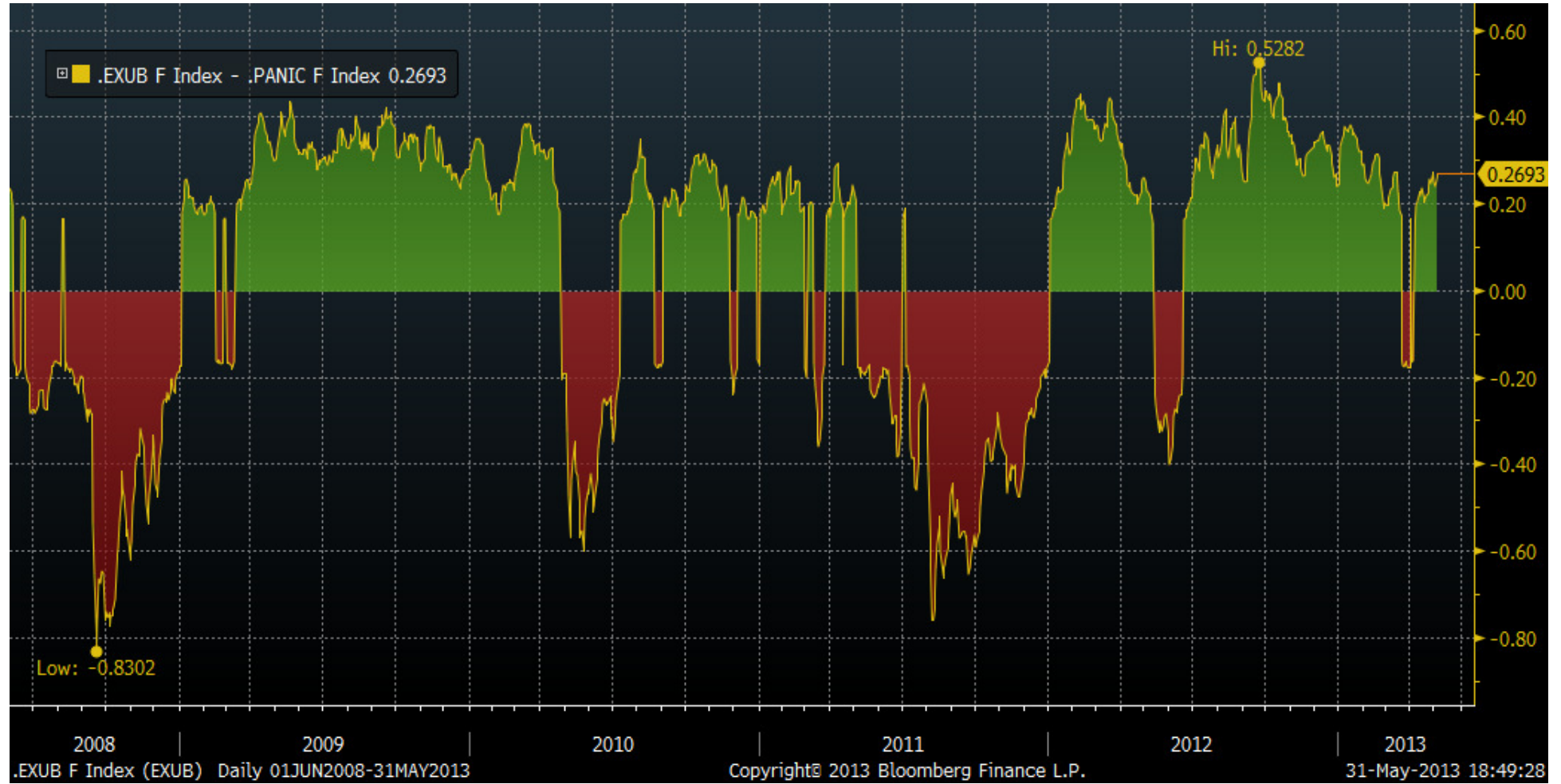
## Measures of Implied Volatility



Interest Rate volatility is measured by the MOVE Index which is calculated as the weighted average of implied volatility of 1 month option expirations on the current 2-, 5-, 10- and 30-year Treasuries; Equity Volatility is measured by the VIX Index which is an exchange traded contract on the CBOE based on real-time prices of options on the S&P 500 Index  
Sources: Bloomberg, Bank of America Merrill Lynch and Chicago Board of Options Exchange; daily data through 30 May 2013

# The Great Reflation

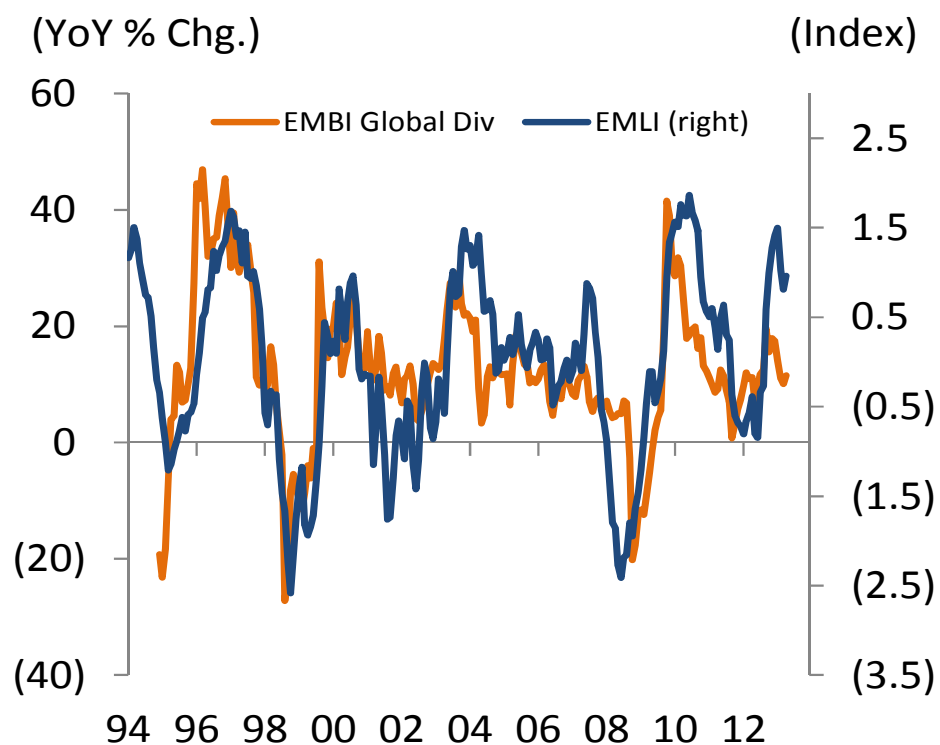
What do you get for \$20tn? Exuberant markets



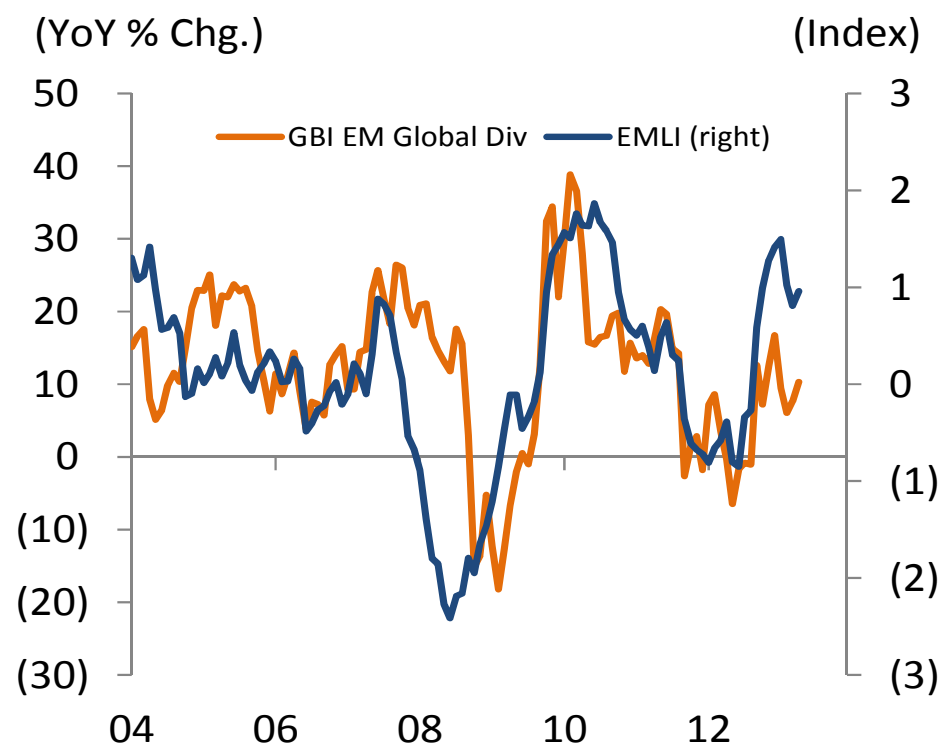
# The Great Reflation

What do you get for \$20tn? Abundant liquidity leaking into emerging markets

### EMLI and EMBI Global Diversified Index Returns



### EMLI and GBI-EM Global Diversified Index Returns



Source: JPMorgan and Schroders; As of April 30, 2013

Charts are for illustrative purposes and should not be viewed as a recommendation to buy or sell. The EMLI is a measure of the change in net capital inflows to emerging markets.

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# Policy Outlook

Another \$4tn on the way

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2013 USD trillion	Government Budget Deficits	Central Bank Asset Purchase Programs
US	\$1.0	\$1.0
Japan	\$0.6	\$0.5*
Eurozone	\$0.2	-**
UK	\$0.1	\$0.1
China	\$0.3	-
<b>Total</b>	<b>\$2.3</b>	<b>\$1.8</b>

Source: Oxford Economics, Thomson Datastream, Schroders, 15 January 2013

2013 figures converted into USD using end of 2012 FX rates.

\*Only purchases of Japanese government bonds (JGBs)

\*\*The ECB's OMT program is dependent on market circumstances

Forecast risk warning: Please refer to the important information slide at the end of the presentation

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# Policy Outlook

## Puts everywhere

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- The “**Bernanke Put**”: deep in the money
  - Unconditional commitment to keep rates low until 2014
  - Conditional commitment to continue QE until the US unemployment rate reaches 6.5%
- The “**Draghi Put**”: out of the money
  - Commitment to do “whatever it takes to save the euro”
  - Conditional on the German parliament’s approval of the use of EFSF/ESM funds
- The “**Abe/Kuroda Put**”: deep in the money
  - Commitment to push Japanese inflation up to 2%
- The “**King/Carney Put**”: in the money too?
  - Commitment to push UK nominal growth to 5%



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# Report Card on Central Banks

Non-standard policy: competing theories

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## In the Blue Corner: Portfolio Balance Channel

Interest rates ↓

Asset Prices ↑

Investor Confidence ↑

Consumer Confidence ↑

Consumer Spending ↑

Corporate Confidence ↑

Corporate Investment ↑

Employment & Wages ↑

## In the Red Corner: Non-Neutrality of Money

Money Supply ↑

Price Level ↑

Economic Activity ↔

Redistribution of Wealth ↔

Income Inequality ↑

Social Tensions ↑

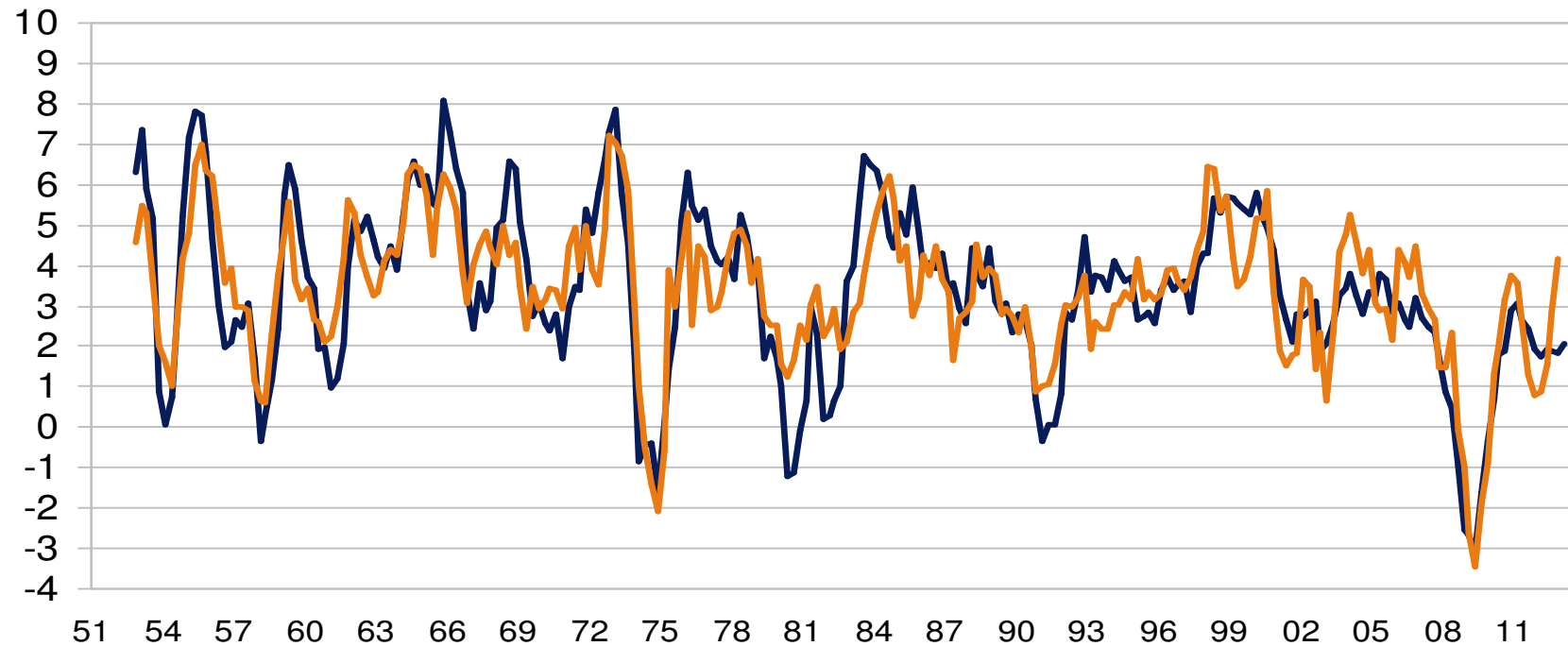
Beware the “cobra effect”

# Report Card on Central Banks

## Non-standard policy impact: US consumption

- In the US:  $\Delta C = 0.75 + 0.66 * \Delta I + 0.12 * \Delta W + \varepsilon$

y/y%



— US real consumer spending growth, y/y%    — Estimated

\* Source: Schroders. C = Consumer Spending, I = Net Income, W = Net Wealth

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# Report Card on the Economic Recovery

The US is well ahead of the Eurozone

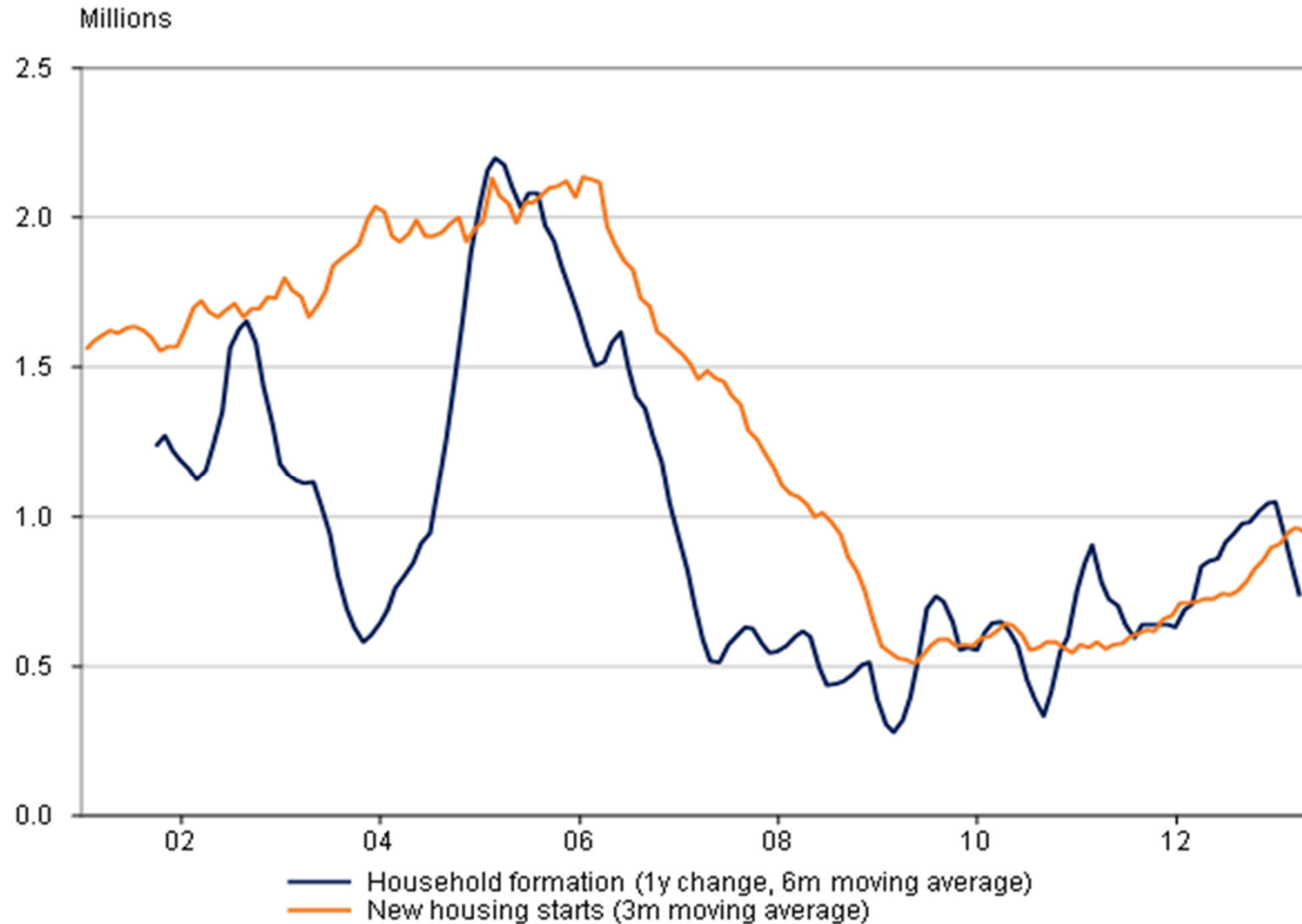
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	US	UK	EZ	Core	Periphery
Financial sector stability	✓	✓	✗	✓	✗
Lending growth	✓	✗	✗	✗	✗
Housing prices stability	✓	✓	✓	✓	✗
Private investment growth	✓	✗	✗	✗	✗
Fiscal deficit reduction	✗	✓	✓	✓	✓
Improving competitiveness	✓	✓	✗	✗	✓

Source: Schroders at January 2013

# US Housing Turning Positive

Household formation is supportive of new construction



Source: Thomson Reuters Datastream, Schrodgers, Updated 05/06/2013

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# Economic Rebalancing

Much more to do to move away from debt-financed consumption

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Country	Private consumption % of GDP	Public consumption % of GDP	Total consumption % of GDP
US	70.6	16.2	86.8
UK	62.6	23.6	86.2
France	58.2	24.6	82.8
Italy	59.9	20.7	80.5
Spain	57.3	20.7	78.1
Japan	58.7	19.0	77.7
Germany	56.8	19.2	76.0

**As consumption declines as a share of output, it must be replaced by investment and productivity**

Source: Thomson Datastream, January 2013

Note: Based on real figures, average between Q4 2007 – Q3 2012.

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# Political Outlook

## Many hurdles but no crisis

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- In the US:
  - From the fiscal cliff to the fiscal bungee
  - Republicans hope to fight on the Debt Ceiling, Continuing Resolution and Budget Sequesters
- In the EU:
  - Slow progress towards political and fiscal union
  - Plans for a banking union are facing major technical and political hurdles
- Middle-East
  - The region is the most unstable since the fall of the Shah in 1979
  - US policy is drifting with a focus on preventing terrorism without a strategic doctrine

**Markets are not priced for an accident**

# Market Outlook

## Distribution of expected returns from US treasuries

- Assuming a stable yield curve

Investment Horizon	Years	1	2	3
Compound Return		1.2%	2.4%	3.6%
Compound Volatility		4.2%	5.9%	7.2%
	Max.	7.6%	4.3%	3.2%
	99%	7.3%	4.2%	3.2%
	95%	6.3%	3.8%	2.9%
	90%	5.4%	3.4%	2.6%
	75%	3.4%	2.3%	1.8%
<b>Annualized Return</b>	<b>50%</b>	<b>1.2%</b>	<b>1.2%</b>	<b>1.2%</b>
	25%	-1.6%	-0.8%	-0.4%
	10%	-4.1%	-2.6%	-1.9%
	5%	-5.7%	-3.7%	-2.8%
	1%	-8.5%	-5.8%	-4.6%
<b>Negative Return</b>	<b>Prob.</b>	<b>39%</b>	<b>34%</b>	<b>31%</b>

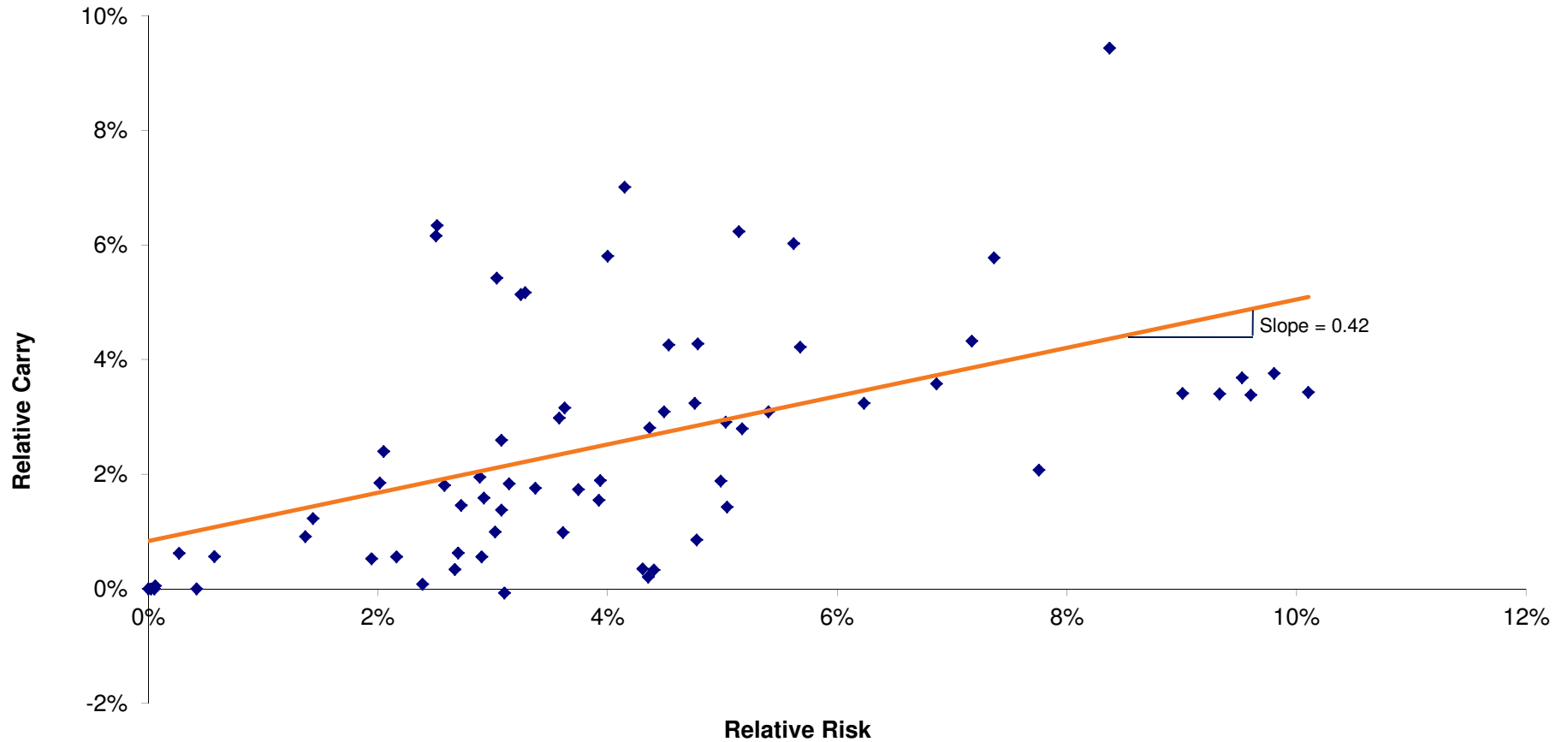
- Using forward yield curves

Investment Horizon	Years	1	2	3
Compound Return		0.1%	-0.1%	-0.2%
Compound Volatility		4.2%	5.9%	7.2%
	Max	7.6%	4.3%	3.2%
	99%	7.2%	4.1%	3.1%
	95%	5.9%	3.5%	2.6%
	90%	4.8%	2.9%	2.2%
	75%	2.6%	1.5%	1.1%
<b>Annualized Return</b>	<b>50%</b>	<b>0.1%</b>	<b>0.0%</b>	<b>-0.1%</b>
	25%	-2.7%	-2.1%	-1.7%
	10%	-5.2%	-3.9%	-3.3%
	5%	-6.7%	-5.0%	-4.2%
	1%	-9.5%	-7.2%	-6.0%
<b>Negative Return</b>	<b>Prob.</b>	<b>49%</b>	<b>51%</b>	<b>51%</b>

Sources: Bank of America Merrill Lynch, Schroders. Data as of 31/05/2013  
 Forecast risk warning: Please refer to the important information slide at the end of the presentation

# Market Outlook

The global credit curve shows that carry-to-risk is only marginally expensive

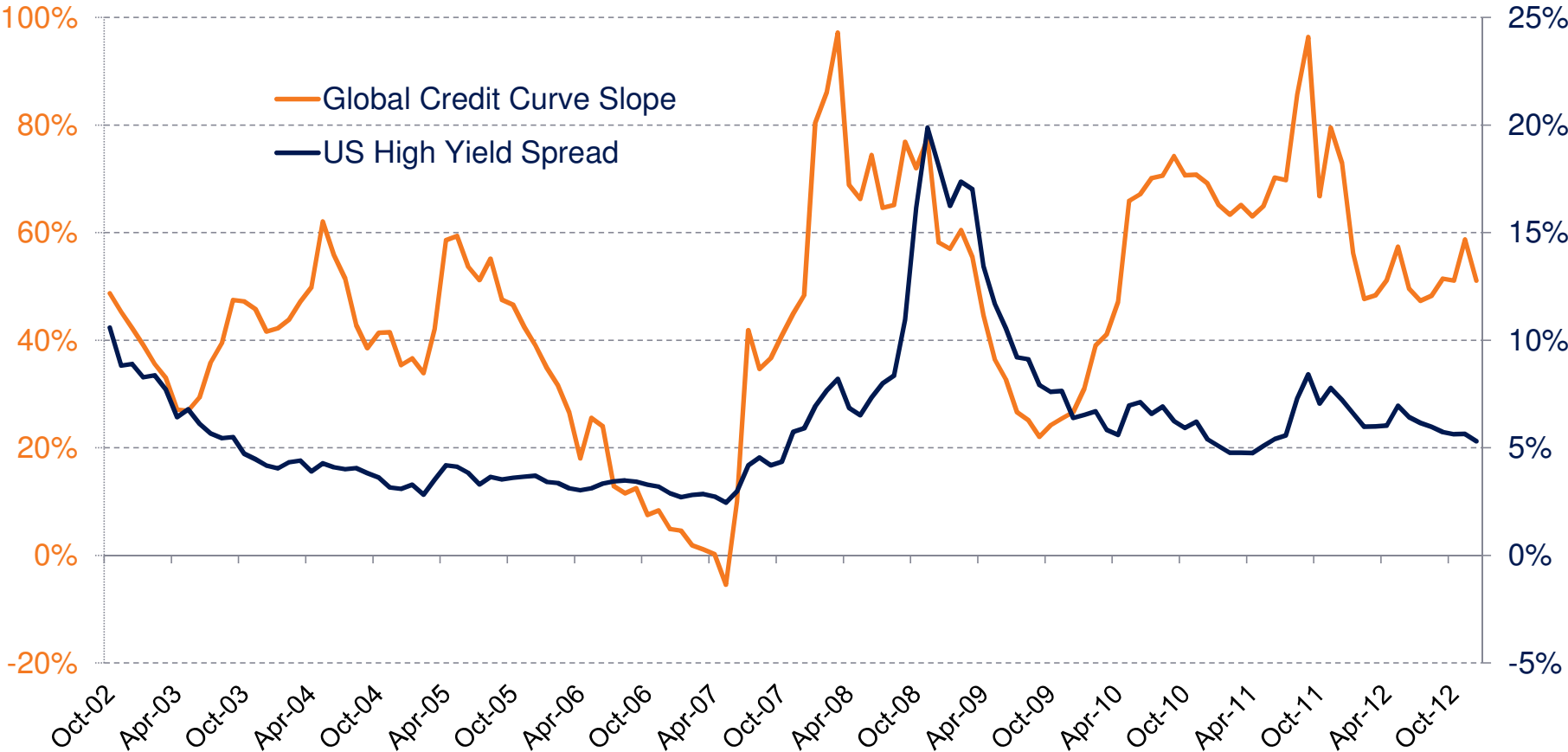


Currency-hedged yields in excess of LIBOR plotted against 12-month volatility of returns in excess of LIBOR for 69 fixed income market sectors  
Sources: Bank of America Merrill Lynch, Schrodgers. Data as of 31/05/2013



# Market Outlook

The global credit curve shows that carry-to-risk is fair value

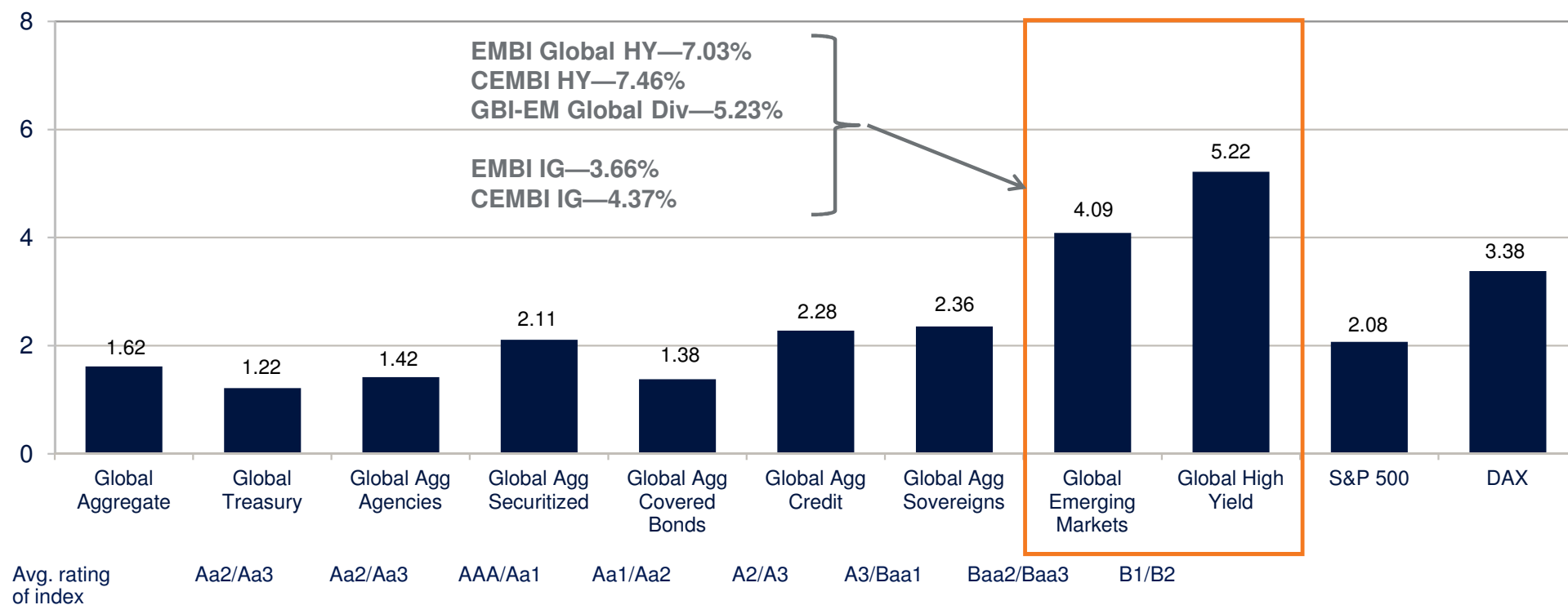


Currency-hedged yields in excess of LIBOR plotted against 12-month volatility of returns in excess of LIBOR for 69 fixed income market sectors  
Sources: Bank of America Merrill Lynch, Schroders. Data as of 31/12/2012

# Global High Income: A Global Opportunity Set

High yield bonds provide more income than other alternative investments

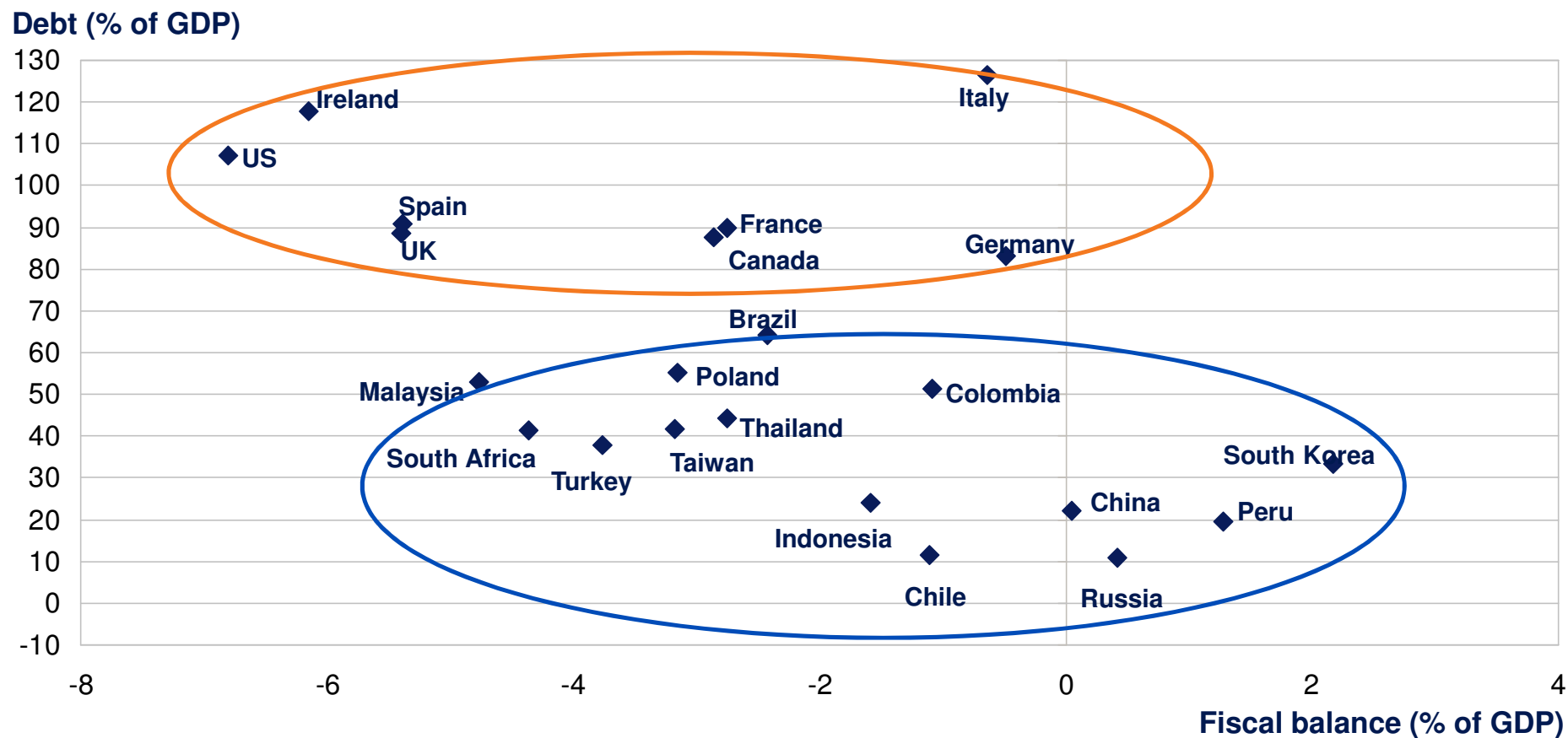
Yield (in %)



Yields for all fixed income sectors reflect the yield-to-worst of the respective Barclays Capital index; yields for equity indices reflect the dividend yield; data as of 30 April 2013  
The Global Credit index is the Barclays Capital Global Aggregate Credit Index, and the Global HY index is the Barclays Capital Global High Yield Corporate ex CMBS & EMG 2% Issuer Capped Bond Index  
Sources: Barclays Capital Live, Bloomberg

# Market Outlook

“Emerging markets” are now high quality



Source: IMF World Economic Outlook, Thomson Datastream, Schroders, 15 January 2013

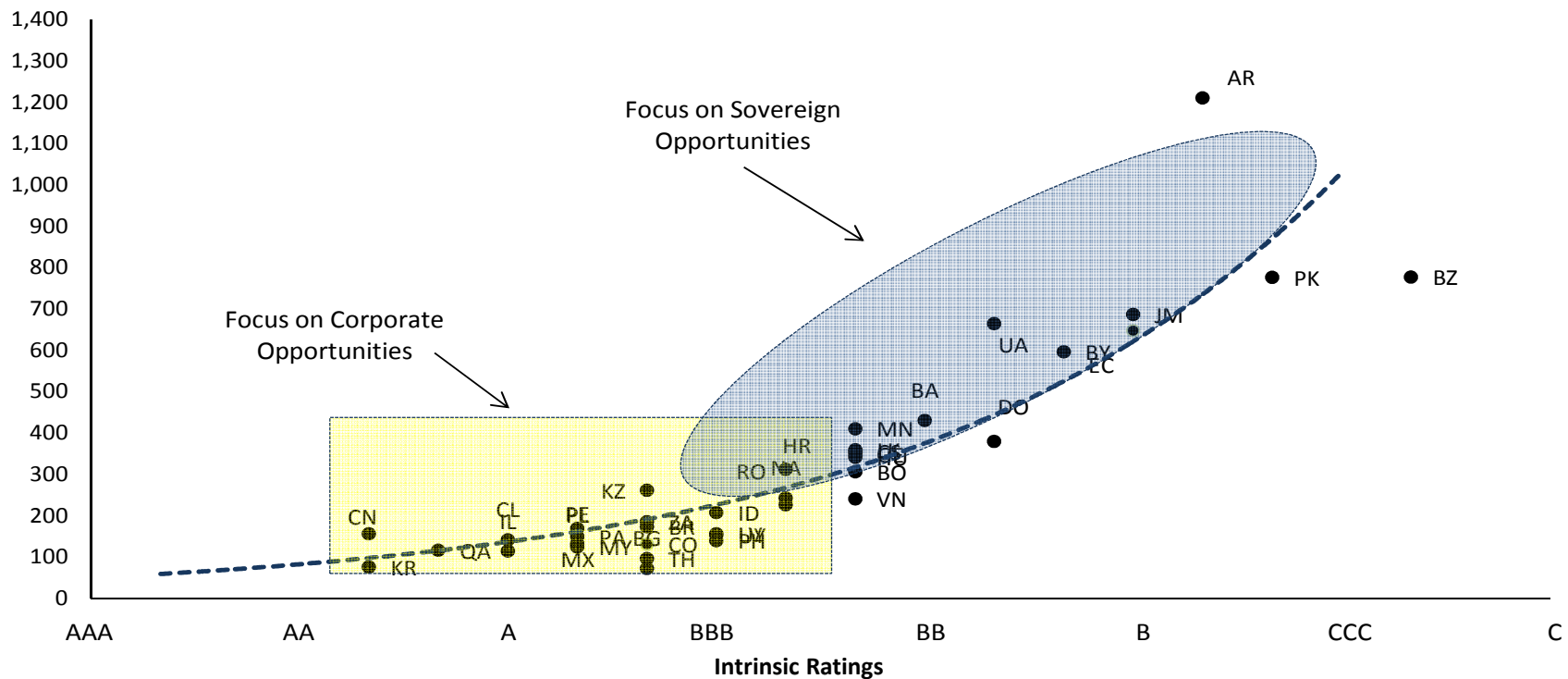
Note: Debt is general government gross debt as a % of GDP, fiscal balance is general government structural balance as a % of potential GDP.

# Sovereign and Corporate: Security Selection

Finding the most attractive “Strategic Markets” along the global credit curve

## Intrinsic sovereign ratings and value discovery

Spreads (Basis Points)



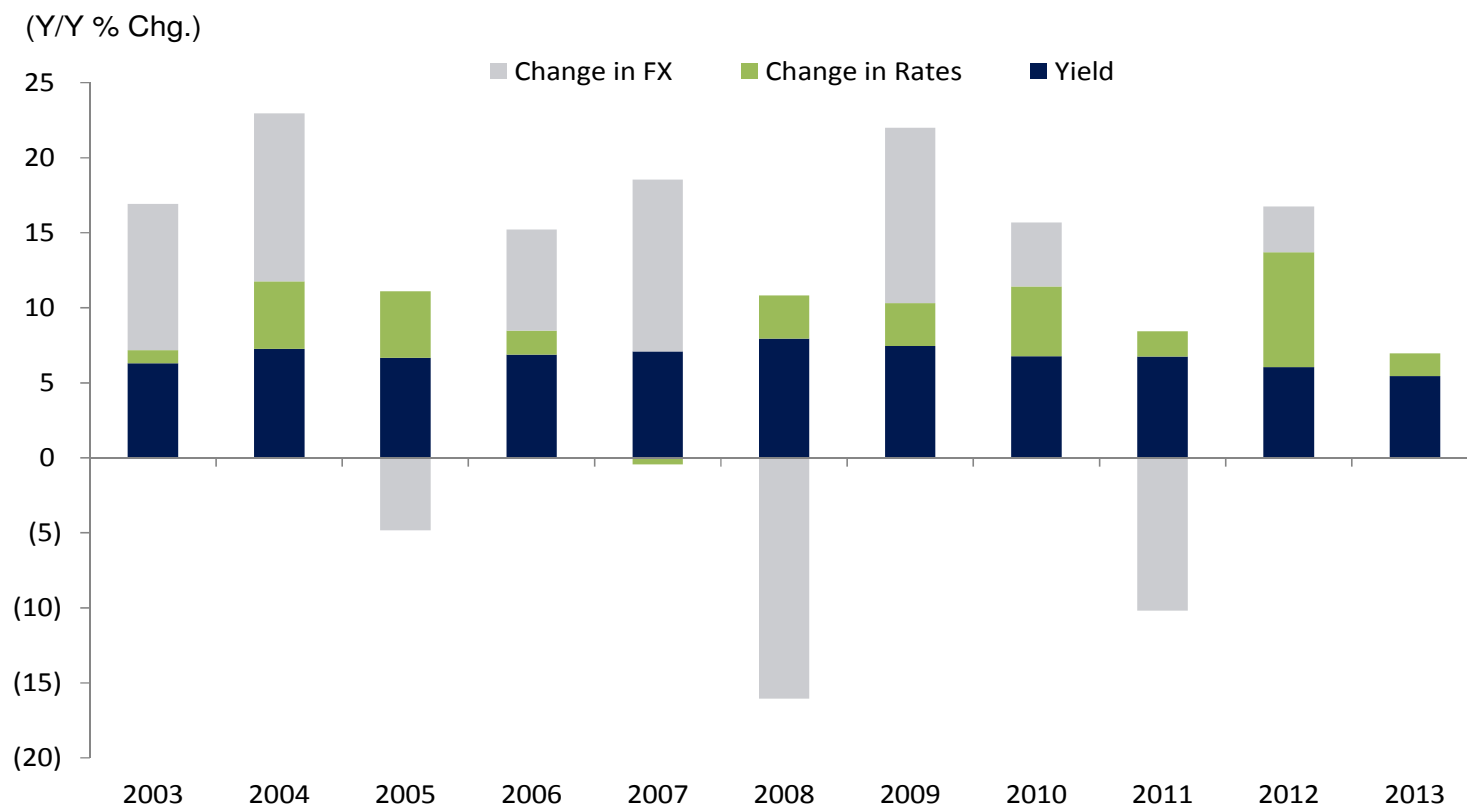
Source: Schroders; As of April 30, 2013

Charts are for illustrative purposes and should not be viewed as a recommendation to buy or sell. Analysis and data are subject to change. Each data point represents a specific bond within the JPMorgan CEMBI index.

# In Local Markets, Currencies Should Dominate Rates in 2013

The rally in rates drove local currency returns last year

## Return Components of GBI-EM Global Diversified Index



Source: JP Morgan, Bloomberg and Schroders; 2013 reflects actual FX and rates percent changes year-to-date and average yields through April 30, 2013  
Charts are for illustrative purposes and should not be viewed as a recommendation to buy or sell.

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# Conclusion

The silver lining: uncertainty creates volatility, volatility creates opportunity

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## A great rebalancing has to occur

- Currencies will be the transfer mechanism for much of the imbalance – exploit them
- Markets will overshoot in each direction, creating tactical opportunities – trade them
- From time to time, this will result in markets offering cheap hedges – use them
- Bank deleveraging will lead to a higher credit spread equilibrium than in the past – stay engaged
- Secular opportunities in Asia and EMD will continue to be present – commit to them (but be aware of volatility!)

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# Fixed Income Carry

## Asset classes

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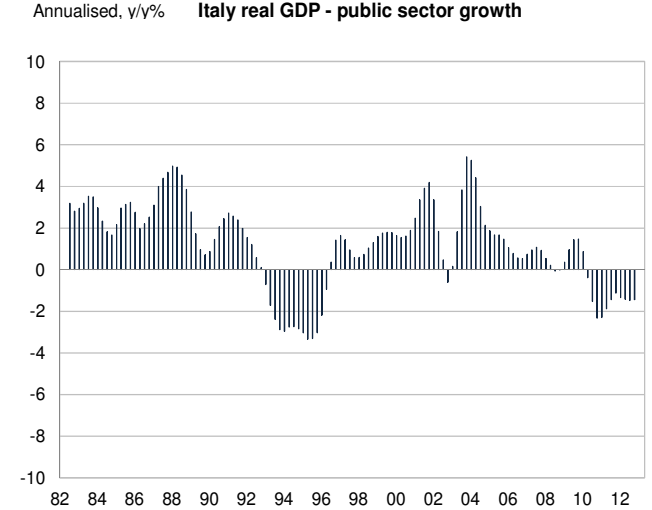
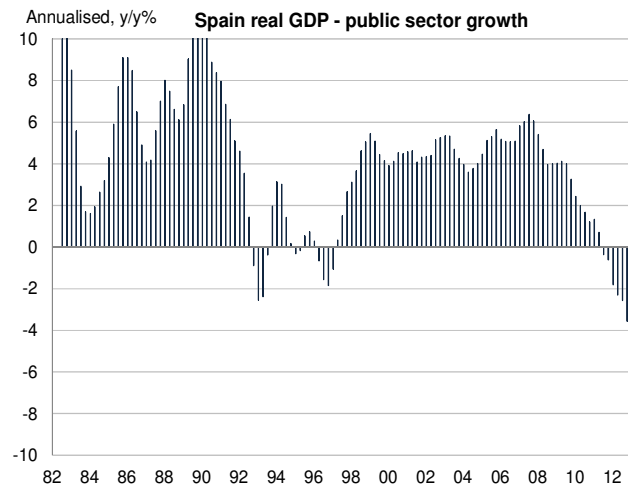
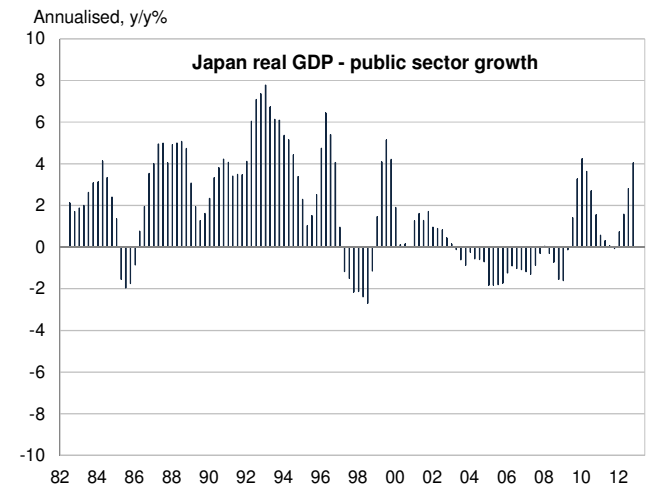
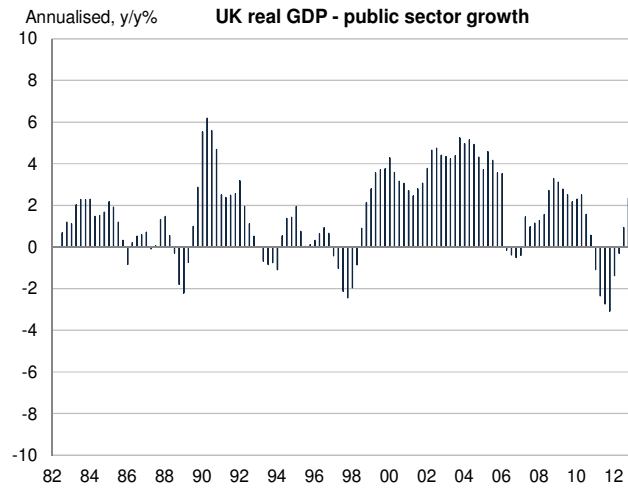
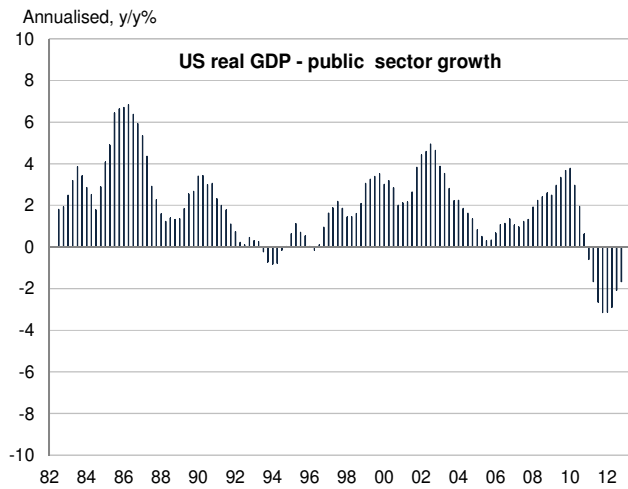
- We track the yield, total return and risk (volatility of total return) dynamics of the following fixed income asset classes:

US Asset Backed	Municipals 1-5 Yrs AA-AAA	Australian Corporate	UK Gilts
USD Non Financial Constrained	EMU Securitised/Collateralised	EMU Corporate Non-Financial	US Treasury
US High Yield	EM Sov&Cred Asia (USD)	Brazil Sovereign Debt (USD)	Canadian Govt
US Mortgage	EMU Quasi-Govt	EM Sov&Cred Latam (USD)	Swiss Govt
Asian Dollar IG Corporates	South Korea Sovereign Debt (USD)	Philippines Sovereign Debt (USD)	German Govt
Build America Bond 1-12yr	EUR 1m Libor	Japanese Govt	Australian Broad Market
Asian Dollar HY Corporates	EMU Broad Market	Sterling Lower Tier 2	New Zealand Govt
EM Sov&Cred Emea (USD)	USD EMD External Debt Sovereign	Sterling Quasi & Foreign Govt	Swedish Govt
EMD USD Diversified Corporate	Euro High Yield	Indonesia Sovereign Debt (USD)	USD 1m Libor
EUR Non-Financial Constrained	EUR HY Constrained	Euro Lower Tier 2	JPY 1m Libor
Build America Bond	US Covered Bonds	Sterling Broad Market	GBP 1m Libor
Sterling High Yield	EMU Corporate	Mexico Sovereign Debt (USD)	AUD 1m Libor
US IG CMBS	US Corporate Non-Financial	Turkey Sovereign Debt (USD)	Hungarian Govt
Sterling Corporate	Sterling Financials	South Africa Sovereign Debt (USD)	Australian Govt
Municipal Master	EMU Direct Govt	South Africa Govt	Norwegian Govt
US Corporate	Sterling Collateralised	Euro Tier 1	Sterling Tier 1
Sterling Non-Gilts	Euro Financials	Czech Govt	Polish Govt
EMU Non-Sovereign			

Source: Schroders.

# Public sector growth

## Austerity in the Periphery but not yet in the Core

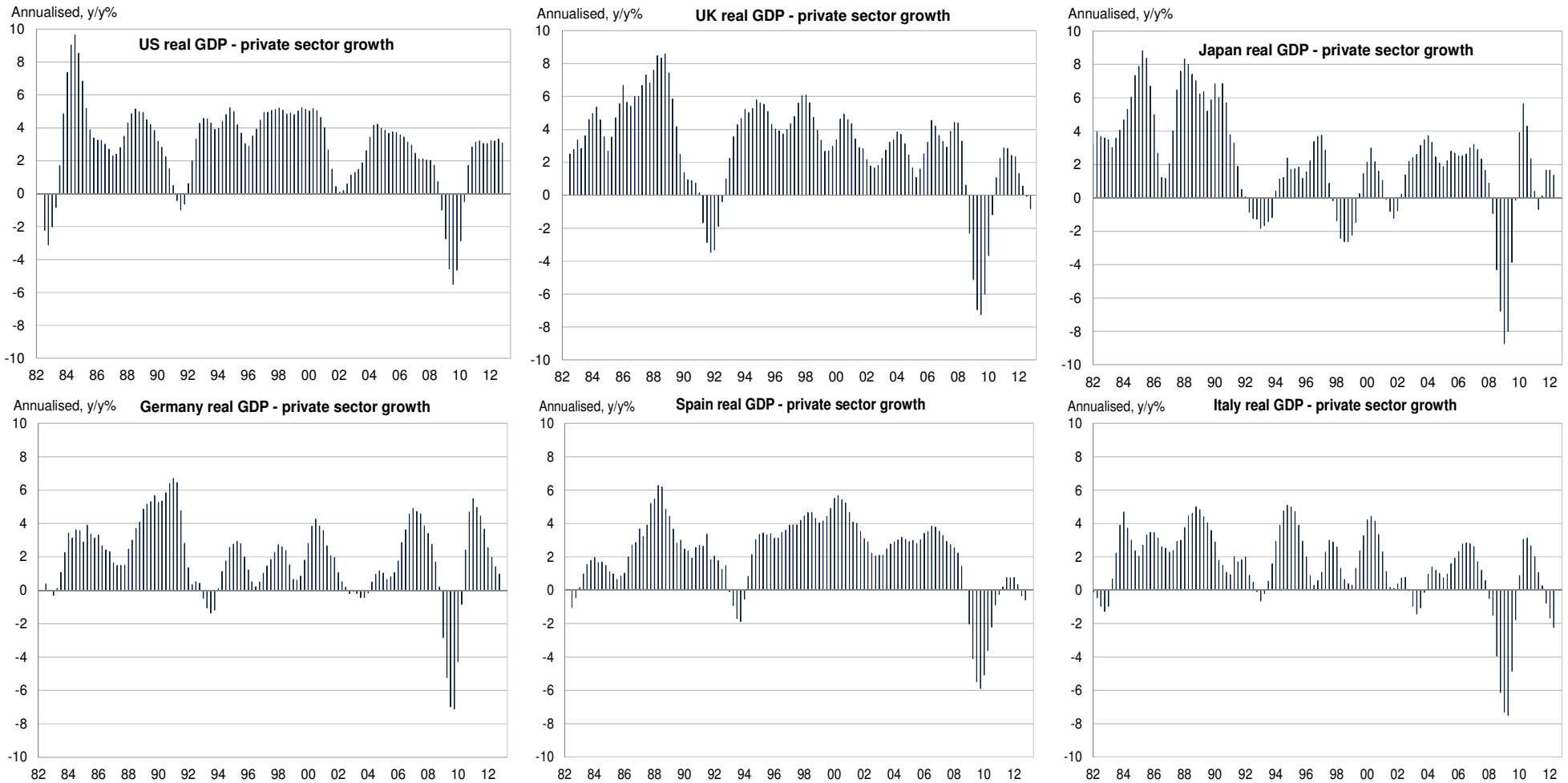


Source: Thomson Datastream, 1 March 2013



# Private sector growth

## Slowing down in the Core, negative in the Periphery



Source: Thomson Datastream, 1 March 2013

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