

# Fixed Income Strategy

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## Don't be so negative

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### Overview

Every day it feels as if global bond yields can just keep moving lower and lower. Well, it's probably because for most of the year they have! Global growth has been decelerating, inflation is low and trade tensions are rising. This has prompted the Federal Reserve and 32 other central banks around the world to cut policy rates this year. At the same time, others (i.e., China) have provided other forms of accommodation to boost their economy and lower rates. Consequently, the world's bond market now yields 1.4%, down 100bp over the last 12 months.

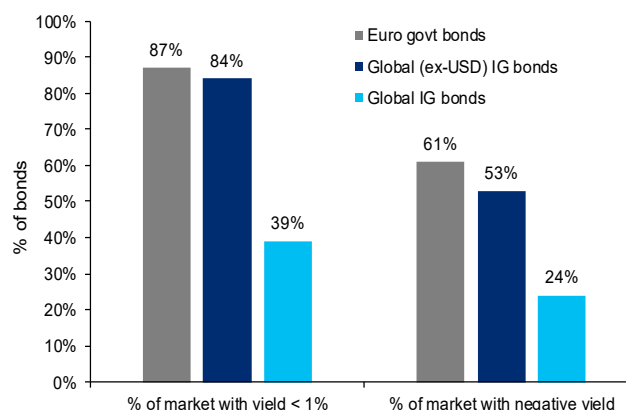
Of course, higher yields found in US dollar (USD) bonds have elevated the aggregate. If we were to exclude USD bonds, the global bond market yield drops to 0.3% (**Fig. 1**). This is principally from the growth in bonds that traded with a negative yield, which now makes up 25% of the world's bond market (a market value of \$16 trillion in USD terms) (**Fig. 2**).

**Figure 1. Global yields (ex-US) are at historical lows**



Source: Bloomberg Barclays Indices as of August 28, 2019. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

**Figure 2. Negative yields are 25% of the global market**



Source: FTSE Russell as of August 28, 2019

### What we expect for US rates

10-year Treasury (UST) rates are now roughly 15bp from its July 2016 all-time (intraday) low of 1.32%. Meanwhile, the 30-year long bond has reached a new low of 1.92% as of this writing. Though the yield curve between 3-month T-Bills and 10-year UST has been inverted since May, this relationship has deepened to -50bp. To add, the yield between 2-year and 10-year UST seems to be finding a home in negative territory, after hugging the zero bound over the last few weeks.

Looking forward, we think there are four important factors that can continue to weigh on US rates:

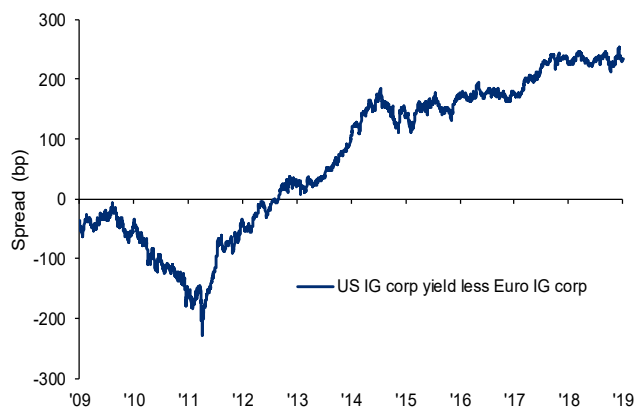
- US bond market yields are still globally attractive.** Despite the rally, the UST market yields 1.6%, which is 130bp higher than the average non-US developed sovereign bond market. In investment grade corporates, this differential exceeds 225bp (**Fig. 3**). For investors looking to generate higher levels of income in their fixed income portfolios (and not treat their bonds like stocks), demand for US dollar debt will likely remain elevated.

- 2) **Possible quantitative easing amid low yields.** With the European Central Bank (ECB) likely to restart their asset purchase program (APP) later this year, an indiscriminant buyer will be brought back to the market. In our view, a new APP may need to be meaningful. This could include higher issuer limits on sovereign bonds and possibly new markets not previously considered (i.e., high yield). This could leave little else for private investors looking to build portfolios. With the average Eurozone yield -0.5%, investors may need to look elsewhere. The US market would likely be the first consideration.
- 3) **Global central bank policy is to remain accommodating.** Though September rate cuts by the Fed and ECB are imminent, market expectations imply more easing is likely. Chinese policy easing is also highly anticipated to confront declining trade-related growth ([see latest Asia Strategy Bulletin](#)). If a “race to the bottom” ensues, US rates would likely follow.
- 4) **Trade friction is likely to remain.** Though impossible to predict the next “tweet”, it seems clear that tariffs are an important tool in the current US administrations ability to negotiate trade deals. The inability to predict the next threat is alarming enough. That said, rising tariffs could still have meaningful impacts on markets, economies, and investor sentiment ([see recent global strategy bulletin](#)). This is likely to keep the bid for high quality US bonds high, and rates low.

To be fair, it would be naïve to think that rates can only move in one direction. August has typically been characterized as less liquid, with lower trading volumes. So it should be a consideration that 50% of the move in 10-year UST this year has occurred over the last four weeks. As market participates return from holiday, a deeper market could cool the rise in rate volatility (**Fig. 4**).

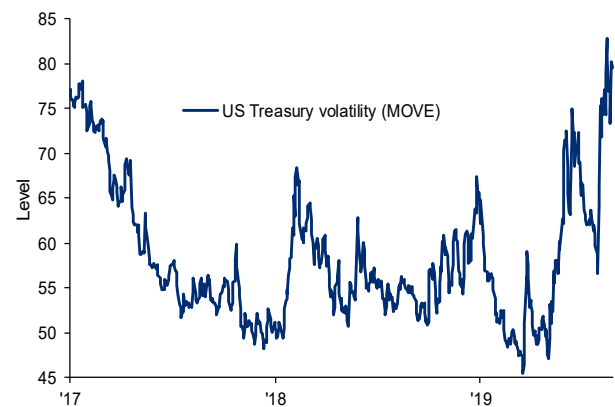
Fiscal policy or trade deals (or hopes of one) could also offer some relief. However, fiscal expansion seems unlikely near-term, while trade deals may not provide a meaningful offset to an increasingly supportive technical environment. At the same time, decelerating fundamental trends offer little solace.

**Figure 3. US/Europe yield differentials remain wide**



Source: Bloomberg Barclays Indices as of August 28, 2019. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

**Figure 4. Rate volatility has risen over the summer**



Source: Haver Analytics as of August 28, 2019. The MOVE Index measures U.S. Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries

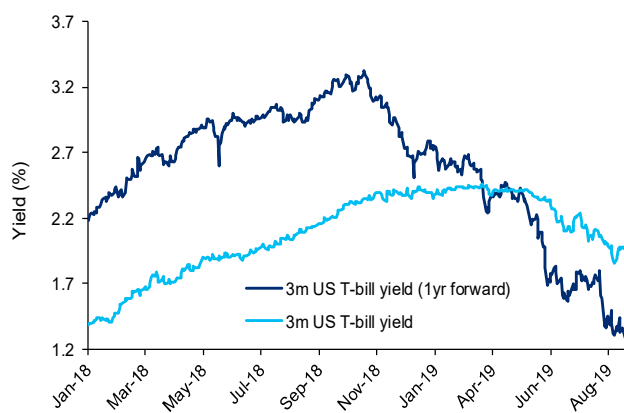
## Portfolio strategy – Best thinking

With global rates expected to remain low and uncertainty high, we advocate building well-diversified global portfolios. Citi Private Bank's Global Investment Committee is neutral global fixed income, but holds large overweight's to high quality US fixed income (UST and US IG Corporates). Below are some of our best ideas on how to invest in the current environment.

- **Extend duration in high quality bonds.** Sitting on too much cash or rolling T-Bills runs the risk of frequent reinvestment at lower rates. Futures markets are pricing in 100bp of rate cuts through 2020, while forward markets are pricing 3-month US T-Bills, one-year forward, at 1.3%. This is 70bp lower than current 3M yields (**Fig. 5**).
- **Prefer duration in US IG corporates.** Yield curves in US IG corporates are not as flat/inverted as UST curves, while spread curves remain positively sloped (**Fig. 6**). Rising leverage does pose some longer-term concerns, though more so in higher quality IG. Best value can be found between 5-7 years. Favor Utilities, financials and non-cyclicals which tend to exhibit outperformance in periods of risk-aversion.
- **Consider inflation-linked assets to hedge risks of rising tariffs.** Though inflation expectations have fallen, the risks of rising tariffs could have a negative effect on growth (keeping yields low) and longer-term effects on consumer prices. Indeed, US TIPS (Treasury Inflation Protected Securities) pay interest based on changes in the US CPI (consumer price index). 5-year inflation breakevens at 135bp are now 50bp below their long-term average.
- **Create higher yields, by hedging lower yielding markets.** With US/European interest rates differentials so wide, the cost to hedge US dollars is expensive. At the same time, hedging euros is not. Utilizing cross-currency markets, investors are actually able to create positive carry when hedging euros to US dollars. Current 12-month forward euro contracts imply a positive carry near 2.5%. This could turn a 5-year single-A euro corporate bond yielding -0.2% into a positive 2.3%. This strategy can be implemented more simply through euro-denominated managed strategies, in a USD share class.

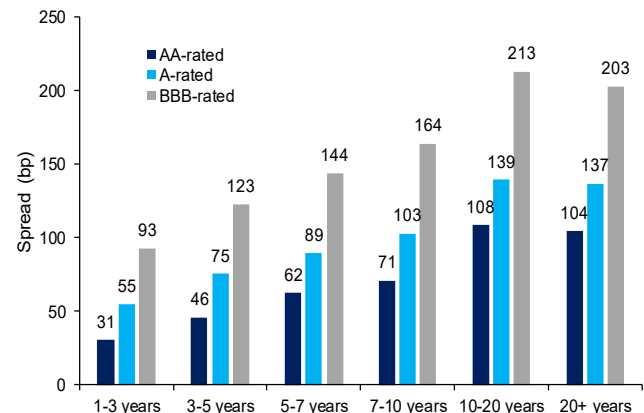
- **Favor high quality HY and bank loans.** BB/B-rated HY bonds have gained 11% YTD, though yields near 5% remain relatively attractive. Spreads are likely to remain tight, alongside low default rates. Wider spreads from spikes in equity volatility should be taken advantage of, unless recession risks become more evident. Relative value currently favors bank loans, which offer higher all-in yields (LIBOR plus spread) along with 50% less price volatility (**Fig 7**).
- **Preferred stocks offer higher coupons and lower beta.** Since January 2018, UST curve flattening has supported relative outperformance in US bank preferreds over bank stocks. With the curve to remain flat, preferreds can provide investors the option to invest in the US financial sector, with less volatility. Though preferreds have a positive correlation to equities, performance has a beta 5x times lower than bank stocks versus the S&P 500. Average yields around 4.0% are low by historical standards, but this equates to a spread pick-up of nearly 300bp, or 75bp wider than BB-rated HY bonds.
- **Favor external emerging market (EM) debt on relative value.** As developed market (DM) yields drop, higher EM yields offer more value. Average global EM USD aggregate benchmark yields at 4.9% are 370bp higher than DM markets (1.2%), or 450bp higher than DM markets ex-USD. Latin America has the highest regional yield (~7.0%), but also comes with higher volatility. On the other hand, average Asia EM USD yields closer to 3.7%, but offers much more price stability. We stress the importance of global diversification when investing in EM, as the market tends to be more idiosyncratic. At the same time, those idiosyncratic episodes also allow EM to offer attractive long-term risk-adjusted returns.
- **Municipal valuations are cheaper longer-term, not shorter.** Massive inflows into US municipal bonds has driven short-term yield ratios (to UST) to historical lows. Even on a taxable-equivalent yield (TEY) basis, high quality munis have become less competitive to taxable bonds (**Fig. 8**). Of course, this is not always the case in certain high tax states or in certain lower quality issuers. Best value still in longer-term munis, where TEY's well exceed those found in taxable bonds.

**Figure 5. Forward market implies lower yields ahead**



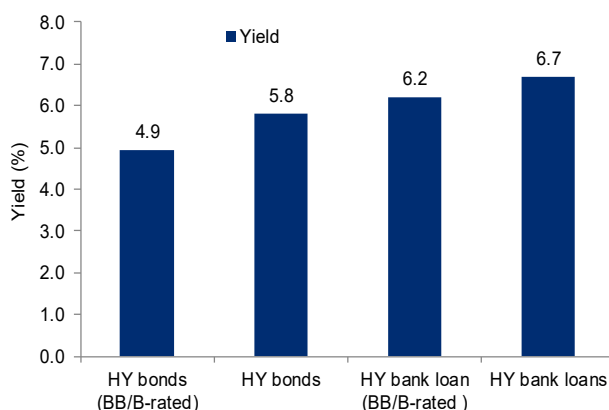
Source: Bloomberg as of August 28, 2019

**Figure 6. US IG spread curves are positively sloped**



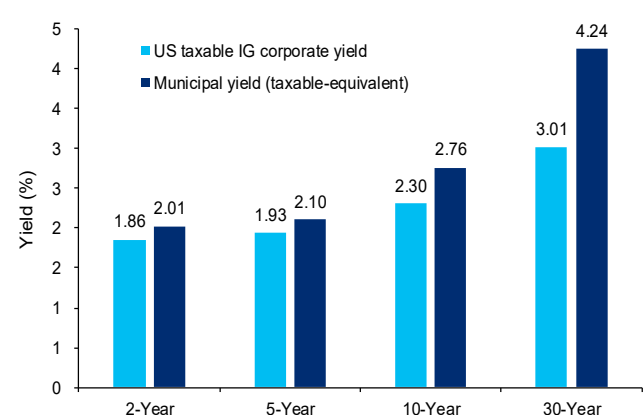
Source: FTSE Russell as of August 28, 2019

**Figure 7. HY bank loan yields are higher than HY bonds**



Source: Bloomberg Barclays Indices, S&P as of August 28, 2019. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

**Figure 8. Short-term munis are expensive to taxable bonds**



Source: Bloomberg as of August 28, 2019. Taxable-equivalent yield (TEY) uses the Federal tax rate, Affordable Care Act (ACA) rate and average State Tax rate.

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