

STILL CHASING YIELD WHEN YOU SHOULD BE CHASING SAFETY?

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Bill Hackney, CFA
Atlanta Capital
404-876-9411

bill.hackney@atlcap.com

Complacent investors got a rude wake-up call early in 2018. The confluence of a strengthening economy, a big tax cut, and a budget deal calling for \$300 billion in additional spending was more “good news” than the markets could take.

As often is the case, bond investors reacted first, sending interest rates up and bond prices down sharply in January. Stock prices continued to power higher until the Labor Department reported on February 2 what some investors have long feared: wage inflation had returned. Average hourly earnings for all employees grew 2.9% year over year in January. And that news sent stock prices into a violent decline.

It's not that investors begrudge the average worker a pay raise. Rather it's that wage inflation had been remarkably tame last year, despite an improving economy and price increases in oil and other industrial commodities. Investors know that the Federal Reserve closely watches “core inflation,” i.e., inflation excluding food and energy. The Fed doesn't necessarily want to raise interest rates if inflation is being driven by higher gasoline and food prices. These prices can be jerked around by the weather and geopolitics. But the Fed will react to higher core inflation, which is largely driven by rising wages.

The Fed's 2% solution

In pursuit of its mission to maintain price stability, the Fed would like to see core inflation hover around 2%. For the last decade, the Fed and most other central banks didn't worry about inflation because they were fighting *deflation* with low interest rates and easy money. Now, inflation has returned. And the higher wage inflation goes, the harder it is for the Fed to keep core inflation at 2%.

I view the recent turbulence in the stock and bond markets as a wake-up call to investors. The investment landscape has changed. Higher volatility and higher interest rates are the order of the day. Investors should forget about the so-called new normal of persistently sluggish economic growth and low inflation. Rather, they should try to remember the old normal—a time when easy money begat higher inflation and higher inflation begat tighter money and higher interest rates. Sometimes the Fed's tight money policies strangled the economy and sent it into recession.

Of course, the prospect for higher interest rates has been long anticipated: ultra-short bond funds have reported massive inflows over the past 18 months. It is important to remember, however, that not all substitutes for money market funds are created equal. During the great financial crisis of 2008-2009, one money market fund “broke the buck,” a few ultra-short bond funds experienced double digit declines, and popular substitutes for cash equivalents like structured investment vehicle notes and auction rate securities ran into severe liquidity problems. The common thread linking all these disasters was the lack of attention to the quality and structure of the debt securities owned in these funds.

Repercussions for lower quality credits

In the ultra-low interest rate environment of the past decade, many fixed income investors successfully chased yield by lowering credit quality or using leverage or exotic financial structures to enhance their yields. But, as the Fed continues to tighten the monetary screws and interest rates march higher, there likely will be economic repercussions. Credit spreads — the gap between lower quality bond yields and higher quality bond yields — will eventually widen as lower quality, debt-addicted companies begin to experience financial difficulties.

In my view, it is time for investors to stop chasing yield and start chasing safety. To be sure, the US economy is still in good shape and credit market conditions remain favorable. But there are some worrisome “straws in the wind” regarding the debt markets. Last year, US corporate debt as a percentage of Gross Domestic Product (GDP) hit an all-time high. (Yes, higher than the level reached before the Great Recession of 2008-2009.)

Zombies on the rise

Last October, renowned Wall Street economist Nancy Lazar published a piece titled, “The Rise of Zombie Firms—A Problem for the Living.” She noted that zombie firms—American companies which couldn't service their debts from cash flow and thus were kept alive by borrowing money—had tripled over the last 15 years. Today the zombies represent 7.6% of the Russell 3000 universe. (No telling how many private companies are in this condition.) Lazar concludes that “super-accommodative central bank policies certainly contributed to the rise of the zombies, by making capital cheap and investors hungry for yield. The undead are thus less inclined to innovate and invest, weighing on economy-wide productivity.” What's more, I would conclude that these zombies will be a significant source of financial distress during the next recession or credit crisis.

With interest rates on the rise, short and ultra-short fixed income should have a prominent place in a diversified portfolio. But care should be taken to ensure that portfolios aren't increasing credit and liquidity risks while decreasing maturity/duration risk. Most “enhanced yield” fixed income products have some degree of credit or liquidity risk. So look under the hood of fixed income portfolios to ensure that unintended risks are not present.

How can investors spot an ultra-short manager who can successfully navigate an increasingly risky economic environment? Look at how the manager performed during the last two recessions. There are ways to enhance yields without taking on too much credit or liquidity risk, however, the number of managers pursuing such strategies is limited. After all, chasing yield has been a top performing fixed income strategy for the past few years. But remember the old saw: Past performance does not predict future results.

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