The Investment Podcast

Episode 4: The folly of forecasting – finding value in an uncertain world
12 May

David [00:00:33] Hello and welcome to the Investment Podcast. My name is David Parsons and I'm Head of the Public Debt Investment Specialist Team here at M&G. I'm joined today by Richard Ryan; M&G's Director of Fixed Interest Portfolio Management and we are here to discuss some of the current issues in the fixed income market. Hello, Richard. How are you?

Richard [00:00:51] Thank you, David. Thanks for having me on.

David [00:00:53] So, Richard, there's been a lot of positive momentum in credit markets since the COVID crisis a year ago, with central banks supporting markets and governments supporting their economies. But can this really last? What happens when the music stops?

Richard [00:01:06] It's a really good question, David. So, I guess we need to think about how we got here in the first place. If we cast our minds back to 10 – 15 years ago, to the financial crisis, we came into that with excessive leverage building up in the banking system, and that led to ever more risk-taking. When the system then cracked, we got an inordinately large macro shock and central banks responded to that by cutting rates and trying to stimulate demand with lower interest rates. When that failed, or didn't give them the response they wanted, they took the next step of extraordinary monetary policy and brought about quantitative easing. So, they bought up securities and flooded the marketplace with ever-increasing amounts of cash. What is fascinating is that we've gone from crisis to crisis. In each episode, and if we go back to the 2011/12 European sovereign crisis, the 2015 global growth crisis, the commodity crisis, and then last year's market response to COVID, each time that we've got to another one of those episodes, central banks have responded in the same way – more QE and more cut rates. In the intervening periods, the system has never really righted itself to a point where we can get back to what people would think of as more normal levels of interest rates. And actually, that's called a second-round effect. If you think about what the response to this is, if you're a company and you want to borrow, it's cheaper and cheaper to borrow. So, you increase your leverage and with that increase in leverage, your ratings begin to drift lower. With a more complicated macro backdrop, maybe your earnings are impacted like they were last year and those ratings continue to continue to fall. With rates as low as they are, it doesn't matter because you as a company can continue to borrow really cheaply and in fact, you can borrow and extend out the term of that borrowing. So, in market-speak, what you've got is a situation where interest rates are incredibly low and credit spreads are incredibly tight. It's another way of saying that valuations are at a high point in time when arguably risk in the system is high as well. So, you're getting high valuations, low compensation for risk and the risk in that market is high. You then get higher leverage and that translates into weaker ratings, we've seen that particularly in investment grade markets, and then longer duration, so you've got much more sensitivity to those changes in interest rates. You boil it down to the fact that investors are now taking higher levels of risk in a riskier market and when you go back to your question as to what happens when the music stops? Well, we've seen that time and time again in each one of these crises. This is where the markets will take a pause and you have that possibility of that quite sharp collapse in valuations. It doesn't take very much, with these types of excessive levels of risk in the marketplace for that to happen.

David [00:04:26] Yes, I tend to agree with you on all of those points, and in addition to that if you look at the structure of markets and how they have changed over the last 10 years or so. For example, if you look at European Investment Grade and U.K Investment Grade Markets, those were markets that were more than 40 per cent in triple-A and double-A bonds 10 years ago. Yet today they're about 10 per cent in triple-A and double-A. You have markets that are approximately half in triple B bonds. So, the inherent riskiness of markets has gone up quite substantially over that period. What would have been seen as relatively low volatility, low-risk type investment-grade mandate 10 years ago is now inherently much riskier what with rising leverage and all the other factors you took the time to lay out for us there. So, I guess coming back to the original question, when do we think the music might stop? How much longer can this persist before we hit an inflexion point?

Richard [00:05:28] That's the million-dollar question. The reality with risk is that it's a tautology really and we don't ever see it coming, that's the true nature of risk. We as investors work in an environment where we're confronted by a variety of risks every day such as inflation, growth, commodity prices, leverage and earnings. So, with all of these things, there are risks and the market makes an assessment every day on what is important and what is not important. It isn't a question of whether it's important, but when is it important? Is it important today? Is it important tomorrow? If you go back to some of these crises and these big inflexion points like the European sovereign crisis of 2011/12, it came as no surprise to investors that certain economies in Europe were running very high levels of debt. But for very, very many years, that wasn't a problem for today, it was a problem for tomorrow, the day after or sometime in the future. Therefore, markets broadly ignored it. Then, there's a switch of focus. There's something that happens somewhere that brings that forward to today and suddenly that's the one that captures the market's imagination. So, we could discuss at length all sorts of different risks that we face today but the real question is which one will capture the market's imagination? And I think there's the fallacy of the forecast, which is, market participants, investors (like politicians and commentators) and others can't forecast the future. They can't tell you with any degree of certainty which one of those risks is going to materialize, become the central focal point for the marketplace, and then potentially create the spark that leads us to one of these big sell-offs. But there is a consistent feature to each one of those and the consistent feature isn't what started with or how it unwinds. The consistent feature is the one thing that you need to have beforehand before you can have that sell-off and that's a high level of valuation. So, in my world, in corporate bonds, what that translates to is you really need an environment where spreads are very, very tight, so you're getting very little compensation for all the risk that you're taking, because in that environment, if you think about it, if you've got very little compensation for risk then anything that upsets the apple cart can then have an outsized effect because you don't have any margin for error in your valuations. When we look at the marketplace – we think about these risks. We think about all the things that could happen, the fragilities within the marketplaces and the areas of instability, but the reality is, the one thing that we focus on the most is the valuation. Do you get compensated for taking that risk? And is the spread and yield sufficient enough to pay you to take that risk? Where it isn't, you've got to pause and think that if we are not getting paid to take that risk then what's my potential downside here? We've seen time and time again, even in markets that have had a 10-year bull run, we've seen single episodes, sometimes very brief and sometimes extended, where those risks have come to the forefront, markets have become concerned about them and they sold off aggressively. In that one point in time, as markets collapse, you've unwound or lost all the gains you've made in multiple years in the run-up to that. So, for us, the point is what do the valuations tell you? How tight or how high are those valuations? That gives you the indication of the susceptibility of the marketplace to one of these sell-offs. But you've got to be patient in some cases. It's not a question of just being patient for weeks, months or quarters, in some cases, it's a question of being patient for years.

David [00:09:35] That's very interesting. We've seen that there can be a variety of triggers for these sell-offs, a reset of valuations from very overextended levels back to more reasonable levels. But typically, we've observed in recent crises that the sell-offs correct very, very quickly. So, you can get a very rapid sell-off, followed by a relatively rapid recovery. Is this spike-like price action something that can become more of the norm as investors feel that they can't sit out of weakening markets to a point where valuations are compelling, but where they feel they have to immediately start buying in on any kind of weakness in markets?

Richard [00:10:18] I think it's that markets are becoming more conditioned to respond to more active central banks and with the last crisis, the COVID induced selloff that we saw last year in March, April, May, was followed by quite an aggressive action by the US Central Bank, by the US Federal Reserve. They did something which they had never done before and that is to step out and to buy or promise to buy corporate bonds. Up until then, they had done a variety of extraordinary QE measures but never stepping into the corporate bond arena. They were smart about it. They looked and enquired about where the points of tension were in the marketplace and they set about easing those by stepping in and being the buyer of last resort. But this is a toolkit that they developed in the financial crisis and other crises in the run-up to this, so they were prepared, capable and willing to go out and do that. So actually, if you compare and contrast this sell-off to the one that we saw after the Lehman Brothers collapse and the financial crisis, this was many times faster. It probably took up a third of the time for markets to recover than it did in the Lehman crisis. So that does give you an indication that if you want to be in a position to take advantage of those and thus you have to be prepared. If you start putting these pieces together and if you're going in prepared, but you can't forecast what and where those inflexion points are going to be, then the only thing you can do is to rely on those valuations and be prepared then when valuations get high and the spreads get really tight, it is time to step aside from the marketplace and begin to take that risk off and be really patient. That's quite difficult – when everything is going fine in a marketplace and valuations continue to rise and it goes against you as economies open up and do well, things can then go against you and the perception is that risk is low, it is a very difficult environment to stand aside in. But if you do that then these events that are occurring with an unerring degree of regularity, as they do come about, then you are singularly in a fabulous position to go and take advantage of them and not everybody is in that position. That means that rather than being a price taker, you become a price setter and you can step in. Liquidity is plentiful and you can take advantage of those episodes and by doing that, you do two things: not only do you put yourself in a position to take advantage from a performance perspective but, you can also change the return profile that you run because you aren't susceptible to those big sell-offs, and actually you let the market carry you higher as you come out of them and that's quite a powerful way of looking at these markets at the moment.

David [00:13:20] Yes, I agree with you. I think the other side of that is that there's an awful lot of short-termism from investors as well, trying to chase returns without necessarily having that kind of a value framework built around them. I look at markets today and I think that if investors could be persuaded to take a longer-term time horizon, then better returns can be realized through the investment cycle rather than just trying to constantly chase markets up and hope that you can exit markets before the inevitable reset occurs. What do you think about short-termism in markets?

Richard [00:13:56] I think you're absolutely right. Alongside short-termism, has gone a focus on features of markets like momentum and both of these perpetuate spikes of volatility and spikes in market pricing, which can be higher and lower. That's important because you need to give yourself the option and the strength to go out and buy into a falling market in those episodes. If you follow the momentum, it's very hard to do, you wait for the markets to turn before you can get back in. Now, markets aren't continuously priced so once they begin to turn, especially in fixed income and credit markets, your ability to go out to acquire positions and to build positions of the market begin to deteriorate and your pricing advantage deteriorates quite quickly as the market ramps higher. But that short-termism, if I'm worried what the price of this asset is going to be tomorrow, and I think I'm in a downdraught and the markets are collapsing then I might never get the confidence to go out and buy. But if I'm not thinking about just tomorrow's performance but I'm thinking about a year or two from now and I know that the asset is undervalued today – it might get cheaper tomorrow - but I can look out over the long term and I know that this asset should appreciate in value, then that gives me the confidence to go out and buy into those falling markets, which is absolutely what you need to be doing in this environment. As those prices collapse, much as you haven't been able to see what drives them lower, we will never know what will turn that market and drive it higher but we do know it does happen. We need to rely on the valuations both on the downside, so, as we think that this is expensive and it could crack, and there will be a better opportunity, when we come to that opportunity we shouldn't be blinded by the fact that we don't know what the catalyst for the rally will be. But we have to be confident that over time those markets will normalize and that we will see that rally. So, it goes both ways, both in protecting your downside, but also in taking advantage of that upside. We can't see the future and that short-termism stops you from acting in the right way, it stops you from selling when you should be and it stops you from buying when you should be. I think the other thing is that we create narratives around these market moves and very few people will see an individual market collapse before it happens, but everybody will then be able to explain it as it comes out of that collapse. This perpetuates this idea that we can forecast it and that we can see it in advance. We can explain it with hindsight for the most part but we don't always see it coming which perpetuates this idea that we can see where the cracks are and perpetuate the idea that we'll be able to see the crash before it happens. Therefore, that also convinces you to hang on with expensive assets when you shouldn't be and to my mind, we can't. The one thing we can observe with certainty is the pricing that the market affords, it's that valuation, we should rely on that to be able to guide us as to what the right thing to do with our assets is.

David [00:17:11] So if I had to ask you just to summarize what you have said in this podcast, how would you think about markets today, given everything that's gone before? What would your summary be of how you think investors should be addressing markets in the current environment and looking ahead too, because this could perpetuate for some time to come with all of the central bank support and the distortions that it brings to valuations. So, what are your key tenets of how you think we should address markets today?

Richard [00:17:43] I think valuations are high and I think spreads are tight. We've come back through the pandemic and yes economies are beginning to open up and we're beginning to loosen those restrictions at different paces across the globe but we're beginning to get to grips with this. But valuations that have gone right back to where they were pre-pandemic and the reality is that we have seen the introduction of more risk into this marketplace: we've got lower ratings we've got more triple B issuers, we have tighter spreads and longer duration bonds so we're more susceptible to these price moves. We then come back to this idea of valuation. We weren't great fans of the market valuations in January 2020 and we're back at those same valuations and if we want to be consistent with ourselves then we shouldn't like the valuations today either, everything else being equal. But actually, things aren't equal – we're putting a lot of store of value in this great big recovery and we are putting a lot of store value in the fact that economies are opening up and we've got very little compensation for risk. So, I think that this is one of those episodes where we should be patient, we should be conservative, and we should be de-risking portfolios. We should be building that war chest, the firepower to come back out when markets crack. At the same time, we need to be doing this with our eyes open and know that we have to be patient because this period of low spreads could last for a long period of time. What is fascinating to me is that we have got an acronym and that is TINA, 'there is no alternative'. We had that same mindset back in January 2020, or I should say the market had the same mindset back in January 2020. There, they were comfortable taking risks and they were comfortable buying expensive assets because they couldn't see with any degree of certainty what was coming and they couldn't see what would derail it. I would say that today we're in the same spot. We can't think of alternatives or the market can't think of alternatives. Therefore, it forces itself to take extra levels of risk but we're not getting compensated for it. So, we would prefer to do something different and that is just to stand aside, let the market run, be patient whilst knowing that this could take some time, but then be in a position when the market cracks, to take advantage of it. This conservatism isn't a permanent position, it's just a tactical position that will unwind as better valuations emerge in the marketplace and we're pretty confident that they will over the coming periods.

David [00:20:26] So pulling that together, it's about taking the right amount of risk at the right time and the right price. I suppose you could say that patience is probably the most underrated but most effective investment strategy. Thank you very much, Richard. It's been very interesting chatting with you this afternoon and greatly appreciate your insights. Thank you.

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