Opportunities in Fixed Income

This summer there was a sell-off in the Fixed Income markets, initially prompted by the Fed's "tapering" talk and signal to pull back quantitative easing. The Fed's message was widely interpreted as the "beginning of the end" of US easy monetary policy. This immediately brought investor's focus to the prospect of the current low rate environment coming to an end. As a result, we've seen a significant sell-off across the fixed income spectrum. Yields of the 10 year Treasury have hit 3% (from 1.8% in late May). In June, investors withdrew $59 billion from bond mutual funds- the worst monthly outflow in history. Investor have redeemed over $100 billion from bond mutual funds from the period of June 1- August 28th.[1]

The rapid rise in rates the markets experienced this summer has left questions about the future of the bond markets and where to find value in fixed income. We believe that this sell-off has created some appealing opportunities; the premium for longer dated securities is nearly double historical levels. This looks interesting given our belief that there is a good case for rates to take a breather from their rapid rise- due to the lukewarm state of the economy. We are currently looking to invest in select high quality credits with longer dated maturities and high current yields, which will help add value to the portfolios of our clients for whom this type of investment is suitable.

Premium for Holding Longer Dated Securities

The rapid sell-off the 30 year Treasury has faced over the past 3 months has brought its spread over the Fed Funds rate to 3.7%, close to double the historical average (2.0%) – see Chart 1 on the next page. This is a significant premium to be holding longer dated securities- and we believe that investors can add value to their portfolios by having some exposure to high quality credits on the longer end of the yield curve.

This is a nice compliment to our core fixed income strategy – which has been over-weighted in Credit versus Treasury rates, while staying short on duration (our average fixed income portfolio has a duration measure of 3.8 vs. 5.3 of that of the BarCap Aggregate index). Lately, we have recommended adding exposure to floating rate bank loans (as discussed in our Thinking Man's note "Senior Bank Loans- A Chance to Diversify Within High Yield" on May 30th).

The Thinking Man's Approach

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The significant sell-off across the Fixed Income spectrum has created interesting opportunities for clients looking to enhance the yield of their portfolios. The current premium for holding longer-dated securities is near twice its historical average- and given our general short duration of fixed income portfolios- is a nice compliment to our strategy. We discuss our views on rates going forward in this "mixed" economy and our focus on credit selection in high quality companies.

For more information and details on the list of stocks we like to play these themes, please inquire: ideas@bigsurpartners.com

[1] Investment Company Institute, "Flows Data 2013," September 4, 2013.

However, with the back-up of more than 100 bps in the 10 year Treasury and the indiscriminate sell-off in Emerging Markets credits we detect an opportunity to increase our duration risk as we add to our EM credit exposure. Our goal here is to increase the current yield of our fixed income portfolios, via adding duration and EM credits risks. We believe this is a good opportunity to do so, given that we don't believe there will be a continued rapid rise in US Treasury rates from here.

Chart 1: Spread Between US 30 Year Treasury Yield and Fed Funds Rate Over Last 20 Years

Mixed Economy Makes It Unlikely For Rapid Rise in Rates to Continue

Some investors are concerned about the continuation of rapidly rising rates. We don't see a risk of rates moving up too drastically in the near term- as we don't believe the health of the US and global economies warrants this. US economic data has been mixed for the most part and economic recovery remains subpar. While we have seen robust manufacturing data and car sales, both retail sales and job creation have been mediocre. A divided Washington does not help- Congress must agree to fiscal decisions, including funding the government to avoid a shut down and raising the debt ceiling before September 30th. This contributes to an environment of uncertainty, which makes corporate CEOs and other decision makers delay their economic decisions. Thus, with the private sector's "animal spirits" subdued and the government sector under sequestration, US employment remains weak.

A closer observance of some key data paints a complicated picture. In August, the jobs growth number was below expectations and it was the 40th consecutive month in which more unemployed workers left the labor market than found jobs! As JP Morgan's Economist Feroli points out, US "under-employment" measures (which considers both discouraged workers and part-timers) stands at 13.7%. Additionally, the labor participation numbers for August were the lowest in 35 years- since August 1978 (see Chart 2 below). A decrease in labor participation shows that discouraged workers have stopped looking for work all together. Some believe that this can be attributed to the attraction of "not working" versus "working" - as the increase in using welfare benefits like food stamps and federal disability rolls have exploded since the recession. Fears that we are in a "voucher economy" may pose more difficulties in our labor markets.

Chart 2: Labor Participation Over Last 20 Years

Another disappointing factor in US employment is the low quality/ low pay of new jobs. This year, 52% of jobs added have been in Food Services, Administrative Services and Retail sectors- a notable increase from last year (36% of new jobs were in these sectors) or 2011 (35% of new jobs were in these sectors).[1] Jobs in these sectors are typically low paying and part time- and will have minimized impact on bolstering consumption trends.

The question is whether the economy is strong enough to withstand a less accommodative stance from the Fed. BigSur thinks that for their 17-18th of September meeting, the Fed will make a "gentle"

[1] CreditSights, "Charting the Labor Markets: Septaper Off the Table?", September 6, 2013.

tapering (around $10B), full of caveats on how it can be reversed and assuring that the Fed Funds rate will be anchored at 0.25% for the foreseeable future. Only when unemployment falls to 6.5% or below, will the Fed expect to start considering a rate hike (i.e. tightening). All these elements lead us to believe that the 10-yr UST benchmark has priced in most, if not all, a "gentle" tapering.

Conclusion: Selective Opportunities

As discussed in our note on August 21st - "Emerging Markets Debt: Time to be Selective" – we believe that the sell-off has created attractive buying opportunities, but stress the importance of selecting high quality credits. This is also especially true when deciding to buy a longer-dated security- we are looking for companies we feel extremely comfortable with. Credit research and company knowledge are key. One such example is the largest Brazilian engineering company, key to infrastructure projects in a country with huge growth "bottle-necks" due to lack of infrastructure. This need has created a meaningful place for the company for years to come. The company has low leverage, significantly positive free cash flow and typically has 15% advances from clients- all contributing factors to making it a strong credit.[1] We feel comfortable that this company's credit quality (BBB and stable) is a good addition to a portfolio that currently has a low duration. While there may be volatility in the price due to eventual rising of rates- over the long term, with high coupon payments- we believe this is still an attractive investment (especially for investors looking for good cash-flows and higher current yields). The 30 year bonds (2042) are offering a current yield of 8.2% per annum and a yield to maturity of 8.3%.

For more information on opportunities that we are looking at, please inquire your advisor or write us at info@bigsurpartners.com.

[1] J.P.Morgan, "EM Corporate Focus List: September 2013," September 6, 2013.

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