CEF Insights: Time to Look Outside the US for Fixed Income

Rod Davidson, Head of Fixed Income Investment Specialists with Aberdeen Standard, and the Closed-End Fund Association discuss the outlook and opportunities for fixed income markets outside of the U.S.

Rod Davidson

CEFA: **Welcome to CEF Insights, your source for closed-end fund information and education, brought to you by the Closed-End Fund Association. My name is Diane Merit. Today we are joined by Rod Davidson, Head of Fixed Income Investment Specialists with Aberdeen Standard Investments, and their family of 10 U.S. closed-end funds. We're happy to have you with us today, Rod.**

RD: Hi, nice to speak to you, Diane, and looking forward to answering some of your questions.

CEFA: **Rod, Aberdeen Standard is a global investment manager, and you look at fixed income investments in all world markets. In recent months, we've experienced an unusual economic environment across many parts of the world. Can you give us an idea of where the general fixed income market stands in Europe?**

RD: Sure. As you've mentioned there, we at Aberdeen Standard Investments, we manage about $190 billion of fixed income assets in cash liquidity and the full range of bond funds.

A large proportion of those are managed out of our European offices in Edinburgh and London, and for European and global clients. There's no question that what we've experienced over the last few months through COVID-19, the emergence of and the dealing with, and the price movement as well, has made it a very tricky environment for bond investing and in a sense made investors very nervous.

Now, I guess you got to put things in context, 2019 was a strong year for returns across the fixed income asset class from rates, investment grade, high yield and emerging debt, bonds and funds across the piece, all performed quite strongly.

And I guess coming into the year, we were quite positive for a continuation of that rally certainly for the first six to nine months of the year. Of course, an exogenous shock like COVID-19 is very hard to plan for. So I don't think there really would be a manager out there that could say they had a great period during March this year, because it's impossible to really set a portfolio up for a circumstance like the one we experienced. The negative, I guess, for investors in general now is to try and contain the outcome of the virus and the extent and the impact it's had on the economic outlook, which as we've seen from the numbers as being quite dramatic.

RD: So to sum it up, bond investors in Europe are nervous as a whole, but they have seen markets settle down. Bid and offer prices have normalized and buyers have started appearing again with cheapened prices. So that in itself, it gives some degree of room for optimism for the future. However, you can't ignore the dramatic economic data that's currently being printed in countries around the world, including Europe.

CEFA: How about Asia and Australia?

RD: Certainly during March it was a very similar situation, but since then we've probably seen a slight split between the Asian subcontinent and Australia itself. I guess Australia we'll come to second.

But in a way, the markets in Asia for fixed-income have settled down quicker. And there are a number of factors here. The dominance of China within the region and the fact that China was an early entrant to the COVID crisis, but would appear to be an early exiter as well.

So, they very quickly clamped down travel movement around Wuhan and beyond. And they seemed to have got things under control very quickly. Whereas Europe was a bit slower to the party, Europe and North and South America and in a sense are still facing some ongoing issues. Now that's not to ignore, there won't be small regional or local spikes in the virus, but it certainly seems as a whole, the controls that China put in place give a degree of confidence within China and across the Asian region that actually things could normalize quicker.

So, we've seen bond market settle down. And in fact, I know in our Taiwan office, even during the height of the March COVID period, they were able to raise about $100,000,000 in a closed-end fund for China. So, in a fixed maturity strategy, very similar to the closed-end arena. So, it shows you that although investors were nervous for a period, they seem to have settled down quicker.

Australia on the other hand, probably because its more globally linked, it has a high degree of dependence on China and Asia, but it also has more global links historically. It's probably facing a more tricky economic future. In fact, the numbers are suggesting Australia is going into its first recession in 30 years. So, I think for the politicians and the central bankers in Australia, it's a different set of conditions that they have to face and the investors there will be very wary of the immediate future.

CEFA: Many investors have looked to emerging markets for higher yields. How have these markets been impacted by COVID-19, and the resulting economic and monetary stimulus policies?

RD: Again, a very good question. In fact, March was I think when I chatted with the emerging market team and Brett Diment, our Global Head of EMD. And he was highlighting the sell-off in emerging markets, actually in March was the most aggressive that he can remember, and he's a seasoned professional from the emerging market arena.

But he feels that the acute sell off nature in March was, that the only other time that he's experienced as aggressive a move was back in the Russian crisis in the '90s. So, you can see in that early period across all the markets that had rallied and were well supported during 2019, suffered badly during March. And indeed within the EM arena, we haven't seen a full correction, in terms of the sell off, that we might have experienced in the investment grade arena. But that aggressive sell off was fueled by a very dramatic widening of bid offer prices.

RD: And again, I kind of highlight that we saw, for example, a large increase in investor allocations to emerging market corporate debt, June 2019. And I guess some of those investors got nervous. We saw a few sellers in March, but in general, most investors sat on the sidelines to wait and see how this would pan out.

And then in actual fact, by the end of April, we saw investors coming back into the market, as you rightly point out, looking at the new pricing in the emerging market arena and the increased yield opportunities that are there. I think the good thing from an investing point of view now is that some of those opportunities are still there. And yet we do think as we edge our way through the early part of this economic slump and maybe view the recovery appearing in 2021, the emerging debt actually could perform very well.

And we expect to see more buyers appear at these cheapened levels. The monetary stimulus, as you point out, is extremely important as a key guide to the support that we've experienced in the market. And indeed, now you see this general consensus view that used to be very much focusing on the developed world. Now we're seeing central banks in the emerging market arena in a position to lower their interest rates on the back of softer inflation data that allows them to support their domestic economies.

So, in general, the coordinated central bank and government bond buying programs have been extremely important. And it's given a level of confidence that we know when we look back to the financial crisis that a similar situation unfolded. We felt the support from markets coming in and settling investors angst.

CEFA: **U.S. Investors are typically underexposed to non-U.S. investments. Given the current market dynamics, should these investors be looking to diversify their fixed income exposure with international markets?**

RD: I think this is, probably, as good a period as any in the last 20 years for U.S. investors to consider this type of activity, to consider broadening their asset allocation. And one of the reasons I say that is because COVID-19 has been a bit of a leveler, prior to the appearance of the virus, the U.S. economy for the previous 15 years had been regarded in a much stronger firmer position, certainly post the financial crisis in 2008. When the Fed and the Treasury were very quick to stabilize what was potentially a very tricky situation in the U.S. They were able to stabilize the situation and allow markets, both equities and bonds to continue feeling well and find support as did the economy.

COVID-19's different. It's definitely attacked economic confidence to a higher degree than people might have expected. And this is partly because, post the financial crisis, in a sense the U.S. had been through a very stable economic period. Yet they were saying that that was coming to an end, even towards the end of last year.

And although, as I mentioned earlier, our fixed income analysts and managers weren't expecting an immediate correction or a downturn in the economy in the first part of this year. They thought the recession was eminently possible in 2021, or indeed early 2022. COVID-19 has fast tracked this recession. So, we've kind of leveled the economic playing field.

And as such, there are two things going on here. Firstly, from a U.S. investor point of view, you might well consider that the strength of the dollar has been evident for the last 10 years, at least, may be about the turnover, or at least stabilize against some of the other currencies. The second point is we're now seeing a narrowing of the interest differential, which is in general, a key supporter of currencies, where you get a positive carry.

RD: So, U.S Interest rates have been quickly cut to zero and U.S. government yields have headed towards zero in a pretty steady fashion. So that pickup in yield or interest rate differential that was available has narrowed dramatically. And therefore, whilst it's been good to own those securities during that period, the attraction of owning them going forward has been lessened.

I think maybe a good case for investors listening to this call to just have a look at the historical risk reward charts that are quite easy to get a hold of if you contact someone at Aberdeen Standard they can provide it.

But a risk reward across the fixed income asset class, and you will see that U.S. credit for example, has performed very well versus a lot of the other sectors that you might consider. And therefore there have been good reasons why U.S. investors have ignored overseas assets.

One difference in there is some of the parts of the EM asset class, which over similar periods have actually generated investors, good returns, albeit with slightly higher volatility, but you could evidence slightly better returns on average on an annualized basis.

But I think when you add the factor in that perhaps the dollar has passed its peak and the U.S. economy has weakened some uncertain economic policies are currently on the table. And therefore I think it's a good time for U.S. investors to perhaps think about expanding their domestic investment picture.

CEFA: What is the impact of investing in different currencies and how should U.S. investors consider this in their investment decision?

RD: It's a very good question and there's no simple answer, in terms of what investors should do. Because owning an overseas currency against the dollar, will either produce a positive return or a negative return on top of the underlying security that they own.

So, typically in the past, you've seen if U.S. Investors have edged into the overseas markets, especially in the investment grade arena, they've typically hedged out the overseas exposure. And so, they don't take any non-currency view. They just take the non-currency assets.

And what you've found over the last 10 years is a global credit portfolio in dollars, so fully hedged back to dollars, would've produced a slightly lower return than U.S. investment grade credit as I've just been talking about. But also, they would have done that with a lower level of volatility.

So typically, what you're experiencing there is a broader diversification of assets. So it reduces volatility you've hedged there, any currency risks. So the returns are similar. As we mentioned, if investors think that the U.S. dollar might fall, then they should be looking at adding a bit of overseas currency exposure. So not only will they benefit from the assets that they own, but they'll benefit from an appreciation of the overseas currency that they own.

RD: As I mentioned, the tricky scenario, in the case for the larger currencies, like the Euro, like the Yen is you still have a confused interest rate differential scenario there. Where most countries Europe, Japan and the U.S. have interest rates at, or close to zero. And in case of Europe, in a negative position. So it's slightly harder to understand that scenario.

But again, when we add in the EM arena, there's no question. When you move into the local currency EM exposure, which is often found to be a blended fund that you would want to take some un-hedged exposure. It's expensive to hedge out that currency risk. And again, if we think the dollar has a good, the chance of rolling over ... Then you would want to run un-hedged in that area of the market.

And it's not been a good performer in the past, over the last 10 years, but actually the chances are it could perform well in the immediate future.

CEFA: How does Aberdeen consider the impact of currency fluctuations, as you structure your fixed income portfolios?

RD: Well, as I've just been mentioning there that all our different fund managers take account of the currency, the non-base currency, exposure of their strategies and they decide to hedge or un-hedge depending on their outlooks for the markets.

Many of our strategies are fully hedged to make the investor decision much ... In investment grade space, I would say many of our portfolios are fully hedged because we wanted to make it easier for investors to understand the risks that they're taking in that portfolio.

And then, as I mentioned, in the emerging world it's slightly more broader than that because it's expensive to hedge away your currency exposure in the local currency arena. So sometimes we're quite active in that we will hedge out bits of exposure there to certain currencies, perhaps Brazil, during this period because of their poor response to the COVID-19. But it will be very tactical in nature because it would cost you to hedge away that currency exposure.

CEFA: Rod, some fixed income securities can have limited liquidity, particularly in periods of market uncertainty. What advantages do you see in managing a closed end fund through volatile periods? As compared to other products structures.

RD: Again, very good question, because there's no question that liquidity is always a feature of what fund managers in the fixed income world think about. Because it does vary and become quite tricky during difficult market periods.

And I think I mentioned earlier on if we use the EM arena as an example again, the bid offer rose dramatically during March this year on the COVID-19.

The fund managers in that situation, when it happened so dramatically, there's not a lot they can do. What they will suggest is it's not a good period for investors to try and move money in and out of the funds or indeed as fund managers, you try not to do too much activity during that period because it would be costly for the funds.

RD: And so open-ended funds lend themselves to more inflows and outflows. And absolutely when you look at the closed-end arena, the funds that have the same exposure in the closed-end side will suffer the same volatility in the underlying asset pricing, but you don't suffer the same issue from the flows in and out of the fund by investors.

So, that is a major benefit from the closed-end arena. Investors accept that they are slightly longer term in nature, in terms of their investment horizon. And that definitely benefits all investors and the fund managers during extreme price movement periods.

CEFA: Among your family of closed-end funds, Aberdeen manages, Aberdeen Asia-Pacific Income Fund, ticker "FAX", Aberdeen Global Income Fund, ticker "FCO", and Aberdeen Income Credit Strategies Fund, ticker "ACP" for U.S. Investors, as well as Aberdeen Asia-Pacific Income Investment Company, ticker "FAP" for Canadian investors. Where are you seeing the best opportunities among countries or regions after all the uncertainty we have experienced?

RD: Well, the good news for all these strategies, outside of ACP, which is a corporate high yield strategy, is the Asian credit arena is one that we would be very optimistic for, for the immediate future.

As I mentioned the region as a whole seems to have managed the COVID-19 situation very well. And you might have expected with the densely populated countries there that there might have been more difficult situations, but indeed that's not been the case.

And in fact, one of our favorite countries there, Indonesia has done a terrific job in the management of COVID-19. So in general, we're optimistic for Asia as a whole. And indeed, there is a bit of a longer-term theme that as we see China developing their Belt and Road strategy, that there is a slight shift of some of the power from West to East in terms of economic development. And again, that will be good for investments in the region.

If I look more specifically at ACP, the yield is very attractive. There's no question. And being a well-managed strategy by Steve Logan, he will be very mindful that the high yield corporate market still has some issues to face. Defaults are on the rise. I think the recent numbers suggested, risen to four and a half percent already this year and could head towards a double-digit number by the end of the year.

And so, I think any high yield fund has to face the fact that we will see a significant part of the U.S. and global high yield market run into a default scenario. And therefore, all the analyst work will be maintained on making sure that you don't own those securities that run into difficulty.

So, a trickier arena, especially given the macro backdrop. But again, you're being well compensated with a very attractive yield. And therefore on average, in the course of the next two years, investors will do reasonably well, as long as their managers avoid some of those difficult situations.

CEFA: With central banks indicating the low rate environment may be with us for some time, do you see significant differences between opportunities in sovereign debt and corporate credit?

RD: Well, the corporate credit arena cheapened up significantly during March. So we've already seen the opportunity appear in this part of the market. And even though investors aren't dramatically, certainly Aberdeen Standard investors, the fund managers aren't dramatically changing their portfolios. We think that there will be clear winners within the different sectors in the corporate market.

You've got troubled areas like the oil sector, which is very obvious. But travel, retail, et cetera, those will remain troubled for a while. Within that, there might still be some investment opportunities, but you can imagine our investors are probably focusing a bit more in some of the stable sectors where they think the names will trade on a more stable basis going forward.

In terms of sovereign debt, in a sense, perhaps outside of the Asian region, you'll find all the developed world's sovereign debt trading towards the same level. And actually this has been a path that they've been on for the last 30 or 40 years, with varying positions along the way.

But, as I mentioned, I think the one significant thing you see from a U.S. investor point of view is a narrowing of the differential between the U.S. and markets like the UK, Europe and Japan. Interestingly, what we are probably going to see is more demand appear for Chinese government bonds in a period like this, because actually there is a pickup in yield in Chinese government bonds. It wasn't there two or three years ago, but it is there now. And even in the last few weeks, we've seen some investors ask us about the situation there and perhaps how they can invest in that market.

CEFA: Is Aberdeen Standard's active management approach an advantage in these types of market environments?

RD: Yeah, that's a very general question.

So, I'm always conscious that we manage many, many different mandates and funds. As I mentioned, close to $200 billion of fixed income assets. So there are a lot of different moving parts within that.

Primarily we are regarded by the market as an active global manager. And we do think that the situation that we see in front of us is a good scenario where we expect to perform quite well. We rely in credit related strategies on about 80 analysts based around the world that have a very strong track record of good credit research. So good fundamental research will help the fund managers identify not just the sectors, but the names within the sectors that will do best during this unfolding period over the next 12 to 18 months.

So, we would consider we are well-placed. The active style feels like it's the right position because there are going to be winners and losers. So owning whole allocations to underlying benchmarks may not be the best strategy. Certain parts of the market you want to own, certain names within that. Another part you want to avoid.

We mentioned just before, in terms of the default cycle for high yield, that could be quite aggressive. We've not really experienced that marginally through the financial crisis, but it's going to be much more acute than that this time. So there will be definitely names to avoid and being an active manager with a global reach will be important for that.

CEFA: **Rod, Aberdeen manages fixed income strategies for many types of investors. Focusing on individual investors in the U.S., how do you see global and emerging market fixed income investments being best positioned in the portfolio of income oriented investors?**

RD: Well, again, in kind of summary from a few points that we've touched on earlier on, the higher yield opportunities give investors, that we can find in some of the global markets and especially in the EM arena, it gives investors some cushion that even if there is a bit of volatility ahead, we can't rule that out completely given the extreme economic numbers that we're seeing printed at the moment.

So we think global emerging market portfolios will do well, within that, Asia is probably going to be an excellent performer. So certainly, if there ever was a good time for U.S. investors to consider opportunities outside of the U.S., I think we're at that point.

CEFA: **Rod, thank you so much for taking the time to join us today.**

RD: It's a pleasure. Thank you.

CEFA: **And we want to thank you for tuning into another CEF insights podcast. For more educational content, please visit our website at www.cefa.com.**