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Investment viewpoint

What next for Swiss bonds?

For professional and Swiss qualified investor use only • Fixed Income

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Summary

In the new year, the Swiss macroeconomic environment has been buffeted by global developments, while maintaining its own, unique features. As such, the Swiss economy has echoed part of the deterioration seen in the Eurozone, but also showed signs of domestic resilience amid diminishing slack in the economy.

We expect economic developments in the Eurozone to guide Swiss National Bank (SNB) policy, especially because the Swiss franc is one channel for imported inflation in Switzerland. Should the European Central Bank (ECB) become more dovish due to Eurozone growth deceleration, we believe the SNB could echo with moves of its own. That said, certain Swiss indicators such as the output gap and labour measures, show a relatively buoyant domestic picture that could act as a multiplier in a potential recovery scenario.

Turning to the investment landscape, investors in Swiss bonds currently face extremely low or negative yields, as well as receiving increasingly limited return from lengthening duration. Falling interest rates have been the main driver of performance in recent years for the Swiss bond market, and especially benefited passive investment solutions. Going forward, however, we see very limited scope for interest rates to drop further.

Bond investors could find better opportunities in Swiss corporate bonds, where a highly-specialised investment approach can help them navigate the distinctive features of the Swiss market. In our view, there are compelling arguments for moving into Swiss corporate bonds with shorter-dated exposure, rather than taking on the additional interest rate risk inherent in buying longer-dated bonds.

A dedicated and disciplined investment approach is best-suited to take advantage of the return potential available in Swiss bonds, we believe. Our investment approach is an actively-managed, long-only fixed income strategy, which has been in place since 2008. Investment decisions are based on the principle of specialisation whereby different alpha portfolio managers have their own risk budgets and, using different skills and strategies, generate uncorrelated returns.

Taking a medium to long-term view, we believe that Swiss bonds can continue to provide attractive risk-adjusted returns in the current, low yield environment.

The Swiss macroeconomic outlook: a unique profile

The start of 2019 has been marked by a shift in sentiment amid tamed expectations for higher US interest rates and a concerning slowdown in the Eurozone economy. The global backdrop continues to be challenged by trade wars, the rise of populism and worrying signs of slower economic growth. Within this context, the Swiss economy has a unique profile as the Swiss National Bank aims to steer the franc through the vagaries of the global backdrop.

In the new year, the US Federal Reserve adopted a more dovish stance, saying it was willing to be patient and flexible regarding the path of its policy rates. On the balance sheet normalisation, the Fed will slow its tapering of Treasury securities from May, and plans to end the Treasury taper in October 2019. In the Eurozone, the European Central Bank has reduced its latest economic forecasts to reflect a notable softening of economic indicators across the area including GDP growth, economic activity indicators (PMI) and industrial production.

At its March meeting, the ECB lengthened its forward guidance for steady rates - it now sees rates remaining on hold through 2019 at least. The bank also unveiled a fresh round of low-cost funding for banks, Targeted Longer-Term Refinancing Operations (TLTRO-III), and we believe it could eventually consider further easing measures if necessary. This means the low yield environment is set to continue in the Eurozone, and raise the spectre of the Japanification of Europe.

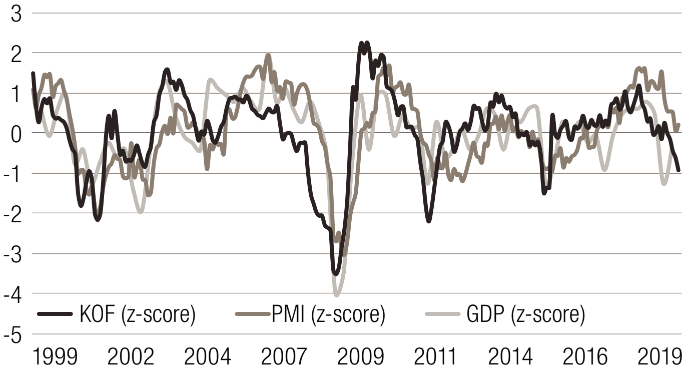
The shift in new year sentiment has occurred in an environment of continued global uncertainty. While global growth is moving sideways, sentiment is nonetheless weakening and geopolitical risks are increasingly entrenched. Concerns persist over the trade war between the US and China, the rise of populism generally, doubts about Italy's economic policies, the “gilets jaunes” protests in France, and the challenges of Brexit negotiations. While we still see global growth slightly below trend, the outcome is by no means guaranteed and the timing may be uneven and volatile due to such factors – this renders the outlook challenging.

Within this context, the Swiss economic picture presents a unique profile. The Swiss National Bank continues to keep its monetary policy accommodative through deeply negative rates and its readiness to intervene in the market to prevent the franc from appreciating. Typically, the strong franc dampens imported inflation, especially through the trade channel with the Eurozone. As such, the SNB closely tracks Eurozone developments, and has intervened in the past to ensure that any softening of the euro is not accompanied by firming of the franc.

Domestically, there are signs of a sharp softening in some Swiss indicators (GDP, PMI, KOF). That said, certain other indicators (output gap and labour measures) show a relatively resilient domestic picture.

The Swiss economy continues to expand, but parts of the macroeconomic backdrop have echoed the deterioration seen in the Eurozone. As such, Swiss GDP had a soft patch in Q3, but rebounded somewhat in Q4. The weakness applied to most components, especially business investment and exports, while consumption remained resilient. Other indicators have also pulled lower. The KOF Economic Barometer in Switzerland fell to 92.4 in February 2019, representing the lowest reading since 2015, and suggesting that growth is below trend and continues to slow. After holding largely steady in December, Swiss PMI also slumped in a fall that appeared rather broad-based, even if the PMI figure nonetheless remained in expansionary territory.

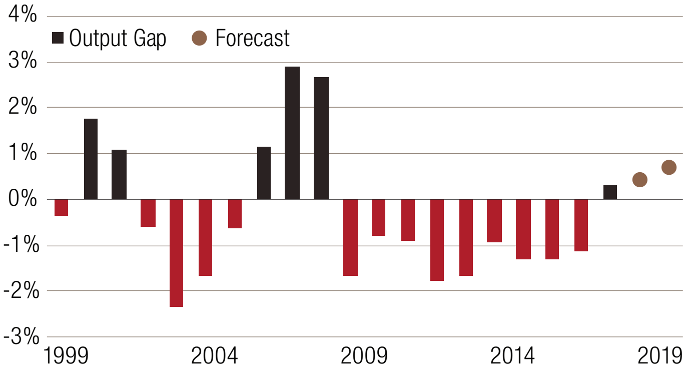
FIG. 1 KEY SWISS ECONOMIC INDICATORS



Source: KOF Swiss Economic Institute, Credit-Suisse, Bloomberg and LOIM.
For illustrative purposes only.

Some Swiss indicators, however, signal continued domestic resilience, namely a tight output gap and strong labour market. With unemployment at 2.4% in February, the economy is approaching full employment and the level is at cycle, if not structural lows. These labour market conditions could, at some point, raise domestic inflationary pressures through wages. Secondly, output gap estimates have also closed and moved into slightly positive territory. This questions the amount of slack left in the economy, and could act as a multiplier in a potential recovery.

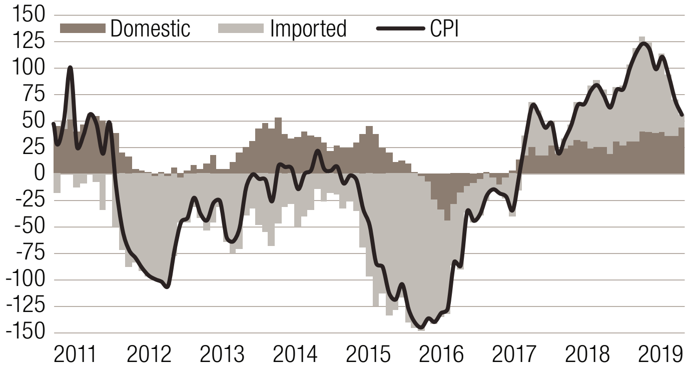
FIG. 2 SWISS OUTPUT GAP ESTIMATE



Source: OECD and LOIM. For illustrative purposes only.

Turning to inflation, core inflation was 0.4% in February, lower than the 0.5% anticipated, and the headline CPI reading stood at 0.6% y-o-y, slightly firmer than forecasts. Notably, the SNB lowered its projections for the conditional inflation path at the March meeting. Breaking down domestic versus imported inflation can add more granularity, in our view. While domestic inflation has held steady and could be further fueled by the tightness of the labour market and the lack of economic slack, imported inflation is driven by the franc's exchange rate moves and has generally fallen, not least because of low oil prices. If the Eurozone economy deteriorates further, or if political uncertainty increases, fostering safe haven demand for the Swiss franc relative to the euro, this will further channel negative inflation into the Swiss economy via the currency.

FIG. 3 SWISS INFLATION (DOMESTIC VERSUS IMPORTED)



Source: SNB and LOIM; Measured in bps.
For illustrative purposes only. Past performance is not a guarantee of future results.

There remains a risk that inflation could even print negative this year. We see the SNB remaining on hold and monitoring the franc, waiting for the ECB to be the first mover except if the Swiss franc depreciates meaningfully and persistently – a scenario we see as rather unlikely at the moment. That said, domestic factors mean that when the SNB eventually moves to tightening policy, it will be doing so in an economy that is already approaching full employment and little slack. This would likely quicken the pace of any potential tightening and necessitate a harder brake from the SNB.

Our base case scenario is for the SNB to remain on hold for the time being, and warn about the strong franc, especially because of the Eurozone slowdown. We are closely watching the currency as a driver for policy and expect the SNB would tolerate a limited appreciation of the Swiss franc. Should the ECB move to an even more dovish stance, the SNB could echo with moves of its own.

Further large-scale currency intervention is rather unlikely, however, as decreasing marginal benefit could shift the cost-benefit analysis of these measures, we believe. Additionally, the risk of being labelled a currency manipulator by the US Treasury at some point acts as further backstop. Overall, we see a continuation of the dovish status quo of current negative rates in Switzerland, coupled with a readiness to intervene in currency markets.

The opportunities in Swiss corporate bonds

Investors in Swiss bonds currently face extremely low or negative yields, as well as receiving increasingly limited return from lengthening duration. Falling interest rates have been the main driver of performance in recent years for the Swiss bond market, and especially benefited passive investment solutions. Going forward, however, we see very limited scope for interest rates to drop further. Rather, as previously outlined, we see Swiss interest rates being kept on hold and, eventually, probably rising.

Negative yields are entrenched in the Swiss market. For instance, over the past three months, the 10-year Swiss Confederation yield has kept to a rough range of -0.35% to -0.30%.[1] To find slightly positive yield in government bonds, investors must go farther down the maturity spectrum to around the 15-year and longer tenors.[2]

We believe that such returns are not sufficiently compensating investors for the additional interest rate risk they are incurring with such long duration. For each additional year of maturity, the risk (measured by the volatility of the returns) increases by approximately 0.5%, according to our calculations. Because credit risks usually correlate negatively with interest rate risks, a corporate bond portfolio can be less volatile than a portfolio consisting of Swiss government bonds with comparatively longer maturities. We therefore argue that investors should look to corporate credit for a better risk-return profile.

Taking a medium to long term view, we believe that Swiss corporate bonds can continue to provide attractive risk-adjusted returns in the current, low yield environment. In our view, there are compelling arguments for moving into Swiss corporate credit with shorter-dated exposure, rather than taking on the additional interest rate risk inherent in buying longer-dated bonds.

We believe that only a dedicated and disciplined, active investment approach can best take advantage of the return potential available in Swiss corporate bonds. Our investment process reflects our investment philosophy, which is based on the fundamental conviction that consensual decisions do not confer significant market advantage. That is why our investment decisions are based on the principles of specialisation and personal responsibility of our individual investment experts.

Our investment approach is an actively-managed, long-only fixed income strategy, which has been in place since 2008. The investment process focuses on an efficient allocation of the skills of each team member, and therefore strictly separates the beta from the alpha allocation. The various alpha portfolio managers have their own risk budgets and targets in order to generate uncorrelated return contributions by using different skills and strategies. Due to its high level of flexibility, our process can be easily adapted, extended and scaled to new investment themes or strategies and is, by design, less dependent on a single star manger.

Swiss bonds: high quality, growing choice

Given an average rating of AA, the credit quality of the general Swiss capital market is known to be very high. The market is characterized, above all, by Swiss government, sovereign, government-related entities and public debtors. It is also well-diversified in terms of borrowers, and we believe it will continue to attract both domestic and foreign issuers. This profile means that Swiss bonds should be relatively well positioned, even in the unlikely event of an economic crisis, we believe.

[1] Yield on CH0224397346, Swiss Confederation bond 0% due June 2029 from 01 December 2018 to 01 March 2019; Source: Bloomberg, LOIM. Yields are subject to change and can vary over time.

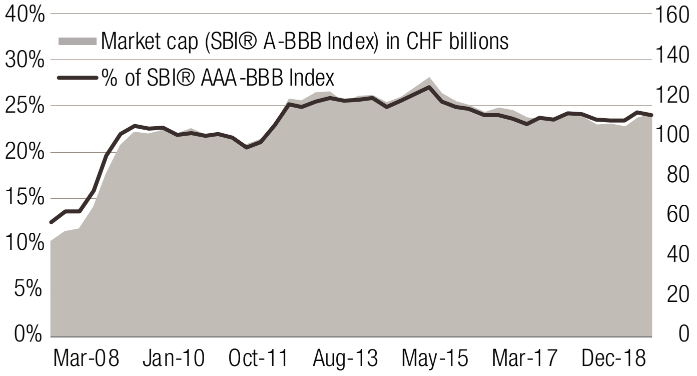
[2] Yield of 0.08% on CH0024524966, Swiss Confederation bond 2.5% due March 2036 as at 25 February 2019; Source Bloomberg, LOIM. Yields are subject to change and can vary over time.

Over the past decade, there has been a significant increase in the A to BBB rated segment of CHF-denominated bonds, as shown in the figure below. In our view, this creates more opportunities for specialists, and a bigger, more diversified investment universe.

The increase in bond supply has been partly fuelled by bank deleveraging over the past decade. Such regulation-driven deleveraging in turn drove smaller and mid-sized corporates to seek credit in the capital markets rather than through banks. Secondly, an increase in the number of new issuers and downgraded companies has also led to an increase in the A-BBB segment of bonds. The figure below shows how this area of ratings has increased as a proportion of the SBI A-BBB index over time. More specifically, there has been a four-fold increase in BBB issuers over the past 10 years.

FIG. 4 SBI® A-BBB MARKET CAPITALISATION

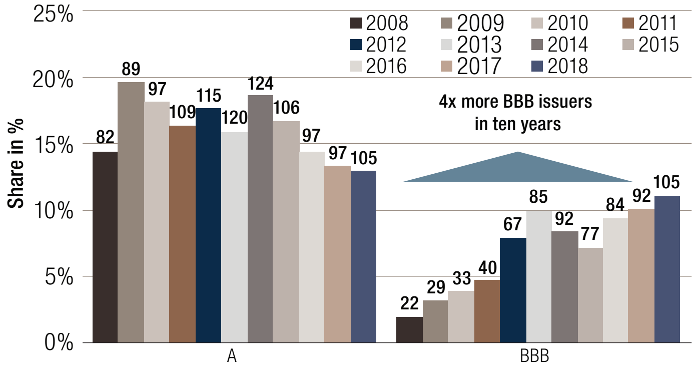
Market capitalisation evolution



Source: LOIM, POINT, SIX Swiss Exchange. Calculated by LOIM.

FIG. 5 A & BBB-RATED ISSUER PROGRESSION

Share of SBI® AAA–BBB and number of issuers

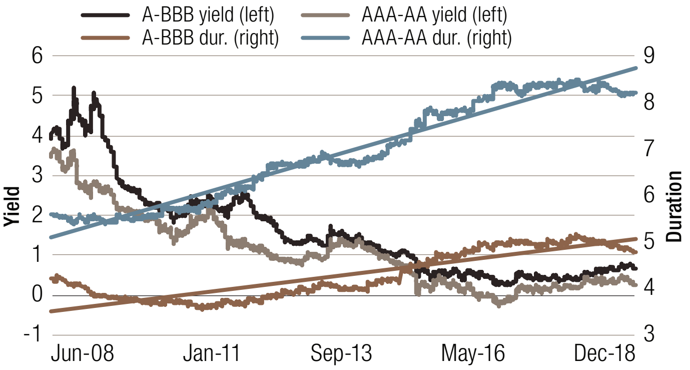


Source: LOIM, POINT, SIX Swiss Exchange. Calculated by LOIM.

Within this deeper investment universe, we believe that the A to BBB segment is a “sweet spot” in Swiss fixed income relative to other ratings categories. As a comparison, the AAA-AA segment of bonds offers very limited upside versus downside risks because yields are not far from record lows and average duration – around 8-years - is at all-time highs, as shown in Figure 6.

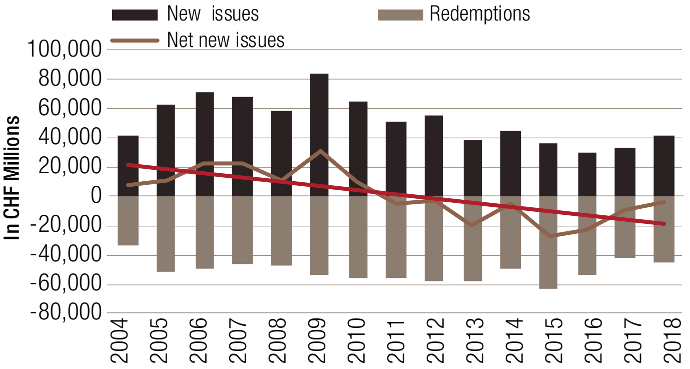
We prefer instead bonds rated A to BBB. Debt from borrowers in this ratings area has shorter average duration – roughly 5-years - than the AAA-AA bracket, and derives more yield from the credit element. Secondly, corporate bonds are technically-supported by negative net supply, meaning redemptions are greater than new issues. Thirdly, in a low growth economic scenario, we believe that corporates would continue to manage their balance sheets more cautiously without substantially increasing their leverage. As such, we do not expect a significant increase in default rates. We believe that the average credit quality of CHF bonds should remain high.

FIG. 6 YIELD & DURATION OF A-BBB & AAA-BBB



Source: Bloomberg, as at 31 December 2018.
Past performance is not a guarantee of future results.

FIG. 7 SWISS CORPORATE AND FOREIGN ISSUERS' BONDS



Source: SIX Swiss Exchange, Computed by LOIM, as at 31 December 2018.

In the current low yield environment, we believe Swiss corporate bonds could offer investors opportunities. The credit element could provide yield[3] for a shorter average duration, therefore mitigating interest rate risk relative to other instruments. A very low default probability for the sector rounds out the favourable factors in the overall risk-return equation, in our opinion and creates a “sweet spot” for investors.

[3] Yields are subject to change and can vary over time. Past performance is not a reliable indicator of future results.

An illustration: Oerlikon versus Confederation

In order to illustrate the potential benefits of corporate credit, we compare a bond issued by Swiss industrial equipment manufacturer, OC Oerlikon Corp, and a Confederation bond issued by the Swiss government.

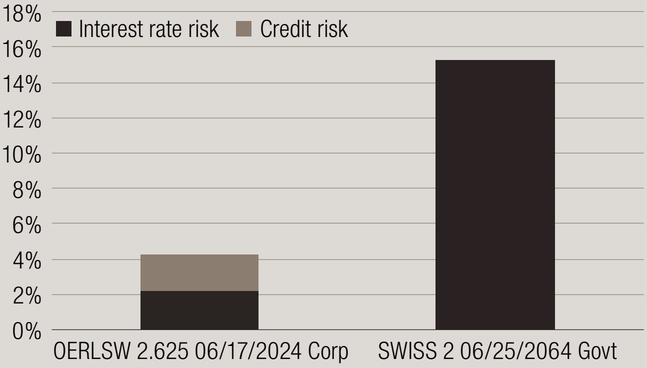
Oerlikon provides advanced materials, functional coatings and process technologies to the aerospace industry. In its research and development, Oerlikon aims to help cars and airplanes use less fuel, make tools last longer, and improve the manufacture of textiles.[4] It is rated BBB by Zuercher Kantonalbank, and BBB- by UBS, Credit Suisse and fedafin, with stable outlook. As at 31 January 2019, Oerlikon's 5-year bond and the Swiss Confederation 45-year bond both yielded 0.38%, as seen in the chart below.

	OC OERLIKON CORP	SWISS CONFEDERATION
Coupon and maturity date	2.625% maturing 17.06.2024	2% maturing 25.06.2064
Rating	BBB/BBB-	Aaa
Yield	0.38%	0.38%
Approximate duration	5 years, 5 months	45 years, 5 months

As at 31 January 2019; Source: Bloomberg, LOIM; Past returns are not an indicator of future performance.

Despite the yield equivalence, the 5-year corporate bond has far less interest rate risk than the much longer-dated Conf bond of 45-year because it has a shorter tenor. Instead, the credit component of the Oerlikon bond provides yield, and the diminished interest rate risk means much-reduced volatility. The figure below shows the components of risk in each bond, relative to the return volatility incurred.

Components of return volatility



Source: Bloomberg, LOIM calculations based on monthly data from 31 December 2015 to 28 February 2019.

We believe this example illustrates that investors can be rewarded for taking on corporate credit risk, and the yield achieved from the credit element is for a much shorter duration than the government bond. This mitigates the interest rate risk of the instrument relative to the much longer, and therefore more exposed, government bond. In this situation, we believe the lower volatility and duration profile are compelling.

Swiss corporate bonds require a dedicated and disciplined approach

We believe only a highly-specialised approach can navigate the distinctive features of the Swiss market. The Swiss bond universe is relatively smaller than other markets, generally suffers from poor liquidity, and is mainly used by buy and hold investors. We believe that our dedicated and disciplined investment process is ideal to maximize the opportunities available, especially in corporate credit.

Our approach re-thinks classic benchmark thinking by identifying opportunities for alpha and separating that from simply replicating the benchmark. As such, after constructing our index, we undertake a top-down and bottom-up selection process, as well as on-going monitoring supported by a team of credit analysts. We look to generate additional performance by developing investment strategies to take advantage of opportunities we identify. These strategies aim to address openings in the most efficient way, while taking into account client-specific constraints.

We believe the Swiss market generates ample opportunities for specialists to find added value from distorted valuations caused by market inefficiencies. For instance, the illiquidity of the Swiss market means bond prices can fail to reflect issuer fundamentals, and the general pricing of bonds can be inefficient. Against this backdrop, an approach rooted in deep credit analysis can exploit such mis-pricing. Our experience in managing liquidity risks enables us to take advantage of attractive liquidity premiums.

We adopt a multi-portfolio manager approach that values expertise and accountability of investment professionals. As such, each of our Swiss fixed income specialists is allocated an individual risk budget based on their experience, knowledge base and track record. Portfolio managers can generate trade ideas according to their skill set, which maximizes the chances of capturing extra returns and identifying extra risks.

We have a stable, experienced team that strives to constantly develop new ideas. The team is comprised of managers, credit analysts and a broader LOIM research team that has, on average 14 years of experience. In our view, having a team with complementary skills is key to managing risks because it encourages diversification and helps produce returns that are uncorrelated to bear or bull markets.

With a team focus on corporate credit, our investment approach has a proven track record of consistently out-performing over the past decade.[5] Our corporate bond strategy has a structural short duration, which is kept in line with the benchmark SBI A-BBB TR. In past years, our short-duration strategy has managed to make the same return as other, longer-duration strategies, even without the benefit of interest rate falls in recent years.[6] We believe the key to this record is our investment process.

[4] As at 01 March 2019. www.oerlikon.com.
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[5] Past performance is not an indicator of future results. Source: Bloomberg as at 31 December 2018.

[6] Performance of LO Funds (CH)–Swiss Franc Credit Bond Fund over 1y, 3y and 10y relative to other funds. Source: Bloomberg as at 31 December 2018. Dividend distributing institutional client share class, net performance in CHF. Past performance is not necessarily a guide to the future.

Conclusion

The current low yield environment looks set to continue for the time being, given the global backdrop for monetary policy. A recent slump in economic growth in both the Eurozone and Switzerland is likely to keep policymakers in both areas on hold. Still, the unique, domestic features of the Swiss economy could also surface in the event of a recovery, amid signs of decreasing slack in the economy. We believe investing in Swiss corporate bonds makes sense, especially from a risk-return perspective. In comparison to higher-quality bonds, the risk emanates not merely from interest rates and is distributed much more evenly between interest rate risk and credit risk. Only a dedicated and disciplined investment approach can maximize the possibilities in Swiss corporate bonds, we believe.

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