17 96

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Urgency for positive real returns as Japanisation grips Europe

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10/19

October 2019

We believe the negative real rate environment is here to stay, especially in the Eurozone.

p.04

At a glance

- Japanisation is usually understood to be a prolonged period of very low growth and low inflation alongside low nominal rates as experienced by the Japanese economy from the late-1980s.
- We believe the Eurozone is beginning to show conditions attributed to Japanisation, even if there are also differences. Key drivers of Japanisation in the Eurozone include the financial crisis of 2008-2009 and the sovereign crisis of 2011-2012, which led to extremely accommodative monetary policy without a consequent rise in inflation.
- The US-China trade war has further harmed the cyclical growth picture as heavy debt burdens and changing demographics dampen both long-term growth and inflation outcomes globally.
- As real rates plummet to multi-decade lows in G4 economies, fierce debate has erupted over the effectiveness of such loose monetary policy and led to questions about what ammunition central banks have left.
- We strongly believe that negative real rates are here to stay, especially in the Eurozone as fiscal policy is unlikely to be used outside of a deep recession. This more permanent reality of negative rates is untenable for investors seeking positive real returns.
- How could investors navigate this environment? We outline various publicly-traded assets that can help investors achieve a positive real return objective. We make the case for deploying quality-focused implementation as investors re-calibrate the risk profile of their investment portfolios.
- We highlight opportunities in:
  - Corporate credit, especially rated BBB to BB;
  - Moving down the debt capital structure of quality/high-rated companies;
  - Emerging market fixed income, hard currency debt, especially from Asia;
  - Dividend yields in developed market equities;
  - A calibrated multi-asset approach focused on liquidity;
  - Convertible bonds for equity upside while keeping a bond protection floor.

To achieve positive real return targets, we see useful avenues still available in publicly-traded markets as investors reassess the government bond dominated part of their portfolios.

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This document has been prepared by:

Salman Ahmed
Chief Investment Strategist at Lombard Odier Investment Management (Europe) Ltd.

Jamie Salt
Fixed Income Research Analyst at Lombard Odier Investment Management (Europe) Ltd.

For further information, please visit www.loim.com

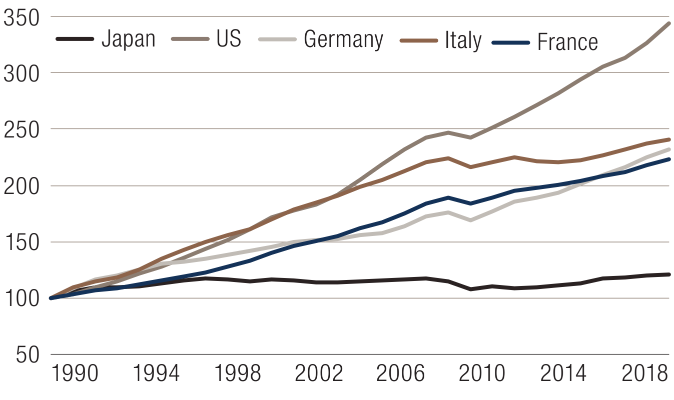
Eurozone showing symptoms of Japanisation

Japanisation[1] is usually understood to be a prolonged period of very low growth and inflation alongside low interest rates as experienced by the Japanese economy as far back as the late-1980s. The economic conditions which are referred to as "Japanisation" take several dimensions, but three key features are typically associated:

- **Stagnant growth:** actual economic growth is significantly below potential.
- **Secular stagnation:** a long-lasting period of low growth as sensitivity of economic outcomes to macroeconomic policy diminishes.
- **Zero or below zero nominal rates:** the concept of the effective lower bound of interest rates at zero or below, which hinders a further reduction in real rates, thus rendering monetary policy impotent.

Japan's experience of sustained deflation and very low real growth show that an advanced economy can fall into a prolonged period of stagnation and negative inflation. Figure 1 illustrates the power of this negative compounding effect: nominal GDP indexed to 1990 for the US, Japan and Germany show the deep wedge in economic outcomes of the various countries resulting from a prolonged period of stagnant growth and low inflation/deflation.

FIG. 1 NOMINAL GDP IN LOCAL CURRENCY (INDEXED TO 100, 1990)



Source: World Bank, LOIM calculations. Note that we focus on nominal GDP here rather than real to align with later discussions on debt levels.

Although, growth dynamics are on a downward trend almost everywhere, the case of the Eurozone economy sticks out given low growth and a sustained period of below target inflation despite extraordinary support provided by monetary policy in recent years.

We believe the single currency union is beginning to show conditions normally attributed to what is referred to as Japanisation in the academic literature.

That said, the Eurozone case of apparently sustained economic malaise also displays significant differences compared to Japan. For instance, Japan went through a clear phase of an asset bubble forming then bursting in both equity and real estate markets. As such, the Topix index peaked in 1989 before undergoing a 62% peak to trough fall in 1992.

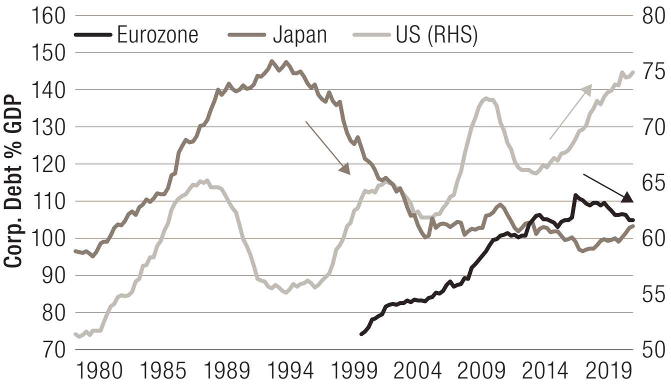
While the Eurozone has not seen such an isolated asset bubble, we nonetheless identify multiple crisis shocks. For instance, the 2008-2009 financial crisis and the 2011-2012 sovereign crisis, followed more recently by the trade war between the US and China. Such multiple shocks, both to economic fundamentals and to confidence, have likely contributed to the conditions normally attributed to Japanisation. In addition, similar to Japan, given the deteriorating health of the financial sector dealing with elevated non-performing loans (NPLs), we have also seen damage to the credit channel which was only partially healed after the various interventions of the European Central Bank (ECB), which has basically flooded the financial system with liquidity in a bid to avoid a repeat of the Lehman situation. The multitude of backstop tools introduced since the sovereign crisis have restored some confidence in the long-term solvency and liquidity of the European financial sector. Still, the Eurozone remains far removed from a true banking union, and the sustained negative rate environment, continued fall in trend growth and increased regulation since 2009 have all continued erode the banking business model.

The credit channel issue is starting to be reflected in recent corporate debt trends, where we are now beginning to see signs of a peak in the Eurozone, despite the very accommodative policy stance of the central bank. That said, the credit cycle is still not fully broken yet, though we do think that another cycle down in economic growth is likely to accelerate the damage leading to outcomes similar to what we saw in Japan, post the mid-90s.

The US-China trade war has further harmed the cyclical growth picture as heavy debt burdens and changing demographics dampen both long-term growth and inflation outcomes globally, including in the Eurozone. Although latest newsflow suggests that there has been movement towards a partial deal, we continue to think that given the profound disagreements between the two sides on a number of pertinent issues, uncertainty stemming from the conflict is here to stay.

[1] Japanisation is also referred to as Japanification.

FIG. 2 EU CORPORATE DEBT SEEMS TO HAVE PEAKED



Source: IMF. ECB. Bloomberg. BNP Paribas.

The Eurozone is heavily exposed to the gyrations in the global economic cycle, and the resulting uncertainty around the current global trading framework has led to a serious slowdown in global business spending, which is now expected to contract in coming months.

As real rates continue to plummet and hit multi-decade lows in G4 economies (at the 10 year point, real rates are -1.8% in Germany, -0.1% in the US and around -0.5% in Japan), debate is intensifying about what ammunition is left for policy makers if global growth continues to deteriorate. This confirms to us the existence of the main conditions associated with Japanisation as there is now clear acknowledgement from central bankers that we are approaching the limits of monetary policy when it comes to supporting growth and generating inflation.

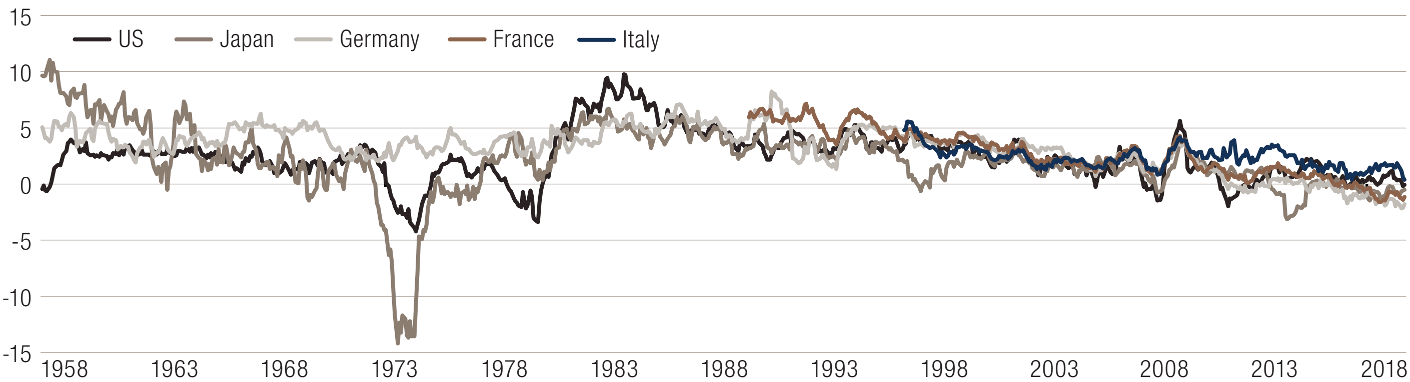
For instance, the sharp dissent regarding outgoing ECB President Mario Draghi's latest far reaching easing programme shows opinions diverging on the future scope and conduct of monetary policy in the single currency union. Of course, the limitations of monetary policy are not lost on Draghi either, who has strengthened his call for governments such as Germany and the Netherlands to use fiscal stimulus in a bid to avoid a recession and a further erosion of inflation expectations.

Recently, Draghi has also been quoted as saying that Modern Monetary Theory (MMT) should be **considered**.[2] MMT basically allows money-financed fiscal programmes to be used (or so-called helicopter money), reflecting a huge departure from Orthodox macroeconomic policy paradigms in place since Bretton Woods. In addition, comments by ECB Chief Economist Philipp Lane in a recent interview also indicated that the central bank may stand ready to accommodate any fiscal easing by governments, thus allowing rates to remain low as fiscal policy kicks into gear.

Indeed, such a shift in focus suggests that sustained and sharp criticism of Japanese authorities in the early 2000s by Western policy makers and academics was perhaps misguided. Currently Eurozone real rates have turned negative and fallen far through what Japan faced at the turn of the century, indicating that very easy financial conditions make much less of an impact than expected on key economic outcomes (i.e growth and inflation).

When it comes to future policy changes, whichever school of thought wins will have a significant and long lasting impact on cross-asset returns and volatility, and perhaps more importantly on the role of risk-free instruments in the financial system. Indeed, if monetary policy continues to push both real and nominal rates more deeply negative, it will become important to ask: Why should investors hold assets guaranteed to lose money especially if the "portfolio stabilizer" role of government bonds is also blunted as rates reach the effective lower bound? Market participants may still drive demand for negative yielding paper, including central banks spurred by policy goals, banks fuelled by demand for high quality liquid assets to fulfill their regulatory needs, and liability-driven players. However, it is becoming increasingly questionable for investors (participants with an expectation of positive real return) to justify holding government bonds beyond a tactical horizon, given the context of Japanisation. As such a more permanent reality of negative rates is untenable for investors seeking a positive return and diversification benefits associated with holding government bonds.

FIG. 3 REAL 10Y YIELDS IN G4 ECONOMIES – NEGATIVE AND NEAR-MULTI DECADE LOWS



Source: Bloomberg, various central banks.

2 https://www.bloomberg.com/news/articles/2019-09-23/draghi-says-ecb-should-examine-new-ideas-like-mmt.

Negative rates here to stay

We believe the negative real rate environment is here to stay, especially, in the Eurozone. Even if the current cyclical downturn stabilises somewhat, structural factors such as changing demographics, low productivity growth, very high debt burdens globally and continued demand for duration will maintain downward pressure on rates, in our view.

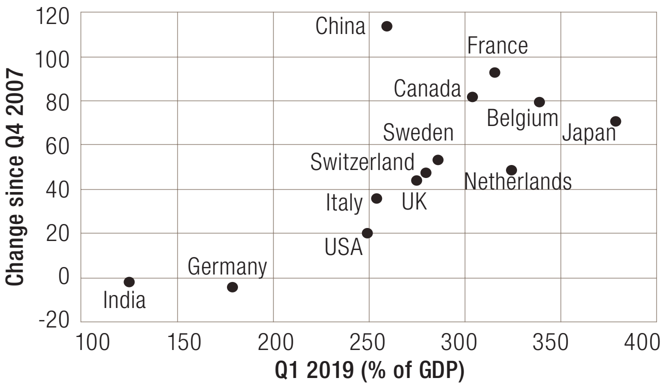
Although, a seismic shift in attitudes towards fiscal policy can help arrest the forces of Japanisation (as has been highlighted by several influential economists including Draghi), we see little chance of meaningful fiscal support coming to the fore in Europe anytime soon. On this front, the Netherlands has announced a sizeable easing of the 2020 budget (around 1% of GDP), which will be the country's highest deficit since 2009, but this is small for the region. In Germany, some fiscal easing is also planned for 2020 (0.3% of GDP), but this still falls far short of what is needed, in our opinion. We see no telling sign of fiscal easing coming from Germany in the near future, and note the country's economy matters significantly to the region. Currently, the main risk is that impactful fiscal easing by Germany will only come once a recession is well and truly embedded – we believe this will further strengthen the forces of Japanisation in the Eurozone.

On the other hand, structural deflationary forces such as changing demographics are set to be a driving force both in key developed market (DM) and emerging market (EM) economies in the coming years. For instance, the average old age dependency ratio in OECD countries is projected to increase from 30.2% to 36.2% in 2027,[3] and studies such as Guibaud et al (2013)[4] show that countries with older populations have lower term premiums as aging causes asset and liability management (ALM) that favours higher fixed income duration allocation.

On the cyclical front, a large drawdown in equities (which is a cyclical risk premia) may induce further demand for fixed income as de-risking takes hold. This is a risk scenario generated by a rising likelihood of a recession in coming months as business confidence indicators continue to flash red globally including the Eurozone.

We also see more mismatch in the supply and demand for duration going forward. We believe already elevated debt ratios in the non-financial corporate sector (see Figure 4) blunt the incentive for a significant increase in debt supply in the coming years from corporates. On the other hand, demand for duration is likely to increase from central banks (which had paused quantitative easing for a few quarters and are now restarting asset purchases), and regulation-driven players such as banks.

FIG. 4 CREDIT TO THE NON-FINANCIAL SECTOR – DEBT BURDENS CONTINUE TO GROW



Source: Bank for International Settlements, LOIM Calculations.

Given this structural and cyclical backdrop, it is natural and pertinent for investors seeking a positive real rate of return to ask what investment strategies reach their targets, particularly as real rates settle in negative territory in a range of major markets. The issue is severe for EUR based investors, who, unlike USD based investors are unable to take advantage of the yield pick-up on offer driven by the cross currency basis spread. The basis market offers around 55 to 70bps of yield pick-up above 10 year Treasuries currently for USD based investors holding JGBs and bunds respectively.

Indeed, as global business cycle weakness has reappeared, there is a newfound urgency for positive real returns as negative nominal and real rates in risk free assets bed-in in a variety of major markets.

3 OECD iLibrary.

4 Guibaud, S., Nosbusch, Y. and Vayanos, D. (2013). Bond Market Clienteles, the Yield Curve, and the Optimal Maturity Structure of Government Debt. Review of Financial Studies, 26(8), pp.1914-1961.

Tackling negative real yields: publicly-traded assets

To reach the positive real return target, we see useful avenues, which are still available in publicly-traded markets as investors reassess the government bond dominated part of their portfolios. We go through these avenues in detail below in order to highlight the key features of the various options available to investors.

Favourable risk-return in crossover

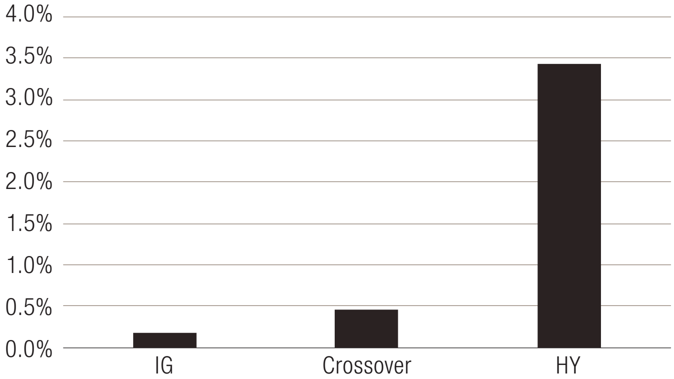
Our analysis continues to show that increasing allocation to pure investment grade (IG) credit at the expense of government bonds will not help much, as increasingly, we find the IG universe is being dominated by duration risk, intensity of which has strengthened in recent years.

Within the corporate credit universe, investors could move lower down the ratings spectrum for yield enhancement while still preserving the portfolio's average IG rating. In particular, we believe the crossover universe, consisting of the BBB and BB rating buckets, to be **a sweet spot** within the credit spectrum.[5]

Indeed the universe of BBB securities has expanded significantly since the 2008 financial crisis, from USD 936 billion in 2007 to more than USD 4.2 trillion currently. We believe a number of corporates in this space are prepared to deploy significant action (such as stopping share buybacks, dividend cuts etc.) to retain their IG rating. In addition, the vulnerability created by the rise of leverage in this segment is mitigated by very healthy **interest cover**. Should risk-free rates remain very low as we expect, then that cushion is likely to be an important source of protection[6] against both downgrades and potential defaults if the cycle turns. Furthermore, within the BB rating segment, the "**fallen angel effect**",[7] which has been more widely documented in recent years, adds a layer of structural outperformance against other rating segments.

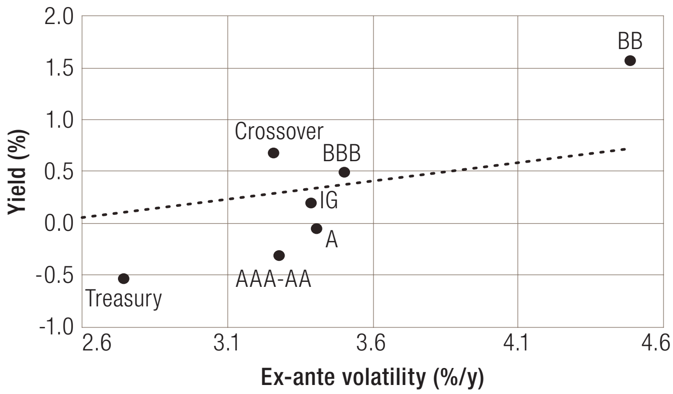
Consequently, coupling of the BBB and BB rating segments (whilst maintaining the average IG rating of a portfolio) could help investors to move towards their target return objectives. Importantly, this ratings bucket has in the past displayed a relatively low default risk profile, and compares favourably with the higher grade credit universe, despite offering higher yields as shown in Figures 5 and 6.[8]

FIG. 5 MOODY'S 3-YEAR DEFAULT RATE (ANNUALISED)



Source: LOIM calculations, Moody's annual default study 2018.

FIG. 6 EUR HEDGED YIELD VERSUS VOLATILITY OF GLOBAL FIXED INCOME SEGMENTS



Source: Bloomberg Barclays Indices, LOIM calculations. As at 30 September 2019. We use the Bloomberg Barclays monthly Global Risk model to calculate ex-ante risk as at 30 September 2019. Model considers historical rate-spread correlations.

5 For an extensive analysis, please see our white paper titled 'Crossover: the credit sweet spot' https://am.lombardodier.com/contents/news/white-papers/2019-1/august/crossover-the-credit-sweet-spot.html.

6 Capital protection is a portfolio construction goal and cannot be guaranteed.

7 Fallen angels refer to borrowers who have had their ratings downgraded from investment grade to high yield. The fallen angel effect refers to the broad outperformance of such bonds relative to their direct peers documented by various studies For instance, see our white paper shown in footnote 4.

8 Past performance is not a guarantee of future results. Yields are subject to change and can vary over time.

Moving down the debt capital structure

Moving down the debt capital structure of "quality" and higher-rated companies is another avenue to harvest additional risk premia with controlled default risk. Here we refer to instruments such as corporate hybrids and/or CoCos (contingent convertible bonds) for banks.

When it comes to the banking sector, given tighter banking sector regulations focused on building both capital and liquidity buffers and continued support of central banks via additional excess liquidity, we believe a repeat of a Lehman-type crisis is extremely low in major economic centers.

The Autumn 2019 repo market issues in the US and the ensuing Federal Reserve action show that central banks remain fully attuned to underlying liquidity issues, which can potentially hinder the healthy functioning of the financial system in a world of stricter regulations and changing central bank balance sheets.

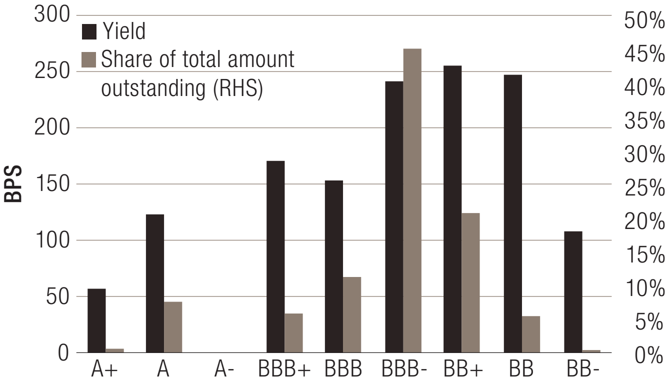
Overall, the outstanding amount of European corporate hybrids has increased more than 6.5 times since 2010 and now stands at EUR 134 billion. Around 45% of the nominal now sits in the BBB- bucket (with a credit spread of more than 250bp), whilst another 30% is rated high yield (HY).

Focusing on implementation, diversification is important to further mitigate the risks accompanying credit investing and given the higher incidence of idiosyncratic risks, quality focused portfolio construction is key in our view. This includes diversifying sectorally, geographically, and by issuer.

We are also emphasizing quality in credit portfolios, especially at this very mature stage of the business cycle, and therefore, we consider leveraging the balance-sheet strength of higher-rated, stronger corporates as a better route to generating excess returns compared to investing directly into HY companies. Moving down the debt capital structure of relatively higher-rated companies also helps counter liquidity concerns which can arise when tunneling down the rating spectrum for additional returns. Such concerns have indeed increased in recent years (what we refer to as "**fractured liquidity**") as the broker-dealer model has come under pressure due to a significantly more stringent regulatory framework implemented after the Lehman Brothers bankruptcy in 2008.

In addition, our emphasis on quality-focused implementation also stems from the inadequacies of standard market-cap benchmarks in fixed income investing, which are designed to reward leverage. Here a fundamentals-driven approach can generate the required **quality exposure**, which is very useful in down markets. Moreover, the implementation of these strategies can also happen in a target date construct, whereby a portfolio of bonds is held for a pre-determined period of time to allow increased certainty and visibility of returns over a given investing horizon. This could suit certain segments of investors.

FIG. 7 CORPORATE HYBRIDS BY RATING



Source: JP Morgan research, MARKIT Group. Rating used is numerical average of S&P, Moody's and Fitch.

FIG. 8 HIGH GRADE CORPORATE HYBRID SPREADS

Source: JP Morgan research, MARKIT Group. Rating used is numerical average of S&P, Moody's and Fitch.

Asia EM hard currency opportunities

The fall in global yields has driven continued inflows into emerging market (EM) hard currency assets in 2019. When it comes to asset class performance, EMs have benefitted from the fact that more than 80% of global central banks have eased monetary policy, driven by the Fed. In contrast, EM local currency flows have lagged again this year as FX returns have detracted from total return performance despite the hefty contribution from duration exposure.

With EM hard currency credit spreads remaining near 2018 wides, we believe the asset class can play a key role in driving structural return generation and diversification due to the still comfortable credit spread buffer on offer. Regionally, as discussed in a recent LOIM paper, credit quality is still significantly stronger in Asia than in CEEMEA and Latin America as **Asian corporates** have been less aggressive when it comes to recent leveraging trends.

FIG. 9 EM HY CREDIT SPREAD (EXCLUDING ARGENTINA)

Source: Datastream, Goldman Sachs Investment Research.

Very high debt ratios in China remain an important risk factor (the country weight of China in the standard JP Morgan Asia Credit Index is around 51%). However, the macro buffers available to China to help avoid a full-blown credit crisis are robust, given the very high domestic savings rate and a strongly positive net international investment (NIIP) position (at the end of 2018, China's NIIP was USD 2.1 trillion).

Here, implementation is again key, as a pure passive approach can run into the inadequacies of the standard benchmarks used by the industry. In contrast, an active approach can help generate excess return as well as helping buffer investors from downside (and especially from specific idiosyncratic risks).

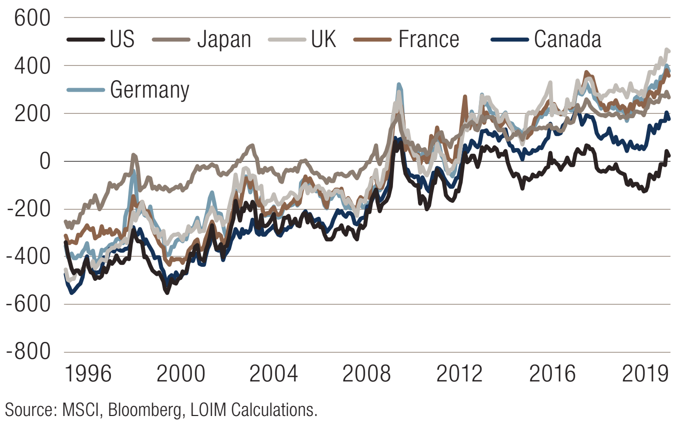
In local currency bonds, the EM universe offers relatively substantial positive real rates but also presents FX risks. On the FX front, despite sizeable depreciation in recent years, the deterioration in growth fundamentals of key emerging markets (versus DMs) and increased propensity of policy makers to use FX depreciation as a safety valve against domestic and international shocks have weakened the undervaluation argument. On a relative basis, we think, there is a stronger case for EM hard currency debt (especially, Asia) to replace local currency as a relatively low vol structural block in asset allocation schemes used by both pension funds and insurance companies.

Quality equities and dividend yield

In developed market equities, we note the very high level of dividend yield and positive spread versus government bond yields, especially when compared to recent history.

Dividend yield in UK equities is now north of 5%, for example, while DMs as a whole offer around 2.5% dividend yield (see Figure 10). There are also significant sectoral and factor style differences. These can be taken into account when building dividend yield, producing a diversified portfolio whilst controlling the beta or equity risk underlying the investment by adopting a focus on quality.

FIG. 10 MSCI INDEX DIVIDEND YIELD SPREAD OVER LOCAL 10 YEAR GOVERNMENT BOND YIELD (BPS)



Source: MSCI, Bloomberg, LOIM Calculations.

For instance, the current span of dividend yield in the UK ranges from more than 10% in the IT sector to only 2.2% in industrials. Of course, lengthy Brexit uncertainty is an important risk factor, though we see only a tail risk of a no-deal Brexit. And, given the current depressed valuations of UK equities, it is important to consider this now-available valuation support, especially because the companies in the FTSE 100 index do the bulk of their business outside of the UK.

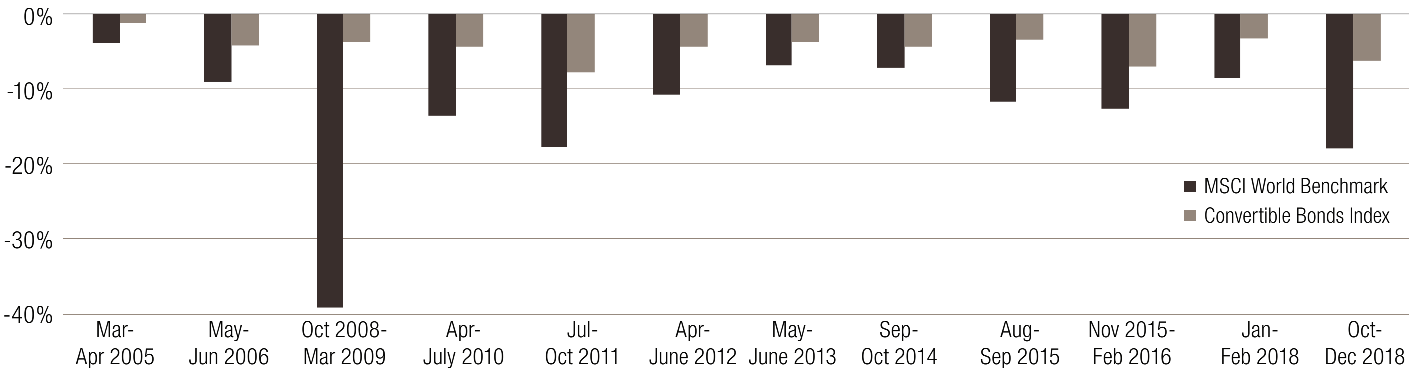
Convertible bonds

When it comes to mixing equity and credit risk, **convertibles** present compelling arguments because they offer equity upside while keeping bond protection floor (as shown in Figure 11). The embedded equity option in the convertible instrument is a valuable source of potential return, in our view, given the very mature stage of the business cycle coupled with low ammunition of the monetary policy side, which has generated an added source of uncertainty in risky asset markets. Moreover, the credit spread-driven yield on offer in convertible instruments (and especially in balanced convertibles) can help contribute to positive real return targets.

Multi-asset

Mixing equity, bond and other risk premia via multi-asset strategies continues to enable investors to access a diversified source of returns. However, given the current macro context, there is value in calibrating the multi-asset portfolio construction approach to allow for a target income generation using a combination of fixed income yield and capital gains. In cases where futures are used to access the various risk premia, the **very liquid nature** of such strategies means that a portfolio calibration which focusses on generating an income target can be applied smoothly, transparently and cost effectively. Moreover, the multi-asset framework can be broadened to include private assets as well in order to capture the illiquidity risk premium. Here, private credit, infrastructure and real estate investing are areas which can be used to enhance return potential of investment portfolios, especially for long-term investors. Already we are seeing strengthening flows, especially in real estate, as the search for yield penetrates deeper into the private assets investment landscape. We plan to publish a follow-up paper delving deeper into the private assets space focusing on the current return potential and risks involved when compared to public markets. Stay tuned.

FIG. 11 CONVERTIBLE BOND DRAWDOWN VERSUS MSCI WORLD DRAWDOWN DURING EQUITY CORRECTIONS



Source: LOIM, Bloomberg, May 2019. For illustrative purposes only. Based on Thomson Reuters Global Focus Convertibles Index hedged in EUR.

Conclusion

As investors face the deepening reality of sustained negative real rates in risk-free bond markets, especially in the Eurozone, there is no doubt that the current configuration of investment portfolios will need to be reassessed. A massive shift in thinking around usefulness of fiscal policy can certainly help lower the likelihood of Japanisation, especially in the Eurozone. That said, we think such a shift in thinking is unlikely to happen unless we encounter a deep recession – which will only strengthen further the forces of Japanisation.

Given this backdrop, we think there are a number of options still available in public assets space which can help investors achieve their target of positive real return. We also think that given the current stage of the business cycle, a quality-focused approach to implementation will be needed as underlying risk profiles of the portfolios are changed to make them more consistent with positive real return expectations.

17 96

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