FIXED INCOME

Cautious European Fixed Income Investors May be Sacrificing Yield

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David Zahn, CFA, FRM
Head of European Fixed Income,
Senior Vice President,
Franklin Templeton Fixed Income Group

Central banks in many parts of the world are shifting away from the accommodative monetary policies imposed after the 2007-2009 global financial crisis. The European Central Bank (ECB) has so far remained reluctant to move down that path, but pressure is growing on its leaders to signal their intentions. As markets wait for clarity from the ECB, Franklin Templeton surveyed continental European professional investors to gauge their attitudes towards changing market tides, asset allocation and investment considerations. David Zahn, Franklin Templeton's head of European Fixed Income, analyses the findings.

It has been well over a decade since the global financial crisis. In this time, markets have experienced a sustained period of easy monetary policy. European fixed income investors in particular have enjoyed periods of generally good returns and relatively low risks, thanks in part to the European Central Bank's (ECB) historic quantitative easing (QE) programme and record-low interest rates.

But in 2018, we are reaching an inflection point as central banks around the world begin a slow path to reduced stimulus. As the US Federal Reserve embarks on a clear rate-hike path and starts to unwind its balance sheet, the situation in Europe is somewhat different. The ECB remains accommodative. We believe it will remain accommodative until it sees inflation in Europe at its target growth rate of 2%. We think this is unlikely to happen before 2020.

But this does not mean that European fixed income markets are safe from volatility.

Despite the ECB reiterating its policy on several occasions, we are seeing isolated selloffs in bonds occurring throughout the year as markets try to accurately estimate the timing of a change in policy. Earlier this year, bond yields across Europe rose following the January ECB announcement, despite no policy change announced.

These bouts of volatility can have a significant impact on the performance of a fixed income portfolio. For example, a 10 basis-point rise (0.1%) on a 10-year German government bond (bund) with an end-of-year yield of 0.427% would wipe out over two years of potential income.

In my view, investors can no longer afford to take a sleepy approach to their European fixed income investments. As volatility returns to the European fixed income landscape, investors may consider taking an active, dynamic and considered approach. I think those that do could find favourable buying opportunities arise through the volatility.

In order to understand more about investor perceptions towards European fixed income, we surveyed over 300 European fixed income professional investors from France, Germany, Italy and Spain on their attitudes and concerns towards the changing market tides, their asset allocation and investment approach[1].

The results were surprising and generally showed that investors were being overly cautious in the management of their portfolios and expressed a generally low risk appetite. Despite this, when they did take risk, it tended to be in high-yield credit instruments, despite fears of stretched valuations. In addition, they generally did not take much action when it came to concerns around low returns, and in some cases took what we'd consider to be too much action when it came to mitigating other concerns such as interest-rate risks. In general, the key themes from the findings were:

- Defensive positioning: Investors reported a low appetite for risk amidst concerns such as rising volatility.
- High yield: Where investors surveyed were willing to take risk.
- Lack of action: Despite the low yield environment, investors were still focused on core European markets with low returns.
- Too much action: Despite thinking interest rates will stay low in Europe, investors surveyed said they were reducing duration, sacrificing precious yield.
- Future trends: Respondents reported emerging appetite for "green" bonds, socially responsible investing (SRI) bond funds and impact-investing funds.

To read or download the full report visit: http://www.franklintempletonglobal.com/european-fixed-income-study-2018

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1. Franklin Templeton European Fixed Income Investor Attitudes, Concerns and Actions 2018. The survey was conducted among a sample of 320 professional investors (advisers and discretionary fund managers) in four European countries: France, Germany, Italy and Spain. The survey was administered during January 2018, by CoreData Research.