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PRICE POINT

October 2017

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Global Fixed Income
Q&A WITH ARIF HUSAIN

Arif Husain
Global Head of Fixed Income

KEY POINTS

- The main risks and opportunities in 2018 will arise from central bank tightening: The risks will arise from the impact of a number of central banks tightening at the same time, and the opportunities will come from increased volatility and differentiation between markets.
- Systematic risk factors do not currently offer good value for money because rates are low, credit is tight, and volatility is muted. One way of responding to this is to allocate more to idiosyncratic risk assets that are sufficiently driven by their own stories to behave differently than the broader market.
- Insurance positions have not offered value for money in 2017 because the markets have not been moving sufficiently when negative events have occurred. However, this may change in 2018, and we think there are risks that will require some form of insurance.
- The 2008 financial crisis forced regulators to take actions that they would previously never have considered in order to save the global economy. As a result, they will be psychologically better prepared to respond to the next one.

Arif Husain, global head of fixed income, answers questions about what risks and opportunities he believes the market will have in store next year, if clients' needs have changed, and whether the world is better prepared for a financial crisis than it was in 2008.

What risks and opportunities do you anticipate in 2018?

The main risks and opportunities will derive from the same place: central bank tightening. The risk comes from central banks basically focusing on domestic agendas—the Federal Reserve, European Central Bank, Bank of England, Bank of Canada, and Bank of China all tightening for domestic reasons. Each of the central

banks tightening individually would probably be OK, but all of them acting in synchronicity may have an impact that the markets are not prepared for.

But there is also a huge opportunity. First, because it will create more volatility in systematic risk factors, which in turn creates more areas in which to invest; and second, because some central banks will continue to ease, creating differentiation. It may well be that some countries that in the past have been considered high risk may end up as better places to invest in than the traditional "safe" countries because of this diversion in monetary policies.

In the past, you have highlighted the importance of differentiating between systematic and idiosyncratic risk. Can you elaborate on this?

First I should probably explain what we mean by systematic and idiosyncratic risk. Systematic risks describe major factors such as credit spreads, movements in equity markets, rates, and so on. Idiosyncratic risk factors are those that move in a different direction than the broader market. They dance to their own tune.

I think most people would agree that the majority of systematic risk factors in the world at the moment do not offer a good risk/return opportunity because rates are so low, credit is tight, and volatility is muted. One way of responding to this is to allocate more to idiosyncratic risk assets that are sufficiently driven by their own stories to behave differently than the broader market—that have some "hair" on them, as we say. However, there tend to be few of these idiosyncratic risks about, which means that in order to benefit from them it is necessary to take more concentrated positions over a longer time horizon and be willing to tolerate some adverse outcomes.

The fundamental things that clients want remain the same: income, protection against the downside, and diversification.

Is insurance likely to still be a major factor in portfolios next year?

You can take insurance in two main ways: You can either be underweight or short something that tends to be high yielding, which presents an opportunity cost, or you make a direct outlay on options. Both types of insurance are currently cheaper than they have ever been. In the first case, this is because yields are so low that there is little opportunity cost in not owning them, and in the second case it is because implied volatility is low, which reduces the cost of options.

Despite being so cheap, however, it's questionable whether insurance has offered good value for money over the past few years. In recent times, the markets have not been moving sufficiently when bad things happen for people to benefit from holding insurance. When North Korea lobbed a missile over Japan, for example, the market reaction was one of nonchalance; when the UK voted to leave the EU, the reaction was more severe but lasted only around five days. Were these reactions the "correct" ones? In my view no, but we have to deal with how markets actually react, not how we think they should react.

So the question for next year is whether the market will continue to be nonchalant, or whether there are exogenous risk events on the horizon that mean that it won't have a choice but to react. We think there are risks that will still require some form of insurance, primarily central bank tightening and the situation in North Korea.

Underpinning our process is a simple question: "What do our clients want from their bond allocation?" Has there been a fundamental change in what clients want from their bond portfolios since you joined the firm?

No. The fundamental things that clients want remain the same: income, protection against the downside, and diversification. I don't think that will ever change. However, it is also clear that the usual sources of income and

protection are not working as well as they have done in the past—yields are so low that U.S. Treasuries no longer offer the same protection, while traditional income products are generating less income. This means that we have to look in different places for those qualities. At the same time, clients are becoming more specific about the level of protection and income they require. Together, these two developments are creating the need for a greater variety of products that tailor to clients' specific needs by investing across a broader range of assets.

Did the last financial crisis leave us better prepared for the next one?

Yes and no. "No" because the next crisis will be fundamentally different. The world worked very hard to fix the credit problems that caused the previous crisis, but one of the consequences of that is that attention may have been diverted from the potential causes of the next crisis. So we may be underprepared in that way.

"Yes" because the experience of the last crisis has left the world better equipped psychologically to deal with the next one. In their response to the last crisis, regulators broke so many rules and tried so many new things that they crossed a legislative Rubicon—they got past the point at which they'd say, "There's no way we can do this" and reached a place where they now say, "We'll do whatever it takes." So when the next crisis comes, the authorities might not have the tools immediately at hand, but they'll be psychologically prepared to take the appropriate action more quickly.

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201710-286570

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