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Who could be the winners and losers in the world of fixed income?

On-the-ground insights

Authorities around the world have unleashed an unprecedented amount of fiscal and monetary support to offset the economic damage caused by COVID-19. The ongoing pandemic will have a profound impact on economies for months and possibly years to come. What does that mean for bond investors today?

Key webinar takeaways

- The eventual global economic recovery will be supported by the fast and creative monetary and fiscal support by governments and central banks which has gone well beyond what we witnessed in 2008/2009
- In the absence of a vaccine and effective therapeutics, the recovery will be unlike any we have ever known – investors must tread carefully. There will be growth setbacks and uneven effects around the world
- Just like in 2008, leverage in the financial system is ultimately getting transferred to governments. This will create winners and losers with some companies and industries better supported than others
- Not all regions and sectors are affected by COVID-19 in the same way. This creates some buying opportunities
- Domestic fiscal deficits funded by central bank bond purchases could reduce the flows of capital across borders in future
- Government monetary and fiscal support could set the stage for an eventual increase in inflation. Investors should consider owning inflation protection in portfolios
- We prefer investment grade over high yield credit and see selective opportunities in emerging markets in the medium to long term

Jonathan Gregory, Head of Fixed Income UK

The COVID-19 market aftermath

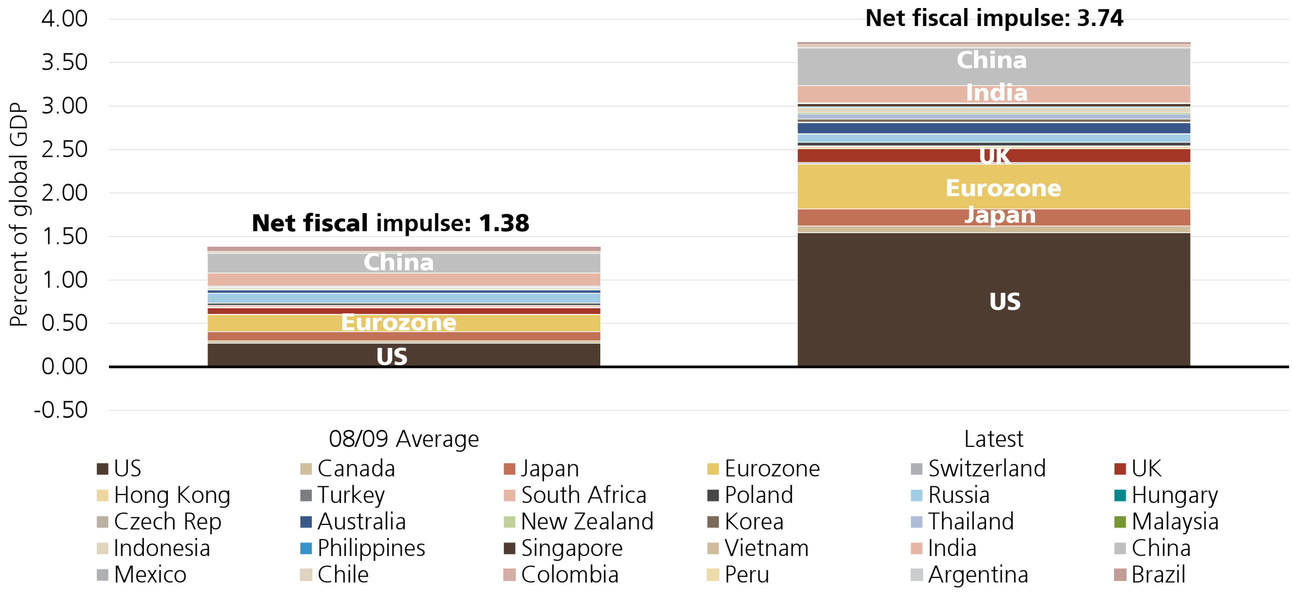
The market impacts post COVID-19 present three key pictures. First, nominal yields are much lower everywhere than before the crisis and real yields are generally lower but haven't rebounded to pre-crisis levels, this could indicate opportunities for real yields to outperform in future. Second, we saw widened spreads across all credit markets, then a retracement which has paused more recently in investment grade and high yield (HY) and more noticeably in emerging markets (EM). EM spreads have not retraced to the same level as HY and Investment Grade (IG) in developed markets which may present some upside opportunity. Third, the dollar experienced a high level of volatility and is now at a higher level than before the crisis started.

This environment will create winners and losers, and risks and opportunities for active investors. The most successful investors will be those that are flexible, question investment decisions and their own expectations and views.

Global fiscal stimulus in perspective

The mantra of governments globally is one of acting quickly and forcefully in response to the market turmoil. Fiscal stimulus today as shown below is almost three times higher than during the 2008/2009 crisis. Furthermore, these figures do not include government guarantee programs and shows just the actual government spending. In reality, the International Monetary Fund has stated that developed market fiscal deficit levels could average at 11% of global GDP by the end of the year or 15-20% if you include the corporate guarantee programs. The figures below, therefore, paint an understated picture of real debt levels.

Fiscal stimulus levels across developed countries



Source: UBS Asset Management, UBS Investment Bank, as at 15 April 2020

From monetary policy to credit policy

Many central banks have had to go above and beyond in their policies to support their economies. The COVID-19 pandemic and associated lockdowns are causing what will likely be the deepest recession since the Great Depression. The US Federal Reserve (Fed) has introduced facilities well beyond those in 2008. The liquidity facilities are very similar to the previous crisis but the Fed has had to expand to include credit facilities incorporating the primary and secondary credit markets. Main-street facilities – support for small and medium-sized companies – have also benefited from the expansion and are an important part of the monetary policy toolkit today.

The journey to the new world

In the absence of a virus vaccine and effective therapeutics the recovery will be unlike any we have ever known – we will need to tread carefully when economies reopen. The path to recovery will be quite uneven across countries. Even with a smooth exit, some countries will face challenges indirectly; for example manufacturers relying on imports from a country which is not as far along the recovery curve, creating supply chain disruptions.

The era of 'independent' central banks and inflation targets is ending. For the past 10 years central banks were the dominant actors in markets, even before COVID-19 the heavy reliance placed on monetary policy alone and failure to meet inflation targets was presenting a challenge to central banks and governments to change the approach. For the foreseeable future monetary policy in many countries will be moving away from devotion to a single inflation target to an approach which is much more coordinated with fiscal policy. Governments will need their central banks to act to keep yields low.

Just like in 2008, leverage in the financial system is being transferred to governments. Fiscal deficits are growing this year which will create winners and losers – by accident or design. Companies supported by government schemes are more exposed to scrutiny on how they pay dividends, directors bonuses akin to the banking sector scrutiny during the global financial crisis.

COVID-19 and the policy aftermath will have implications for the movement of goods, people and capital.

The PowerPoint slides are available upon request.

Q&A:

1 Is the recent repricing in EM a buying opportunity?

Federico Kaune (FK): EM credit spreads are at levels comparable to the 2008/2009 crisis. Spreads haven't tightened in part because developed market central banks are not directly buying EM credit. Spreads are pricing in broad defaults, the lack of capacity and willingness of emerging economies to pay, none of which is likely to be realized. For investors with a medium to long-term horizon, there are opportunities to lock-in high spreads.

Short-term, we expect continued volatility in EM credit and currencies because of the uncertainty surrounding global growth, commodity prices, capital flows and the policy responses from these countries. But if one is willing to take a longer-term view, I believe there is value in credit.

2 What impact have the Federal Reserve's bond purchase programs had on the market liquidity?

Craig Ellinger (CE): We have seen an increase in risk-taking as result of the Fed's actions. In March, the Fed has announced several new support programs and dusted off some old ones. On the quantitative easing front, they recently purchased approximately USD 1.6 trillion in US Treasuries and USD 600 billion in mortgage-backed securities. The purchase of these high quality assets essentially stabilized the markets and improved overall market liquidity. The Fed hasn't bought any corporate or HY bonds yet, but by announcing their intent to do so, they have effectively provided a backstop to the credit markets. It has become much easier for us to buy and sell bonds of all types.

3 What could prevent the US from being a 'winner'?

Jonathan Gregory (JG): The US was in a strong economic position going into the recession, which will help in dealing with the crisis. The Fed and the Treasury are working in harmony, with the Treasury providing the equity and the Fed providing the debt. There isn't quite that harmony between the European Central Bank and fiscal authorities, although it may come.

Perhaps the biggest challenge to the US emerging as a winner is the risk of mis-timing its lockdown exit and the risk of second wave infections. Also, if the US fiscal response gets too large and becomes outright debt monetization, inflation could rise higher than expected or desired.

4 Why haven’t US HY spreads moved that much compared to the rebound in equities?

CE: HY bond spreads have moved since the peak in March from around 1100 bps to 800 bps today, but haven’t retraced as much negative performance as the equity markets have. HY spreads have stalled for several reasons. Fundamentals were already a bit stretched coming into the COVID-19 crisis, and as companies try to cope with it, there is a high probability corporate leverage will increase as revenue and cash flow deteriorates. Defaults are expected to rise. The supply of HY debt is also expected to increase dramatically as fallen angels lose their investment-grade ratings. Also, while improved, liquidity in the HY market is not nearly as good as what has been observed in other markets segments. While the Fed has announced the purchase of HY ETFs, we don’t know how this will actually pan out in practice. We probably won't see further spread tightening until the Fed is more explicit in their plan of HY purchases.

5 Is this the time to buy US TIPS?

JG: We believe TIPS (Treasury inflation-protected securities) are a good opportunity.

Over the past 10 years, we've been used to inflation not being an issue, for a variety of mostly structural reasons so even before the COVID-19 pandemic, central banks were getting more serious about finding ways to move inflation higher. The goal of governments and central banks will be to drive real yields as low as they possibly can to avoid tightening in financial conditions. Couple that with the truly extraordinary levels of fiscal support we're going to see from August on, the likes of which we haven't seen in our lifetimes.

While we will be in a deflationary world over the next few months, there's no question that the risk of inflation will increase thereafter. A decent amount of inflation protection in portfolios makes sense. The 5-year bond looks like a particularly good value at current price levels.

6 Is this the beginning of the end for the eurozone and the European Union as we know it?

JG: Personally I don't think this is an existential crisis for the eurozone. If you are an EU politician disappointed with level of support received from richer countries, it is still hard to articulate a scenario in which you would be better off outside the eurozone. We may not like the way the EU goes about dealing with a period of crisis, but it comes through. There's not a politically credible world outside the eurozone for many countries. Maybe that will come in the future but it's not now.

The European Union does have the institutions to organize a coordinated fiscal policy response to a crisis like COVID-19. The European Central Bank is doing all the right things. I think potentially in the short term at least, the peripheral eurozone members could be among the winners from the ECB's support programs.

7 What sectors of the market are you most confident investing in now that we are most certainly in a recession?

CE: We remain positive on the investment grade (IG) corporate space, particularly in USD. The Federal Reserve has announced unprecedented policy measures to directly support that market through two new credit facilities which should result in considerable spread tightening. We like higher quality credit in general, which includes asset-based securities and mortgage-backed securities. Within IG, we prefer the banking, healthcare, media, and technology; each of which should perform in the current environment.

8 Given the challenges you posed for the recovery what parts of the credit market look most attractive?

JG: The trades we like are in global credit right now. Generally our mantra is to buy what the central banks are buying. As the Fed buys primary and secondary issues, including fallen angels it is underwriting financial stability in the credit markets. We view the IG market outperforming the HY market, we like quality IG names in single A and above and we particularly like the 5-year part of the curve.

9 Which parts of the yield curve do you like in US dollar and EM currencies?

FK: The US dollar sovereign spread curve is very flat in IG and inverted in HY. We are not getting paid to extend duration unless its investment grade, the value is in the short-end of the curve – the 3-5 year spread over US treasuries for HY and the long end of the curve for IG. Overall, there is a compelling yield differential between EM and DM countries.

JG: It's a similar story for the US yield curve. We buy what the central bank buys which is the 5-year point on the corporate yield curve. We do not expect much US yield curve steeping as its highly likely the Fed policy toolkit will be expanded to include yield curve control measures which flattens the curve.

10 What is the outlook for China?

FK: We favor China within the EM space and like the local rates since the central bank has implemented many policies to help with the recovery in addition to opening up its markets to foreign investment in recent years. The government has announced no defaults will take place in China in 2020, providing much needed support to companies. China bonds are increasingly included as a constituent in global indices such as Bloomberg Barclays and JP Morgan Bond Indices which will generate huge investment into the country's bonds.

11 What about emerging market countries in general?

FK: One has to differentiate among different groups. We like some of the larger, mainstream emerging markets countries. There is value, especially at the longer end of the local curve, where 10-year bonds are yielding between 6% to 9%. The most vulnerable countries are low income countries with limited access to international capital markets. Some of the oil-exporting countries are under increasing stress due to declining oil prices, but it is important to differentiate here as well. Some manage their dependence on the oil sector very well and remain in a good position.