

Investing in the Twilight Zone

Global fixed income risks and opportunities

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In brief

- Two competing narratives have taken hold in the global fixed income markets: a risk-off *Case for Caution* based on significant fundamental economic concerns in the wake of the pandemic lockdowns and a risk-on *Case for Optimism* predicated on unprecedented monetary and fiscal stimulus and positive vaccine news.
- Lower-for-longer rates are forecast to prevail for some time to come and, similarly, credit spreads will likely continue to be anchored by central bank intervention.
- For investors, ultra-low yields elevate the importance of generating alpha relative to market beta.
- The best way to generate yield in this environment, in our view, is to be cognizant of duration risk and top-down asset allocation while focusing on security selection.

Investors are in uncharted territory and navigating complex crosscurrents that are likely to persist, including weak economic conditions and the effects of the pandemic. While the efficacy of vaccines recently approved is a bright spot, the manufacture and distribution of the vaccine is likely to be challenging. Normalized economic activity is unlikely to resume before the third or even fourth quarter of 2021, when herd immunity is expected to occur once sufficient numbers of people have been vaccinated.

We see two competing market narratives taking root in this context: a risk-off *Case for Caution* based on the large output gap, weak labor markets and significant economic dislocation and a risk-on *Case for Optimism* that rests on the enormous monetary and fiscal stimulus provided and the positive vaccine news (see Exhibit 1). Market participants must now make investment decisions in the terrain between these two poles — a twilight zone of a kind.

Exhibit 1: Two Competing Narratives — Case for Caution vs. Case for Optimism

Case for Caution – Risk Off		Case for Optimism – Risk On
Fundamentals: weak growth, especially in services	Twilight Zone	Liquidity Injections: unprecedented monetary and fiscal stimulus
Valuations: spread compression		Vaccines: efficacy high; herd immunity in G7 by mid-summer 2021
Geopolitical Risks: US-China conflict; US policy uncertainty		Technicals: strong new issuance; central bank backstop; credit inflows
AI/Technology: disinflationary secular trends gather pace		Green Tech: investment in renewable technology
Market Fragility: dependence on central bank support; credit market liquidity		Reflation Concerns: higher inflation tail risk

Case for Caution

The cautious scenario highlights the fundamental concerns reflected in a large output gap (the gap between actual and potential GDP), significant labor market disruption and elevated levels of unemployment, revenue declines, particularly in the services sector, and high and rising levels of corporate debt. Access to credit is unequal, with smaller companies generally faring worse than larger enterprises and often facing both liquidity and solvency difficulties.

The economic weakness is a global phenomenon, as the output gap for G7 countries shown in Exhibit 2 illustrates. Economic activity and labor markets that have suffered extensive dislocation, particularly service industries such as leisure and retail, will take a long time to recover. The economic scars of the pandemic will persist well beyond the vaccination timelines. In addition, despite the positive news of vaccine rollouts, there continues to be uncertainty over how the virus will evolve, with the discovery of new strains causing concern.

Exhibit 2: Global Activity Plummets —G7 Output Gap as % of Potential GDP



Source: Bloomberg. Annual data from 1995 through 2019. IMF forecasts for 2020 and beyond as of October 2020.

The fundamental concerns have been playing out against the backdrop of less favorable valuations following the spread retracing that has taken place since the initial widening in March, when lockdowns began. At these levels, spreads are generally not adequately reflecting the recessionary conditions.

Geopolitical tail risks remain an ongoing consideration. The anticipated orderly transfer of power in the US is a positive, but there is some uncertainty about what the size of the deficit will be with the Senate now also in the hands of the Democrats. US–China tension is likely to remain heightened across a number of dimensions, including trade policy, intellectual property and technology, especially where there are national security considerations such as 5G mobile networks.¹

Secular disinflationary factors are also a headwind. The increasing adoption of artificial intelligence and other technological innovations are notable disinflationary trends that have accelerated during the pandemic as the need for social distancing has led to more demand for machine-led solutions that minimize human contact. In general, the pandemic has also led to a widening inequality gap, which could have important political and policy consequences in the medium term.

Systemic market factors are an additional concern. The dislocation that occurred in March, when major economies entered lockdown, revealed a market fragility that is hard to ignore. The injection of large-scale stimulus has papered over some of the cracks (for now). In the medium term, however, the systemic fragility of the market will likely come to the fore again. Markets and the economy have become dependent on stimulus, but there is a clear limit to policymakers' largesse.

The large liquidity injections can also have unintended consequences, such as misallocations of capital and other related distortions, including the rise of zombie companies that would not otherwise survive were it not for government intervention.

Case for Optimism

The gargantuan global stimulus provided in response to the lockdowns and the recent positive vaccine announcements are key pillars of the optimistic scenario. The size of the monetary response dwarfs the stimulus provided during the global financial crisis. And this time central banks have increased the scope of their buying as well as the amount, abandoning previous red lines to include municipal, corporate and high-yield bonds as well as financial instruments such as ETFs. Interest rates have declined to levels not seen this century in response.

The extent of the monetary accommodation has raised the question of reflation. Inflation tail risk has risen but is not expected to be a major concern in the coming year given the underlying economic weakness and the expected lengthy recovery.

The global fiscal response to the pandemic has been equally unprecedented. The need to fund the fiscal stimulus with debt inevitably raises the question of debt sustainability, especially in countries like the United Kingdom, Italy and Brazil, which have large levels of national debt to GDP. In the US, with a unified government under the Democrats, the fiscal stimulus this year will run into the trillions of dollars, which, again, will support a quicker economic recovery but raise concerns about long-term sustainability, the increased supply of Treasuries and the path of the US dollar.

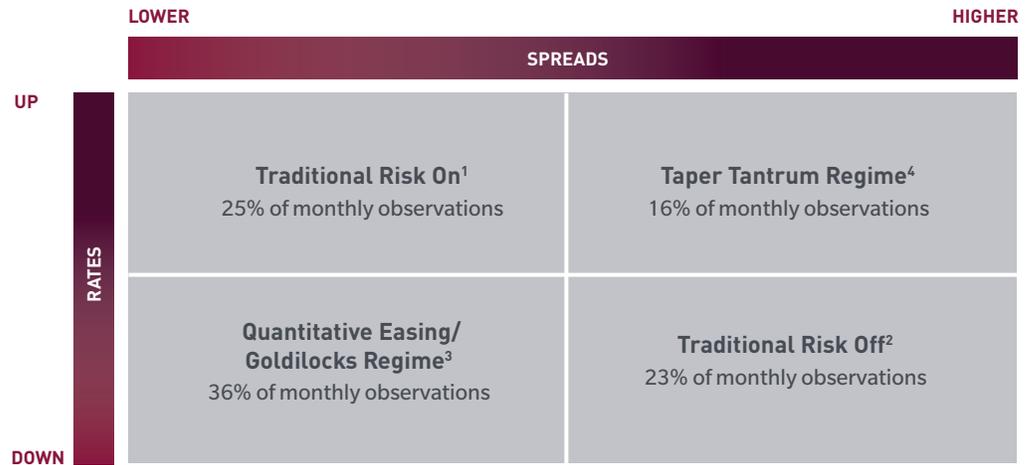
Capital markets — a voting mechanism, after all — have declared the optimistic case the winner, at least for now. If this "Goldilocks" scenario prevails, equity and credit markets are expected to perform well. Credit yields are effectively capped given the nature of ongoing central bank market intervention.

Investing in global fixed income: Goldilocks forever?

Time horizon is an important consideration when examining investment opportunities. The stimulus injected is papering over the cracks in the economy at present, in our view. In about 18 months, though, the markets may well begin to focus on the outside debt on corporate balance sheets and the credit stress that poses as policymakers pull in the reins.

We could see a "taper tantrum" unfold as we have witnessed in the past following a Goldilocks period of accommodative policy. Exhibit 3 plots the different regimes that have characterized the fixed income markets over the past two decades. A Goldilocks scenario fueled by central bank quantitative easing (QE) has existed about a third of the time. These periods have in some cases led to taper tantrums when central banks scaled back QE programs.

Exhibit 3: We live in an unstable equilibrium

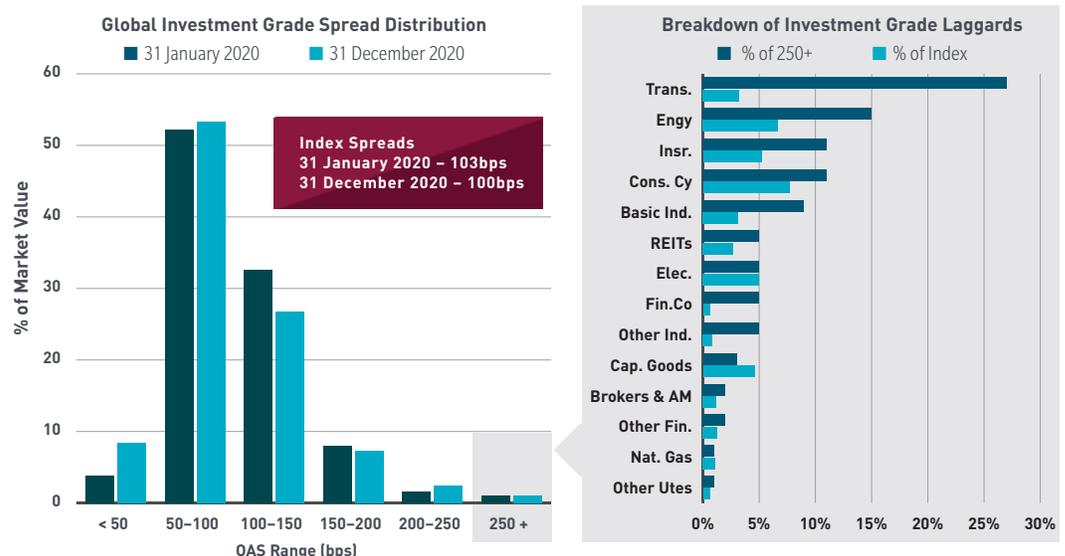


¹ A monthly positive credit spread return and negative duration matched government return.
² A monthly negative credit spread return with a positive duration matched government return.
³ A monthly positive credit spread return and positive duration matched government return.
⁴ A monthly negative credit spread return and negative duration match government return.
 Source: The Bloomberg Barclays Global Aggregate Index monthly total and excess return data from January 1999 to December 2020 was used to calculate monthly observation within each category.

In the near term, vaccine approvals and high efficacy rates have provided a time frame for the end of the pandemic and helped to buoy markets. With spikes in volatility and dislocation often leading to increased dispersion in the investment universe, active security selection may offer opportunities.

Exhibit 4 shows the change in spread distribution for global investment-grade bonds from January to October 2020. The increased dispersion in issues trading above 200 basis points is notable. Tail risks in credit are larger in these types of environments; they also provide investment opportunities.

Exhibit 4: Global Investment Grade Spread Distribution



Source: Bloomberg Barclays Global Investment Grade = Bloomberg Barclays Global Aggregate Corporate Index.

Conclusion

With yields and beta so low, alpha generation will be more important than ever, at least until the environment normalizes. Investors expanding their opportunity set and embracing a flexible global multi-asset approach may support alpha generation.

In our view, the best way to generate yield in the coming couple of years is to be cognizant of duration risk, be agile regarding top-down asset allocation and, most important, focus on security selection. Searching for yield in the liquid rather than the illiquid parts of the market may offer benefits. In a near-term range-bound environment, carry is key, but understanding the associated risks will be critical to avoiding drawdowns in anticipated periods of volatility in the longer term as central banks normalize policy and markets react. In this context, a comprehensive hedging strategy with diversified hedges becomes more important.

We believe credit and emerging market debt may do well in this context. Spreads have lagged in EMD, not compressing in line with other fixed income markets following the spread widening in March. The hunt for yield is unlikely to abate. As long as the optimistic market narrative dominates, risk assets are expected to remain in favor. ▲

Endnote

¹ 5G is the fifth generation technology standard for broadband cellular networks, which cellular phone companies began deploying worldwide in 2019, and is the planned successor to the 4G networks which provide connectivity to most current cellphones.

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