Central Bank Action Will Support Investment Grade Credit

Tom Coleman
Global Head of Fixed Income Investment

In 2020, proactive central bank efforts, including quantitative easing (QE) and purchase programs aimed at supporting credit market liquidity, played a major role in stabilizing and improving the trajectory of fixed income markets. We believe that these activities will continue to be a substantial factor as we look forward to 2021.

The US Fed, for example, is likely to maintain its policy rate at (or near) zero indefinitely as it seeks to achieve its desired outcomes of lower unemployment and higher inflation. In general, we expect continued central bank intervention will keep yields rangebound at historic lows, and for central banks' demonstrated willingness to purchase mortgages and corporate credit to continue to act as a stabilizing factor for credit markets. In this environment, investors will increasingly turn their attention away from government debt to fixed income offerings that provide more substantial yields.

Another force that is likely to influence fixed income decision making in 2021 is the secular bear market that we expect to take shape for the US dollar. Those expectations were reinforced by the Biden victory and the clear prospect of Congressional gridlock (depending on the outcome of two Senate runoff elections in January). A Biden administration is likely to be both more friendly to global trade and more stable, reducing the risk of a downward-spiraling trade war. These benefits for global trade will translate into a disadvantage for the dollar, although pandemic-related uncertainty and high levels of market stress have so far supported relatively high USD valuations. Those high valuations, paired with very low yields for the currency, are generating substantial pressure on USD to revert to fair value.

With this background in mind, we offer a few key points for fixed income investors to consider in 2021:

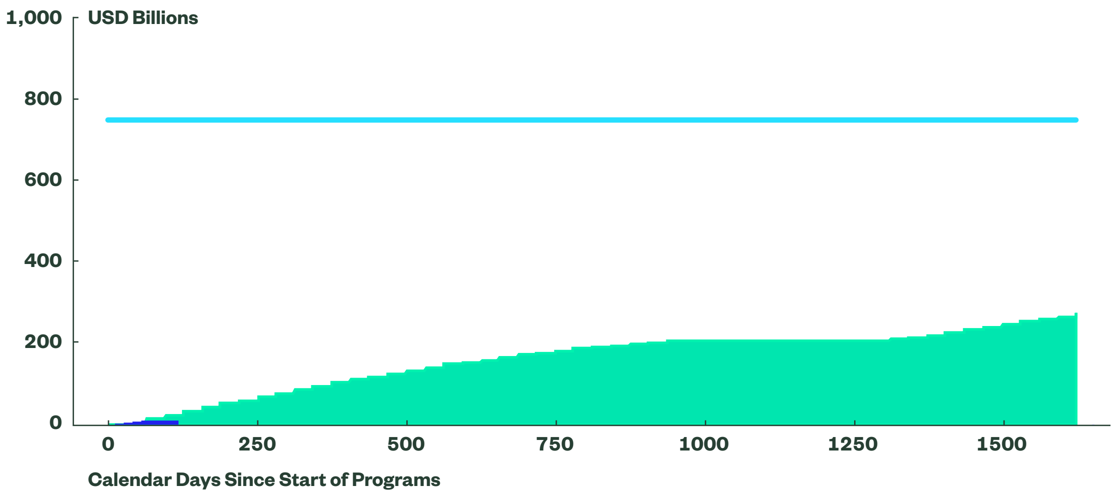
We prefer investment grade corporate credit, where US Fed and European Central Bank (ECB) buying programs have been effective in compressing spreads. The mere signal that central banks are willing to purchase corporate bonds has had a stabilizing effect on fixed income markets. Since the March announcement of the Fed's Primary and Secondary Market Corporate Credit Facility programs, spreads have tightened dramatically — despite the very small volume of actual Fed purchases (see Figure 1).

While the immediate future of the Corporate Credit Facilities has been called into question by the US Treasury's recent decision to let the programs expire on December 31, 2020, we believe this to be a temporary setback and that the incoming Biden administration will likely reinstate the program. The benefits of the program in terms of supporting functioning credit markets are well documented, and the regulatory and legal framework has already been built to support it. In the meantime, the ECB continues to implement its QE activities through the purchase of corporate credit, and the Fed (as distinct from the US Treasury) has already sent a strong signal through its 2020 actions that it stands by to support credit markets if necessary.

Other asset classes favored by central banks, such as US agency mortgage-backed securities, are also likely to benefit from the positive technical effect created by the presence of a large buyer in the form of the ECB's buying program, and by these strong signals of central bank support more generally. The tidal wave of corporate issuance in 2020 has served to strengthen balance sheets; this, combined with the likely support of the Fed in the event of an economic disruption, translates to a favorable outlook for investment grade credit through 2021. Although high yield credit also offers spread potential, we are more cautious with respect to high yield, given the current point in the cycle and rising default risk.

It's also important to note that, due to the significant drop in yields, hedging costs for investors globally have come down substantially. The hedged yield pickup across US corporates therefore should be particularly attractive for overseas investors.

Figure 1
Central Bank Buying Programs Exerted a Substantial Stabilizing Influence on Markets in 2020, Even Though Actual Purchases Were Much Less than Program Capacity
Cumulative ECB and US Fed Corporate Bond and ETF Purchases Since Program Inceptions

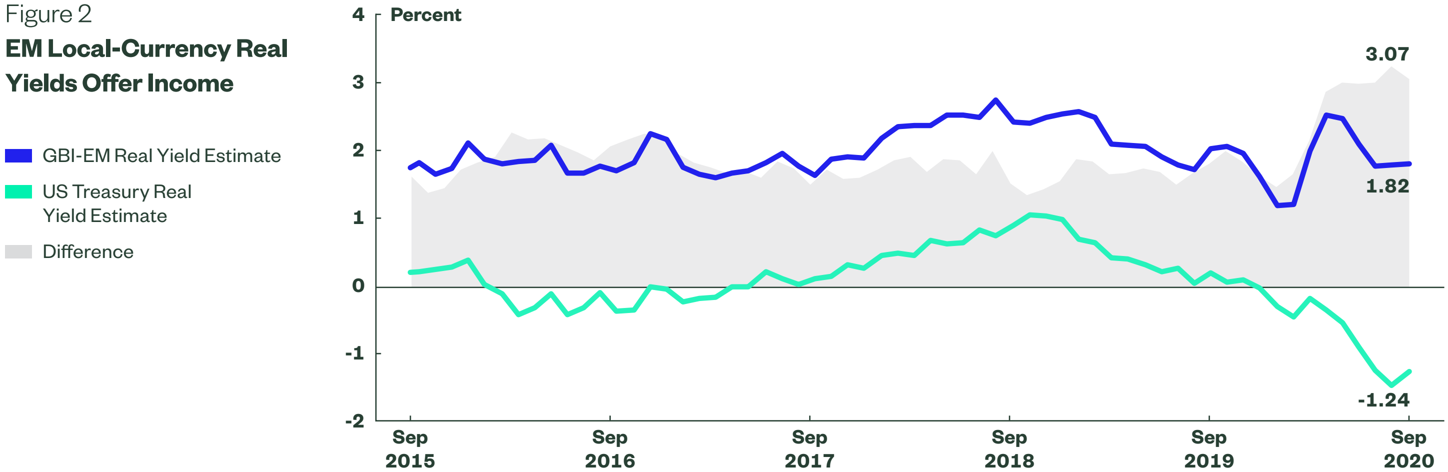


- Total US PMCCF & SMCCF Capacity ($750B)
- Cumulative Fed USD Corporate ETF & Bond Purchases
- Cumulative ECB EUR Corporate Bond Purchases

Source: US Department of the Treasury, as of August 31, 2020. "PMCCF" represents the Fed's Primary Market Corporate Credit Facility; "SMCCF" represents the Fed's Secondary Market Corporate Credit Facility.

In light of a potential bear market in the US dollar, emerging market (EM) currencies are poised to outperform; local-currency EM debt presents a particularly appealing opportunity. EM local-currency real yields are above long-term averages and remain attractive, particularly when compared with US real yields, which have recently turned quite negative (see Figure 2). As we look to 2021 and beyond, and toward a more permanent recovery enabled by a medical solution to the crisis, the US is likely in a better position to recover more rapidly compared with emerging markets. Under those conditions, US real yields should normalize from their current negative levels, narrowing the gap in real yields with emerging markets. This would lead to the relative outperformance of EM bonds, with the potential for a further tailwind from currency.

Figure 2
EM Local-Currency Real Yields Offer Income



Source: State Street Global Advisors, JPMorgan, as of September 30, 2020. For illustrative purposes only.

Meanwhile, EM currency valuations currently reflect the short-term stress of a building wave of COVID-19 infections. If we take a one- to two-year view, however, and consider prospects for a durable economic recovery, we believe that those prospects have yet to be priced into EM currencies. Indeed, EM currencies are currently priced at one of the steepest discounts we've seen in two decades, relative to the US dollar. Given our secular bear outlook on the dollar overall, local-currency debt will be attractive for investors in the coming year.

China will warrant particular attention from fixed income investors in 2021, with very high yields and a steady schedule of capital flows expected via inclusion in bond markets by 2029. China's bond market exhibits relatively low correlation with other asset classes, with a risk profile that matches developed market bonds and supportive technicals, driven by inclusion in bond indexes. As a result, Chinese fixed income assets may have much to offer investors over the next year, not just because of the potential for yield pickup, but also because we see room for appreciation.

As we look forward to 2021, quantitative easing and other central bank actions will doubtless exert a substantial influence on fixed income markets. At the same time, we believe other forces — including the increasingly urgent prospect of a secular bear market for the US dollar — will also become increasingly influential in 2021. Against this backdrop, we favor fixed income assets that are set to benefit from central banks' stabilizing efforts, and we encourage fixed income investors to consider the opportunities presented by emerging markets and, in particular, China.

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* This figure is presented as of September 30, 2020 and includes approximately $80.51 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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