Commentary
Fixed Income

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COVID-19: Navigating Fixed Income Markets

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Fixed income markets have been subject to considerable volatility as the fallout from the COVID-19 outbreak weighed heavily on investor sentiment. Against the backdrop of a huge health crisis, the associated economic shock has been compounded by a collapsing oil price. The result has been a sell-off of risk assets with investors seeking to reverse the 'risk-on' fixed income positioning in place heading into this crisis.

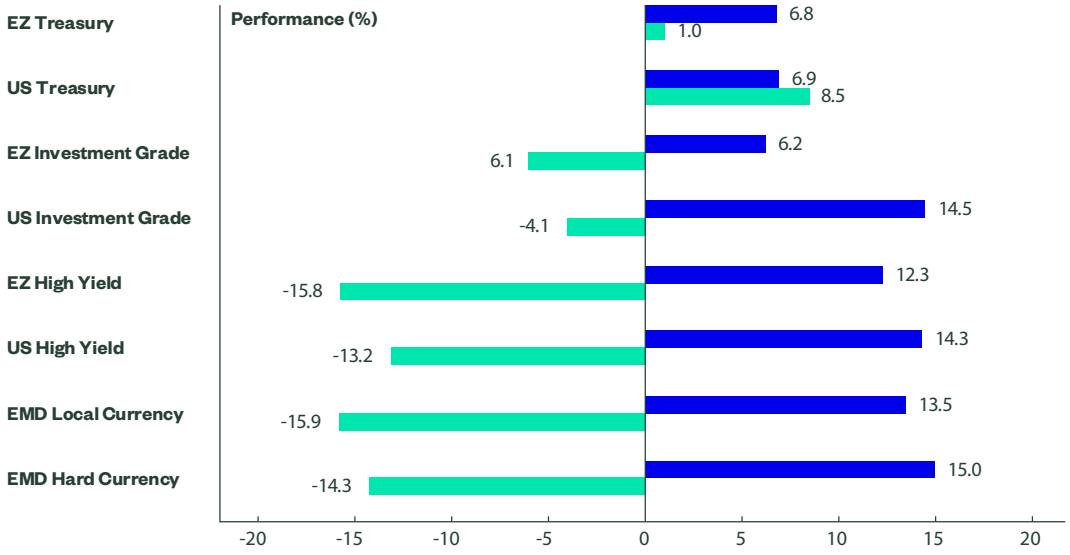
Taking Stock of Fixed Income Market Moves

Fixed income markets have been turbulent since the impact of COVID-19 became clear. The speed with which this crisis has unfolded has been largely unprecedented and a combination of forces have served to create a perfect storm for bond investors. These include:

Economic Impact: Unexpected economic shock has rocked risk sentiment.
Market Structure Disruption: Banks and market participants adjusting to practical realities of new working arrangements.
Risk-on Positioning: Market participants were positioned for a different outlook, with investors generally holding greater allocations of investment grade and high yield credit assets.
Oil Price War: The timing of the dispute between major oil producers and the breakdown of OPEC+ couldn't have been worse.

As illustrated in Figure 1, the switch away from risk assets is evident in the sharp retracement of the 2019 gains achieved by much of the fixed income market. The comparison with US Treasury performance is stark, where strong returns have been accompanied by historically low yield levels.

Figure 1
Investors Turn Defensive as 2019 Risk Asset Gains Reversed



Source: SSGA, Bloomberg 31 March. Illustrative purposes only.Representative index returns based on Bloomberg Barclays for all segments except Emerging market Debt which are based on JPM Indices. Past performance is not a guarantee of future results.

Rapid Policy Response

Bolstered by lessons learned during the global financial crisis, central banks have delivered within days or weeks what in the past might have taken years. The Fed has slashed interest rates to near-zero, with similar actions taken elsewhere. But traditional central bank toolkits have also expanded and quantitative easing (QE) programs have been swiftly implemented, allowing for massive bond market intervention (including corporate bond purchases) and improvements to liquidity in money markets ahead of quarter-end.

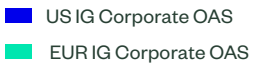
In Europe, the QE commitment by the European Central Bank has helped mitigate the sharp divergence of core and peripheral eurozone sovereign yields, although Italian spreads remain wide amid concerns about the government's ability to limit and finance the economic impact from COVID-19.

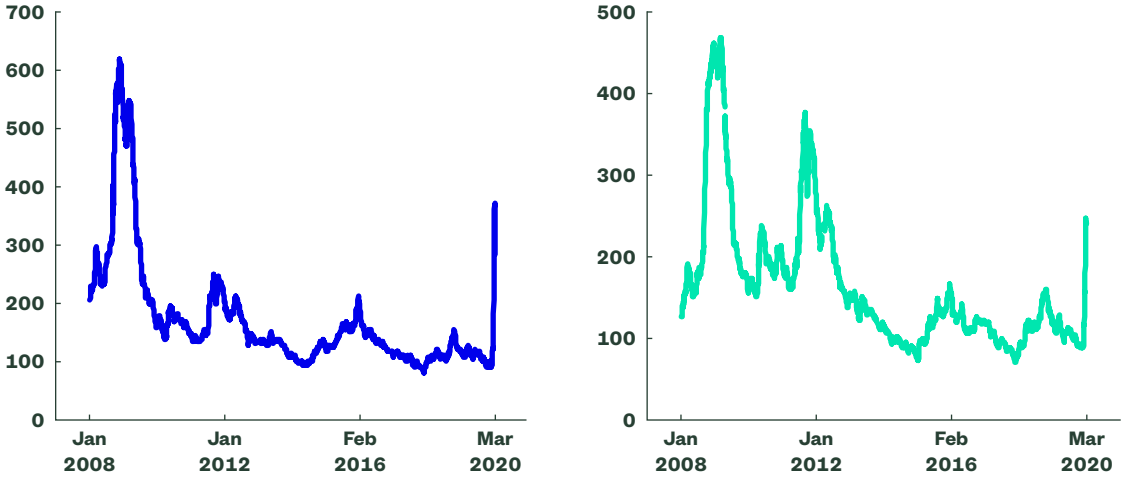
Abrupt Credit Market Sell-Off

The credit market sell-off has seen investment grade credit spreads in the US blow out to their widest level since the GFC, rising from 99bps to 373bps in just 22 days. A similar, if not quite as extreme, scenario played out in Europe, with the latter's relatively better outcome likely attributable to the fact that an ECB QE program was already in place to buy corporate bonds, while the Fed – acting quickly and decisively – had to put this in place.

US credit lagged across all sectors and ratings with the extent of the overall underperformance in part driven by the relatively large US energy sector that has been particularly hard hit by slumping oil prices.

Figure 2
Aggressive and Rapid Spread Widening





Source: Source: State Street Global Advisors, Bloomberg Finance, L.P., data as of March 2020. The above estimates are based on certain assumptions and analysis made by State Street Global Advisors. There is no guarantee that the estimates will be achieved. Past performance is not a guarantee of future results.

Challenging Liquidity Conditions for Investors

Difficult liquidity conditions have seen transaction costs rise sharply across the market. With round trip costs now sometimes measured in percentage, rather than basis points, it is important that investors think carefully before deciding to trade in markets this challenging.

As already noted, liquidity conditions improved in the final days of the quarter as the massive intervention by central banks began to inject a little calm — but things are not back to normal and liquidity remains both costly and challenging. Developed market government bond liquidity has improved significantly in the past week, however liquidity in credit markets remains challenging and expensive — particularly in areas not directly impacted by interventions by monetary authorities like High Yield and Hard Currency Emerging Market Debt.

Caution is Warranted

A question that some fixed income investors are likely toying with is whether valuations have now fallen sufficiently to warrant investment consideration.

From a positive perspective, the fiscal and monetary response has been strong as governments and central banks have acted quickly to bolster sentiment with massive programs. However, the COVID-19 situation remains very serious and the outlook continues to be most uncertain, even amid signs that the number of new cases looks to have peaked in some of the worst affected countries.

The slump in the oil price and weak economic outlook are closely linked to how long the COVID-19 pandemic economic hibernation continues. Caution continues to be justified in such an environment.

Valuations on credit markets are factoring as much bad news as we have seen since the Great Financial Crisis, and so there are opportunities for investors with a longer-term investment horizon, but until we see a meaningful improvement in what the exit from economic lockdown looks like, and/or a resolution on oil, we are unlikely to see a strong rebound in fixed income risk assets. Also, with trading costs close to or at historical highs, trying to be more tactical can be an expensive option.

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