Insights
Fixed Income

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Fixed Income Investing — Opportunities and Mega Trends

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The COVID-19 pandemic has had an unprecedented impact on financial markets and the global economy, drawing an extraordinary response from central banks and governments. But the crisis hasn't derailed all of the investment trends that have gathered momentum through the past decade. Indeed, some of the mega trends have accelerated during this recent period. Three of the major trends making their mark and likely to be maintained include:

- Transparency in fixed income portfolios driving the trend from active to index investing and other more disciplined, risk aware strategies
- Central banks as the dominant force in bond markets
- A growing focus on climate change aware strategies and social bonds

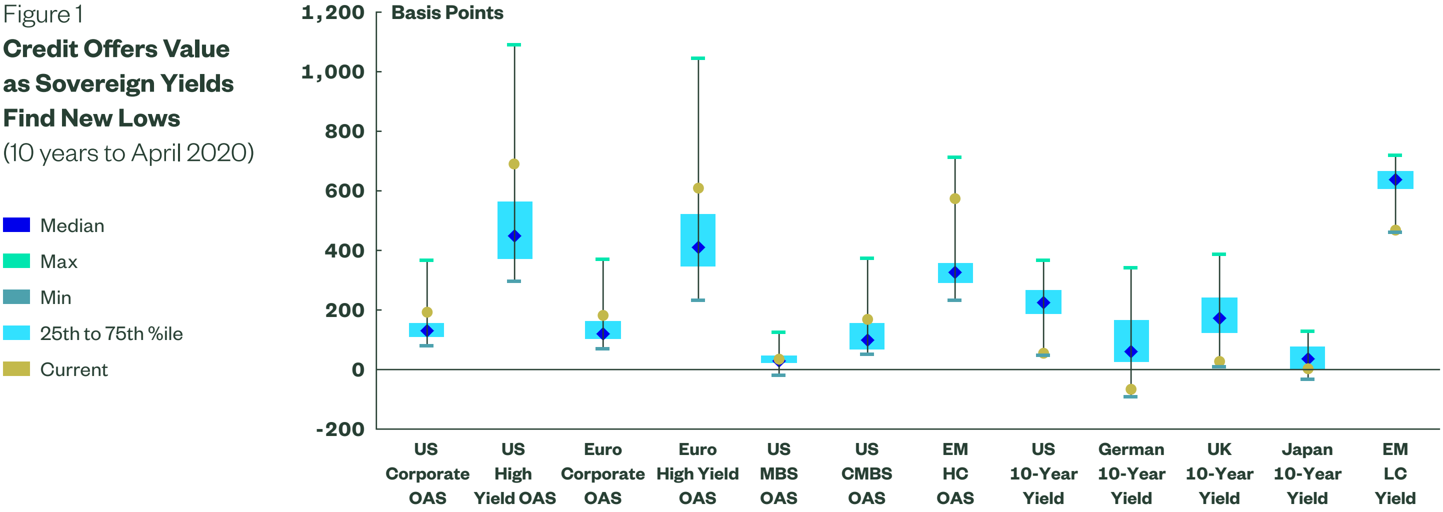
The Opportunity Set

As financial markets settle after the COVID-19 driven turbulence, it's worth having a look at the opportunity set in the fixed income space. Figure 1 shows the range of exposures available and their range of outcomes through the past decade. The candlestick chart shows just how wide credit spreads have traveled over the ten years, particularly for high yield. As of April 30, the spread is not at the maximum, but it is still wide by historical standards and is wider than the 75th percentile. Investment grade corporate spreads are also wide versus historical norms.

While investors have come back into the credit market to take advantage of prices following the sell-off, we believe there is still opportunity for investors to add risk in this space. Particularly in areas directly impacted by central bank stimulus programmes.

Government bond yields, not surprisingly given the massive central bank stimulus since the GFC, are close to the recently established record lows. Of course, central bank intervention is not the only reason yields are so low. Longer-term structural issues are also at play; changing demographics over the long term have been dampening labour force growth, productivity growth and GDP. Trend growth has been falling for some time and the fallout from COVID-19 appears to have accelerated that.

Figure 1
Credit Offers Value as Sovereign Yields Find New Lows
(10 years to April 2020)



Source: Bloomberg Barclays Indexes and JP Morgan as at 30 April 2020.

Transparency in Fixed Income Portfolios

The trend towards indexing fixed income exposures has picked up pace. Part of the momentum behind this has been the increased transparency available to investors in determining where performance is coming from. Investors now have much better insight on what is driving return and how much of that is attributable to beta, alpha or specific factors.

The first quarter of 2020 provided clarity for many investors. Because the market movement was so large and fast, it was difficult for investors to make meaningful changes; as a result, investors could more easily establish the risks that they had been taking in their portfolios, while also getting a better handle on the investment style of their fixed income manager.

For some investors, what they learned may have been concerning and may prompt some to question the value of engaging a more traditional active manager. We expect this to further advance the trend towards indexing, even in areas of the market that were previously considered not to be conducive for indexing, such as emerging market debt and high yield. More disciplined, risk aware strategies like Buy and Maintain and Cashflow Driven Investing may also be areas of focus.

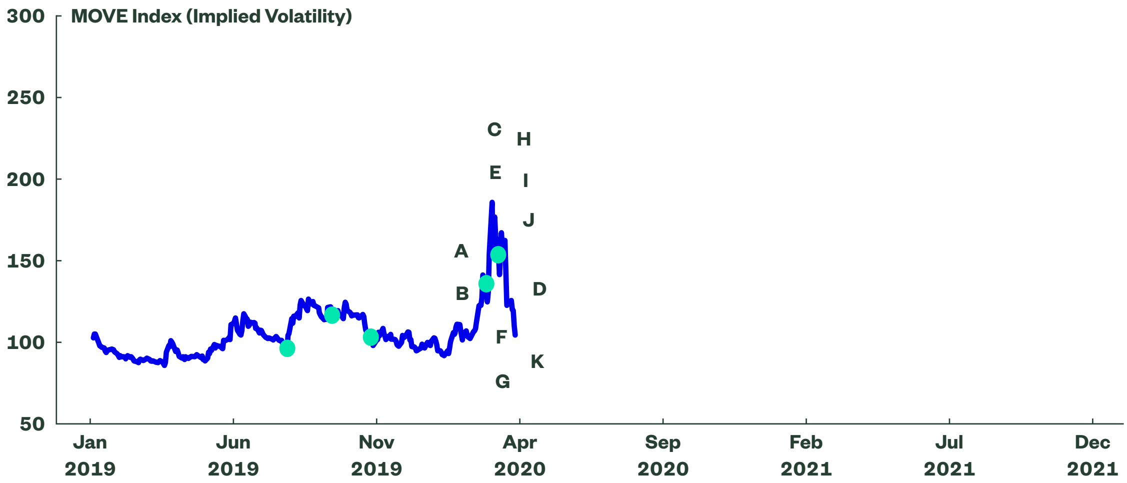
Central Banks as Dominant Market Force

With central banks taking on an increasingly interventionist role in the post-GFC world, it could be argued they have become the marginal price-setters in the market. The shift by central banks to use bond markets as part of their policy toolkit has accelerated through the COVID-19 period. Interest rates have fallen sharply, and central bank balance sheets have expanded significantly.

The speed with which they've acted has been remarkable. Figure 2 shows how compressed in time the action taken has been. What had taken years in the global financial crisis period to achieve has largely been accomplished in the space of weeks and months. Furthermore, the Federal Reserve has implemented measures that have never been done before — as listed in the table in Figure 2.

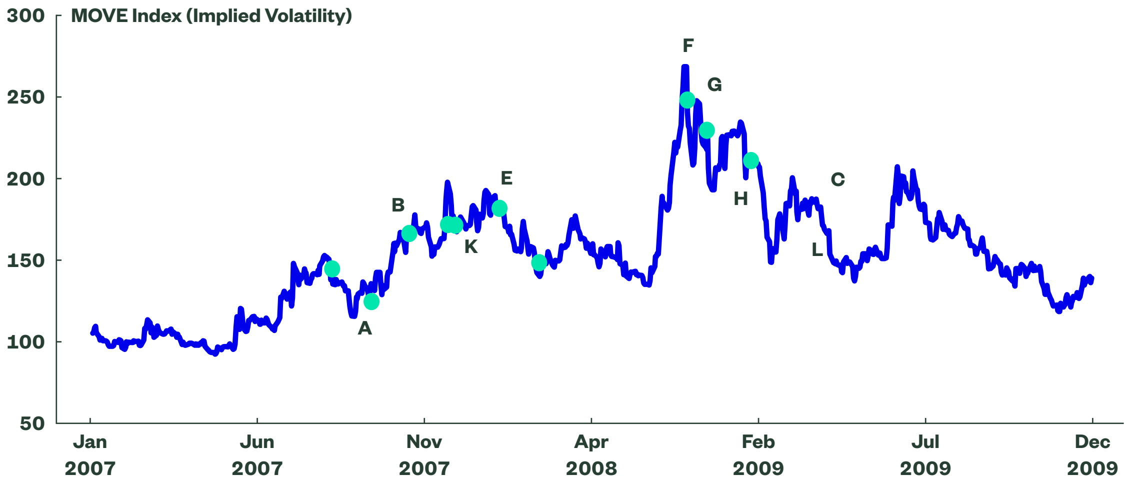
Figure 2
Unprecedented Fed Response to Liquidity Challenge
Policy Response Timeline: COVID19 Pandemic

Federal Reserve Rate Cut



Policy Response Timeline: Global Financial Crisis

Federal Reserve Rate Cut



Source: Bloomberg, Federal Reserve, as of April 03, 2020. Accentuated data points represent days on which the Fed cut the Federal Funds Rate.

	Event	Description	
		COVID19	GFC
A	S&P 500 peaks	02/19/2020	10/09/2007
B	Recession start	February 2020*	December 2007
C	1st QE announced	$700bn	$300bn
D	2nd QE announced	Unlimited	—
E	PDCF announced	Primary Dealer Credit Facility	
F	CPFF announced	Commercial Paper Funding Facility	
G	MMLF announced	Money Market Mutual Fund Liquidity Facility	
H	TALF announced	Term Asset-Backed Securities Loan Facility	
I	PMCCF announced	Primary Market Corporate Credit Facility	—
J	SMCCF announced	Secondary Market Corporate Credit Facility	—
K	1st fiscal stimulus signed	2020 CARES Act	2008 Economic Stimulus
L	2nd fiscal stimulus signed	—	2009 ARRA

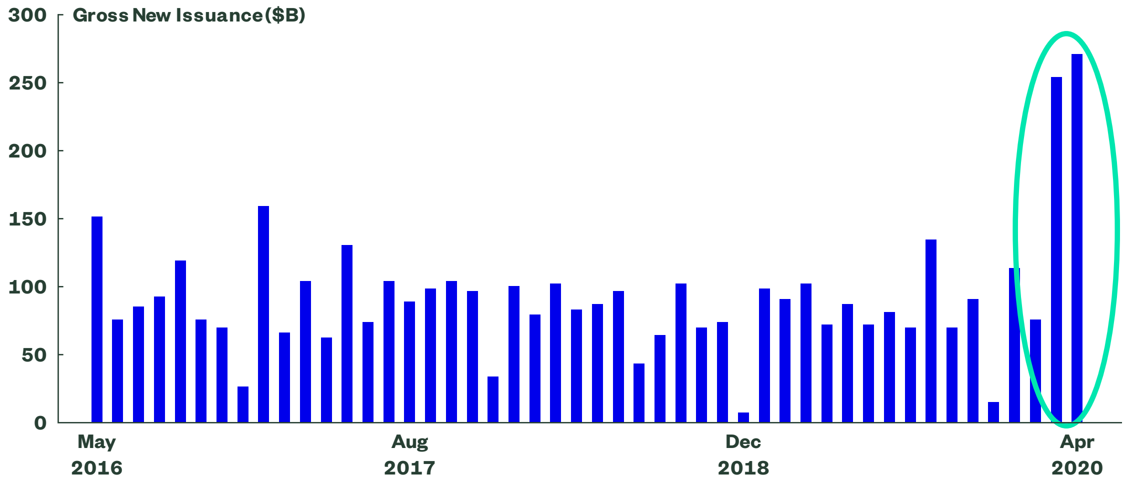
* Presumed 2020 recession starting in February.

Fed Actions Underpin Corporate Bond Issuance

The decision to buy corporate credit assets for the first time is significant. Corporate bond spreads moved quickly lower since the Fed's measures were announced and companies wasted little time in coming to the market to strengthen balance sheets and provide a cushion against the likely economic fallout. (See Figure 3).

The actions of companies suggest that we may have moved quickly from the downturn part of the credit cycle to the 'repair' phase. Issuers in the market are effectively prioritising bondholders over shareholders in order to plan for a more challenging environment, a development that can be quite positive for returns on corporates. What remains to be seen is how long the repair phase will last and what the economic rebound in developed markets looks like. The swift intervention and improvement in market sentiment may mean this phase will be shorter than normal, which would make it a good time to consider adding corporates into fixed income portfolios.

Figure 3
US Corporate Issuance Surged in March and April



Source: Bloomberg Finance LP as at 30 April 2020.

Climate Change in Focus

The COVID-19 pandemic shows how environmental factors can have a huge impact on an economy, on society and on the relative success of business models. Climate change is different — it is obviously a slower moving concern — but recent events highlight the importance of thinking about portfolio risks and considering how to deal with those now rather than wait until the risks are more material.

For example, the top 1% of carbon intensive companies are very detached from the typically low levels of most firms' carbon intensity levels. By removing the biggest 10% of carbon intensive companies from the index, the carbon impact on a portfolio would be reduced by 60%. Low carbon companies are also less likely to be exposed to risks of society changing its view of them because of climate change. And because climate change metrics are reasonably concentrated, changes to a portfolio can be made without radically affecting the investable universe.

Obviously, there is more to climate strategies than carbon intensity. We look at how companies are addressing other indicators, such as fossil fuel reserves and brown revenues, and also how companies are adapting to climate change. Do they have a plan? Are they using green bonds to transition away from obsolete industrial models?

Climate change and how companies respond may well be reflected in returns going forward, and moving to take that into consideration sooner rather than later should be on the agenda of fixed income investors.

Conclusion

The suddenness of the COVID-19 shock has resulted in a significant response from governments and central banks. As noted, the trend of central banks becoming a ever-bigger factor in bond markets is set to continue as the sheer scale of their response overwhelms a ‘normal’ credit cycle. We also anticipate that the trend towards indexing and other disciplined, risk aware strategies will continue to accelerate, as will the appetite for ESG-related strategies.

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