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Past is prologue...but only time will tell

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By the Schroders US Multi-Sector Fixed Income team

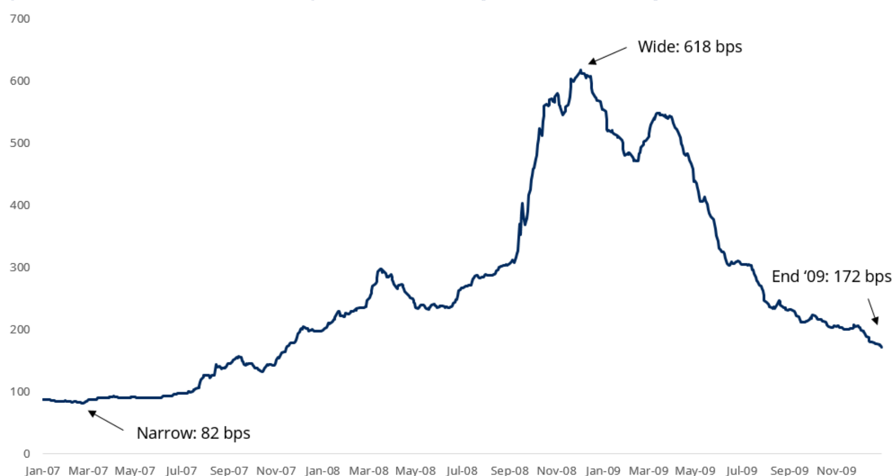
Wow, we think it's an easy assumption to make that the first quarter of 2020 didn't quite turn out how anyone expected as they were ringing in the New Year!

There were those of us who thought valuations were expensive and leverage stretched but were expecting a 'normal' end to the cycle or perhaps some risk aversion coming into the US election later this year. What we got was an abrupt cessation of pretty much all economic activity, a dramatic drop in the price of equities and widening of fixed income spreads across sectors and arguably a more challenged liquidity environment in March than we ever saw during the financial crisis. We think the difference in 2008/09 versus late March 2020 was that in 2008, we didn't necessarily like the prices but there were prices. For a couple of days in March, prices were largely non-existent, even for US Treasuries, especially if you wanted to sell bonds. The other big difference between these two periods is the speed in which prices have recovered to more normal ranges, which is the main topic of this abbreviated quarterly – we're guessing you have heard quite a lot from managers recently – updating, apologizing or pitching!

Before writing this paper, we thought it would be interesting to go back and review our client communications in the financial crisis to see how we were thinking about markets then and the issues that we faced. Of course, the current crisis is very different, but market psychology doesn't change that much, and we know there are things we can learn from how we and the market behaved back then.

The first thing that struck us through re-reading our 2008 and 2009 papers was the extended length of time that spreads were at elevated levels and just how many quarterly papers we wrote extolling the value in the credit market. Yes, the eye of the storm was 'two and a half months of terror' (as we described it then), in the fall of 2008. But corporate credit actually began to widen in the second half of 2007. They then widened steadily from the summer of 2007 until late November 2008, with a little respite in Q2 post Bear Stearns. The recovery which, although looks steep on a long-term chart, took over 12 months to get back to the levels we saw in late 2007. Figure 1 illustrates this much more simply.

Figure 1: GFC investment grade credit spreads (basis points)

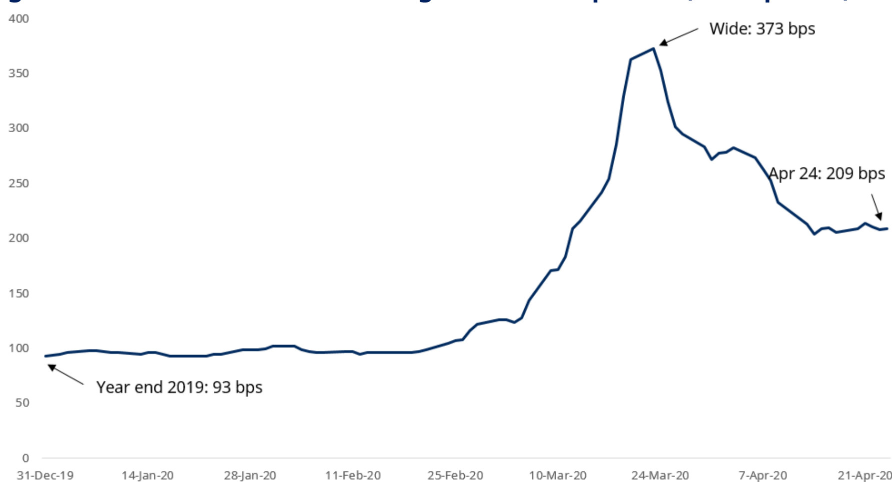


Source: Bloomberg through December 2009. For illustration only.

Back then, the mass government intervention in bond markets was new. Zero yields on Government bonds (ex Japan, at least) let alone negative yields on corporate bonds was a new phenomenon. It began a decade of QE and we can discuss the impact of that as the starting point for today's crisis in another, quieter, quarter.

One reason to look back at the financial crisis is to highlight the incredibly short length of time that corporate bond spreads moved out of 'normal' ranges this time around, at least so far. If in the financial crisis, credit spreads were in unchartered territory for around a year, during the COVID-19 crisis of 2020, thus far, corporate bonds spreads were outside those 'normal' levels for less than a month. The 'two and a half months of terror' reference from our historical paper was less than two weeks this time around. Contrast the following graph with the one above from the previous crisis.

Figure 2: Year-to-date investment grade credit spreads (basis points)



Source: Bloomberg through April 21, 2020.

There are some reasonable arguments to be put forth that would justify a more rapid recovery this time around. Central banks and governments around the world knew what to do and moved incredibly quickly this time, literally in a matter of days. As a result, the liquidity impasse in late March was quickly resolved and it didn't take long for the Fed to signal they would buy corporates and even ETFs and arguably bail out investors along the way. Back then (how times flies during social distancing) there was fear of the widespread collapse of the entire financial system amid the enormous financial leverage and subsequent unwind.

We were able to add a reasonable amount of corporate debt via the new issue market in the terrible two weeks. Some of the long-dated bonds that we added in March, providing the liquidity that the market was so willing to pay a premium for, are now 20%, 30% or even 40% higher.

What we are facing now is clearly different in nature but of equal magnitude. Banks are better capitalized and the stress tests we thought were a little over the top has kept them in a much better position and to be the conduit of the government relief.

However, we question whether the actions of the Fed and other central banks to remove the liquidity blockages merit the speed of the recovery in financial markets. Within three weeks of the widest spread levels in corporates, the market was trading at levels in line with where credit has traded in other recessions. We don't think there will be many who disagree with the assertion that the abrupt economic slowdown we are currently facing, and the uncertainty with which we will emerge from this, will have few similarities with other recessions.

With this in mind, we have largely paused in our activity to add back risk into portfolios that started 2020 so defensively positioned. We are using this period of consolidation to reduce exposures in those sectors which we think will be more vulnerable going forward and replacing them with credits in defensive sectors with stronger balance sheets. Valuations

have screamed back, new issue spreads have shrunk, and everything is beginning to look rather familiar…everything except the future!

With the risk that we have added, portfolios reflect the fact that valuations cheapened dramatically. However, the exposure levels at this time also reflect our view that market pricing is unduly optimistic regarding the likely trajectory of events. Perhaps most importantly, they are well placed to react as both market sentiment and events on the ground move in the face of two powerful opposing forces of economic disruption and monetary and fiscal interventions on a scale unseen in the modern financial era.

Municipals

The municipal market has been on its own roller coaster and by some measures exhibited more volatility than the corporate market. However, most municipal issuers provide essential services and generally have a long history of functioning through varying economic cycles and temporary disruptions. Generally speaking, we think investment-grade entities with reserves and liquidity will better weather this storm compared to high-yield credits or issuers with lower liquidity metrics. Credit selection has always been important in the investment process; we are closely monitoring all sectors for short term (airports, healthcare, higher education, and sales tax revenue bonds) and intermediate term (state and local governments) ramifications. Looking ahead, we believe the muni market will continue to experience volatility as negative headlines pertaining to COVID-19 continue to dominate headlines and impact nearly every aspect of the market. On a positive note, the Federal relief bill will allow the Fed to purchase short-term municipals going forward, which should add some relief in the municipal market on the front end. We firmly believe in the essentiality of the municipal market for long-term investment opportunities and that in today's market environment, prudent analysis and credit selection will drive returns going forward.

US Core Plus

Given our view that the risk/reward trade-off in the credit markets had become increasingly asymmetric, we were positioned accordingly in the "plus" sectors as we entered 2020 with a high-yield allocation close to zero and an emerging market debt exposure at the low end of our range. Despite the dramatic shift in valuations in Q1, we have only added modestly to these sectors. While we were comfortable adding to our investment grade allocation in significant size, thanks to generous concessions and a Fed backstop, that same dynamic does not exist for high yield and emerging market debt.

We believe an excellent opportunity will emerge for these assets in the coming months but would like to see more clarity on the trajectory of growth, the re-opening of businesses and the virus containment strategy before committing capital to these more leveraged and economically-sensitive sectors.

History in the making?

To paraphrase an extremely senior former policy maker we spoke with recently, there is every chance that in the annals of history, the Covid-19 crisis of 2020 will be remembered more than the global financial crisis. We are still in the middle of the current crisis and we believe our positioning is as prudent as it can be to navigate what lies ahead.

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