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Math versus Policy: Which will reign supreme in 2021?

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By the Schroders US Multi-Sector Fixed Income team

I think we can all agree that 2020 was one of the strangest years in recent memory, both from a personal and market perspective. It also demonstrated the futility of building an investment process based purely on forecasting. Even if you had perfect foresight as to the evolution of the virus and the economy in 2021, the market reaction would have probably confounded rational expectations. 30 million people out of work and the market rallies?

Our investment process has focused on valuations for over three decades, and last year more than any demonstrated the benefit of having a clear focus and roadmap to navigate periods of enormous volatility, uncertainty and ultimately, opportunity. In 2021, we'll be keeping an eye on valuations which are currently back to pre-pandemic lows (making the bond math look somewhat bleak). We're also cognizant that continued Fed and fiscal policy support offers a good environment for risk taking, favoring a variety of bond sectors. Let the match begin!

The good, the bad and the ugly

The good news for 2021 is that it is likely to be a year of cyclical recovery and continued ample policy support. The bad news is that much of this is already reflected in valuations and we need to be much more realistic about both absolute and relative returns in fixed income. The ugly is that today the economic distress, political polarization and virus remain significantly worse than 12 months ago while financial assets remain more reliant on the benevolence of central banks globally than at any time in recent history.

Where we have been, and how did we get here

As we begin 2021 it is worth reflecting on what happened last year, what were the drivers that led to such an astonishing market recovery and finally, what is most likely to drive markets over the coming quarters.

Where have we been?

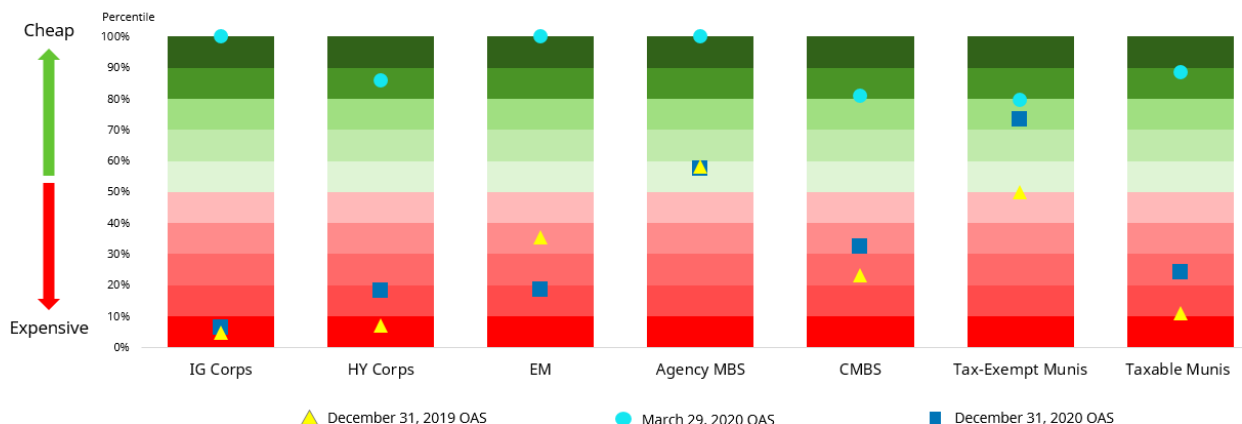
We began 2020 with close to the lowest level of active credit risk in portfolio that we have had in almost a decade. This was not because we expected the turmoil that unfolded in the first half of the year, but because valuations across a variety of asset classes, particularly credit, were approaching multi-decade highs. This was happening while many of the fundamental drivers had been deteriorating, thereby creating an unstable equilibrium and suggesting the risk/reward balance in many asset classes was less than ideal.

However, that changed dramatically through February and March with credit market prices moving from ordinary to the cheapest levels we had seen in 50 years, bar a couple of months during the global financial crisis. Once spreads widened, we decided to re-risk portfolios with a focus on the highest quality companies, those who had the most liquid balance sheets. As you can see from Figure 1, the recovery over the last nine months has been extraordinary. From expensive to giveaway levels and then basically all the way back to where we started the year.

Figure 1: Spreads have round-tripped on the broad indices

Agency MBS and taxable muni have lagged other sectors

Current percentile of OAS for various spread sectors over the past 10 years



Source: Schroders and Bloomberg, as of December 31, 2020. Indices used are the Bloomberg Barclays U.S. Corporate Index, Bloomberg Barclays U.S. Mortgage Backed Securities Index, Bloomberg Barclays Corporate High Yield Index, Bloomberg Barclays Emerging Markets USD Aggregate, ICE Bank of America 1-10 Year US Municipal Securities Index, Bloomberg Barclays U.S. Aggregate CMBS Index, and the ICE Bank of America Broad U.S. Taxable Municipal Securities Index. Current performance trends may not continue.

How did we get here? Understanding the rally and the backdrop for risk taking in 2021

To successfully navigate the investment environment in 2021, we need to understand what led to the remarkable recovery in the final nine months of 2020. What was responsible for the magnitude and velocity of the recovery, despite an extremely challenging health and macroeconomic backdrop? There were two primary drivers: central bank intervention and government stimulus. The key for 2021 is assessing whether these drivers will persist.

Central Bank policy: liquidity shifted from a gush to a tsunami

The intervention from central banks globally was truly unprecedented. We had 31 of them cutting rates for a total of 139 times. As well as slashing rates to zero in the US, the Fed undertook a bewildering array of interventions from quantitative easing to direct intervention in markets which included municipals and corporate credit (including high yield), something that had never occurred before.

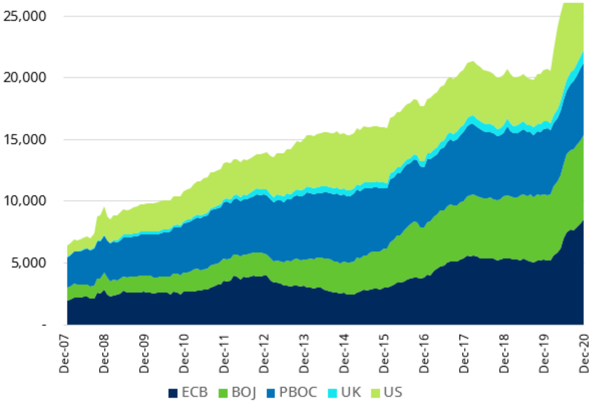
The Fed really did cross a Rubicon in 2020 and effectively underwrote financial assets. The Fed balance sheet grew by over $3 trillion in under 3 months from March through May, almost doubling in size. To put it in perspective, the Fed expanded their balance sheet more in three months last year than they did in the entirety of the global financial crisis of 2008-2009. Figure 2 shows this was not just a US phenomenon but a coordinated global response. This had the effect of driving real bond yields into deeply negative territory and its impact on riskier assets can also be seen starkly with S&P performance in the chart below. If you want a one-factor model to explain the explosion higher in risk last year, this is it.

Figure 2: Unprecedented monetary policy (a) has driven asset prices higher (b)

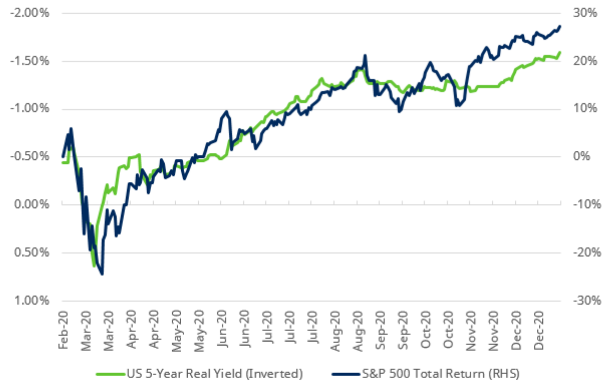
Central bankers are utilising all tools at their disposal to provide liquidity

Total assets of major central banks[1]

(listed in billions of USD)



Driving risk asset performance[1]

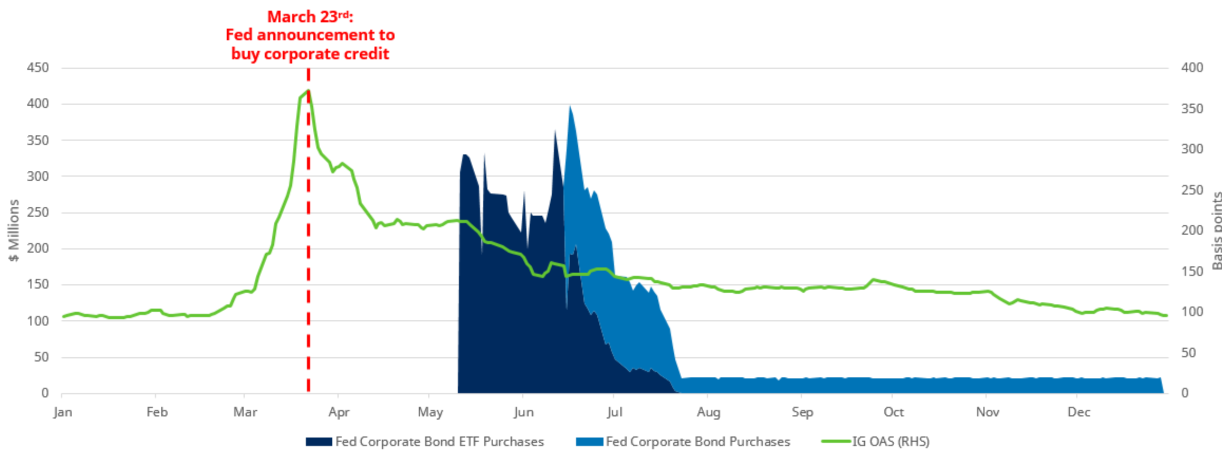


$1.4bn: central bank asset purchases every hour since COVID-19 March lockdowns

Source: [1]Bloomberg, as of December 31, 2020. Past performance is no guarantee of future results.

The result of the Fed intervention in credit markets can be seen starkly in the chart below. As soon as the program was announced on March 23rd, spreads reversed. Their actions moved the liquidity spigots from a gush to a tsunami and financial assets responded accordingly. The Fed's announcement to directly invest in both investment grade and high yield credit markets is something we never thought we would see.

Figure 3: Federal Reserve intervention softened the blow to the US Credit market



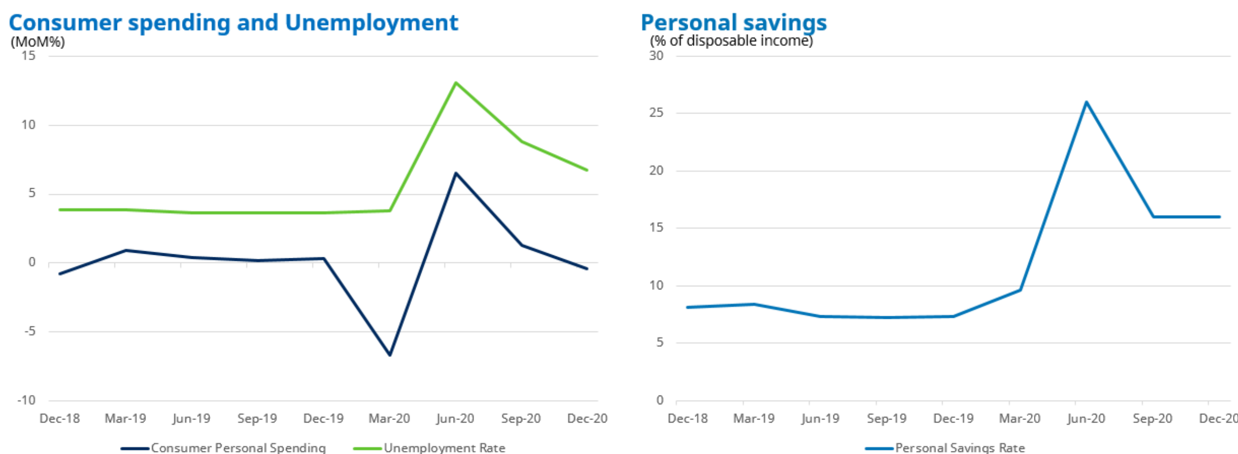
Source: Schroders, Bloomberg, Federal Reserve, as of December 31, 2020.

Government stimulus: whatever happened to the Tea Party?

In contrast to the aftermath of the Global Financial Crisis, fiscal expansion has been working in tandem with monetary stimulus and to a comparable magnitude. The original Coronavirus Aid, Relief and Economic Security (CARES) Act which was signed into law in late March amounted to over $2 trillion in aid, roughly $6,000 per American. This included measures we never have realistically envisioned before including direct payments of $1,200 to individuals, $2,400 for couple and $500 per child. Absolutely necessary but still unprecedented. Again to contextualize this, it was more than double the size of the American Recovery and Reinvestment Act introduced by the Obama administrated in 2009 post GFC. Anyone remember the Tea Party?

These support programs were absolutely crucial in restoring and maintaining consumer spending. Despite unemployment rates more than tripling to over 13% and second quarter GDP printing an annualized -31%, consumer spending actually increased over the year. Additionally the savings rate exploded higher (see Figure 4). It really was one of the strangest recessions we have ever experienced.

Figure 4: Quick stimulus intervention helped ameliorate the impact on the consumer and unemployment



Source: Bloomberg, as of December 31, 2020.

Where are we going?

What is crucial in 2021 is to understand whether these dynamics will persist or not. The Fed is expected to continue buying another $1.4 trillion this year, alongside the purchases of other central banks globally. In addition, they are likely to keep the Fed Funds rate on hold for a number of years, which should keep real yields anchored at the current low levels. In addition, with the Democrats having a clean sweep of Congress (albeit with a very narrow majority) more fiscal stimulus and money in consumers' pockets is the base case expectation. Having former Fed Chairperson and perceived-dove Janet Yellen in charge of the US Treasury department further solidifies the notion of coordinated monetary and fiscal policy.

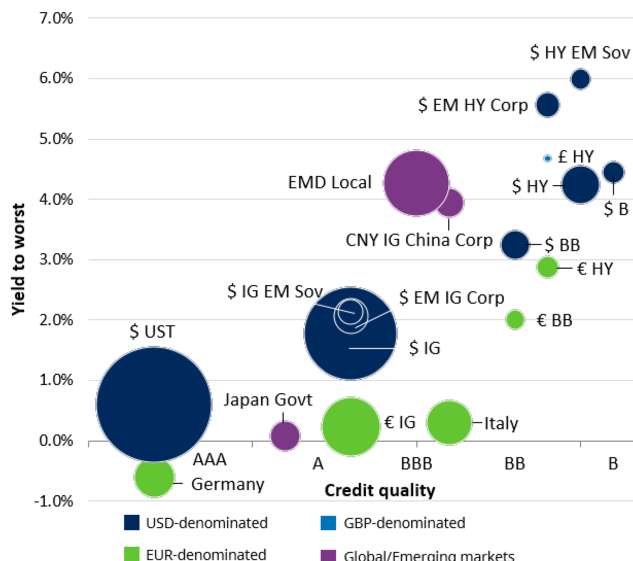
With valuations having round-tripped in many parts of the market, the calculus for us becomes more difficult than it was six months ago. While there is positive momentum in terms of the economy and ample liquidity and fiscal stimulus, valuations suggest that investors should take a more disciplined approach to portfolio construction purely from a prospective-return basis. Current valuations need to be set against the backdrop of a cyclically improving US economy, a supportive central bank as well as the swiftest and largest fiscal support in decades.

The environment should be largely favorable but investors cannot ignore inherent vulnerabilities which underpin the current markets. Any reversal in Fed policy, an uncomfortable rise in inflation or blockage to further fiscal support could create a troublesome environment for risk assets.

From a demand perspective the US fixed income market needs to be contextualized in an environment where 25% of all investment grade bonds globally have a negative yield (see Figure 5). A sub 2% yield for US corporate credit is not exciting in a historical context, but it is outstanding when compared with the yields on offer abroad.

US fixed income will continue to be the global beneficiary for fixed income investors in a yield-starved world (see Figure 5). Cheerleaders for materially higher yields in 2021 will be disappointed once again. In a world of financial repression, persistently low yields is ultimately the objective.

Figure 5: The global fixed income universe looks a lot different now than it did in past decades



Source: Schroders, Bloomberg, Barclays, as of December 31, 2020. Any references to securities, sectors, regions and/or countries are for illustrative purposes only.

This leaves us modestly constructive on corporate credit, but increasingly diversifying into other sectors such as agency mortgage-backed securities and taxable municipal bonds. In addition, we see more value in cyclical and COVID-19-related areas of the credit market and selective areas of High yield, particularly BB-rated bonds. Whereas the second half of 2020 was all about the fundamental cheapness of credit as an asset class, 2021 is more likely to be about a focus on cheaper individual issuers and a rotation into market laggards.

Opportunities remain, but certainly not the beta-driven extravaganza we saw in the latter half of last year. More prudence is warranted today and we need to be more realistic in terms of both absolute and relative returns given the starting point in bond yields and spreads. Constructive caution is our current approach to markets.

A better year for the economy than the markets?

While 2020 was a terrible year both from a personal and economic perspective, it ended up being a great year for markets. We believe 2021 could be the opposite. While our expectation is for a robust economic recovery, we believe the environment for markets is unlikely to be as rewarding. With valuations back to pre-pandemic lows, mathematically the hurdles for returns are that much higher for the coming year. We are acutely aware that any change in the real yield, inflation or fiscal backdrop could fundamentally alter the backdrop for markets.

We still believe there are several pockets of value within fixed income which excite us as we begin the year. As always, valuations remain our most reliable tool and we enter the year with a cautiously constructive posture with less risk than we had a couple of quarters ago. Continued Fed and fiscal support likely means a favorable environment for risk taking for the immediate future, but we are mindful that it is an incredibly unstable equilibrium. We are all looking forward to smoother sailing in 2021, but are painfully aware of the risks lurking beneath the surface.

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