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Marketing Material

# Learning from market turbulence

**In response to the economic damage, ample liquidity should continue to create opportunities, especially in corporate and higher yielding bonds.**

- \_ Interest rates look set to remain low for much longer than most would have thought.
- \_ This results in very low or negative real yields, which in turn supports equities and thus credit.
- \_ Within credit, bond selection is more important than before the crisis. This could make turbulent times quite rewarding.



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We live in turbulent times. For observers of global economics or politics, that might sound both obvious and like a bit of an understatement. In credit markets, however, the summer has been anything but turbulent, ever since the market panic receded earlier this year. So, it is worth reminding ourselves of the tempestuous backdrop – before explaining how this current period of tranquility has come about, how long it might last and how investors might benefit.

In response to the economic damage from the Covid-19 pandemic, numerous fiscal rescue packages have been implemented around the world. Earlier this year, almost a decade after the drawn-out Eurozone debt crisis, Germany and France surprised markets by collectively pushing for the European Union (EU) recovery fund, alongside the EU's budgetary framework until 2027. These proposals have yet to be passed by the European Parliament, as well as various national legislatures. Nevertheless, the announcement has already marked a decisive break in how investors view Eurozone risks, which could permanently change European capital markets.<sup>1</sup> Already, the new EU recovery fund has

significantly benefitted highly indebted countries such as Italy. Rating agencies are taking this new source of support into account, resulting in a lower likelihood of credit downgrades and, in turn, lower borrowing costs.

Adding to the support in the Eurozone and elsewhere, all major central banks are executing bond-purchase programs and remain extremely dovish. To fight the effects of the pandemic and the resulting unprecedented slump in economic output, there has been plenty of additional monetary stimulus. Quantitative easing has become an established and accepted monetary-policy tool. Rates look set to remain low for quite a bit longer than most would have thought likely not so long ago. For one thing, high and increasing levels of public- and private-sector debt would make it very hard and risky indeed for central banks to withdraw the stimulus.

Already, the U.S. Federal Reserve (the Fed) has indicated that it will probably be years, before it even starts thinking about increasing short-term interest rates. Its new monetary-policy framework partially unveiled at its annual Jackson Hole meeting looks more like a natural evolution rather than a clear

<sup>1</sup> <https://www.euromoney.com/article/27fxvgfz9a9gjdskza2v4/capital-markets/the-eu-recovery-fund-may-transform-european-bond-markets>

break. The idea behind average inflation targeting is that the Fed can be flexible in order to reach its newfangled average inflation target of 2%. In the prevailing environment, this should give the Fed more room to keep rates low, supporting our thesis of "low for longer." The bigger monetary problem of the past 10 years has been that the Fed and other central banks found it difficult to persistently get inflation up to 2% and it is by no means clear that things will get any easier when the pandemic is finally over. The reality is that the Fed has almost no ammunition left, even though it has to maintain the illusion of omnipotence.

The result of the ultra-dovishness of central banks has been that more and more government bonds from industrialized countries trade like those in Japan. Even for long durations, nominal interest rates are mostly close to zero, pushing real yields into negative territory. The change has been starkest in the United States. Yields on 10-year U.S. Treasuries, currently at around 0.7% (as of 9/14/20), have been trading at or near historic lows since mid-March. At least as far as the next few months are concerned, we believe it would probably take quite a dramatic catalyst to move U.S. rates, and with them much of the rest of the global financial system, off the current baseline.

Among such potential catalysts, one possibility remains an agreement in Congress on another major stimulus package. However, the prospects for that have been receding. Renewed, widespread lockdowns are another risk. So are the U.S. presidential elections in November. Both the pandemic's path and U.S. politics remain hard to predict, but that should not blind market participants to the potential risks ahead. The elections in particular bring a very real potential for major economic-policy changes, including higher taxes on corporate earnings and capital gains, which could cause market turmoil. Other geopolitical and economic risks include the ongoing battle over technology leadership between the U.S. and China.

From our perspective, real yields look set to remain very low, supporting equities and thus credit. In addition to government-bond purchases, unprecedented central-bank purchase programs for corporate bonds and structured-finance securities should also support the respective asset classes. And if those programs should not be sufficient, central banks have demonstrated that they are willing to do more. We also remain constructive for Asian and emerging-market bonds, both from sovereign and corporate issuers. Moreover, we see strong upside potential in some specific niches, such as U.S. municipal bonds, though, of course, issuer-specific risks need to be watched carefully.

This takes me to a final, broader message. Given the turbulent times we are experiencing in terms of underlying economic realities, it would be surprising indeed if we didn't see occasional periods of market volatility. As we saw earlier this year, such periods tend to result in a much higher dispersion of yields within bond segments. That, in turn, means that bond selection is more important than before the crisis. The accompanying chart is quite a good illustration of this dynamic.

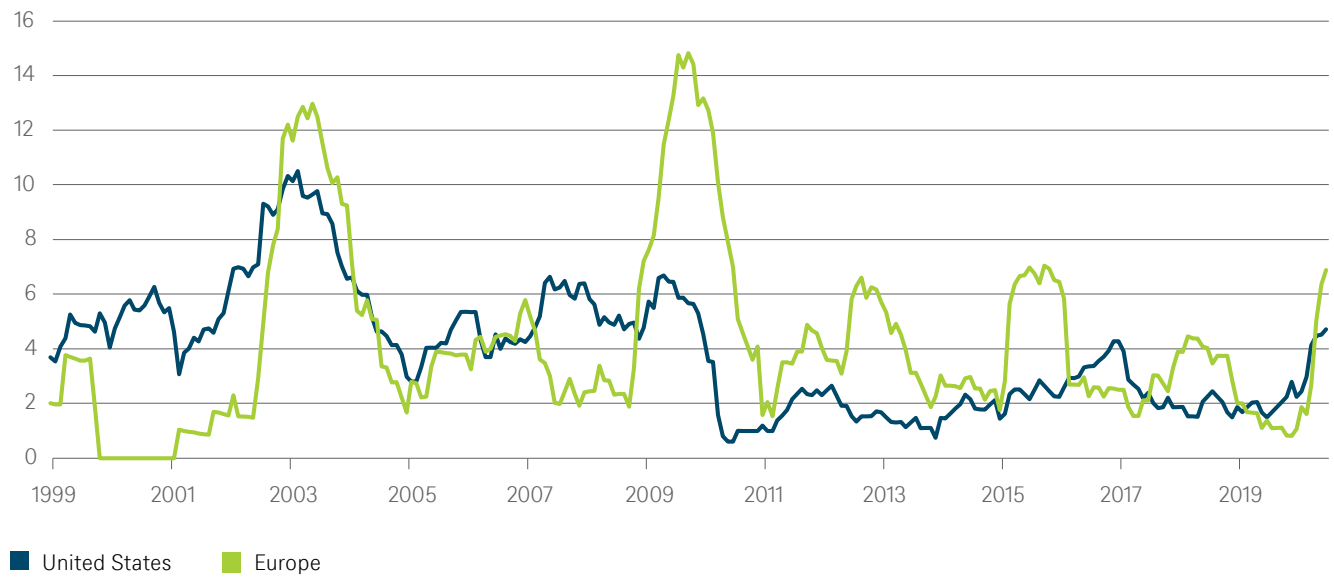
Historically, in times of recessions, a larger than usual share of corporate bonds that received investment-grade credit ratings when they were issued have been downgraded to junk. As you can see in the chart, the share of such "fallen angels" has already been rising in recent months, though it remains historically quite low. Both practical experience and academic research suggest that this could bring opportunities for investors able and willing to buy such bonds during periods of crisis, when others are forced to sell for regulatory reasons.<sup>2</sup> Of course, this requires plenty of analysis beforehand – selecting the better credits within the U.S. energy sector earlier this year, for example. For those able to do this bottom-up analysis, though, we believe that active selection could make turbulent times quite rewarding.

<sup>2</sup> Ellul, A., Jotikasthira, C. and Lundblad, C. "Regulatory Pressure and Fire Sales in the Corporate Bond Market" (February 28, 2011). *Journal of Financial Economics* (JFE), Vol. 101, No. 3, 2011, Available at SSRN: <https://ssrn.com/abstract=1362190>; On recent events in this segment, also see: <https://www.morningstar.com/articles/986638/what-fallen-angels-have-to-offer>

#### AT THE START OF THE FALL

The share of "fallen angels" – corporate bonds that lose their investment-grade credit ratings – is picking up, but remains far lower than during previous crises.

Trailing 12-month 'BBB' downgrade rates in %



Sources: Standard & Poor's Financial Services LLC as of 6/30/20

## GLOSSARY

**Dovish** refers to the tone of language used to describe a situation and the associated implications for actions. For example, if the Federal Reserve Bank refers to inflation in a dovish tone, it is unlikely that they would take aggressive (contractionary) actions.

**Duration** is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

The term **euro crisis** refers to the multi-layered crisis of the European Monetary Union starting in 2010.

The **European Union (EU)** is a political and economic union of 28 member states located primarily in Europe.

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

A **fallen angel** is a bond that was initially given an investment grade rating but has since been reduced to a lower status.

**Fiscal policy** describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

**Government (sovereign) debts/bonds** are debt/bonds issued and owed by a central government

**Inflation** is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

**Investment grade (IG)** refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

**Junk bond** is a colloquial term for a high-yield or non-investment-grade bond.

**Monetary policy** focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

**Municipal bonds (Munis)** are debt securities issued by a state, municipality or country.

In economics, a **nominal** value is not adjusted for inflation; a **real** value is.

**Quantitative easing (QE)** is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

A **rating** is a standardized assessment of the creditworthiness of the issuer and its debt instruments by specialized agencies. The main three rating agencies are the Moody's (Aaa over Baa1 to C, best to worst), S&P (AAA over BBB+ to D, best to worst) and Fitch (AAA over BBB+ to D, best to worst).

The **U.S. Federal Reserve**, often referred to as "the Fed", is the central bank of the United States.

The **United States Congress** is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

**Volatility** is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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