Coronavirus reshuffles the bond markets

The pandemic is putting pressure on government bonds and making corporate bonds interesting again.

- _ The pandemic and the rescue packages have made their mark on bonds.
- _ Government bonds of the most highly rated countries are likely to continue to yield low to negative interest rates but weaker countries are struggling with higher yields.
- _ Our focus is on corporate bonds in the U.S. and Europe. In addition to currently attractive higher yields, we expect yields to decline (and prices to increase) over the next 12 months.

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Stock-market indices are still the first choice as seismographs in times of crisis. However, in this crisis it is the bond markets and their temporary dysfunctionality that have so far made many market participants and central banks sweat. In contrast to the financial crisis of 2007/08, in which the bond markets were logically at the center of the crisis they partly triggered, they have now fallen victim to an external shock, just as other assets have. But, once again, they showed the clearest symptoms of stress, which ultimately forced central banks to come up with gigantic rescue packages.

The tensions came to a head in the last week of February and the first week of March when it became clear that the new coronavirus, SARS-CoV-2, would not remain a problem limited to Asia. On February 19, the S&P 500 had reached its record high and subsequently retreated, followed by spread widening in the higher risk segments of the bond market with a delay of about a week. On the weekend of March 7/8, the two oil superpowers, Russia and Saudi Arabia, launched a price war, as a result of which the fall in oil prices accelerated dramatically (at its lowest point the price was down by two-thirds compared to the beginning of the year). This, together with the imposition of a nationwide quarantine in Italy on March 9, led to a further dramatic market collapse. On this day, U.S. government bonds of all maturities yielded less than one percent for the first time in history. In the course of the month, yields at the short end, below six months, even fell into negative territory.

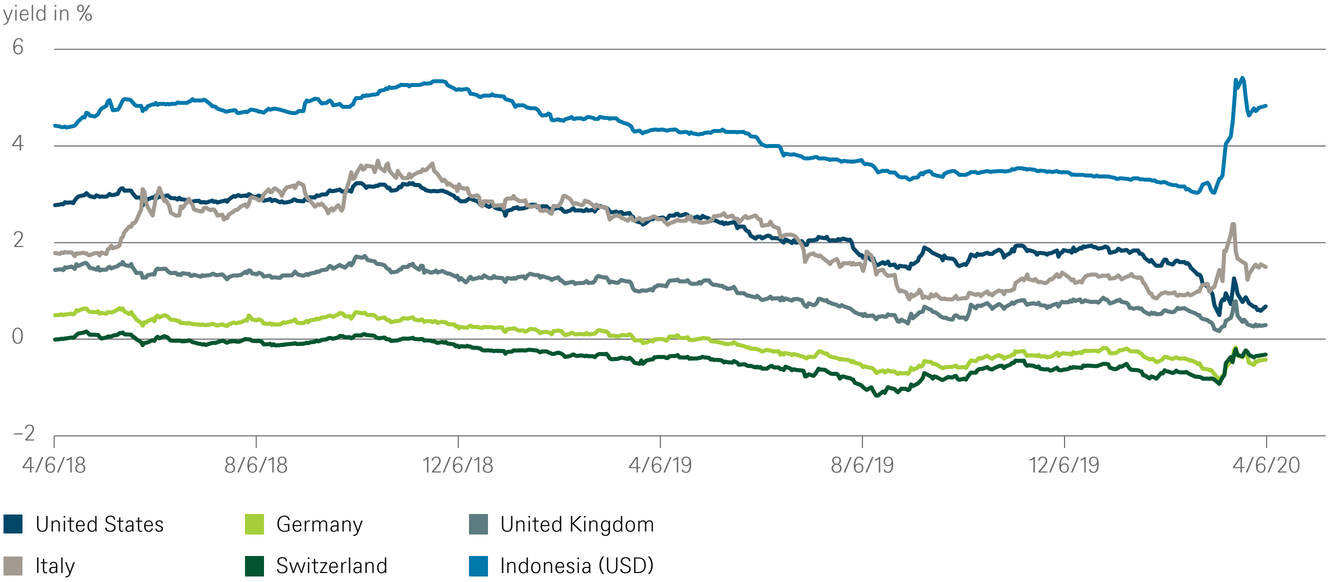
The U.S. Federal Reserve (Fed) reacted gradually to the worsening of the situation. In a first extraordinary meeting on March 3, it lowered the key interest rate by 50 basis points, and in a second extraordinary meeting on March 15, it lowered it by a further full percentage point to the 0.00%–0.25% band. Between these two meetings, as well as following the second meeting, it also announced numerous measures to ensure the availability of short-term liquidity and to incentivize commercial banks to grant loans. Soon a large part of the measures (especially repurchase-agreement (repo) transactions) were given the designation "unlimited." The next round of quantitative easing, i.e. government-bond purchases, was also expanded from an initial $700 billion to "unlimited." In addition, to satisfy the dollar hunger of foreign market participants, dollar facilities were expanded for global counterparties, with the involvement of other major central banks. As a result, from the beginning of March to April 6, the Fed's balance sheet increased by $1.5 trillion to almost $6 trillion. On April 9, the Fed announced that it would provide an additional $2.3 trillion in loans to small businesses and municipalities.

By comparison, the steps taken by the European Central Bank (ECB) look much more cautious. On March 12, the ECB announced a new longer-term refinancing operation (LTRO) program, better conditions for the existing targeted longer-term refinancing operation (TLTRO III) program and additional bond purchases of €120 billion by the end of the year. On March 18, it added a €750 billion Pandemic Emergency Purchase Program (PEPP). While this is intended to follow the guidelines of the previous bond-purchase programs, the flexibility in the country key has been significantly increased, with Italy being the main beneficiary. The relief of capital requirements worth €120 billion should give the banks leeway to lend up to €1.8 trillion more. The Bank of England (BoE) also made a historic move. Never since records began over 300 years ago has the benchmark base rate been lowered to 0.1%. Furthermore, the BoE announced £200 billion in bond purchases.

Some of the programs had little market impact when they were announced. Even a few weeks later the consequences were still hardly recognizable. They were most clearly visible in the European periphery: Italian 10-year government bonds are now yielding around 1.6% again, after spiking to almost 3% on March 18. U.S. government bonds have calmed, whether thanks to the Fed or easing market concerns, reflected in a drop in the MOVE volatility index from a peak of 160 to 60.

10-YEAR SOVEREIGN-BOND YIELDS WERE NOT SPARED

Short-term liquidity requirements even caused German and U.S. yields to rise – in the short term. Yields in Italy and Indonesia are still trading above their pre-crisis levels.



Source: Refinitiv as of 4/7/20

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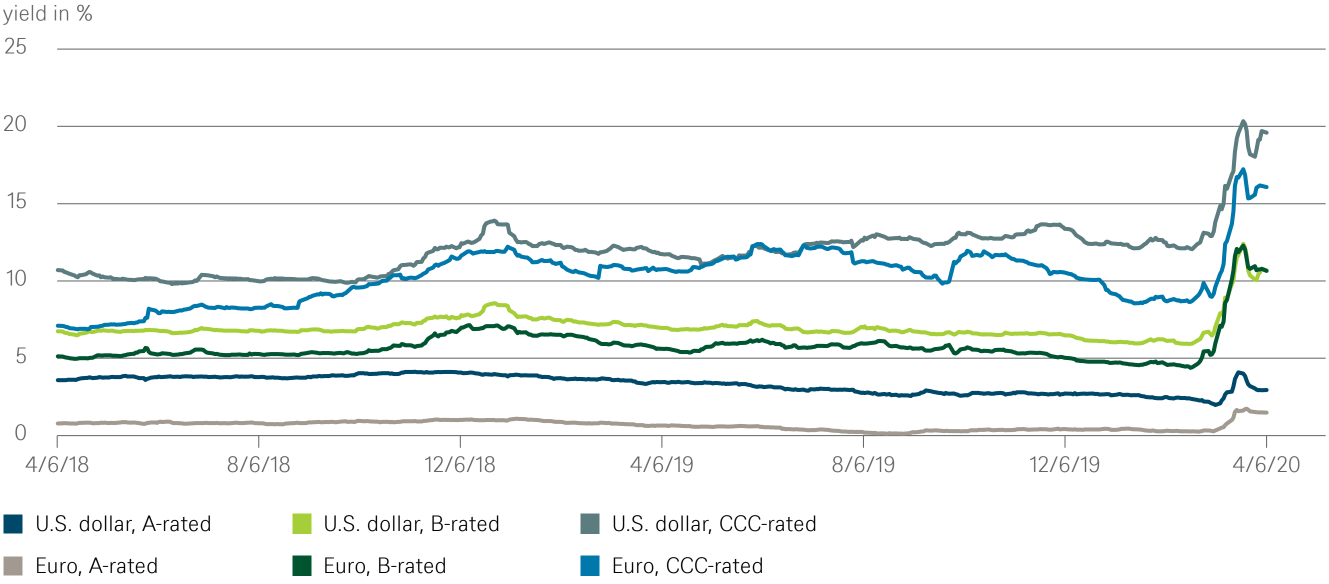
In the case of European and U.S. corporate bonds in the high-yield (HY) segment, a trend reversal from the previous dramatic rise in yields is discernible, as the chart shows, but it is not yet very pronounced. However, the index-level data do not paint a complete picture. In early to mid-March, many segments of the bond market saw very low trading volumes and very wide bid-offer spreads. The immediate liquidity needs of many market participants and also companies led to tensions, especially at the short end of the yield curve. The interventions by central banks and the fact that market participants have regained their ability to act have significantly improved the situation.

So the days of sustained weakness in demand for bonds are over. The market is currently managing quite effortlessly to absorb record-high corporate-bond issuance. However, this reveals a dichotomy in the market. The issuance is almost exclusively in the investment-grade (IG) segment. In the Eurozone as well as in the United States, this segment is also supported by the central banks. There is strong differentiation between sectors, too. Many cyclical sectors are viewed skeptically, and so are sectors that have been particularly affected by the virus, such as retail, travel and tourism, as well as cars and auto parts. This is also where liquidity remains lowest.

AN ERUPTION THAT BRINGS OPPORTUNITIES

It has been a long time since corporate bonds have yielded as high returns as they do now. Even adjusted for rising insolvencies, this looks promising.



The chart shows dollar and euro corporate-bond yields for different rating buckets
Source: Refinitiv as of 4/7/20

Outlook

The pandemic will leave legacies that are likely to occupy us for years after the crisis is over. These include the increase in public debt and the expansion of central-bank balance sheets. In the U.S., for example, the budget deficit could significantly exceed 10 percent of gross domestic product this year, taking it to the highest level since the Second World War. The Fed, for its part, is likely to increase its balance sheet to well above the current record level of almost six trillion dollars. In contrast to the financial crisis, where the Fed's balance-sheet expansion primarily enabled it to transfer debt from the private to the public sector, the current balance-sheet expansion also indirectly serves to finance economic stimulus packages. One day, this should again lead to rising inflation, but in our opinion not in the next two years.

Thus, our fundamental picture of the government-bond market remains intact. We do not expect a sustained and substantial rise in yields on government bonds in industrial countries. Rather, we expect yields to move sideways, in response to conflicting impulses, from higher supply on the one hand and lower growth expectations and central-bank buying on the other. From the point of view of European investors, U.S. Treasuries in particular have lost much of their appeal, as the yield spread over European government bonds has narrowed considerably and the strong dollar makes U.S. investments less attractive. Furthermore, the U.S. Treasury is likely to issue more new bonds than the Fed is likely to buy.[1] In the Eurozone, on the other hand, the ECB's bond buying should compensate for much of the net new Bund issuance of the German state, depending on the degree to which it sticks to its capital key.[2] In response to the ECB packages, bonds from the European periphery have already seen their yield premiums narrow to such an extent that they are no longer our focus.

The case of corporate bonds is different. Their yields have widened considerably since the beginning of the year and have recovered only slightly so far. This is partly due to the enormous issuance that we are currently seeing. Companies are hoarding liquidity, especially in Germany, so that they can survive the drought. This combination of respectable yields and simultaneously strengthened balance sheets could be interesting for investors. At over six percent for high-yield bonds and around two percent for investment-grade bonds in euros, yields here have not been so attractive in a long time – provided we do not experience a corresponding drastic increase in insolvencies, which we do not expect. Even in the U.S., with yields averaging four percent for IG and almost ten percent for HY, we believe that the increased risk of default is more than adequately compensated. Certainly, security selection is key, not least because so many downgrades will or have already occurred in this segment and in a shorter time than ever before. As a result, the number of fallen angels, i.e. companies that lose their investment-grade status, could also rise to record levels. However, such a change offers opportunities to flexible investors. We are cautious about the above-mentioned sectors of tourism, retail and transport, as well as about some cyclical securities in general, which could suffer particularly from the consequences of the pandemic.

We have become more cautious on emerging-market bonds. Some companies and countries might even get through the crisis in better shape than their developed-market counterparts, but the full extent of many problems might only become visible later in the year. There are headwinds for emerging markets from various directions: a strong dollar, low oil prices, a slump in tourism and the collapse of many international supply chains. In addition, many emerging markets have a health-care and administrative infrastructure that could make it difficult to combat the coronavirus, though a generally younger population compared to industrialized countries is an advantage.

Currencies

Currencies were not spared by the first quarter's volatility. Their movements were influenced by both the search for safe havens and liquidity needs. In our opinion, this will be supportive for the dollar for a while yet, but in the medium term we think the dollar will lose its appeal, especially against the euro.

1 It is, however, difficult to make a clear assessment here, as the Fed has announced that its intervention will be "unlimited" if necessary. It therefore depends on if, and at what level, the Fed wants 10-year yields to be capped.

2 The ECB most likely will not stick to its capital key and buy relatively more sovereign bonds from Italy. However, this should still leave the net new supply of Bunds at below €100 billion.

GLOSSARY

The Bank of England (BoE) is the central bank of the United Kingdom.

One basis point equals 1/100 of a percentage point.

Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

A corporate bond is a bond issued by a corporation in order finance their business.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

The European Central Bank (ECB) is the central bank for the Eurozone.

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

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

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.

Liquidity refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price and to the ability to convert an asset to cash quickly.

The Merrill Lynch Option Volatility Estimate (MOVE) Index reflects a market estimate of future U.S. Treasury bond yield volatility.

Periphery countries are less developed than the core countries of a specific region. In the Eurozone, the euro periphery consists of the economically weaker countries such as Greece, Portugal, Italy, Spain and Ireland.

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).

A repurchase agreement (repo) is a form of short-term borrowing, whereby a dealer commits to repurchase the security shortly after it is sold. The dealer pays the repo interest as remuneration.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.

Targeted longer-term refinancing operations (TLTROs) refer to the ECB's providing of financing to Eurozone banks.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

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

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.

A yield curve shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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