FINANCIAL PARTNERS

Global Matters Weekly

04 May 2020

Risks and opportunities in fixed income?

– Andrew Hardy, CFA

Bonds, issued by both governments and corporates, will always have a significant role to play in multi-asset portfolios due to their inherent stability and reliable cash flows, which provide much needed balance for other riskier positions. However, recent developments spurred on by the COVID-19 crisis should prompt investors to consider deemphasising the focus on government bonds from this point and increasing allocations to corporate credit.

Governments will emerge from this crisis saddled with much higher levels of debt to GDP, weighing down on growth yet further and making budgets increasingly difficult to balance. Despite this borrowing costs are unlikely to rise, for now at least, as the extraordinary policies of central banks have ensured government bond yields remain well anchored. The Bank of Japan continues to forge ahead, as demonstrated by their recent move to extend yield curve control into longer maturities. Such measures, along with ETF purchases that go beyond credit to even encompass equities, are increasingly being considered by others.

As well as deteriorating debt dynamics, investors might ordinarily be seeking greater compensation for inflation risk. Although inflation will be depressed by the consequences of this crisis and the ensuing global recession, supply shortages could cause it to become an issue for markets sooner than most expect. Otherwise, the combination of huge fiscal and monetary stimulus injections may stoke higher inflation further down the line. Having reached their lowest levels since the global financial crisis during March, inflation expectations have recovered significantly, but are still running well below target. The resolve of governments and central banks to achieve longer term inflation targets will only be greater now, as modest inflation is by far the least painful way to reduce the real value of debt burdens over time.

Central banks will remain the dominant buyers of government bonds for a long time to come meaning yields will remain at rock-bottom levels. But with little to no compensation to investors for these risks, especially over longer horizons where one should normally be rewarded for a longer term, they draw closer to representing return-free risk. This may prompt investors to focus on shorter term bonds, leaving central banks to buy up the waves of long dated issuance.

Corporate credit looks more interesting. Coming into this crisis high grade corporate bonds provided very little yield premium over government bonds, but that changed rapidly during the first quarter as their higher default and liquidity risks were heavily penalised. Credit allocations tend to compete with equities in portfolios, given how yield spreads correlate with stock prices thus limiting diversification benefits. However, there is a case for tilting towards credit now, given the extent to which credit markets have lagged the recovery seen in equities from the late March lows.

In the event of a strong economic recovery from this crisis, returns for stocks should be expected to outpace the equivalent credits from here. However, if the recovery proves weaker than expected, then credit may deliver better risk-adjusted returns from current levels with less downside risk. We see a lot more bad news having been ‘priced in’ to credit markets which creates this more asymmetric return profile.

Implied defaults in credit markets are very high at present, a topic we will be covering in more detail in a separate note this week. Even with conservative recovery assumptions, realised defaults over the coming years would have to exceed some of the worst cumulative default experiences in history before investors lost money, anything less could result in good returns from here. This partly reflects an elevated liquidity risk premium, which long-term investors should look to harvest.

The unprecedented level and nature of government and central bank stimulus provide further support for credit markets, with the Fed buying corporate bonds for the first time now as well as even high yield bonds. Moral hazard issues are impossible to ignore, but the long-term implications of delaying another wave of creative destruction, in the form of lower growth and productivity, may weigh more heavily on the shoulders of equity holders than bond holders.

Fixed rate corporate bonds face the same risks as government bonds and many more, but with a careful and highly selective (i.e. actively managed) approach it is possible to construct a diversified portfolio of quality credits that can be expected to fulfil their obligations over the next few years and that ultimately provide much more adequate compensation for the risks borne by their holders.

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The **Marketplace**

- Positive trial results for COVID-19 treatment and vaccine boosts sentiment
- European countries plan a loosening of lockdown measures and the partial reopening of economies
- Brent crude rose 23.3%, ending the week at $26.4 a barrel
- Gold fell 1.7% ending the week at $1700.4 an ounce

Market **Focus**

US

- The US equity index had its best month since January 1987 in April, returning 12.7% over the period.
- Q1 GDP growth printed at -4.8% (annualised rate).
- US equities fell 20 basis points last week as the final two days of trading pulled returns down.
- In fixed income markets US Treasuries and investment grade bonds both fell 0.4% over the week, whilst the demand for high yield increased (returning 0.7%).

Europe

- Eurozone GDP fell 3.8% in the first quarter (vs -3.5% expected). Second quarter figures are forecasted to be worse as many lockdowns only started in March.
- The European Central Bank left its deposit rate at -0.5% and confirmed its €1 trn bond purchasing plan but announced new lending measures, including offering banks an interest rate as low as -1.0% from June.
- European equities gained 3.0% over the past week.
- Euro government bonds returned 1.2% while investment grade and high yield bonds returned marginally less at 1.0% and 0.8%.

UK

- UK mortgage approvals for March fell to their lowest level in seven years.
- PM Boris Johnson is expected to announce the lockdown reversal phases this coming week as both the infection and death rates have "passed the peak".
- UK equities ended the week slightly higher, gaining 20 basis points.

Asia/Rest of The World

- The Bank of Japan announced that it would move to unlimited Japanese government bond purchases and a surprise move to triple its purchases of corporate bonds and commercial paper.
- The US-China COVID-19 argument has intensified, with reports of potential tariffs being put in place due to the handling of the outbreak as well as cancelling US debt held by China. However, nothing has been officially announced as of today.

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

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Asset Class/Region	Currency	Currency returns			
		Week ending 01 May 2020	Month to date	YTD 2020	12 months
Developed Market Equities					
United States	USD	-0.2%	-2.8%	-12.0%	-1.8%
United Kingdom	GBP	0.2%	-2.3%	-23.2%	-19.7%
Continental Europe	EUR	3.0%	-0.1%	-16.0%	-9.0%
Japan	JPY	0.7%	-2.2%	-15.8%	-9.2%
Asia Pacific (ex Japan)	USD	3.4%	-1.5%	-14.2%	-10.1%
Australia	AUD	0.1%	-4.9%	-20.5%	-14.3%
Global	USD	0.9%	-2.3%	-14.5%	-5.9%
Emerging markets equities					
Emerging Europe	USD	2.7%	-1.6%	-31.1%	-17.3%
Emerging Asia	USD	3.9%	-0.7%	-11.2%	-6.5%
Emerging Latin America	USD	9.2%	-1.9%	-43.3%	-38.9%
BRICs	USD	3.2%	-1.2%	-15.7%	-10.9%
China	USD	1.4%	-1.4%	-5.9%	-3.6%
MENA countries	USD	6.2%	0.0%	-18.7%	-22.0%
South Africa	USD	2.1%	-2.6%	-34.4%	-35.8%
India	USD	9.4%	0.0%	-23.0%	-21.3%
Global emerging markets	USD	4.3%	-0.9%	-17.3%	-12.9%
Bonds					
US Treasuries	USD	-0.4%	-0.1%	9.4%	15.0%
US Treasuries (inflation protected)	USD	-0.8%	-0.3%	4.6%	9.8%
US Corporate (investment grade)	USD	-0.4%	-0.3%	1.1%	9.5%
US High Yield	USD	0.7%	-0.2%	-8.9%	-4.3%
UK Gilts	GBP	0.0%	-0.5%	9.9%	15.4%
UK Corporate (investment grade)	GBP	0.7%	-0.2%	0.5%	6.4%
Euro Government Bonds	EUR	1.2%	0.0%	0.9%	5.1%
Euro Corporate (investment grade)	EUR	1.0%	0.0%	-2.6%	-0.5%
Euro High Yield	EUR	0.8%	0.0%	-9.6%	-5.7%
Japanese Government	JPY	0.0%	-0.1%	-0.1%	0.6%
Australian Government	AUD	0.2%	0.1%	4.0%	7.8%
Global Government Bonds	USD	0.8%	0.0%	4.1%	8.8%
Global Bonds	USD	1.0%	0.0%	2.1%	6.8%
Global Convertible Bonds	USD	0.8%	-0.7%	-4.2%	0.1%
Emerging Market Bonds	USD	1.3%	-0.3%	-8.1%	-1.9%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 01 May 2020	Month to date	YTD 2020	12 months
Property					
US Property Securities	USD	2.6%	-3.6%	-24.1%	-18.6%
Australian Property Securities	AUD	1.0%	-6.0%	-30.3%	-28.5%
Asia Property Securities	USD	4.6%	-0.9%	-17.9%	-15.6%
Global Property Securities	USD	3.5%	-2.4%	-24.0%	-17.6%
Currencies					
Euro	USD	1.9%	0.5%	-2.1%	-2.3%
UK Pound Sterling	USD	1.5%	-0.5%	-5.7%	-4.3%
Japanese Yen	USD	0.6%	0.1%	1.7%	4.1%
Australian Dollar	USD	0.8%	-1.5%	-8.6%	-8.7%
South African Rand	USD	0.9%	-1.8%	-25.8%	-23.7%
Swiss Franc	USD	1.6%	0.6%	0.6%	5.6%
Chinese Yuan	USD	0.3%	0.0%	-1.4%	-4.6%
Commodities & Alternatives					
Commodities	USD	1.5%	-1.1%	-37.2%	-36.0%
Agricultural Commodities	USD	1.8%	-0.2%	-13.8%	-9.7%
Oil	USD	23.3%	4.6%	-59.9%	-63.4%
Gold	USD	-1.7%	0.8%	11.7%	32.7%
Hedge funds	USD	0.6%	0.0%	-4.2%	0.8%

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For more information, please contact your adviser or alternatively contact:

Financial Partners Ltd.
泛柏資產管理有限公司
9th Floor, Centre Mark II
305-313 Queen's Road Central
Sheung Wan, Hong Kong

Tel +852 2827 1199
Fax +852 2827 0270
client.services@f-p.hk
www.f-p.hk

Important notes