Bond, Income & Defensive Strategies

Newsletter

March 2020

Vimal Gor
Head of Bond, Income & Defensive Strategies

What if the central bank put is worthless?

The resolve of central bankers is only as strong as the performance of equity markets. The latest Fed cut of 0.50% was an emergency inter-meeting shift of monetary policy, and followed a peak-to-trough move in the S&P 500 index of more than 15%.

The official reason for the move cited evolving risks to the economy posed by COVID-19. The real reason was the velocity with which the drawdown in equity markets became super-charged by the end of February. In a matter of days, US equity markets had already suffered three-quarters of the losses experienced in the entire fourth quarter of 2018.

If left unattended, the US economy would be at risk of strangulation by the force of rapidly tightening financial conditions. The effect of falling equity markets and surging credit spreads would combine to choke off lending activity, and eventually the financial system itself. What this chain of events describes is GFC II. The political stomach to face another such crisis is so utterly lacking that the Fed has to move at the first whiff of anything crisis-like. That whiff seems to equate to around 10-15% down in equities.

Half of that cut had already been baked in by markets in the days leading up to the rate decision. The other half had been highly hoped for. The worry, however, is that despite the Fed handing the market what it needed and wanted, the selling didn't stop. If anything, the emergency rate cut was viewed as an opportunity to continue to de-risk, rather than a sign that it was safe to hold on.

Several explanations may apply here. Unlike the Powell Pivot of January 2020, this cut is viewed less as "insurance" but rather as a sign the Fed must know something we don't. The last inter-meeting rate cut by the Fed happened in 2008, amid the fall-out of the GFC. Does this cut mean we're heading into a full-on crisis?

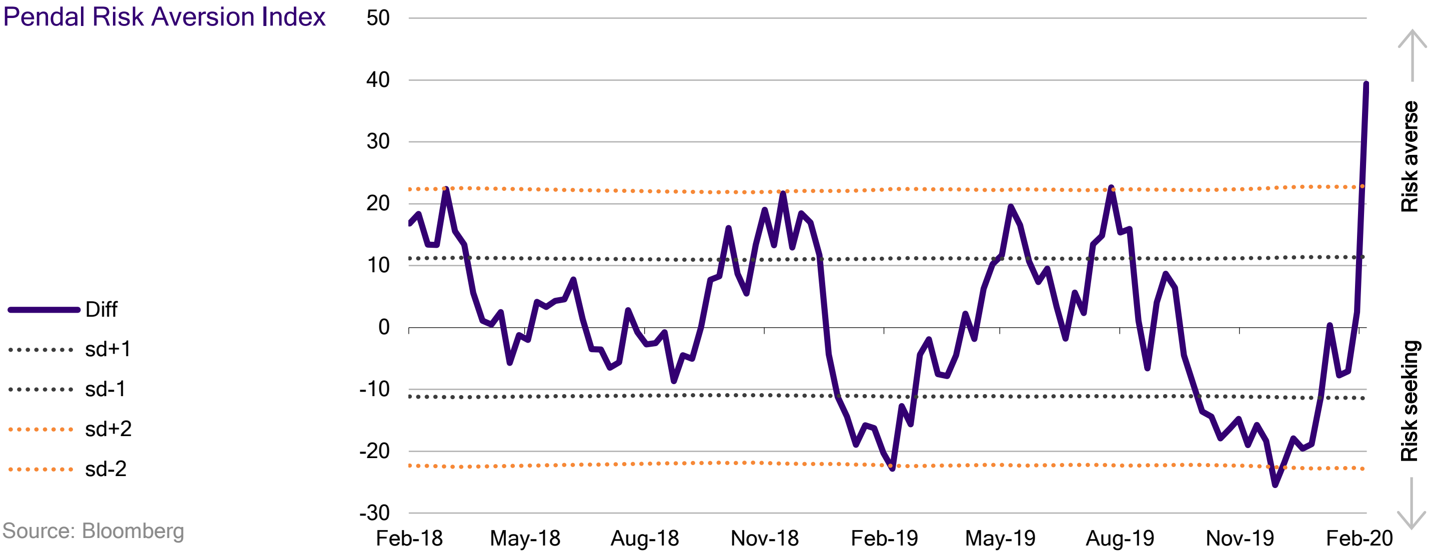
There is also the argument that monetary policy has a limited role to play in tackling this shock. After all, the level of interest rates is not the marginal determinant of business and consumer decisions at present. However, easier monetary conditions are still necessary – even if insufficient in isolation – to tackle the headwinds.

Lastly and worryingly is the possibility that the central bank put has become worthless.

Maximum FOMO to maximum fear

Chart 1

Pendal Risk Aversion Index



Source: Bloomberg

Swings in sentiment have touched both ends of the extremes so far this year. Coming off the end of 2019, buoyed by Phase 1 of the so-called trade deal between China and the US, as well as other nascent signs of recovery in the global manufacturing cycle, risk appetite had reached FOMO territory. Then, as shown in Chart 1, the virus outbreak swiftly took that appetite back to neutral. This first back-up in risk appetite seemed healthy, and all the while was accompanied by a swift reversal in equity markets which marched on to new highs. Then all too suddenly, in the last days of February, levels of risk aversion shot to the extremes with reports of the virus's reach far beyond China and Asia. The reach and speed of the spread surpasses SARS, and entails a heavy economic toll for an uncertain period of time. Most recently, this tail shock has been added to by an oil crash triggered by a Russia-Saudi price war.

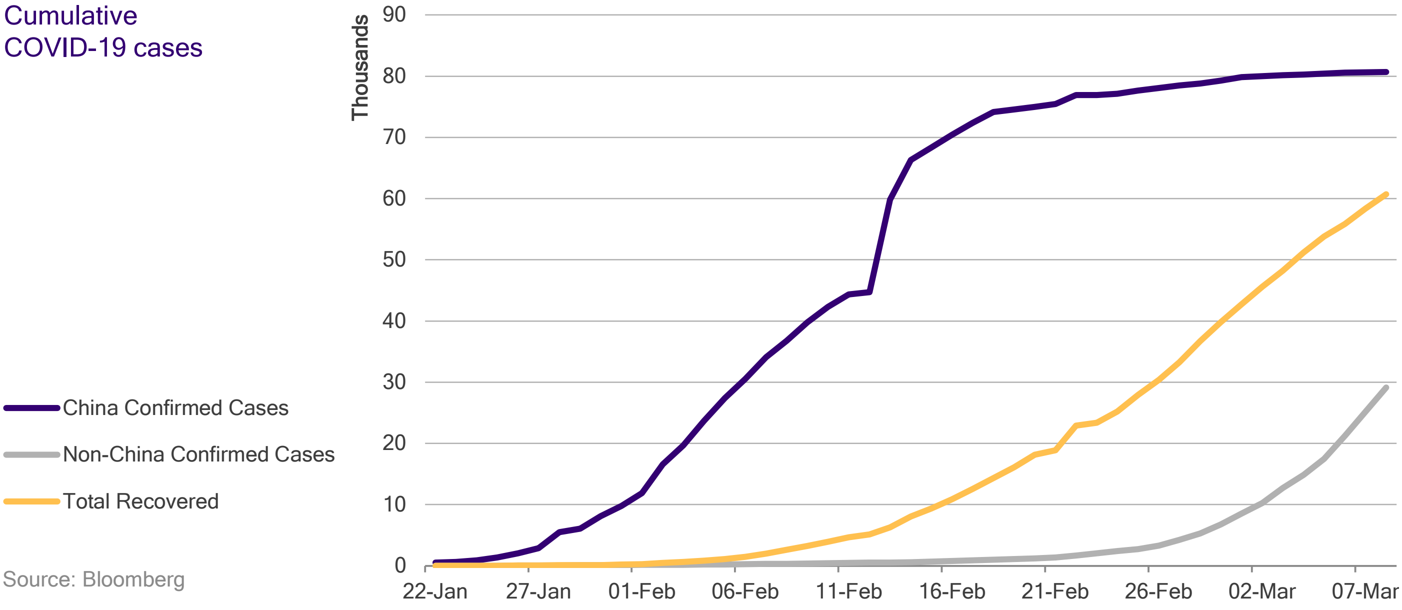
Save lives or save the economy?

Many details are still unknown about COVID-19. Prior pandemic strains of coronavirus such as SARS grew weaker as temperatures climbed. If this strain is similar it would be good news as the northern hemisphere enters the warmer seasons of spring and summer (though less good for those of us down under). However, until there is evidence to support or refute this theory, the prudent course of action from a public health perspective is to limit opportunity for the virus to spread.

China's original response to the outbreak of the coronavirus was arguably far too slow and has received widespread criticism. However, since early February, lockdowns of major cities, limitations on travel, extended public holidays following on from the traditional Lunar New Year break and various other measures have led to a marked reduction in the rate of the spread. This can be seen in Chart 2 below, which shows the material slowing of the growth in cumulative cases within mainland China since mid-February.

Chart 2

Cumulative COVID-19 cases

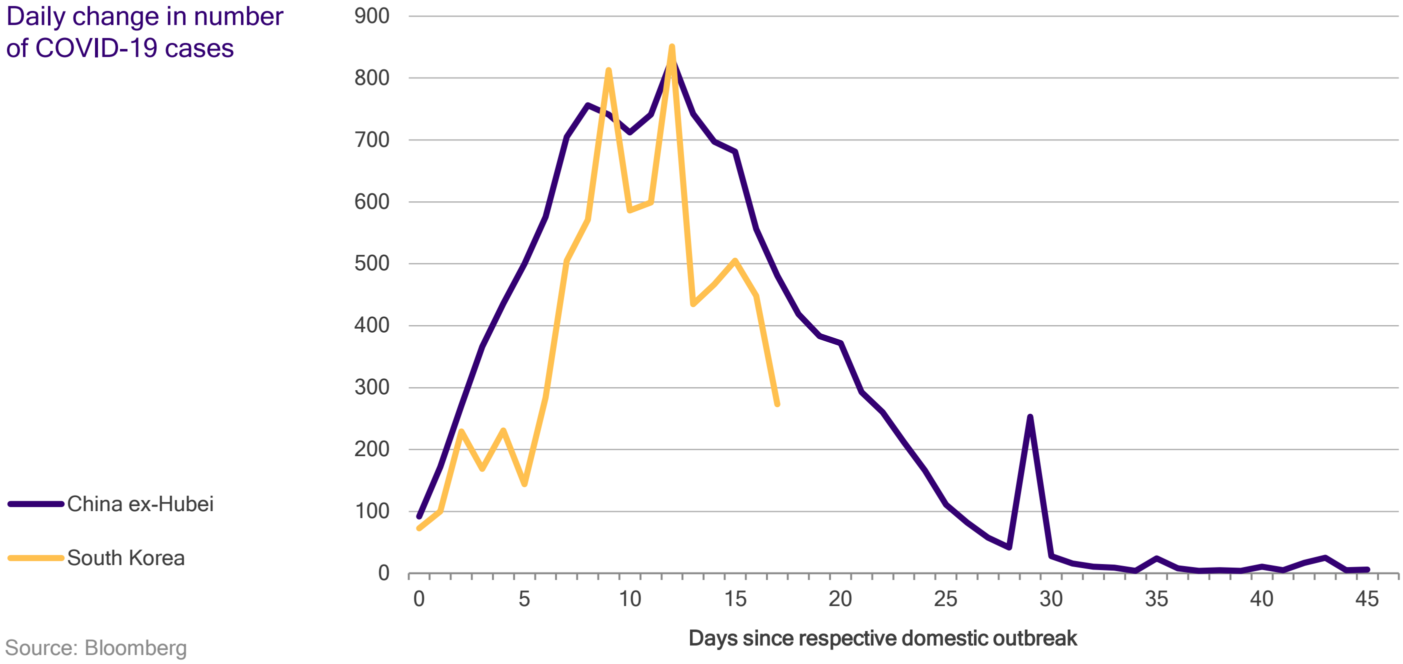


Source: Bloomberg

Fatality rates in China have slowed as medical resource bottlenecks have cleared, and recovery rates have steadily improved. Unfortunately, this hasn't helped control further waves of the virus's spread outside China. South Korea saw cases surge in late-February and more recently new waves have gripped Europe (with the US likely to be caught in this wave, too). The experiences of earlier waves suggests in initial stages the number of new cases in a country tends to gap higher. However, the experiences of China and South Korea offer some hope that exponential rises in the number of cases is not inevitable (Chart 3).

Chart 3

Daily change in number of COVID-19 cases



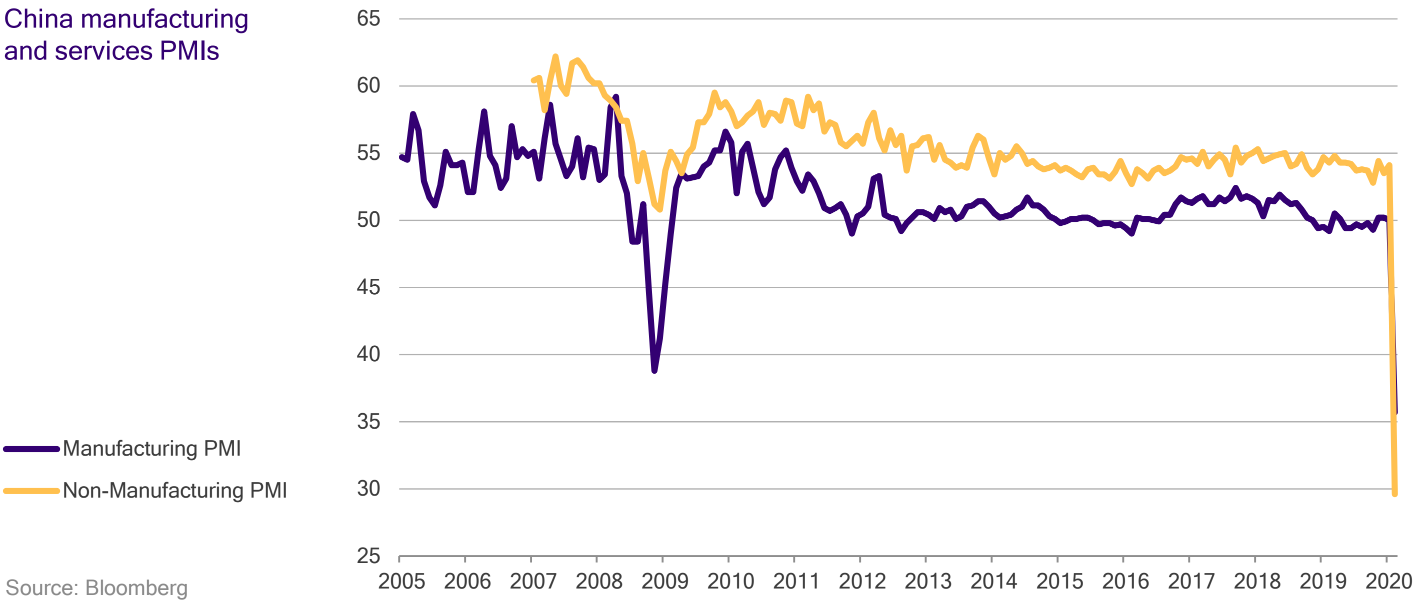
Source: Bloomberg

Fatality rates outside of the Hubei Province of China are considerably lower, suggesting that while the virus appears to be highly contagious, its danger level is lower than that of SARS and significantly lower than MERS. With the behaviour of populations rapidly changing as the virus outbreak progresses, not all hope is lost for more recent waves of outbreak in new countries.

However, as governments step up measures against the spread of the virus, they cannot simultaneously support economic activity. As China's example has shown, combating the spread of the virus had led to an almost sudden stop of economic activity, as indicated by the latest set of Chinese PMIs (Chart 4).

Chart 4

China manufacturing and services PMIs



Source: Bloomberg

Not only do China's latest PMIs indicate economic arrest on a scale that is worse than even the GFC, but the nature of the problem is far different than 2008. China's economic rotation efforts, especially in recent years, now means consumption and services drive a far greater delta on Chinese growth than ever before. When large swathes of the Chinese population are being instructed to stay at home, the spending power of the masses cannot be unleashed to counter the overall decline in economic activity.

Moreover, while it may be reasonable to argue lost manufacturing and industrial activity (from the "old economy") could be made up for in the future to fill order book backlogs, restaurants and movie theatres won't benefit from that kind of activity pay-back. Similarly, tourism and travel-related activity lost now will be lost forever. Even with industrial activity in China returning to around the 70-80% capacity mark, consumer activity remains stuck to the floor, putting greater strains on SMEs in the private sector.

Until there is a vaccine for COVID-19 (which is likely a year or more away), or at least a highly effective drug to treat the outbreak (likely several months away), governments and companies will (and should) act first to limit the transmission of the virus. As such, northern Italy has been put into effective quarantine and travel bans have been rolled out across private sectors throughout Asia. Likewise, any stimulus to come from China cannot afford to stimulate "too much", and will steer clear of consumer-focused sectors. For now at least, it is impossible for government policy to both save lives and save the economy.

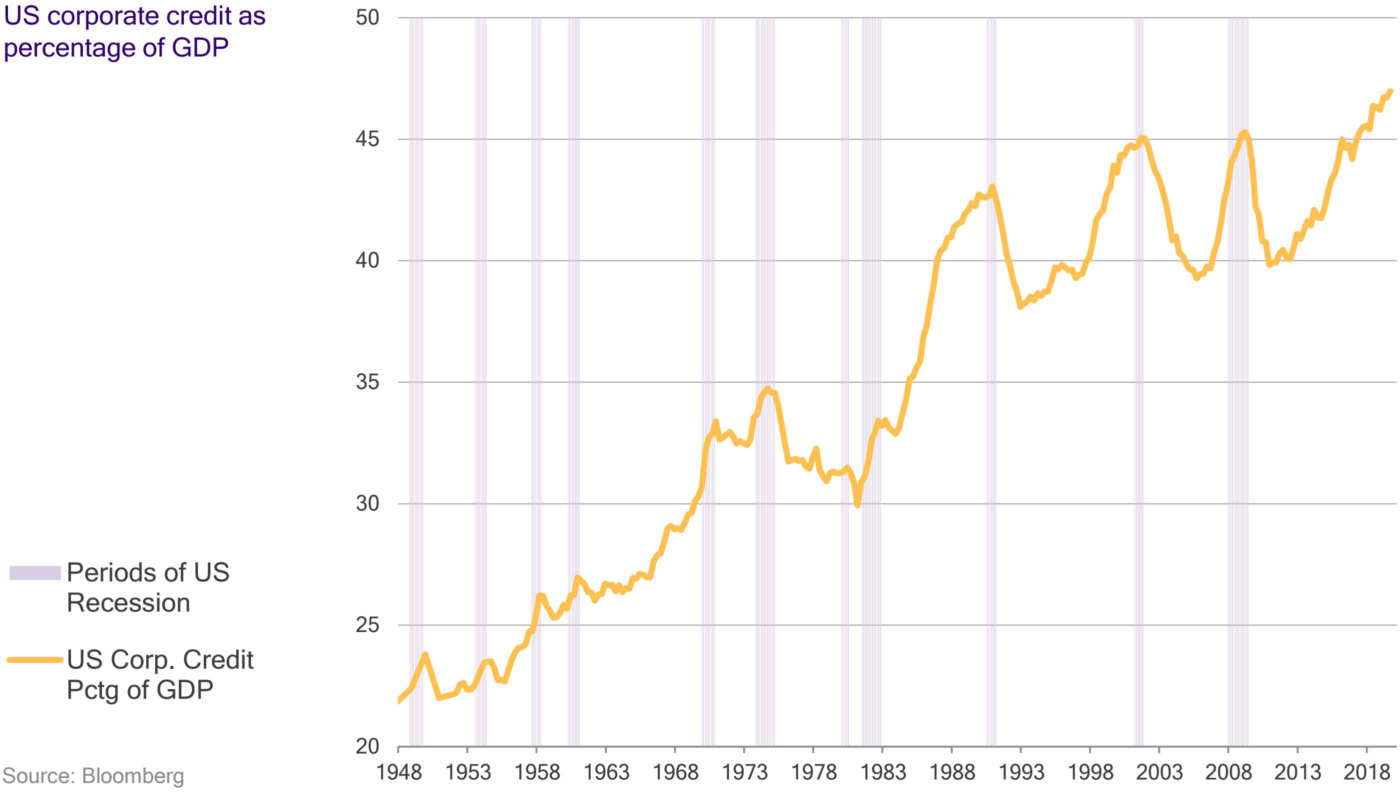
Excesses revealed

As the negative sentiment turbo-charges market moves, it is rapidly starting to resemble a second coming of the GFC. Extreme market moves like the ones we're living through now are known for unveiling where the true excesses lie. During the GFC, the culprit was sub-prime mortgage loans, and the crisis revealed a very over-extended US household sector, as well as an over-levered financial sector exposed to that over-extended household sector. Together with dated banking regulations, misunderstood inter-banking risks and thin reserve requirements, the financial system came close to implosion.

Today, the US household sector is in relatively good shape in comparison to a decade ago. However, more than a decade's worth of very easy money has found its way to other places. In the past, we've discussed at length the distorted incentives that corporates have faced in an environment of falling productivity, unrelenting gains in share markets, and ever cheaper funding. Rather than re-investing earnings into their businesses, CFOs have made the individually rational decision to layer on ever more debt to fuel share buy-backs or to fund mega M&A deals. Those M&A deals largely seek to further grow EPS potential not by focusing on growing revenues, but rather through targeting "synergies" – a corporate finance term for cutting costs and laying people off. As a result, the leverage within corporate America has surpassed historical peaks (Chart 5).

Chart 5

US corporate credit as percentage of GDP

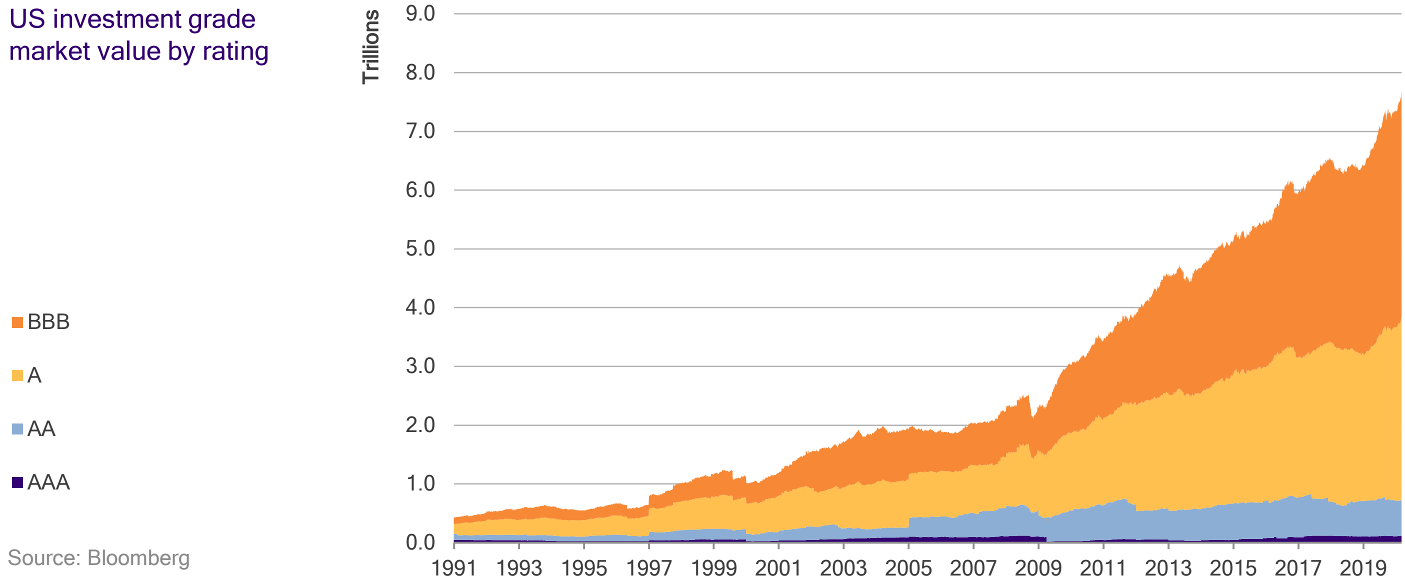


Source: Bloomberg

This has given us concern for a long time as to the sustainability of spread compression in US junk bond markets. But absent a catalyst, the weight of money has largely won out over the last few years. That weight-of-money argument has also seen the average quality of the investment grade index in the US deteriorate, as BBB-rated corporate debt has been dominating new issuance in recent years (Chart 6).

Chart 6

US investment grade market value by rating



Source: Bloomberg

The danger of being on the ratings cusp between investment grade and high yield is that the size of the two markets differ by significant orders of magnitude. The US investment market attracts not only dedicated money from onshore US investors, but also significant amounts of investment from overseas, particularly from savings-rich and opportunity-poor Asian countries. Those investors are not only less interested in securities rated below the investment-grade line, but are usually restricted from being able to consider them at all for their investment portfolios. As a result, the size of the US high-yield market is more than five times smaller than that of the investment grade market. From a corporate issuance perspective, the line between rated BBB and BB means the difference between being able to roll over maturing debt and running out of money.

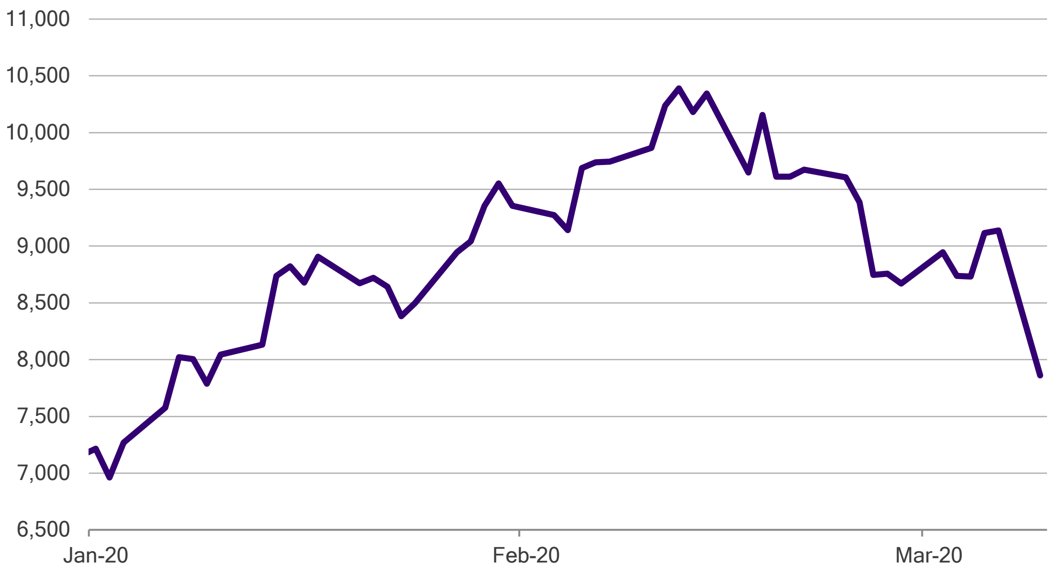
As for the catalysts, they have come thick and fast. COVID-19 arrested and reversed the extreme in risk-seeking sentiment. But in addition, the oil price war is likely to see defaults start to tick up meaningfully in US high yield. BBB-rated corporates in the US have spent recent months working to more creditor-friendly metrics than pleasing shareholders, but those efforts are likely to be entirely thwarted by the vicious market moves of recent days as risk-averse investor behaviour spirals.

This rout is further fuelled by the false promise of trading liquidity offered by the proliferation of credit and junk bond ETFs that need to satisfy outflows by selling holdings into low market bids. Moves like these in markets don't need to last long before large parts of the high-yield market start to become bid-less. The new issuance market in US high yield should be monitored for closure. An extended episode of capital market hiatus will mean severe funding stress for the sector as a whole.

Correlations for global credit markets converge on one in times of market stress, and the breaking of the weakest link in the chain will inevitably reveal hidden excesses in other markets. Watch also for unexpected damage in other asset classes that have been heavily used as collateral in leveraged positions. One such example is Bitcoin.

Chart 7

Bitcoin - collateral damage



Source: Bloomberg

V-shaped, U-shaped, or L shaped?

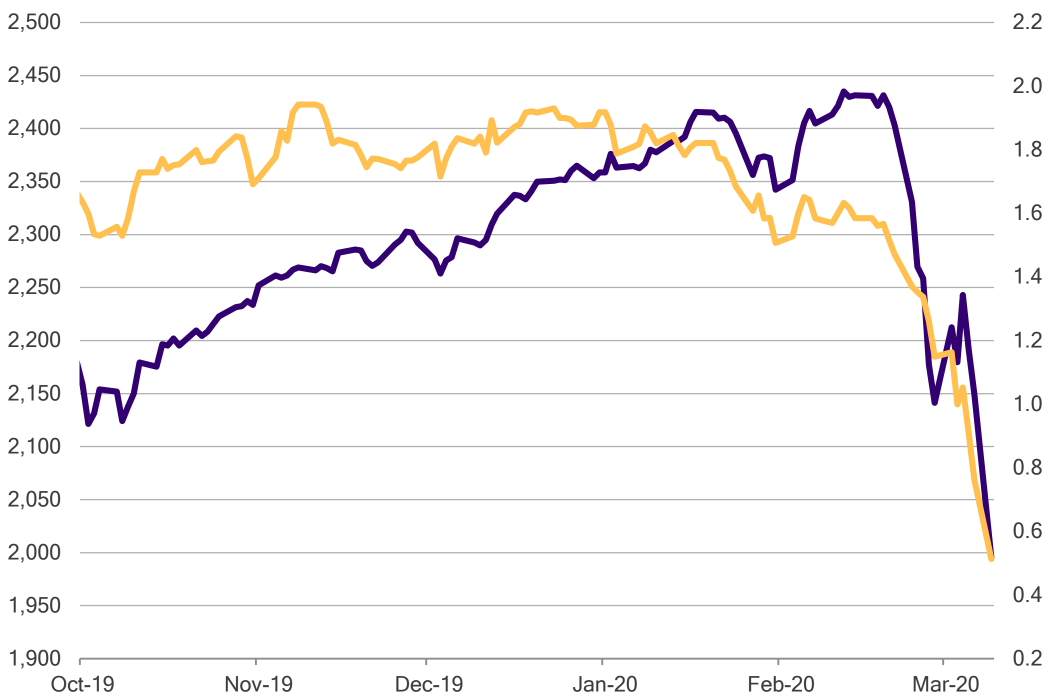
In the initial stages of the virus outbreak, equity and bond markets had very different opinions about the severity of the situation (Chart 8). After an initial wobble, equity markets marched on to fresh highs while rates markets began to price in a greater chance of global recession. It is only since the end of February that equities started to pay more attention. Since then, the price action in markets have been driven by technical forces and for now, fundamentals do not matter. The mentality of all crisis-trading is: sell first, ask questions later.

Chart 8

Equities and bond markets reaction to initial Covid-19 headlines

MSCI World Index

US 10y Treasuries [RHS]



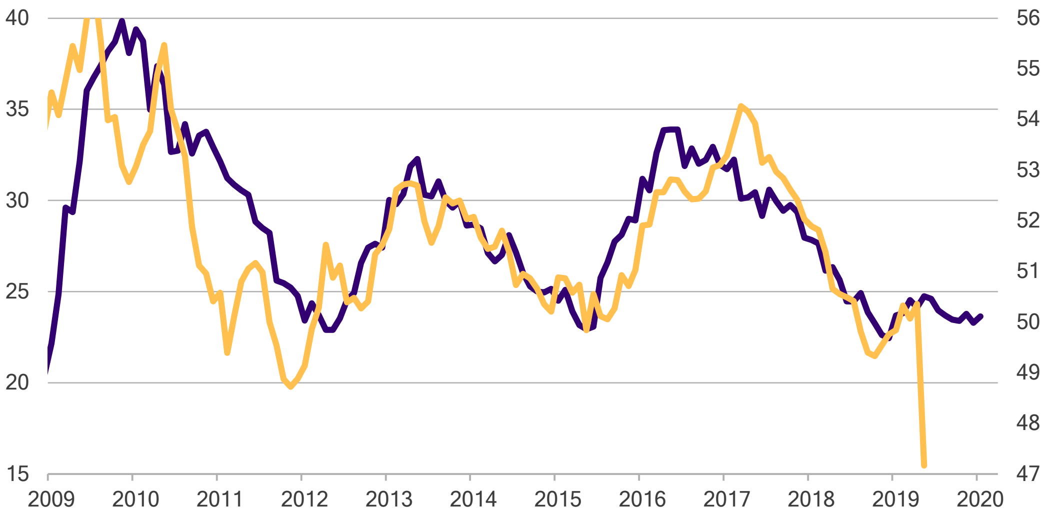
Source: Bloomberg

Long-term investors with cash parked on the sidelines may be watching for value to return. But these funds will be slow-moving and in the near-term likely to be outweighed by the need to de-risk among the masses. For example, funds that target VaR always need to de-risk after an event such as this, as their models will tell them they are carrying far more risk than they should. Short volatility strategies will be forced to take sharp losses in order to neutralise their vega at all costs. Vanilla fixed income funds that sit long credit risk versus their benchmark will also need to start selling into evaporating liquidity conditions when the redemptions come. In the meantime, in an effort to look "active", reaching for hedges via synthetic instruments such as CDS, options, and government bond futures will be inevitable.

A month ago, the consensus thinking was that this would be a temporary shock that the world would get over fairly swiftly. A V-shaped recovery was widely talked about, with expectations of Chinese stimulus to help the recovery along. Perhaps what fuelled some of this optimism lay in the early signs of a manufacturing and trade cycle rebound that had been ever so hard to come by and which finally looked to be gaining some momentum. As Chart 9 below shows, global PMIs had put in a bottom, likely driven by an earlier bottoming of the Chinese credit impulse which we still believe to be the best leading indicator for the global industrial cycle.

Chart 9

A long-awaited turn



Source: Bloomberg

Many economists were quick to revise down their China and Asia growth forecasts for the first and second quarters, but pencilled in a speedy recovery in the second half of the year driven by pent-up demand. The tricky issue is when that pent-up demand becomes demand that is permanently lost.

In that sense, although COVID-19 appears less lethal than its predecessors, that very trait makes it more lethal to the economic cycle. Viruses that spread quickly and exhibit high fatality rates are extremely vicious, but tend to burn themselves out quickly. Viruses like COVID-19 that are highly contagious but with lower fatality rates cause more damage through uncertainty as they take a long time to peak. As discussed above, government responses naturally ought to err on the side of caution, prioritising the health of its populations above all else.

This naturally leads to partial or total shut-downs of activity as the outbreak progresses, to limit the pace of the spread and to alleviate any bottleneck pressures on medical resources. As the uncertainty lingers, backlogged orders are cancelled because the customer at the end of the chain is either fed up or no longer wants to spend the money.

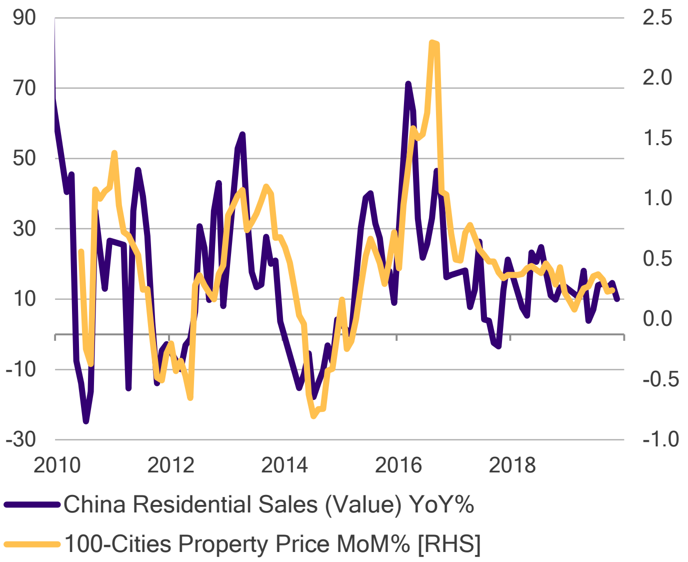
As tourism flows plummet, casual and temporary staff have already been given reduced hours or are being laid off. With the disruption of supply to key materials from China and Asia, businesses then have to consider reducing costs on a more permanent basis. Not only was a V-shaped recovery probably too rosy an outcome to hope for, even a U-shaped recovery now seems elusive. When coupled with the technically driven market dynamics described above, this virus not only stomps out the nascent economic recovery from Q4 2019, but has the potential to drag us into recession. At the same time, any stimulus response has to be measured against the need to slow and contain the virus's spread. The hope is that the virus peaks soon so stimulus efforts can get under way. The fear is a global economy that tips into recessionary territory before then.

In the near term, expect Chinese data in particular to show some signs of life. Taking the example of PMIs, the natural construction of these indices takes the ratio between the number of respondents who say conditions are better month-over-month versus the number of respondents who say conditions are deteriorating. It is easy to see, therefore, that the recent plummeting of PMIs in China could lead to a significant improvement in the following month with more respondents answering positively rather than negatively. Yet this does not necessarily mean the worst is over for the Chinese economy. In fact, with more recent indications that the virus is under control in China even within the Hubei province, we do not expect massive stimulus à la 2016.

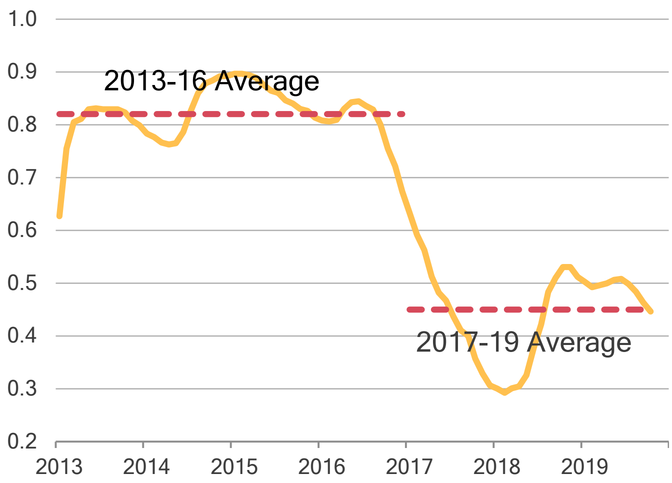
By all means, we expect credit impulse to continue to lift as China ramps up special government bond issuance targeted at more infrastructure projects. At the margins, we even expect some relaxation of rules with respect to shadow-banking deleveraging. However, the panic button is within the Chinese property sector. Allowing large credit stimulus to flow to the property sector, both to developers who will use it to ramp up construction activity, as well as to households who borrow to invest in property, would undoubtedly lift the Chinese economy in the near term, but at the long-term cost of economic and financial stability. For this reason, property policy in China in recent years has effectively targeted a flat cycle through targeted measures at the city and province levels that have significantly reduced cross-city property price correlations (Chart 10).

Chart 10

China's property sales & prices



Property price cross-city correlation



Short of a silver bullet from China, all eyes are on the much hoped-for coordinated global central bank action.

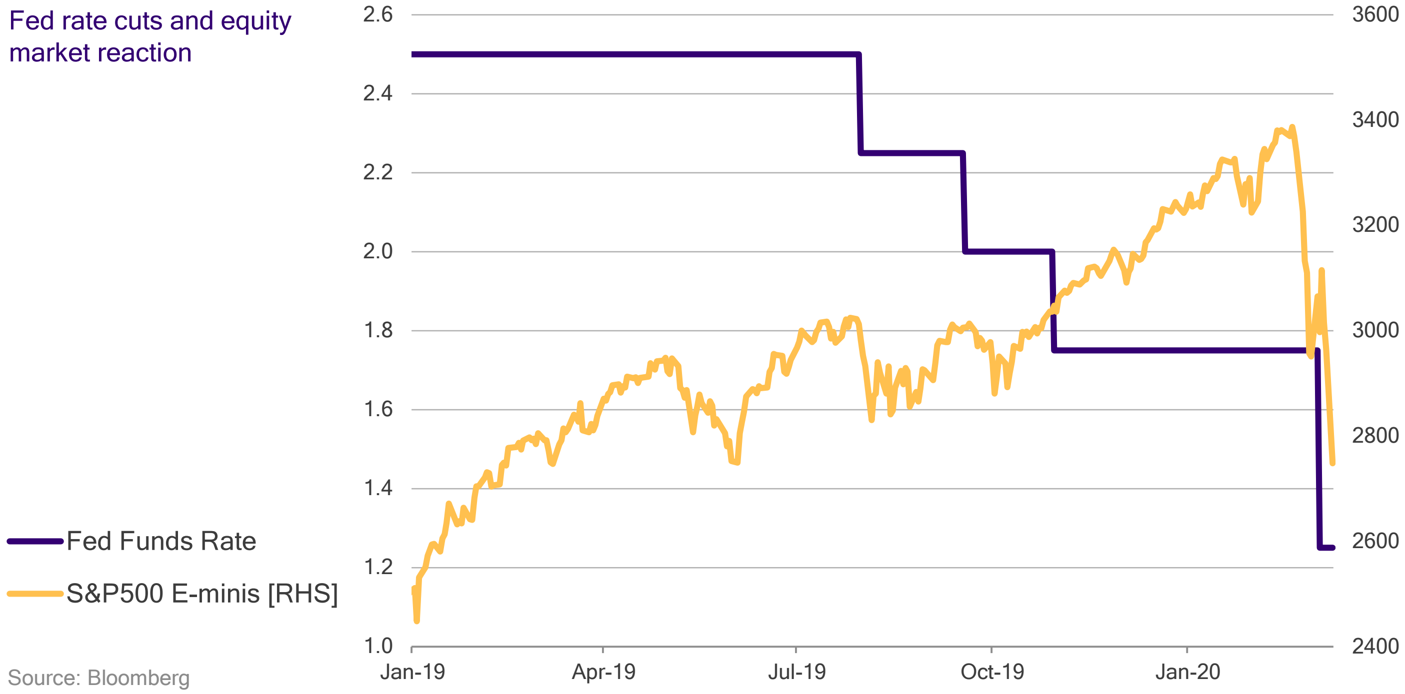
What happens when the central bank put becomes worthless?

In major exchange-traded equities, there are natural upper and lower limits that offer bounds for the ranges in which those markets can trade within one session. These limits serve to act as circuit breakers for when volatility events lead to panic. During the Asian session of March 9, the S&P 500 futures index hit “limit down” by falling 5% within the first two hours of trading.

It was previously expected that the natural circuit breaker for market routs overall would be the central bank put. Exactly where such a put is struck and what mix of policy measures it would involve when triggered is always uncertain, but the market reaction to the Fed’s emergency cut on March 4 suggests this more classic formulation of the central bank put may already be worthless. Despite being double the size of prior cuts seen in this cycle, this cut has done nothing to arrest the selling, as can be seen in Chart 11.

Chart 11

Fed rate cuts and equity market reaction



Source: Bloomberg

A bigger sugar hit than ever before is now demanded amid rapid pricing-in moves towards the effective lower bound for most major central banks. This seems somewhat circular and self-defeating, for if a 50 basis point inter-meeting cut failed to exhibit any worth as a central bank put, how could further cuts affect any change?

Even a coordinated global central bank response of another wave of cuts may still be taken as an opportunity to de-risk. The statements of inaction during the month from the likes of RBNZ and BoK have already been disregarded and discarded in history as moments of insanity. Governor Orr’s judgement of the virus’s impact lasting only six weeks seemed particularly sanguine, while BoK’s emergency meeting days ahead of the meeting seemed to spur no action whatsoever when it came to the meeting itself despite a cut being fully priced in.

At least the RBA cut the cash rate by 25 basis points, leaving one final cut before reaching their self-professed terminal rate. Even the idea of such a non-zero terminal rate is now being heavily discounted by markets.

To be clear, the market is not saying further cuts are enough to change the economic reality that lies ahead, but rather that not to cut would simply be foolish. Cuts will in no way guarantee a bounce in equity markets or even afford any guarantee of stability. No cuts, however, are likely to send those markets into freefall.

This means the classic central bank put now needs to up the ante. No longer is ZIRP sufficient to arrest the aversion in risk sentiment when sentiment had spiralled out of control. Standard QE measures are probably also futile. Instead, a likely panacea would have to involve coordinated global QE targeted at the assets current undergoing fire sales. A great moral hazard dilemma faces policy makers once again. While there is little appetite for a full blown GFC II, it will take a near-GFC outcome to corral such concerted policy coordination at a global level. In the meantime, expect the start of a new default cycle.

Natural circuit breakers

While the world is heavily focused on the left-tail at present, it is worth keeping the right tail possibilities in view. Absent of an amazing global central bank rescue plan, there are still a few natural circuit breakers that exist.

The first is the natural course of the virus's spread. The more it spreads globally, with continued low fatality rates, the more likely the behaviour of populations will revert back to old norms. This may even occur without an obvious peaking of the infected numbers. In essence, this scenario sees the world adjusting to COVID-19 becoming endemic, a part of our existence, and moving on with things. However, with the spread of the virus slowed by government and corporate measures to limit social contact, fear levels are likely to remain elevated for now.

More impactful would be an oil-price war truce, as the world's two largest producers come to their senses and realise there can be no winners in a price war when global demand is on its knees. Such a move would at least lessen one of the fundamental headwinds for US high yield, and may also provide some indirect support to other commodities.

Lastly, there are natural circuit breakers in the investment community. To the extent that there remain large pools of savings globally chasing yield and return, there will come a level in the market rout that longer term investors will find appealing. Relative to a pre-GFC world where "the other side" of the real money trade would be populated by short term bank proprietary trading desks or hedge funds, the natural circuit breaker investors of today are likely to be steadier hands and stand a greater chance of successfully leaning against the negative sentiment. Unfortunately for a lot of global equity markets, valuations had become so lofty ahead of this sell-off that further corrections are likely before we see those steady hands provide support.

At the extreme right tail, let's also not dismiss the possibility of over-stimulus. Once the swell of coronavirus has passed over Australia, likely to be evidenced by great surpluses of bog roll on BOGOF (buy one get one free) special in every aisle of our supermarkets, fiscal stimulus will likely ramp up significantly to join ranks with monetary stimulus. As with all economic stimulus programmes, they are politically difficult to roll back. As such, the effect of the stimulus is likely to outstay its need, and cause other problems further down the line. For those in need of longer term inflation protection in their portfolios, now is probably the right time to be bargain-hunting.

For more information call us on 1800 813 886
or visit **pendalgroup.com**