Bond, Income & Defensive Strategies

Newsletter

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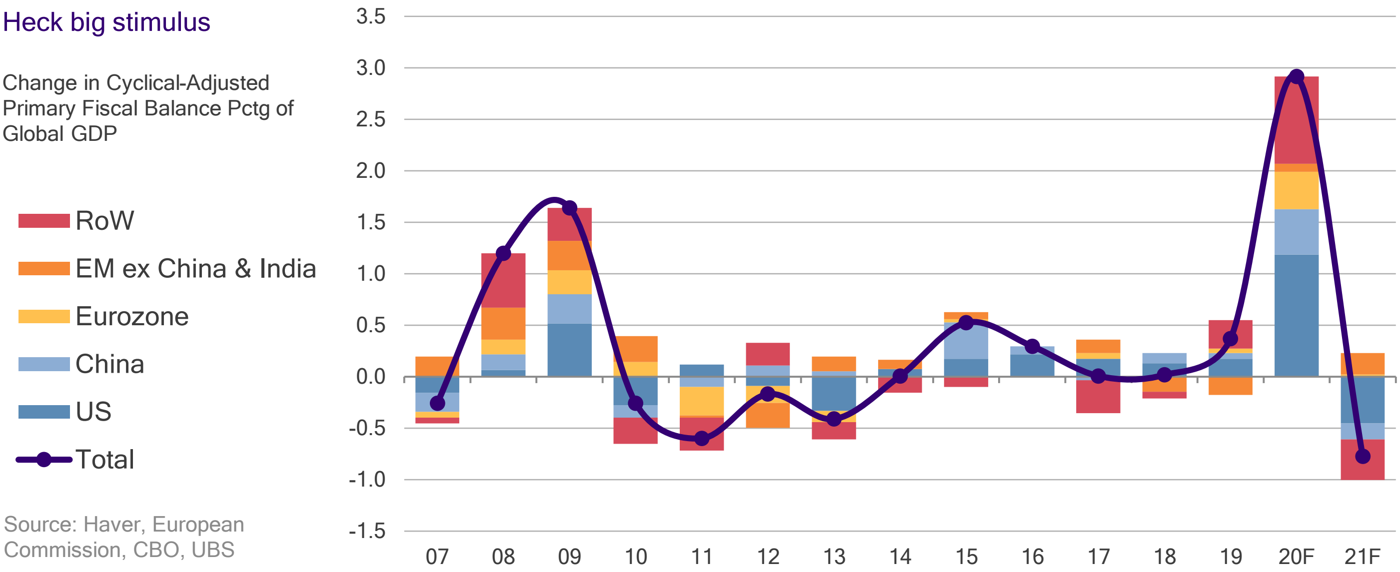
Go big and go home

There's nothing like a crisis to cut through red tape and focus the attention of policy makers on what really matters. As events unfolded in recent weeks we learned the unthinkable quickly becomes normal, and academic debates about the proper use of limited policy space are exactly just that – academic. The list of monetary policy responses rolled out is nothing short of extraordinary. For that we have the GFC to thank. Led by the Fed, which learned on-the-job through the course of 2008 and 2009, major policy rates have been slashed to zero (for those not already at negative rates); Quantitative Easing (QE) programs have been rolled out in unison; and yield curve is effectively in place to stop long-end yields from running away. The fiscal cavalry has also arrived, with packages announced globally to date equating to nearly 3% of global GDP and likely to grow further. This figure is already close to double the amount of stimulus thrown at the GFC over 2008/09. It excludes credit guarantees and support offered to businesses affected by the broadening of various shutdown and lockdown measures.

Chart 1

Heck big stimulus

Change in Cyclical-Adjusted Primary Fiscal Balance Pctg of Global GDP



Source: Haver, European Commission, CBO, UBS

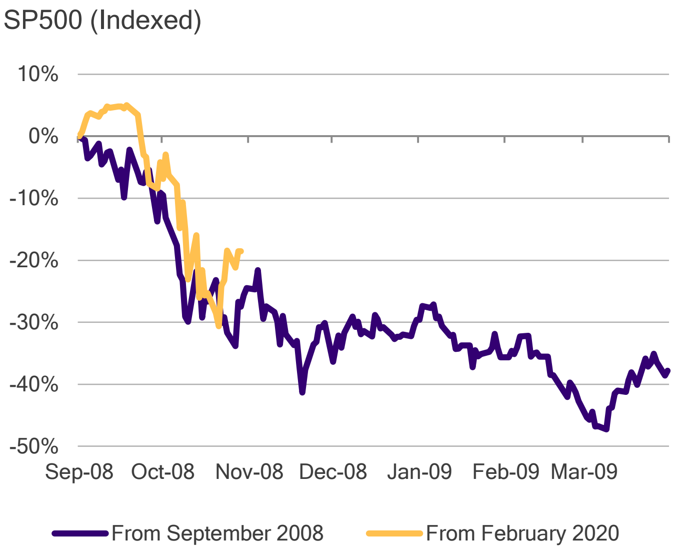
Despite all this, relief rallies in global risk assets have been too shallow to give comfort that the bottom is in. It may be – as we alluded to in last month's newsletter – that the central bank put is close to worthless. But at the same time as going big on stimulus, we've also been told to go home.

The necessary GFC comparison

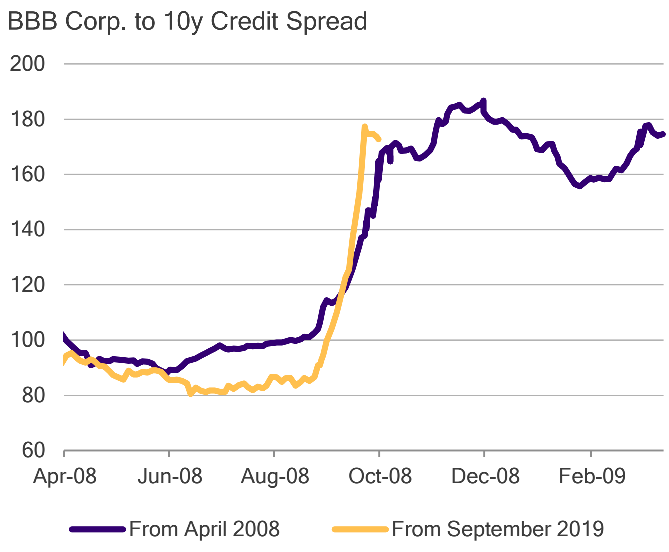
It is natural to look for shape and context for the current situation using prior episodes of crisis, and certainly several key asset classes are following the shape of the GFC playbook. The charts below compare current equities and credit market moves normalised against the start of the GFC period.

Charts 2a 2b

Re-living the GFC



Source: Bloomberg



Source: Deutsche Bank, Bloomberg

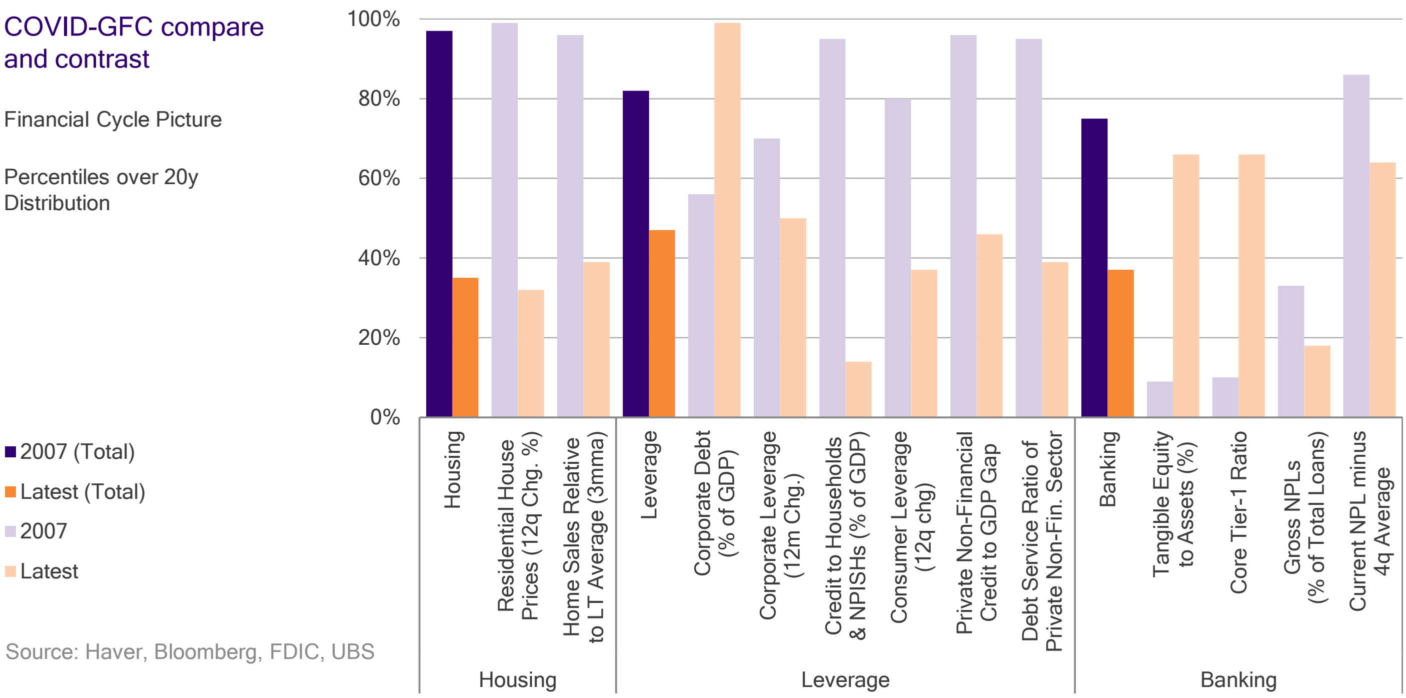
Price action aside, it is important to note the very meaningful distinction between these two events. The GFC was a hit from "Wall Street" to "Main Street", to use American parlance. The COVID-19 shock is exactly the reverse. Unlike the GFC, the exogenous shock hits the income statement and does not originate from a balance sheet recession. As the below chart shows, the same points of vulnerability in housing, leverage and the banking system are not present in today's conditions.

Chart 3

COVID-GFC compare and contrast

Financial Cycle Picture

Percentiles over 20y Distribution



Source: Haver, Bloomberg, FDIC, UBS

The economic recession that is unfolding is a direct result of public health policy that must involve the shutting down of vast swathes of economic activity. Companies and businesses in the service sectors are being put through a period of hibernation. The goal is to slow the spread of the virus and buy time for the current state of medical infrastructure (which varies widely globally), and ultimately a medical answer to the COVID-19.

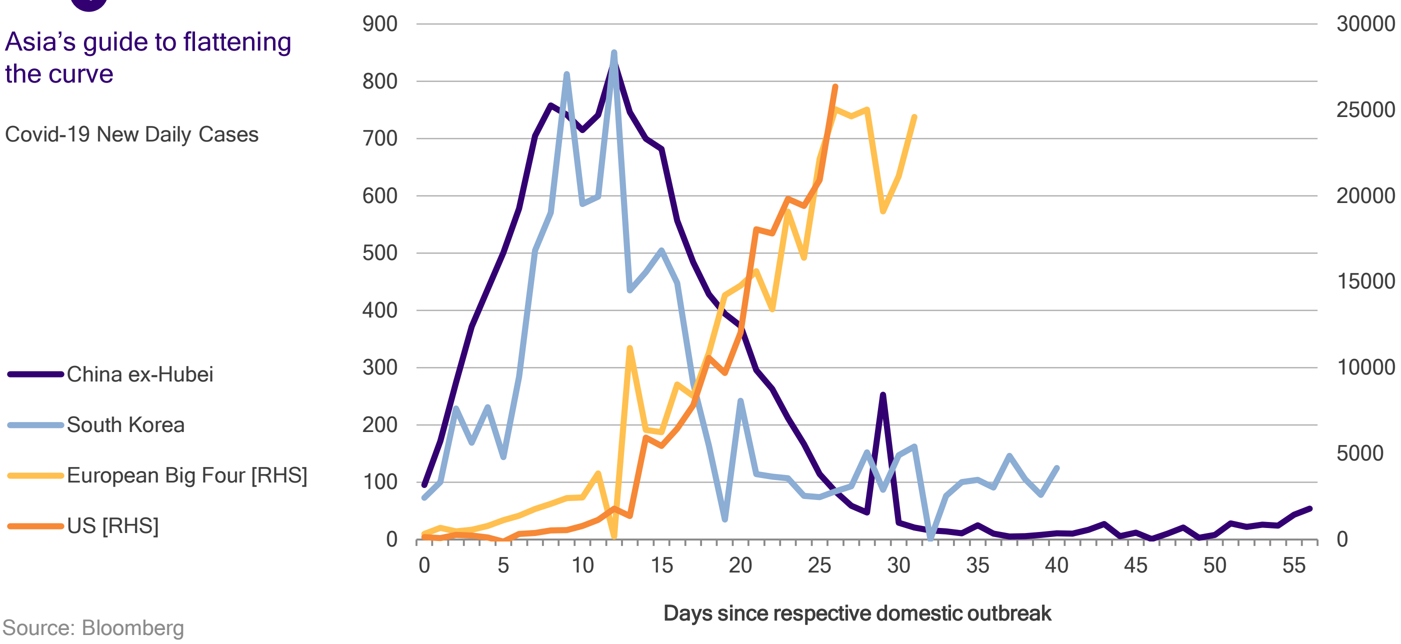
A cure worse than the disease

While the near-term outlook is a continued increase in shutdown, lockdown and social distancing measures, policy-makers everywhere are grappling with the notion that this is not a sustainable "cure" for the disease, and may well result in an economic casualty. While we'd all like more certainty as to how long this unprecedented period of hibernation will last, it is a matter of when and not if a cure and a vaccine will be found against this virus. The medical answer is not as binary as it may first seem. As the Chinese experience with the virus showed, being able to quickly roll out a point-of-care antibody test for the virus could be the next major intervention and help to return immune parts of the population back to normal life before a vaccine is developed. Depending on the speed and cost of rolling out such testing, it has the potential to release up to 50-60% of the total US workforce from the sidelines by the second half of this year. The north Asian experiences of being able to flatten the COVID-19 curve also provides encouragement.

Chart 4

Asia's guide to flattening the curve

Covid-19 New Daily Cases



Source: Bloomberg

There is a need for policy coordination during this government-enforced shutdown period. To the extent that the economic slowdown is largely man-made, the lifting of restrictions ought to release some natural momentum back into the economy. However, that depends on the duration of the enforced hibernation which will determine the ability of businesses and households to financially survive and re-emerge on the other side of this crisis. It is therefore not unexpected to see that the Fed has quickly taken a leaf out of the European QE playbook, and added support for corporate credit to its toolkit.

Central banks as buyers of last resort

Although this crisis has not been driven by the need for disorderly deleveraging – as was the case in the GFC – some of the moves in the credit space have been just as vicious and have happened more quickly. Part of the reason is the extra layers of regulation and recapitalisation the global banking system has been put through since the GFC. And rightly so. But the effect of such regulation leaves no banks willing to expose their balance sheets to unnecessary risk, despite being flooded with so much liquidity they have cash coming out of their ears. Rather than relaxing the very rules that were meant to strengthen the financial system against another crisis, this is the time for central banks to step up and honour their roles as buyers of last resort.

Regular readers will be surprised to hear me say this. Over the years, my distaste for credit risk has been repeated via the forum of this newsletter. Not because I hate the very nature of corporate bonds but because of the growing risk of deteriorating credit quality that were not being reflected in ever-tightening credit spreads, especially in the junk debt space. And when central banks do step in as buyers of last resort, certain assets simply shouldn't be touched. Over-levered, opportunistic and marginal business models are supposed to fail when the going gets tough. The system needs to be able to clear, at least a little. The trouble is when the bad risk in the system is unable to clear (because who would want to buy a bond that is sure to default), the good stuff gets dragged along with it. This has been the main cause of the widening in the majority of investment grade spreads globally over the course of the past few weeks. In a rush to shore up liquidity, either to spend or more likely to hoard, investors will sell what they can and not what they have to.

Yet if government public health policies are to be given a half decent chance, lifelines also need to be extended to the economy. In the absence of a central bank or government backstop for the pricing of blue-chip investment grade corporate credit risk, the cure will almost definitely be worse than the disease as the widespread collapse of businesses leads to the destruction of the economy's productive capacity. With too much lasting damage to the supply side of the economy, not only do we lose the ability to bounce back on the other side, but we will also be contending with inflationary problems further down the line.

Shout out to MMT

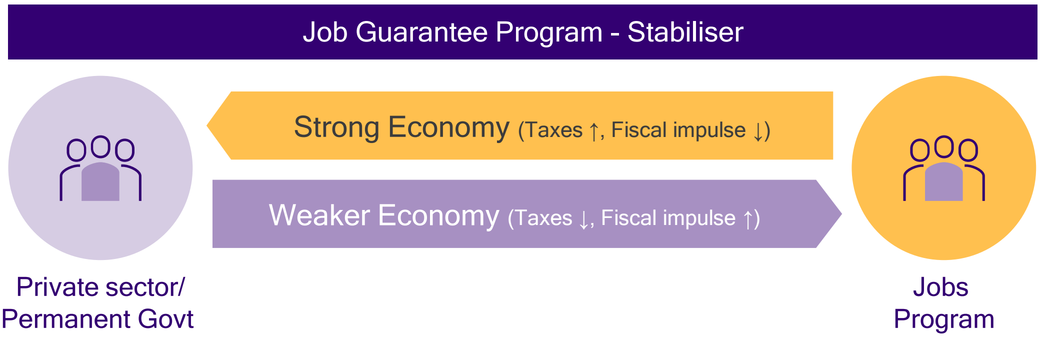
The worst of the economic downgrades are yet to come, and at this stage it doesn't even matter how deep the correction will be. Unemployment numbers have already been rising rapidly. Unlike a typical recession (led by the more cyclical manufacturing sector), the current situation has hit the labour-intensive consumer and services sectors. More important than the magnitude of the growth shock is how quickly activity and therefore employment is able to bounce back.

Here, we think it's worth highlighting a policy framework from the MMT school of thought. MMT, or Modern Monetarist Theory, gets a lot of flak for espousing socialist thinking. However, at the heart of MMT is the idea that the economy is there to support the welfare and wellbeing of people, and not the other way around. To that end, government employment schemes that absorb workers shed from the private sector would be a very fitting idea for the current crisis. Regardless of how MMT proposes that such schemes are funded, the idea is an economic policy that supports individuals with gainful employment until they are able to find work again in the private sector.

Such a scheme is likely to lessen longer-term damage or rising structural unemployment rates, which would be typical of any normal recession, let alone this highly abnormal one.

Figure 1

A leaf from a different textbook



Supporting employers is also the way to consider the central bank backstop for high-quality IG credit. I am the last person to be a fan of bailing out the creditors, but if the negative sentiment spiral is likely to cause systemic dysfunction on a seismic scale, a circuit breaker is needed until we're out of hibernation. The coordination between the health and economic responses will determine the shape of the recovery. We all want a V over a U, and definitely not an L.

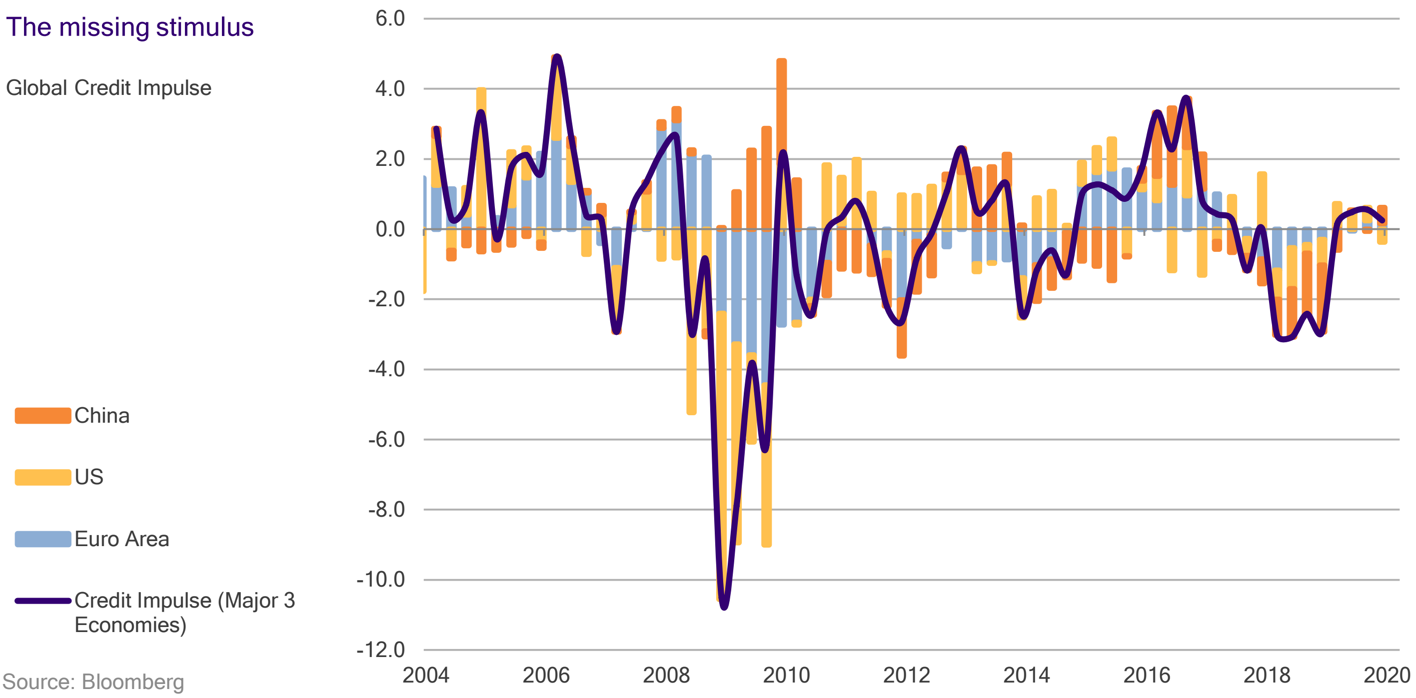
The missing stimulus

China is where this virus started. While it is encouraging to see successful control of the outbreak in China – with Wuhan also about to re-emerge from lockdown –perversely it is bad news for the global economy. Unlike prior health crises such SARS and financial crises such as the GFC, China today has much reduced firepower and is more reluctant to use it. Stimulus efforts have been stepping up and will continue to do so. But the nature of the stimulus is focused on where this crisis has hit the hardest. At the same time, this inward-focused stimulus is unlikely to see credit growth explode in the same way as 2009/10, or even the last economic downturn in 2015/16.

Chart 5

The missing stimulus

Global Credit Impulse

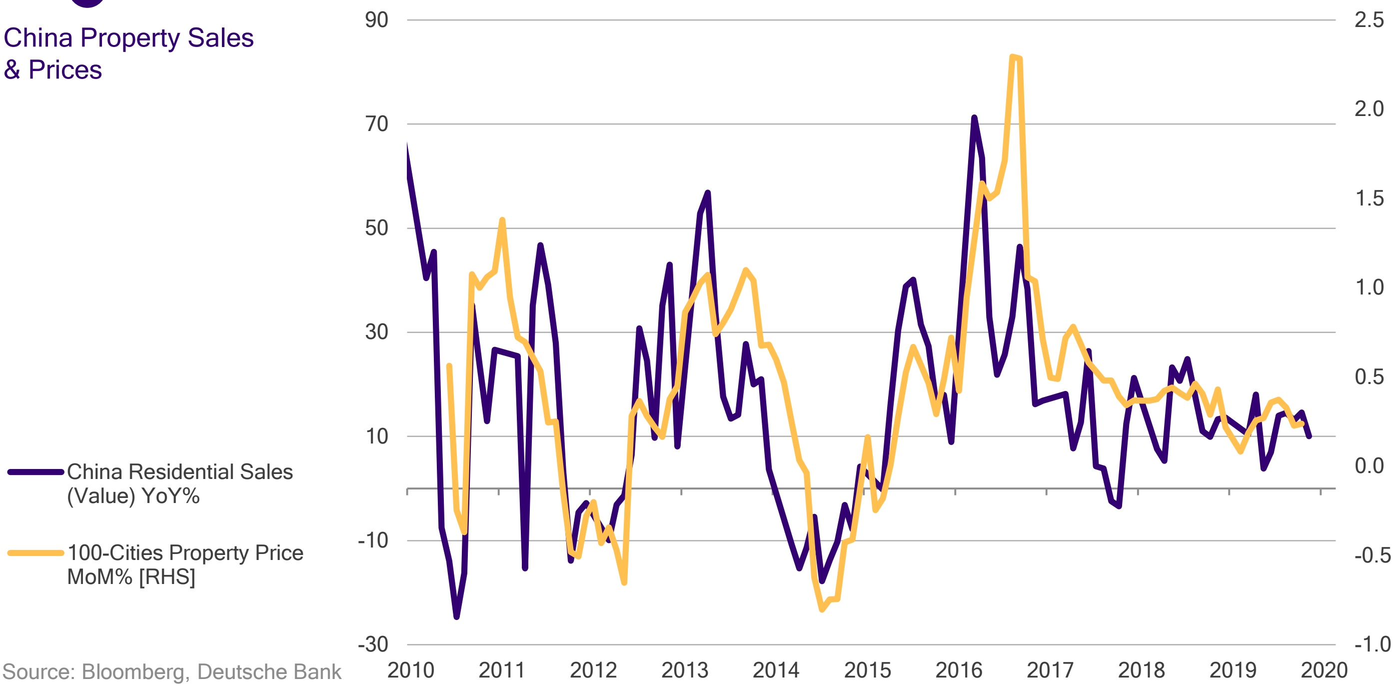


Source: Bloomberg

Ultimately, China's panic button is unleashing a bubble in its property sector. Absent another shock matching the magnitude of the current one, Chinese leaders would be loath to undo their efforts over recent years to eradicate the property cycle.

Chart 6

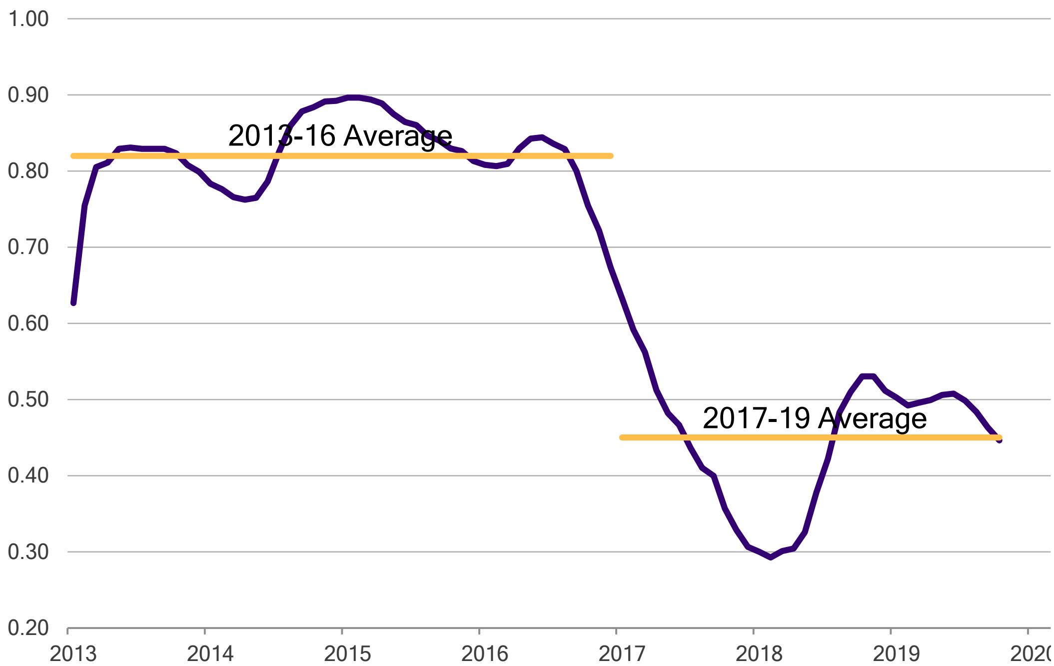
China Property Sales & Prices



Source: Bloomberg, Deutsche Bank

Chart 7

Property Price Cross-City Correlation



Source: Bloomberg, Deutsche Bank

Oil, liquidity, valuations and the savings glut

In these highly uncertain times, let's close with some silver linings.

Oil has been an unwelcome complication in this current crisis. Corporate defaults in the energy sector are inevitable, and it will look worse than the energy defaults of 2015/16. However, oil at $20 also buys some relief for oil importers and households (once they're allowed to leave their houses again). China's announcement that it will stock up on its national oil reserves illustrates the bargain-basement levels to which the oil price has fallen.

The Fed is trying to get in front of funding pressures. It is pumping liquidity into the onshore financial system through slashing rates, QE, targeted purchases that hold down the yield curve, and massive amounts of repo. It is also allowing some of that extra liquidity to flow into the offshore dollar economy. Onshore funding stresses are caused by corporates who are drawing down their revolvers and calling on their credit lines, maybe because they need the cash, but mostly because it's the rational thing to do when the near future looks so uncertain. Offshore dollar funding is largely used by the emerging economies, who at times like this feel a double whammy of investors running for the door and a strengthening US dollar.

In this regard, the Fed's extension of USD swap lines, much like it did during the GFC, buys some breathing room for the offshore USD users. To the extent that the Fed's efforts at stabilising funding pressures onshore will eventually end the cash-hoarding behaviour of US corporates, more of that USD liquidity is likely to find its way offshore over time. To the extent that there is a thinly veiled "weak dollar" policy being pursued by the US and if it is successful, will provide some further reflationary support for the world economy outside of the US. And to the extent that US IG as an asset class is a member of the too-big-to-fail club, you can expect more Fed support along the lines of what has been done thus far.

Valuations imply a varied range of economic outcomes depending on which asset class you look at. On the whole, while it may be encouraging to hear that global equity markets are already pricing a more dire scenario than global recession, equity prices are unlikely to stage a miraculous comeback short of the Fed including the S&P 500 into its QE program (not impossible, I'll admit).

The main tailwind behind equity valuations in recent years has been corporate buy-backs. Debt has been cheap but productivity has remained on a declining trend. The rational decision for any corporate to make is to seek stronger IRRs by issuing more debt and buying back its own shares. Not only has this tailwind come to an abrupt stop, but is going to reverse into a strong headwind.

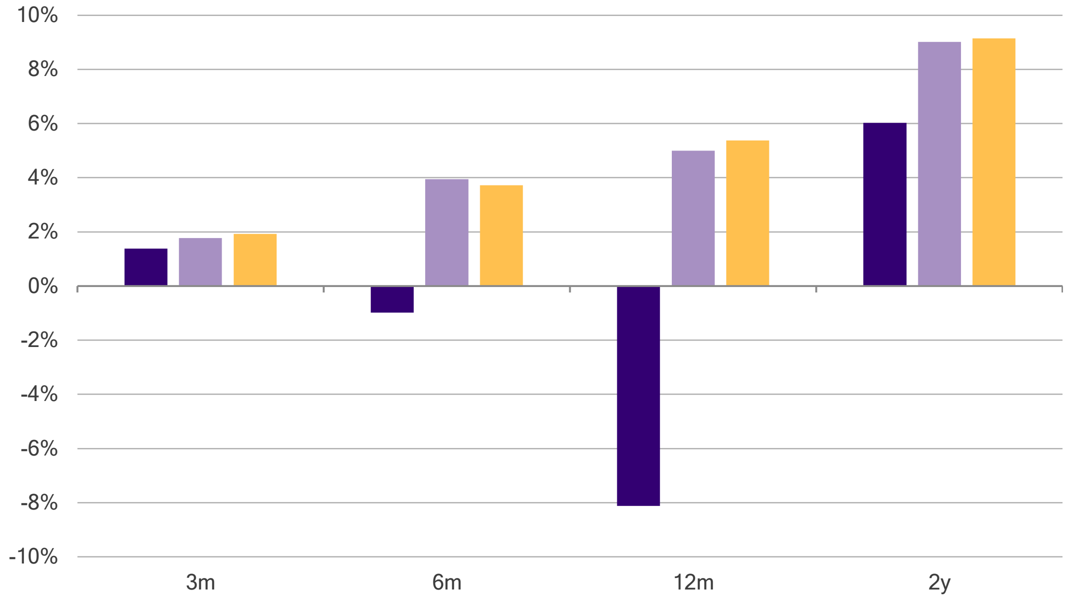
Balance sheet repair will be the first order of business when capital markets resume normal functioning. Expect share issuance to pick up pace. In addition, the implicit in the support to corporates extended by governments and central banks as part of various stimulus packages seems to be the expectation that dividends will be dramatically curtailed. A reminder of why dividend yields are not the same as bond coupons. Regardless of what valuations imply, the market needs better earnings visibility before a more sustainable bottom can be found. Luckily, we know this is again a "when", not an "if" question.

A more simplistic approach again finds reason to at least not hate investment grade credit here. The chart below is a rough-and-ready analysis of total return outcomes over short-term and medium-term periods of buying Australian IG credit after a significant blowout in spreads. If you share our view that this is a growth shock like (although far worse than) the oil crash of 2014/15, rather than the shock that was the GFC, scaling into the right sort of credit risk at current levels looks appealing both from the perspective of the loss buffer given higher credit spreads, as well as decent return potential for investors able to hold a medium-term view. With global rates likely pinned for the floor for some time to come, the global savings glut will be searching for yield more urgently than ever before on the other side of this crisis, and quality income assets ought to carry a premium.

Chart 8

Time to play the strong hands

Total returns after large spread widening



Source: Bloomberg

Conclusions for investing

The growth shock from COVID-19 will be dire, and it is largely academic and irrelevant to arrive at any forecasts for key economic measures. As a result, any lift-off in interest rates is likely a long way off. Any significant re-steepening of yield curves will be capped by central banks, just as we witnessed in March. Bond yields may be low, but bonds will only get more expensive in coming months.

Equity valuations look cheap to some and still expensive to others. Again, this debate is largely academic until there is visibility around earnings. We believe there is safer and better equity beta to be had in investment grade credit, assuming you are able to sort the wheat from the chaff.

The US dollar is likely to maintain a bid in the near term, but the turn is likely to be vicious once current dollar hoarders lose the need to hoard. This matters most for emerging markets. Given how hated the asset class currently seem to be – understandably so when considering the standard of EM healthcare infrastructures – there will come a point to tip back in to the asset class. The longer-term drivers of income and diversification needs remain intact and will be fuelled further by the larger global savings glut to come. The euro suffers a more binary fate, as this will likely be the crisis to finally end the Eurozone experiment, or fiscally unite the region in a way we never thought possible.

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