Bond, Income and Defensive Strategies

Weekly Note

April 24, 2020

Is this the eye of the storm?

It was a relatively calm week for markets, matched by a more relaxed view in the community that we may be past the worst. Daily new COVID-19 cases have dropped to almost single figures and the talk has been focused on when shutdowns can end. The RBA has crushed short-end volatility with its Yield Curve Control of 3yrs at 25 basis points. But even 10-years could only muster a tame 10 basis point range between 0.8% and 0.9%. Perhaps the most revealing thing was hearing the thoughts of RBA governor Phil Lowe on the likely path for the economy. After all the RBA has better access to data and more economists than the private sector, even if recently they have been guilty of optimism in forecasting.

The RBA is looking for unemployment to reach 10% by June and for hours worked to drop by 20%. GDP is forecast to fall 10% in the June quarter before rebounding. Inflation will be negative in the June quarter before lifting to 1% by year end. All shocking – but not unexpected. Crucially though, inflation, unemployment and GDP will not return to pre-crisis levels for at least two years and likely far longer. Talk of V-shaped recoveries ignores the structural as well as cyclical damage done. U-shaped or even W-shaped is far more likely – and even then very drawn out. As a result cash rates will be stuck at the lower bound for at least three years and potentially for most of the decade. Long-end bond rates may keep some volatility with inflation and real rate volatility but will maintain general support as investors once again chase yield.

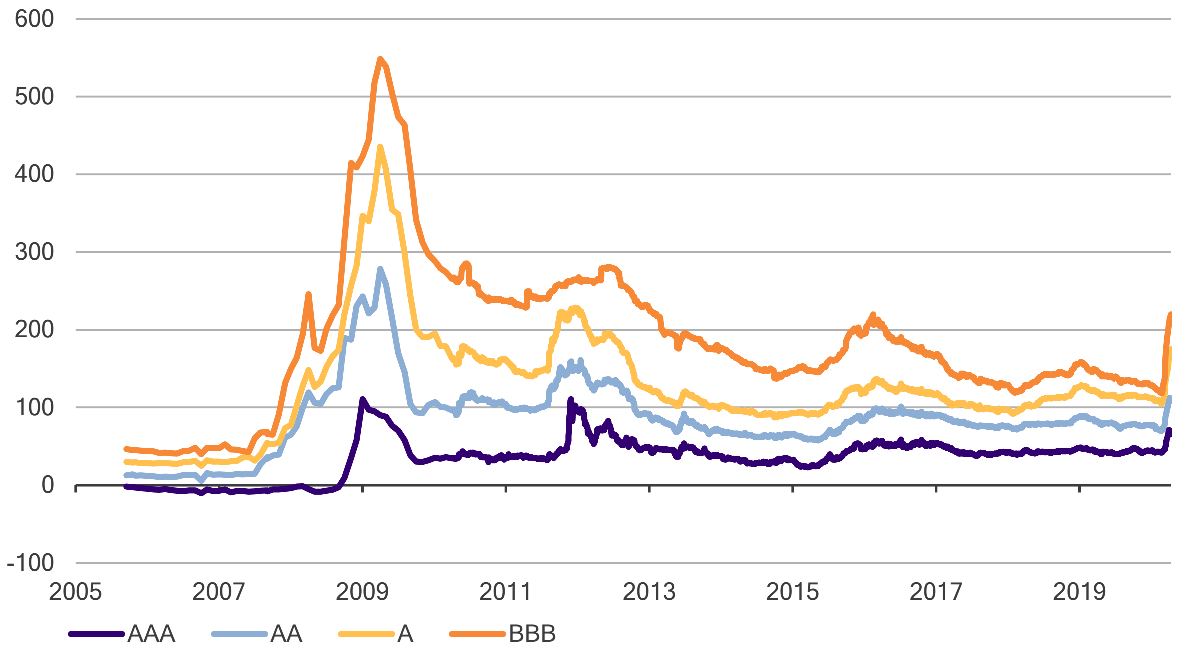
The timing of vaccines and anti-viral treatments remains the big uncertainty. No-one knows the answer, including the RBA, so there is considerable room for error. While we hope for the best we must still plan for the worst – that the current calm is the eye of the storm. Decent carry and caution mean bonds remain an important part of diversified portfolios and should do well in most outcomes.

As mentioned in the last few weeks, we have cautiously gone overweight investment grade credit in a number of our composite funds. This is the first time in more than four years and recognises that pricing is finally reflecting the risk/reward profile we need to invest (see chart below on spreads).

There is a preference for names exposed to the domestic economy as the path out of this crisis may be a far longer one for international sectors. The performance of different sectors and even different companies will make micro analysis as important as macro. For this we lean heavily on the expertise of Pendal's equity team who are in constant touch with the economy on a company-by-company basis. These real-time insights are vital in times like these where uncertainty is high and macro data is unreliable as a guide.

Some of the key areas of opportunity are occurring in the BBB space where some spreads are even wider than in any period since the GFC (see chart below). With the potential for government support of key infrastructure projects – as well as stronger balance sheets than during the GFC – the upside for some of these names relative to the downside, given the spreads on offer, make for compelling opportunities.

Australian Corporate Spreads



Source: Pendal

Let’s hope it is not the eye of the storm – that we have passed through and are emerging on the other side.

Medical scientists – not governments or central banks – ultimately hold the key.

As investors we must watch but also prepare.

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