Bond, Income & Defensive Strategies

Newsletter

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Vimal Gor
Head of Bond, Income & Defensive Strategies

What would be a "good" outcome?

The initial economic and health policy responses to COVID-19 were fairly consistent globally. The movement and congregation of people were heavily restricted by way of shut-downs and lock-downs. Fiscal support was quickly unleashed to help with the economic fall-out that those restrictions created. Interest rates were slashed everywhere and central banks ensured financial systems were flush with liquidity.

As the pandemic continues, subsequent rounds of policy actions have begun to differ and fairly markedly in some cases. Countries such as Australia and New Zealand have been at the more stringent end of activity and mobility restrictions. The latter pursued an elimination strategy. Elsewhere in the world, subsequent rises in infection rates have been met with responses aimed at minimising further strains to the economy. It can be broadly agreed that more fiscal firepower will be needed in coming months. But the extent to which it is forthcoming now also varies due to politics (United States) or balance sheet constraints (large parts of the emerging markets). As a result, the markets look to monetary policy once more to deliver another sugar hit, albeit with almost no policy space.

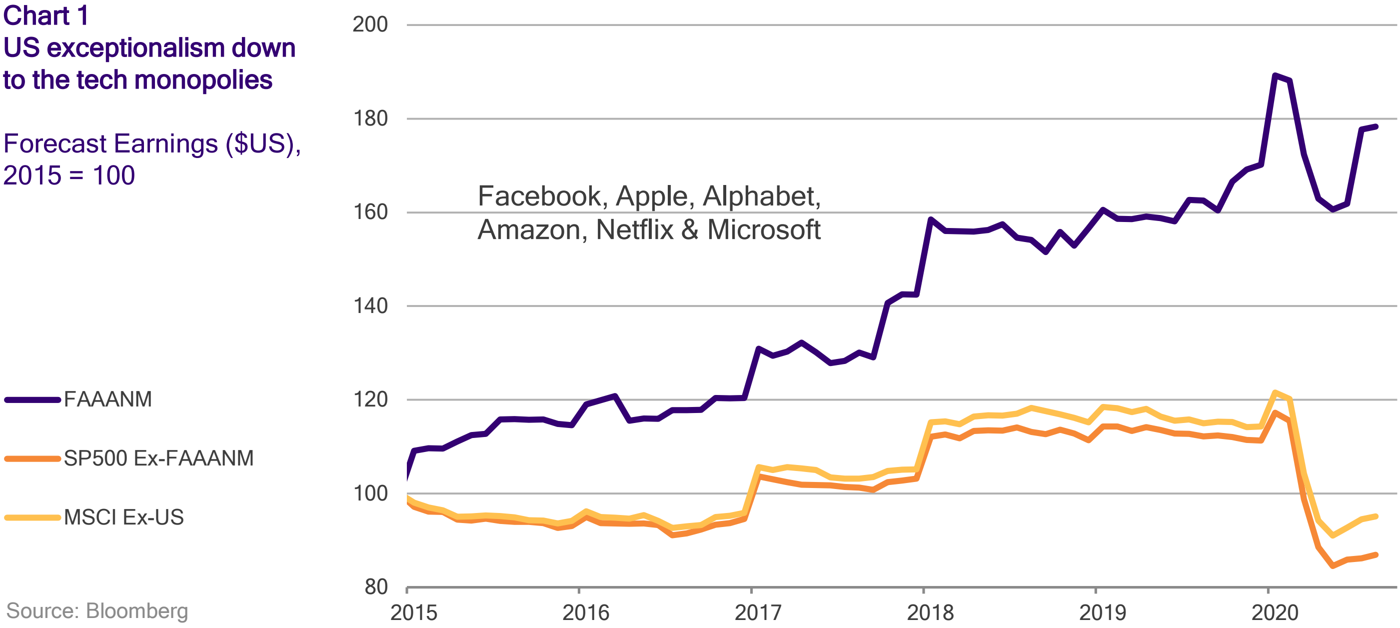
Through all of this equity markets have staged a remarkable recovery. In the case of the US, driven by the big tech names, there has been a super-recovery to new all-time highs (Chart 1). This recovery has in part been led by the economic data, much of which is weighted to production and the supply side and hence far quicker to come back after the initial shut-downs. Changes in the behaviour of individuals and corporates lit a fire under the tech sector, giving it growth and defensive characteristics. Hopeful headlines of vaccine development have also injected doses of optimism to the market recovery.

Whether these gains can extend (and for how long) now depends on a few key factors. In the near term all eyes are on the US elections and who ultimately controls the White House. A vaccine breakthrough is another possible near-term hope gaining greater consensus. Beyond these immediate factors, the market will look at the ability of the economic recoveries to sustain their momentum. While monetary policy and frameworks such as the Fed's Average Inflation Targeting will count towards the growth factor, fiscal is clearly the more important lever at hand. Central banks matter right now in how they do their part to enable greater fiscal stimulus.

There is a fair amount of consensus about what is good and what is bad in the way these factors play out. A vaccine breakthrough would undoubtedly be good for global health – and the sooner the better. But we don't think it's such a clean outcome for markets, depending on your risk-asset focus. A "Blue Sweep" in the US elections is considered to be a favourable outcome. But again, we take issue with this consensus thinking. In this newsletter we look closely at how these factors can play out, especially in the context of risk markets and fixed income. A "good" outcome isn't as obvious as it might seem.

Chart 1
US exceptionalism down to the tech monopolies

Forecast Earnings ($US), 2015 = 100



Source: Bloomberg

"Biden good, Trump bad"

Before we delve into US election scenarios, it should be noted that a contested election would clearly be bad for markets. Given the large proportion of mail-in ballots this year due to the pandemic – and Trump's crusade to de-legitimise postal voting – the chance of such an outcome is not insignificant. The post-September rally in US equities has been attributed to polls pointing more to the left. But this is also because the markets like certainty. A stable and clear margin between the two candidates is interpreted as a lower likelihood of a contested election outcome – and therefore markets getting back to business sooner. In addition to this, the polls are showing a higher likelihood that the Democrats could win the Senate compared to a few weeks ago. A "Blue Sweep" would pave the way for cleaner passing of bills and freeing the deadlock on more fiscal spending.

Two main reasons are touted for why a Democratic victory would be a good. The first is that the Democrats would spend, spend, spend. The second is that Biden would be soft on China. Polls point to the growing likelihood of a "Blue Sweep". But if the Republicans retain the Senate it will most certainly throw a spanner in the works as far as more fiscal spending and infrastructure are concerned.

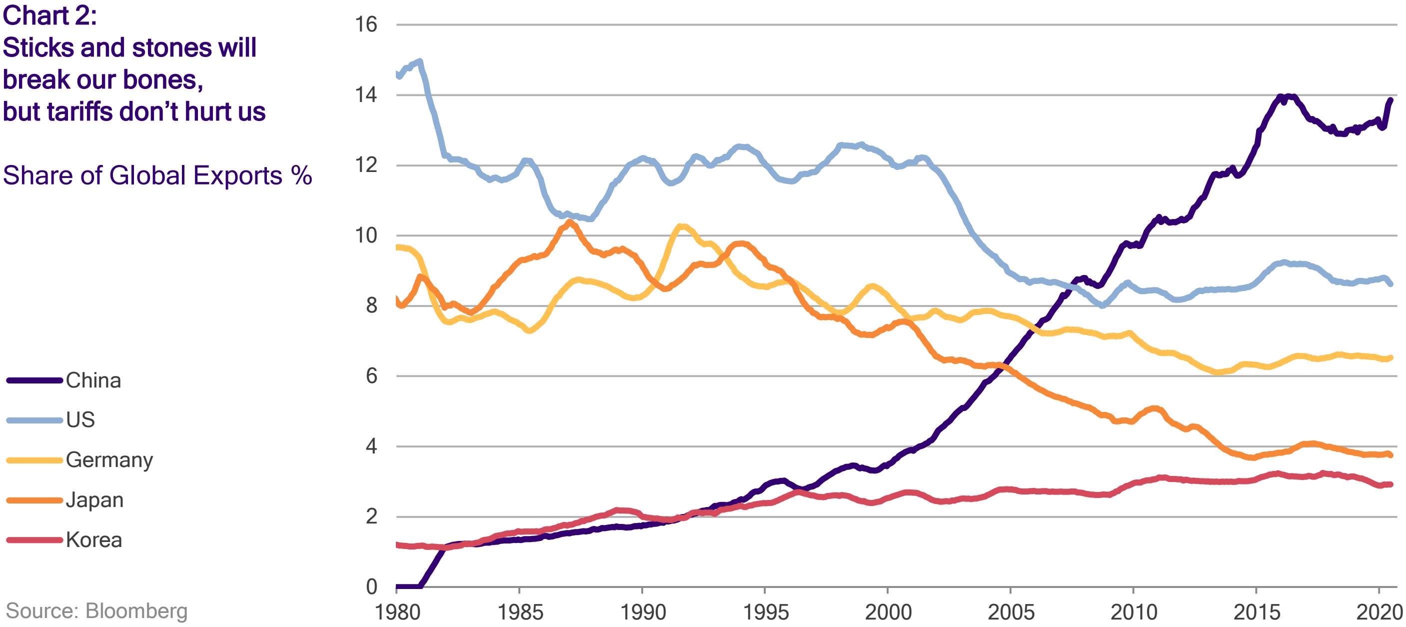
Under Trump the Republicans are united. Under a defeated Trump large portions of the Republican Party are highly likely to reunite with their fiscally conservative roots. In the immediate aftermath of such an outcome, the prospect of fiscal disappointment is likely to snuff out – if not reverse – some of the recent momentum in equity markets.

There are also the Democratic tax proposals to consider. Turning to traditionally leftist principles, the Biden campaign has harped on about inequality and wealth concentration. Proposed changes to capital gains taxes alone could do significant, albeit short-term, damage to the equity markets if investors engage en masse in pre-emptive selling of the mega-cap tech stocks. A handful of large tech names now account for more than 45% of the S&P 500 index, surpassing the share of the entire tech sector in the index at the peak of the dot com bubble. Profit-taking in this sector could trigger model and retail selling of the entire market. In addition, analyst estimates suggest the Biden-proposed corporate taxes could take an average of 10% off the US share market EPS – and closer to 15% for the big tech companies.

The other widely held belief is that Biden's position on China will be much more market friendly than Trump's has been in the past four years. His credentials for multilateralism during the Obama administration are attributed to this thinking. It follows that not only would equity markets love a Biden win, but so would emerging markets – and the US dollar would weaken. We don't think it's as straight forward as this. While Trump has been successful in awakening the American masses to the unfair nature of the economic relationship between the US and China, he has not been successful at correcting the bilateral imbalance (Chart 2).

Chart 2:
Sticks and stones will break our bones, but tariffs don't hurt us

Share of Global Exports %



Source: Bloomberg

Despite trade tariffs levied on Chinese exports to the US in recent years, China's share in the global export pie is as big as it has ever been.

Some of the recent surge can be attributed to the disruption of global supply chains during the peak of the crisis, leaving China's supply chain to be the first and the quickest to recover back to capacity.

Also during this time, higher global demand for some of China's key exports (laptops, computers, medical equipment) has soared, resulting in Chinese exports growing against a backdrop of shrinking global trade volumes.

More importantly, even at the peak of the trade war unrest between the US and China, Trump's demands steered clear of China sore spots such as human rights, climate change and democracy. China would find it impossible to negotiate on these issues. If forced to do so, they would view as a threat to their sovereignty. However the Obama administration had already started to stir these issues before the 2016 elections and they will likely be taken up again under Biden. While the immediate impact on markets will be less obvious compared to an overnight surprise tariff hike or venomous anti-China Tweet, the ultimate result will be a less co-operative China, and perhaps one more willing to contest the legality of the Trump-era tariffs. In addition, Biden's hostile stance towards Russia and Turkey poses a concern for emerging market assets in the medium term because they are heavyweights in most EM indices.

Conversely, under a Trump win, China is likely to offer concessions quickly to reach a quick and smooth Phase 2 trade deal. By now, Trump is a known entity to China and they have always been better at playing the long game. A quick resolution on Phase 2 may see Trump turn his trade war rage towards Europe. This would play into China's hands of a softer yuan, given the euro has the second-highest weighting (behind the US dollar) in the CFETS Renminbi basket. Also under a Trump win, the Republicans are more likely to pass an agreeable fiscal package, and the status quo may be easily digested by markets after the initial disappointment. In any case, how Trump behaves in the event of defeat is far less predictable than a victorious Trump – and we know how much the market dislikes uncertainty. He will have three months remaining in office after the elections should there be a Biden victory, which will provide plenty of time and opportunity to wreak havoc. China tensions are more likely to rise, not fall, as Trump seeks out a scapegoat for his defeat.

Vaccine hopes

We all dream for an effective COVID-19 vaccine. We are not vaccine experts and cannot offer any valuable opinion on how soon such a solution could develop. We just know that trials and approvals take time, the virus itself may mutate and its availability and accessibility will vary greatly by country. There is also the issue of how much immunity such a vaccine could offer. Annual flu shots offer between 40-60% immunity only. Nevertheless, if a definitively positive vaccine headline was to pop up overnight, the knee-jerk reaction in global equity markets should be a positive one. But what then?

It has been precisely the severity of the economic havoc wrought by the pandemic that has caused even thrifty governments like ours to cut open the purse strings – more so than most governments were willing to do in response to the GFC. Major global central banks have cut rates to their effective lower bounds and made commitments to use tools and frameworks that will help them anchor rates for longer.

If a vaccine was to appear that could put the world back to normal, would there be any justification to keep monetary conditions as loose as they are today? If governments believe fiscal policy should be counter-cyclical, there goes the fiscal stimulus as well.

If there was such a way to withdraw stimulus in an orderly and measured fashion, one could see the possibility for natural economic momentum to take over from stimulus-driven recovery. Still, that won't prevent the initial market reaction from being negative for both equities and bonds. That is a big "if" because stimulus is always far easier to deliver than take away. The more likely scenario is one of over-stimulus, running into capacity constraints and good old-fashioned inflation. Ask any central banker today and that would be far from their forecasts – probably an inflation scenario that exists only in their wildest dreams. But it would be a true test of what the Fed really means by Average Inflation Targeting. Instead, the way in which we are now trying to cope in this era of COVID – while sub-optimal for global health outcomes – likely provides the goldilocks scenario to keep the markets happy. Growth is recovering, but unemployment is still a worry as the services sectors have been hardest hit. As a result, monetary and fiscal conditions must remain accommodative to support a continued recovery, while inflation concerns remain far in the distance. This recipe seems to cook good risk-asset outcomes.

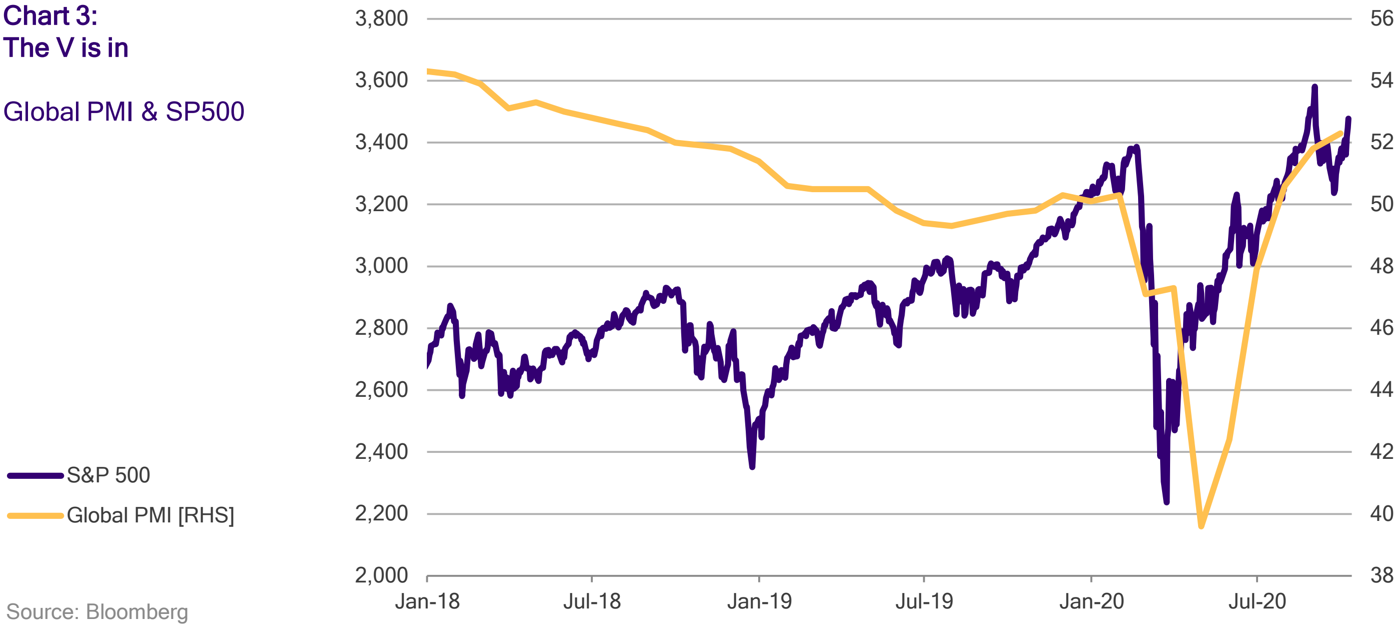
The alphabet soup of recovery shapes

This pandemic-driven recession has been historically unique in its characteristics. Usually the industrial parts of the economy lead us into and out of recessions, despite this becoming and smaller and smaller part of most developed economies in the past two decades. This is because the services sectors tend to be more stable, less reliant on commodities and structurally lighter on operating leverage. This economic downturn has seen the opposite. Mobility restrictions and various lock-downs have turned off the revenue tap for large swathes of the services sector. In turn, fiscal stimulus has come to the rescue, and remains the main life support system for large parts of economies.

Nevertheless, as most of the economic data that the market pays attention to focuses on the industrial sectors and production, it's hard to ignore the pronounced V-shapes in key measures such as PMIs (Chart 3). Against this backdrop, perhaps it's easier to understand the V in equity markets as well.

Chart 3:
The V is in

Global PMI & SP500



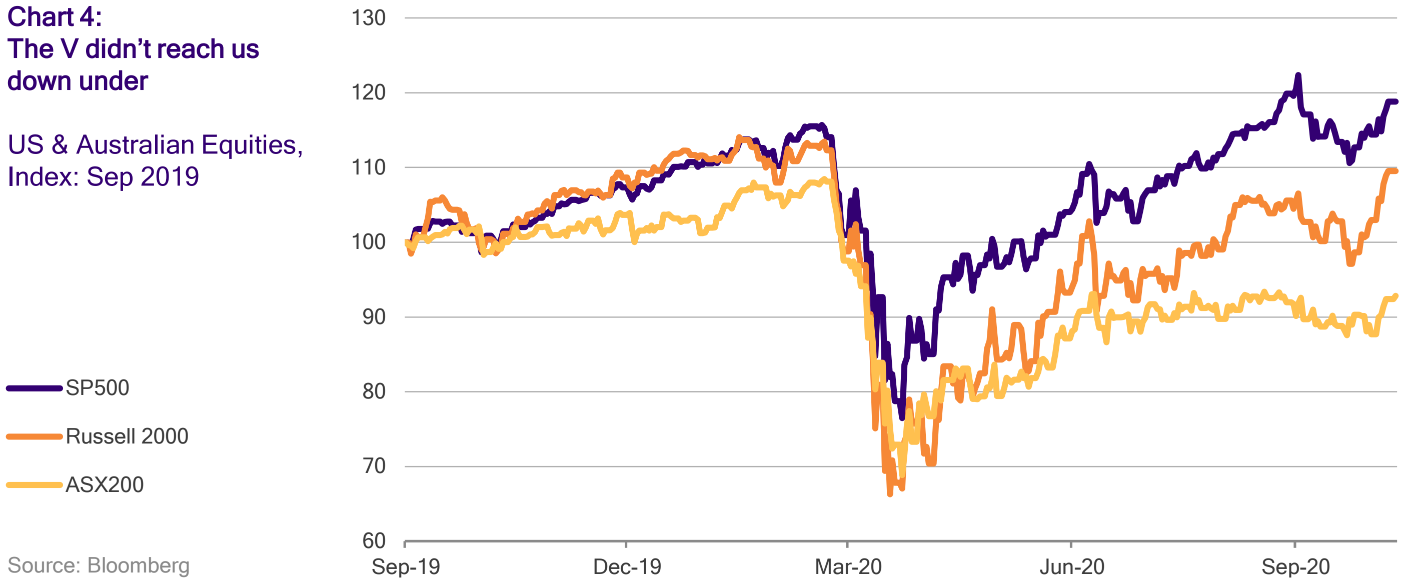
Source: Bloomberg

That recovery shape looks a little different when we move away from headline manufacturing indices and from defining “equities” by the S&P 500 alone.

Starting with the equity markets, the US is unique in the presence and size of the new tech sector. As Chart 4 below shows, even the Russell 2000 index (which is a more “whole economy” depiction of the US) took longer to participate in the recovery momentum seen in the S&P 500. When you look further afield to stock markets like ours – where there is a dominance of financials and mining and a distinct absence of FAANGs – our equity market recovery shape resembles more of an “L” than a “V”.

Chart 4:
The V didn’t reach us down under

US & Australian Equities, Index: Sep 2019

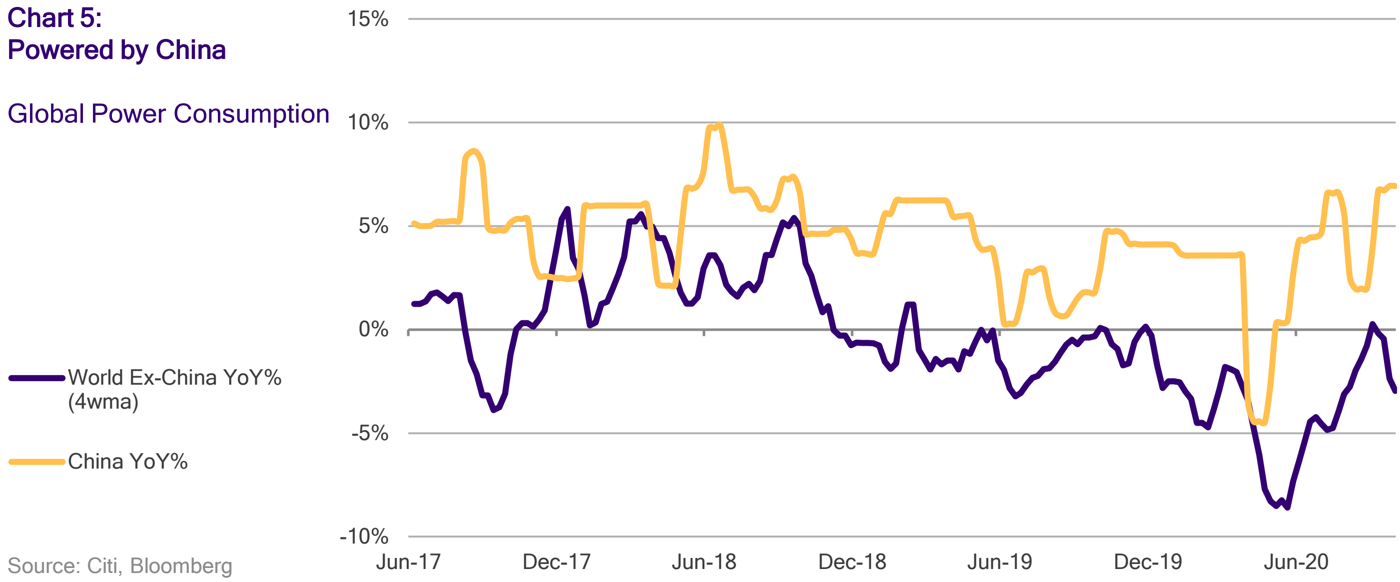


Source: Bloomberg

In terms of the economic recovery, even if we just focus on the industrial and supply side of the story, much of the strength in the recovery has been dominated by the speed of China’s industrial recovery (Chart 5). Here we know China’s story is different to everyone else’s because of the ability of the authorities to direct lending, which invariably finds its way through to construction via state-led infrastructure as well as a boom in the real estate sector.

Chart 5:
Powered by China

Global Power Consumption

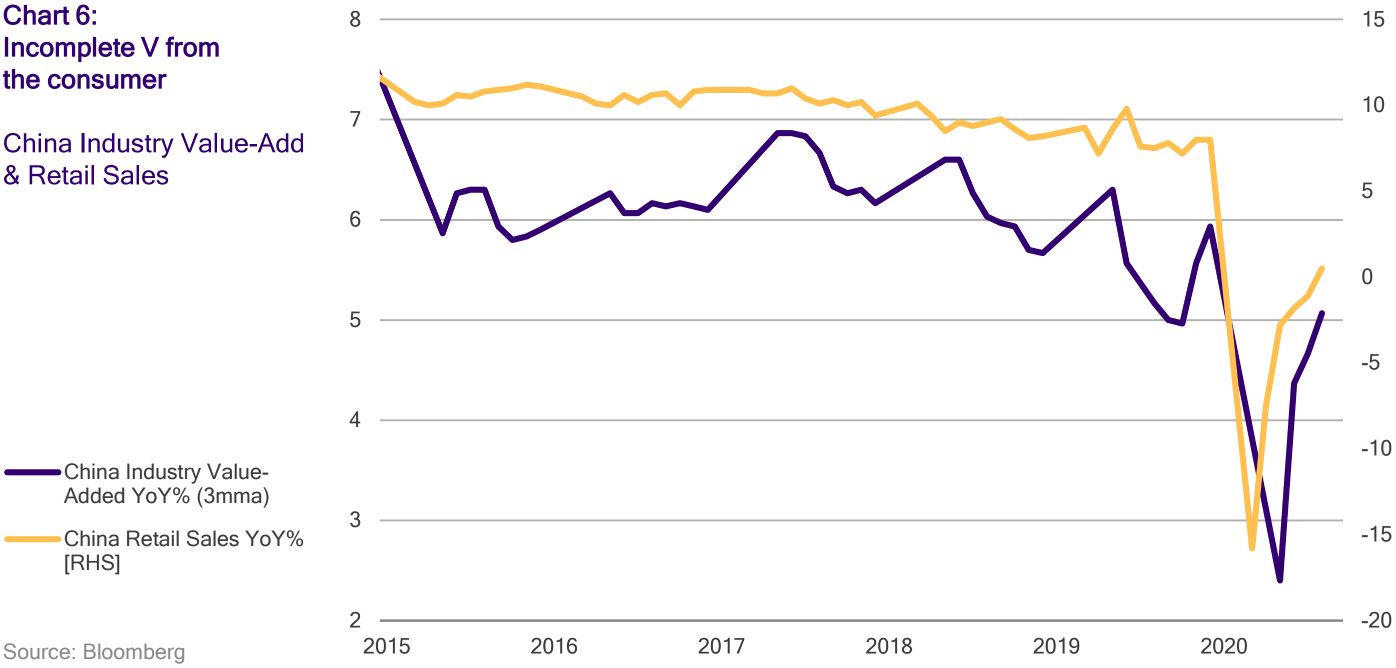


Source: Citi, Bloomberg

China's story has also been different because it was first in and out of the health crisis, and seemingly better (or luckier) at managing subsequent outbreaks. Even then, a clear gap remains between the recovery of the supply side of the economy. This is indicated by measures such as industrial production versus the recovery of consumer activities such as retail sales (Chart 6).

Chart 6: Incomplete V from the consumer

China Industry Value-Add & Retail Sales



Source: Bloomberg

When we have a clearer picture of how much the global recovery has varied so far between regions and between sectors, there can be better appreciation of the factors that may weigh on the momentum of that recovery in coming months. There is not only cause for concern from the fiscal stalemate that drags on ahead of the US elections, but also potential for a lower growth impulse to come from China. The latter will be driven by the peak of monetary and credit easing now behind us – as has been hammered home in recent days by the PBoC – and a continued structural trend to become more self-sufficient in satisfying the growing demand of the Chinese middle classes. "Made in China 2025" has been pushed backstage, replaced by a strategy whose name is intentionally less politically charged: "The Dual Circulation Strategy". Yet it amounts to the same end goal: boost Chinese demand, satisfy it with Chinese production and displace international competitors with a growing share of Chinese exports. The next stage of China's economic recovery should see a catch up of consumption activities, with less positive spill-over to the global economy than experienced in the V so far.

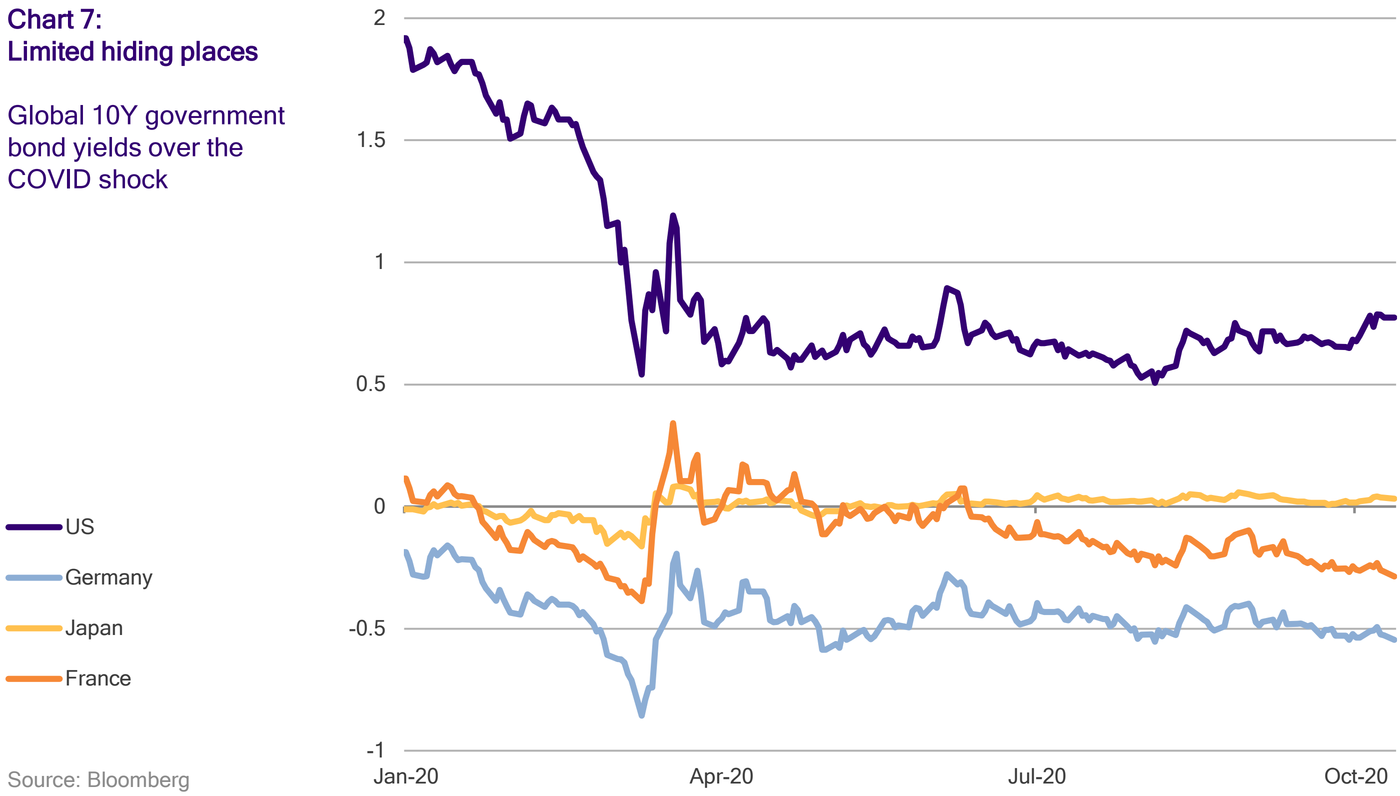
Step out of your silos

In recent months the search for yield and questions about fixed income's role in portfolios have intensified. Most of the clients we speak to feel there is no choice but to be pushed further along the risk spectrum, chasing whatever mediocre income they can find, while feeling uncomfortable, or at least uncertain, about what kind of additional risk they're taking on.

There was a time that simply having an allocation to high-quality government bonds, either domestically or diversified internationally, gave you everything you wanted from a fixed income portfolio. Yields were high enough to provide a satisfactory level of income, while policy rates were far from their lower bounds. Investors could feel comfortable about the ability of those bonds to perform well in times of equity market stress. This defensive quality of G10 government bonds continues to be a key reason why many investors can't let go of their need to allocate at least some of their fixed income funds to very low-yielding markets – in some cases fairly negatively yielding ones. While in a crisis correlations tend towards one, the performance of core global government bonds since the peak of the crisis has differed hugely. This validates investor concerns that with yields at such levels, not only is income woefully insufficient from high-quality government bonds, defensiveness may also be lacking (Chart 7).

Chart 7:
Limited hiding places

Global 10Y government bond yields over the COVID shock



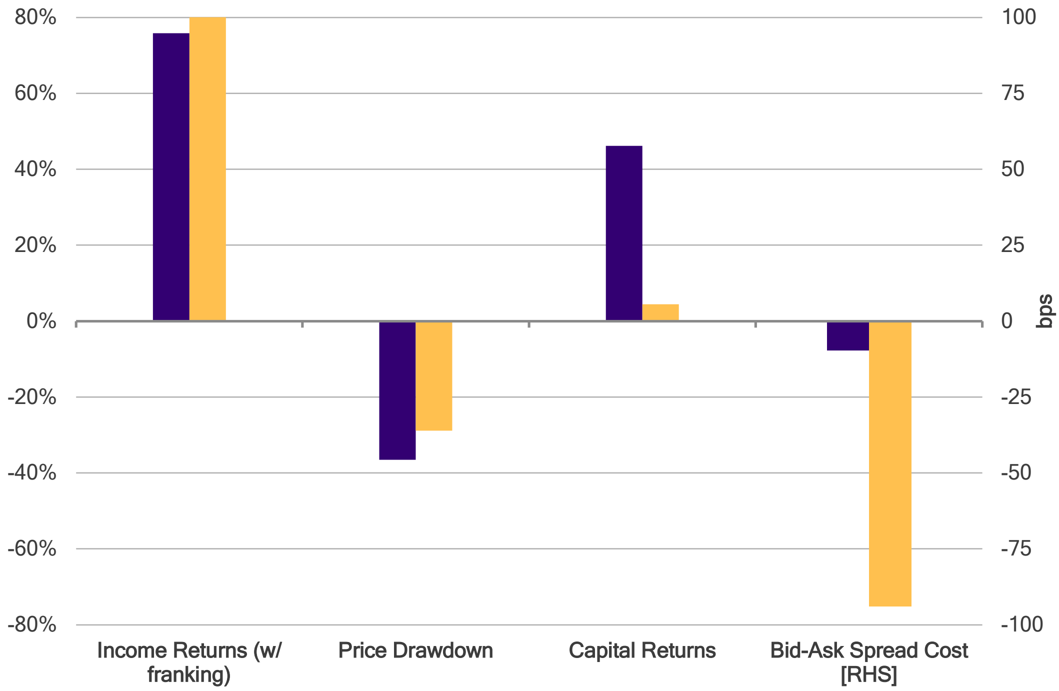
Source: Bloomberg

With this in mind, alternate means of generating a defensive return profile must be considered. The obvious place to start would be in the land of volatility, but implementation here is key. We know that maintaining a long volatility bias is an expensive habit to keep up over the course of an entire market cycle. Also worth considering are government bonds outside the G10. Emerging markets as an asset class tends to provoke either a love or hate response among clients we speak to. But while indices are dominated by those with bad debt habits, many emerging market sovereign yields have started to exhibit some defensive characteristics over the past decade. During the COVID crash, for instance, being in Chinese government bonds would have returned a better outcome than being in European or Japanese ones.

At such low yields globally, the income problem also needs to be considered somewhat separately to defensiveness. In the decade since the GFC the natural tendency is to supplement portfolios with more and more credit risk.

To various degrees most fixed income managers have been reaching out along the risk spectrum, down the ratings scale and (unbeknownst to most until a big sell-off) down the liquidity ladder. Out of those three sacrifices made to portfolios – risk, quality and liquidity – the latter exhibits the most non-linear of characteristics. In any crisis liquidity immediately dries up and is only available in very few assets. In trying to solve the income problem, investors could do well to think outside the usual silos that the investment industry has slavishly followed for generations, and look to different assets and ways of implementation to allow that hunt for yield to stay as liquid as possible (Chart 8). In times of market stress, it is likely these parts of the portfolio where you'd want to ensure a safe exit.

Chart 8: Equity exceptionalism



ASX 200
US High Yield

Source: Bloomberg

Conclusion

The market narrative has been buoyant as the world tries to move on under the fog of COVID. While there are significant right-tail risks to consider, it's also important to acknowledge how far some markets have come since the depths of the crisis earlier this year. The pace of both market and economic recovery has also varied greatly between regions and sectors. What may at first appear to be "good" scenarios may not necessarily lead to good outcomes as far as risky assets are concerned. Consensus thinking such as "a Biden win is good" should not be bought into without careful consideration.

The momentum behind the economic recovery globally is difficult to keep up when obvious tailwinds lie ahead. Those include various uncertainties and challenges that befall the world's two economic giants. Those potential risks on the horizon will almost certainly keep major global policy rates as well as yield curves well under control. Nevertheless, it doesn't help investors address issues that have become structural problems in their portfolios. Namely the search for yield, but also the desire to keep a portion of their portfolios liquid and defensive to provide diversification against racier allocations elsewhere.

The COVID crisis has accelerated the urgency of these structural problems. With yields and yield curves pinned as low as they are, it is not only useful – but rather quite essential – to break free of the normal moulds of traditional asset class definitions and address these portfolio goals separately. The standard pre-COVID yield-chasing model of adding more and more credit beta to portfolios is unlikely to satisfy standard portfolio goals traditionally filled by fixed income allocations. More credit beta will not only take away defensiveness. It will also result in a much lower liquidity profile – and still with very lacklustre income-generating potential. Anticipating how each asset class will behave given a "lower forever" environment littered with potholes will be crucial to working out how each should be used to re-create a "fixed income" allocation for the next ten years.

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