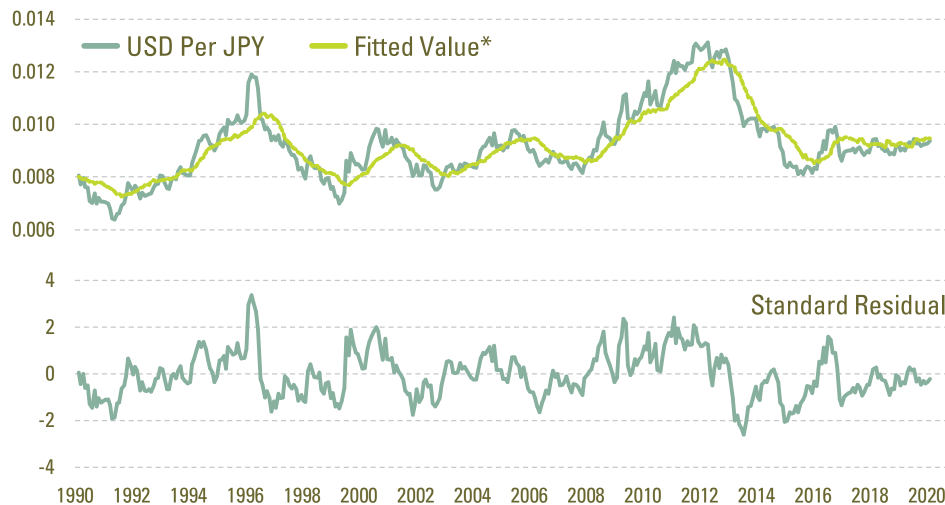
Global Fixed Income

Themes, Positioning & Market Conditions

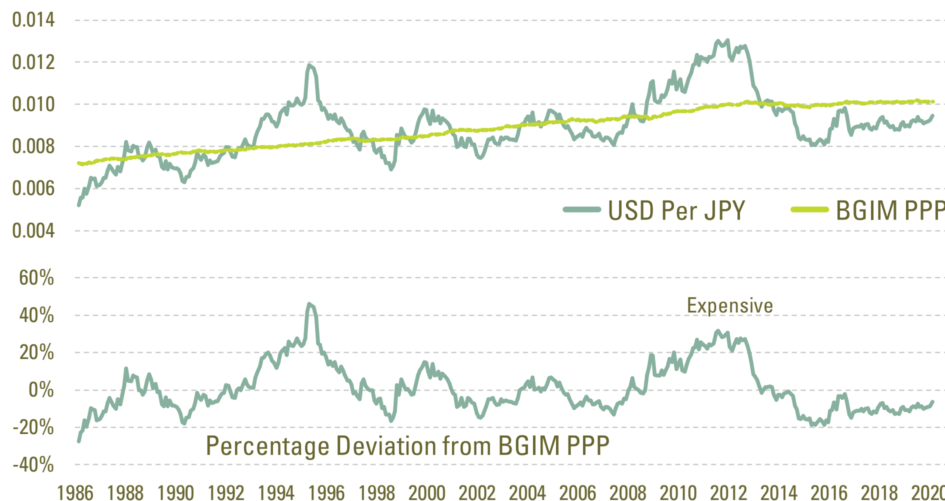
The coronavirus (COVID-19) pandemic is a black swan event that has created a challenging time for all investors—the exogenous shock has distorted market responses and traditional signals. Market movements over the last two weeks have been swift and outsized, leaving few if any assets classes to trade on actual fundamentals. The current market environment presents a short-term challenge to our investment philosophy, particularly with respect to valuations, and the traditional role rates and currencies have as economic regulators. Yet, this environment has also presented opportunities to reaffirm our process and philosophy, notably through our decision to increase Japanese yen exposure in long-only strategies, as warranted by our valuation framework, as shown in **Figures 1 and 2**:

Figure 1 Japanese Yen Valuation
USD/JPY, As of 3/15/2020



*Estimation interval: 1998M12 – 2020/01 Source: Brandywine Global

Figure 2 Japanese Yen Valuation
USD/JPY, As of 3/9/2020



Based on PPI Source: Brandywine Global

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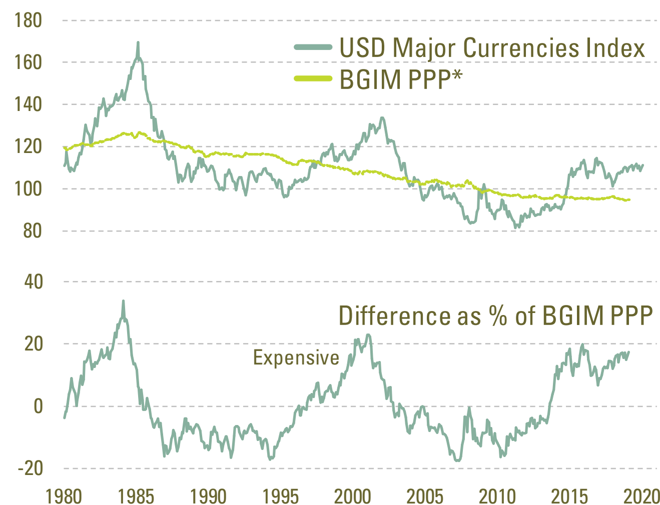
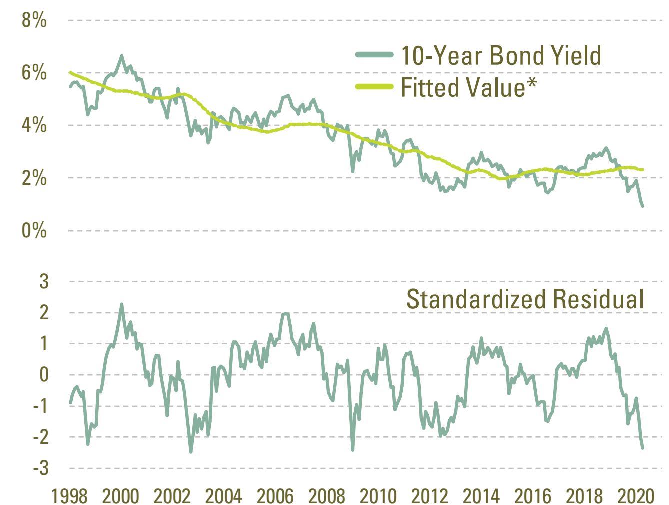
Meanwhile, the U.S. dollar and longer-dated Treasuries continue to screen expensive according to our valuation models—one reason why we have not meaningfully added to these exposures. See **Figures 3 and 4** for our valuation models. As an example, the 30-year Treasury is currently about 3 standard deviations above its mean. The other reason why we have not added to our U.S. exposure is market volatility itself. In March, the 30-year Treasury yield dropped 170 basis points (bps), with 86bps of that move occurring in just two days—a change that usually takes place over a one-year period. In our view, the Treasury market is still in dysfunction, and the time horizon typically baked into 10-year yields has basically collapsed. Oil prices also no longer offer a reliable signal. The energy market received its own demand shock, and we do not expect crude oil prices to recover any time soon. The question is whether oil prices have found a bottom or will continue to fall as economic activity contracts.

Figure 3 U.S. Dollar Valuation
As of 3/9/2020



*Based on GDP Weighted PPI of 6 Countries: Euroland, Japan, UK, Canada, Switzerland, Sweden
Source: Brandywine Global

Figure 4 10-Year Treasury Bond Model
As of 3/15/2020



*Estimation interval: 1998/1 – 2020/01
Source: Brandywine Global

Up until the March 9 shock in oil prices, emerging market bond yields were falling alongside developed market sovereign debt. In a one-week window, market risk aversion has hit an extreme. While it is not the right time to make extensive changes to our positioning, the current environment does present an opportunity to think about when markets will be primed for an inflection point. We believe the combination of globally low rates, cheap oil prices, and worldwide fiscal stimulus should create a snapback in economic activity, as well as our performance. Nevertheless, the global economy is either in or about to head into recession. Unlike a typical recession, this one would result from the demand shock, and not from typical cyclical excesses like overleverage. Therefore, determining how long and deep the valley in economic activity could last will depend on two factors: how quickly China's economic activity can bounce back, and how potent stimulus from the Western world will be to revive consumption. Since these are broad-based macro themes, we will continually monitor the following factors to gain a better understanding of when a rebound could occur:

- Number of new COVID-19 cases reported at a country level
- Details of fiscal and monetary stimulus packages
- Activity in credit markets

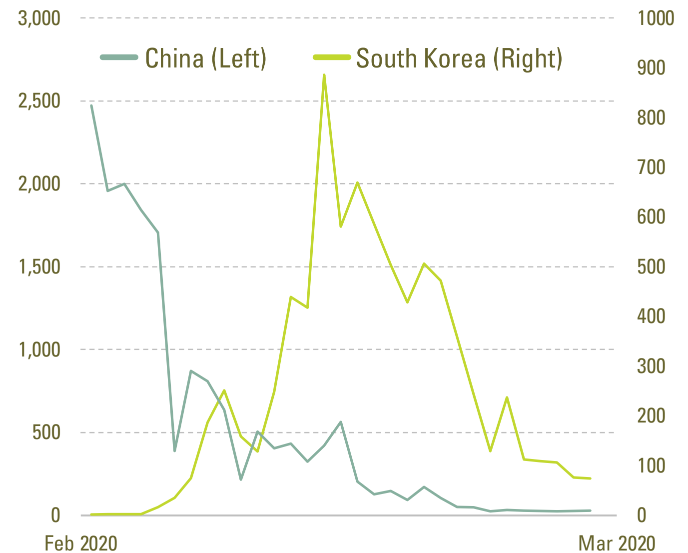
AN ARCHETYPE FOR MANAGING THE VIRUS

The world is looking for a model that is truly replicable in terms of managing the virus. China has done a solid job by all accounts, but we are looking for a reasonably sized democracy to successfully control the COVID-19 outbreak. The way South Korea has handled the outbreak may provide a model for how markets should be pricing in information risk on the virus.

SOUTH KOREA

The data on Korea looks increasingly like how China did in February—new cases are no longer rising at an exponential pace. **Figure 5** compares the rate of new cases in China to South Korea. If the trend holds, there would be a 4-5 week period for cases to peak, as was the case in China. In the coming weeks, we will be looking for Chinese 10-year yields to stabilize, which could be a bellwether for a decline in risk sentiment and rebound in growth.

Figure 5 New Cases in China versus South Korea
As of 3/16/2020



Source: Macrobond, ECDC

CHINA

The period leading to the peak will depend on how effectively a country responds to the virus. The longer it takes to reach the peak, the greater the hit to a country's consumer confidence, and a reason for investors to remain bearish on the services industry. *We will continue to monitor individual country virus curves, using the benchmark of a 4-5 week period for new cases to reach a peak.* We believe a positive signal will be when headline risk subsides, which would likely occur when markets do not react to a spike in the number of reported cases.

In light of how the Korean government has handled the recovery, we initiated or added to won exposure across all Global Fixed Income strategies, as a way to capitalize on the country's recovery and upon the belief that Asia will lead the Western world in the economic recovery from the virus.

POLICYMAKING AND ECONOMIC RESPONSE

Many countries, including China, South Korea—and most recently Germany—have been incredibly responsive with policymaking. Chinese authorities threw a liquidity lifeline to small-to-medium-sized and state-owned enterprises (SMEs and SOEs). Germany most recently extended cheap credit to all businesses. The European Central Bank (ECB) relaxed capital requirements and changed its targeted long-term refinancing operations, with commercial loans offered at negative rates. **The U.S. government must follow these examples.** The Federal Reserve's (Fed) March 15 emergency decision to cut its policy rate to near zero and boost assets by $700B was necessary but not enough to placate markets when trading opened the following day. Despite central bank action, it looks like markets will continue to trade on fear in the short term. The Fed has used up a lot of policy ammunition, and its job now will be to avoid a liquidity crisis. The selloff in equities also highlights that markets expect more to be done by the Fed; in our view, this includes purchasing corporate debt.

From the fiscal side, while cutting payroll taxes may be helpful, much more is also needed. The U.S. House of Representatives has passed a bipartisan package that now awaits approval in the Senate. While the government is stepping up, the *public and private sector* must implement policies. These types of programs would meet market expectations:

- Fed finances U.S. Department of Treasury to lend to all businesses.
- Banks initiate temporary changes to commercial and personal lending.
- Government creates backstop for corporations and SMEs to access cheap credit to continue operating.
- Corporations access revolvers to continue operations.
- Corporations reduce hours worked rather than laying off employees.

Generally, a U.S. fiscal package would be bearish for risk-free rates and bullish for growth, which should bode well for our positioning. However, if the proper policy responses are not put into place, the U.S. economy may be on the cusp of going from a demand shock to a financial one. The risk is that the short-term cash crunch will lead to bankruptcies. The U.S. economy needs to avoid a cascade of defaults caused by the virus-related slowdown in economic activity. We will be monitoring credit conditions to see if these policies are effective.

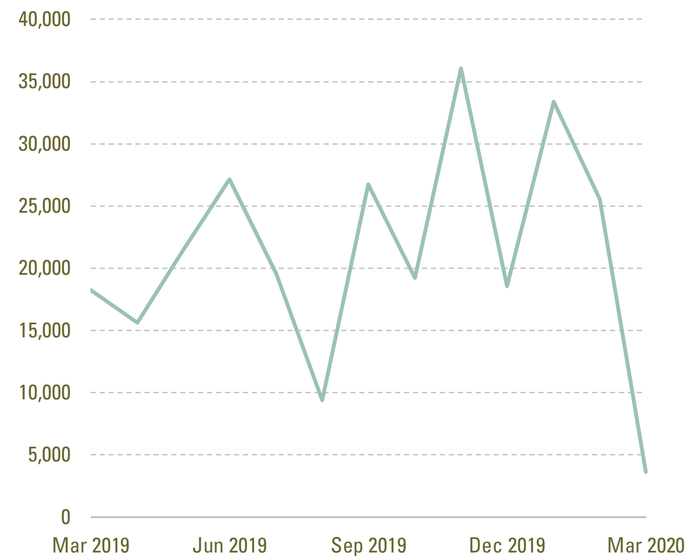
CREDIT MARKETS

Since stimulus should be targeted to SMEs and the private sector, we will be monitoring credit market conditions closely:

- The rate of new issuance, particularly in the U.S. and Europe
- Credit default swap spreads in the U.S. and Europe, especially in financials

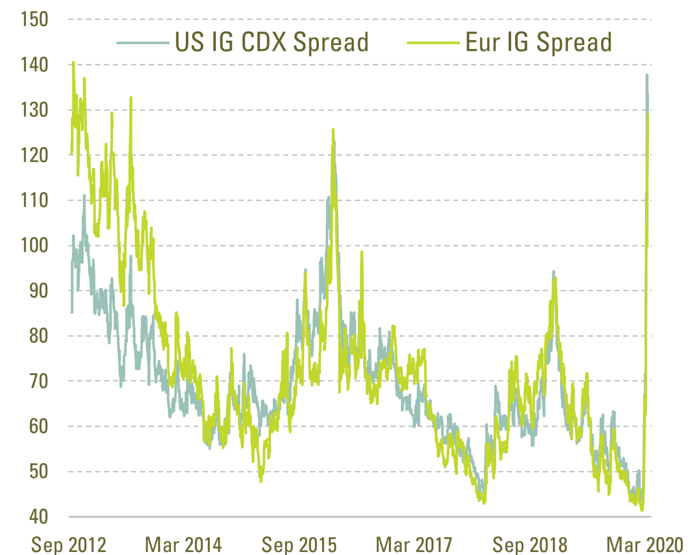
Figure 6 illustrates the sharp decline in high yield new issuance, which looks primed for an inflection point as the Fed slashed the policy rate during its emergency meeting on March 15. Additionally, the Fed action taken the week of March 8 was meant to front-run counterparty risks to short-term liquidity, so that banks could lend to companies already hit hard by the slowdown, such as airlines and the hospitality industry—this was a constructive, albeit necessary step. We need to see more liquidity pumped into markets. At the close of that week, the yen and euro were down while stock markets were up. The money that had flowed to into funding currencies could now be flowing back into other asset classes—we think this is a sign that money is starting to look for risk, and that the dollar may also begin to weaken again. However, credit default swap and investment grade spreads have widened, as shown in **Figure 7**—to around levels not seen since the tail end of the European Sovereign Debt Crisis. Given the Fed's March 17 decision to start buying short-dated commercial paper, we hope it's another stepping stone to pumping liquidity into corporate credit markets.

Figure 6 HY Bond New Issue Volumes
Face Values (US$mn Equivalents), As of 3/31/2020



Source: BofA Merrill Lynch Global Research

Figure 7 Investment Grade Credit Spreads in the U.S. and Europe
As of 3/16/2020



Source: BofA Merrill Lynch Global Research

CONCLUSION

Our base case has been that the coronavirus would create a short but severe demand shock. The shock should have been transitory because of the cushion created by the preliminary stages of global growth at the outset of the year. Now that the virus has spread, concerted monetary and fiscal easing is needed for growth to reach an inflection point. In the short term, we expect a lag in policy efficacy while COVID-19 is receding. However, in the medium-term the impulse of globally coordinated easing could eventually outweigh the economic drag created by the virus. Nevertheless, some weakness in the near term could create periods of market volatility:

- Number of new cases reported in the U.S. to significantly rise with more testing
- Some deterioration occurs in labor market conditions, both in the U.S. and around the world

Since traditional signals from financial markets are temporarily distorted, we will continue to monitor the following factors for signs of stabilization:

- The number of new cases reported and number of weeks until a peak on a country-by-country basis.
- The yield on China's 10-year Treasury bond.
- S&P 500 performance as a gauge for market sentiment and expectations.
- Credit market health, including CDS spreads and new issuance

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