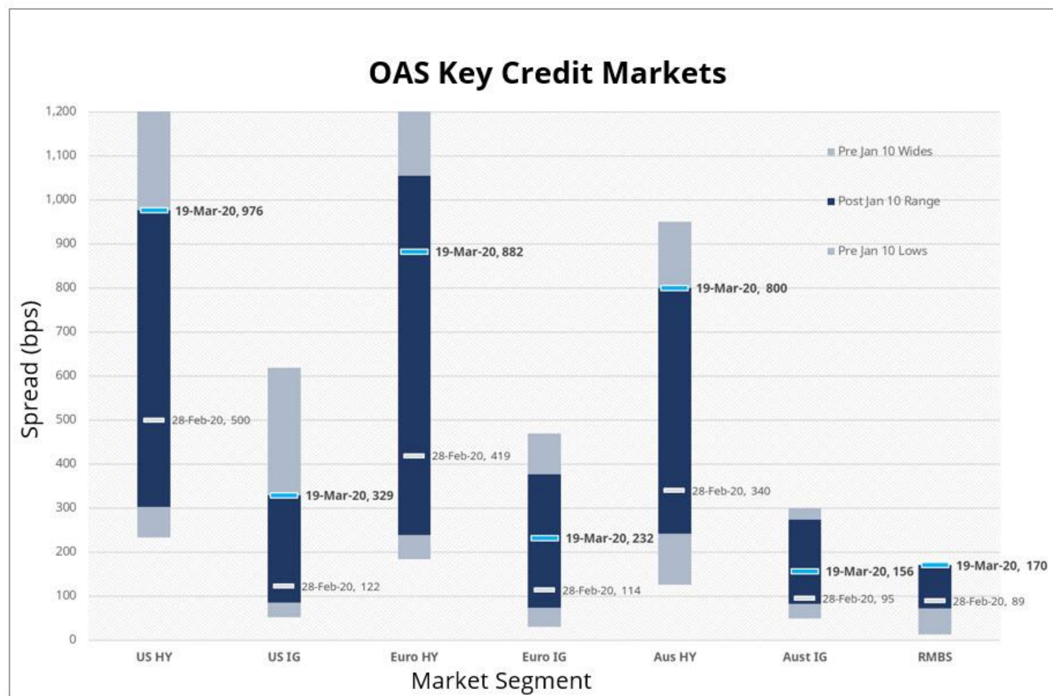
Outsized returns await resilient and patient investors

25 March 2020

The past few weeks have been nothing short of extraordinary in fixed income markets. The extent to which markets have moved on an intraday basis has been unprecedented, with indiscriminate selling observed across interest rate markets and credit centric sectors.

To put into perspective the extent to which markets have moved in recent times, the below chart seeks to illustrate the relative performance across key credit markets. Specifically, it seeks to demonstrate the speed with which spreads (the additional return investors require for investing in non-government issued bonds as measured as the margin above the risk-free rate), have widened, and how these compare in a historical context.



Note: US and Euro High Yield capped at +1200bps *Source: Schroders, Bloomberg, Westpac, Shaw & Partners.*

The chart above highlights two key points:

1. Credit spreads have widened significantly since the end of February 2020, with the most significant moves in High Yield; and
2. Spreads are now at (or near) 10-year wides.

Why have spreads widened so aggressively?

At Zenith, our Consulting team works closely with our in-house research team, who have been liaising with fund managers to understand the market dynamics. The consensus appears to be that credit spreads have been adversely impacted by four key factors:

1. ***Concerns that defaults may rise:*** As global authorities implement measures to fight COVID-19, there are growing fears that select bond issuers will fail to remain solvent and/or meet their debt obligations (i.e. coupon payments and the return of capital) in a timely fashion. Consequently, investors are demanding a higher spread for lower grade credits.

2. ***Low levels of market liquidity:*** Credit markets are presently dysfunctional with bonds trading at wide bid/offer spreads, and on significantly reduced volumes. Transactional volumes have however been concentrated across index-orientated and listed fixed-income vehicles, which have been subject to escalating redemptions.

3. *Increased risk aversion:* As with prior periods of market stress and uncertainty, investors have gravitated toward higher-grade bonds. This 'flight to safety' has seen spreads on lower grade credits become more volatile and widen as investors show a preference for government-issued bonds over corporates.

4. *Rebalancing:* There is a growing trend amongst investors to reduce their fixed income exposures and to redeploy proceeds to equities and other growth-orientated asset classes. This 'rebalancing' has intensified as equities have continued to underperform fixed income in relative terms.

What are the opportunities?

As spreads continue to widen, a growing number of market segments are looking cheap when viewed in historical terms. For example, the year-to-date (option adjusted) spread on US Banks has widened from 0.93% to its 2.94% (as at 18.03.2020). Similarly, AAA-rated European corporates have widened from 0.49% to 1.26% and BBB-rated US corporates have blown out from 1.2% to 3.45%.

With spreads across all credit market segments widening materially, we believe there will come a time where markets stabilise and opportunities to purchase quality bonds on attractive terms are plentiful.

While we do not seek to time markets, we nonetheless believe that manager selection will be integral going forward, particularly as this extends to enhancing income and participating in the capital appreciation of oversold bonds. With respect to the former, it is our contention that the resetting of portfolio income at higher levels will be particularly valuable in an environment where global cash rates are suppressed.

How are Zenith's portfolios positioned?

We believe that managers with a demonstrated track record in bottom-up fundamental analysis and sector rotation, are best positioned to benefit once markets stabilise. Regarding the former, we favour those managers with teams of dedicated credit analysts, on the grounds that fundamental assessments can aid in the identification of pricing anomalies and corporates subject to default risk.

Regarding sector rotation, significant value can be added where managers are able to actively tilt a portfolio (relative to a benchmark) to different market segments such as government, semi-government and credit. Managers that have shown proficiency here are those that incorporate a mix of fundamental and technical considerations. This can extend to an assessment of macroeconomic and credit fundamentals, technical considerations (I.e. foreign capital flows) and sentiment-based indicators.

Finally, given the increasingly integrated nature of global markets, we believe that managers with regionally based teams (supported by dedicated trade functions) are best positioned to take advantage of market anomalies in real-time.

Be patient and avoid the hysteria

We are living through extreme times and market volatility will likely continue in the near term. That said, we believe there will be significant opportunities to add value. This is particularly the case for investors that avoid emotional decisions and take a ‘through-the-market-cycle’ approach.