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JULY 2020

Insight INVESTMENT

US PENSION MARKET

A statistical and qualitative review of Q2 2020 and investment outlook

Economic data released over the quarter clarified the catastrophic economic damage caused by efforts to control the spread of COVID-19 and the National Bureau of Economic Research confirmed that the US economy officially entered recession in February. Despite this, optimism grew through the quarter, buoyed by tentative signs of recovery in forward looking data and hopes that a vaccine or combination of existing drugs may allow the virus to be brought under control.

Whether this optimism proves to be justified will only become clear in the coming months and years, and the start of the traditional winter flu season is likely to be a key test point. For now, it seems wise to tread carefully, hoping for the best but preparing for the worst. Market volatility presents both risks and opportunity and balancing these dynamics will be critical in the months ahead.

- After a rollercoaster ride through the first half of the year, the funded status of many pension plans would have returned to a similar level as at the start of the year.

- In our solutions section, we look at how plans can potentially achieve full funding in the current uncertain environment.

- Corporate credit issuance surged in 2020 and we have observed issuers prepared to bring deals at spreads higher than market levels, presenting potential opportunities for those with cash to invest. With the Fed now directly purchasing corporate bonds, markets are now focusing on a how this will impact the spreads of eligible issuers.

- We undertake a simple exercise to compare the potential performance of investment grade and high yield credit and conclude that investment grade credit has the edge for now.

- A key risk for markets is the continued rift between Western countries and China. In the long-term, if the world moves away from China as a low-cost producer, it has potentially major implications for margins and inflation.

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A recession is when your neighbor loses his job.
A depression is when you lose yours.

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RONALD REAGAN

A TIDAL WAVE OF LIQUIDITY
BRINGS SPREADS CRASHING DOWN

Although the economic outlook for the rest of 2020 and even 2021 remains highly uncertain, credit markets reversed course on a tidal wave of central bank liquidity and government support. With interest rates around the world already at or close to historical lows, central banks turned once again to quantitative easing, but buying bonds at a speed way beyond that seen during the global financial crisis. Purchase programs were also expanded to include corporate credit:

- The Primary Market Corporate Credit Facility[1] is designed to provide investment grade companies with access to credit so that they can continue to operate through the crisis.
- The Secondary Market Corporate Credit Facility[2] is designed to support market liquidity by purchasing the bonds of investment grade corporates in secondary markets. This facility is also able to purchase US listed exchange traded funds whose investment objective is to provide broad exposure to US corporate bonds – some of which will also contain high yield issuers.

The combined size of these two facilities can be as much as $750bn.

As investors anticipated the entry of this huge new buyer to the market, liquidity concerns evaporated, and the spreads of investment grade credits plummeted almost as rapidly as they had spiked upwards a few months previously.

For many pension plans, funded status embarked on a rollercoaster ride through the first half of the year, ending Q2 not far from where the year started, but having plunged in the interim. The second half of the year should hopefully prove more stable, with Treasury yields likely anchored by the Federal Open Market Committees forecasts that rates will remain on hold for years to come and credit spreads likely capped by central bank purchases. As they try and navigate this new and uncertain world, the question many plans will ask is whether to add to credit holdings in the current environment, and we explore this further in our outlook section later in this document.

Figure 1: A rapid rollout of bond purchase schemes[3]

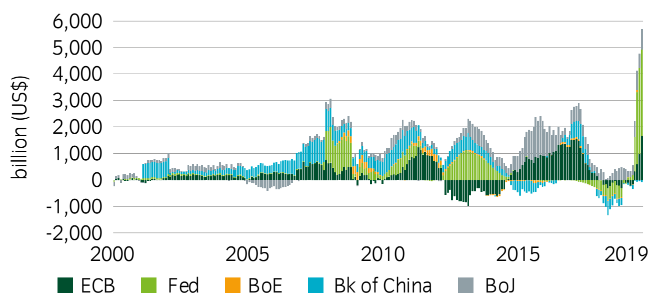
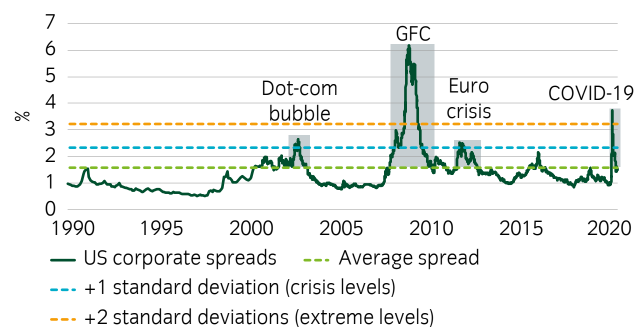


Figure 2: Spreads plunged almost as quickly as they spiked[3]



[1] https://www.federalreserve.gov/monetarypolicy/pmccf.htm [2] https://www.federalreserve.gov/monetarypolicy/smccf.htm
[3] Source: Bloomberg and Insight. Data as of June 30, 2020.

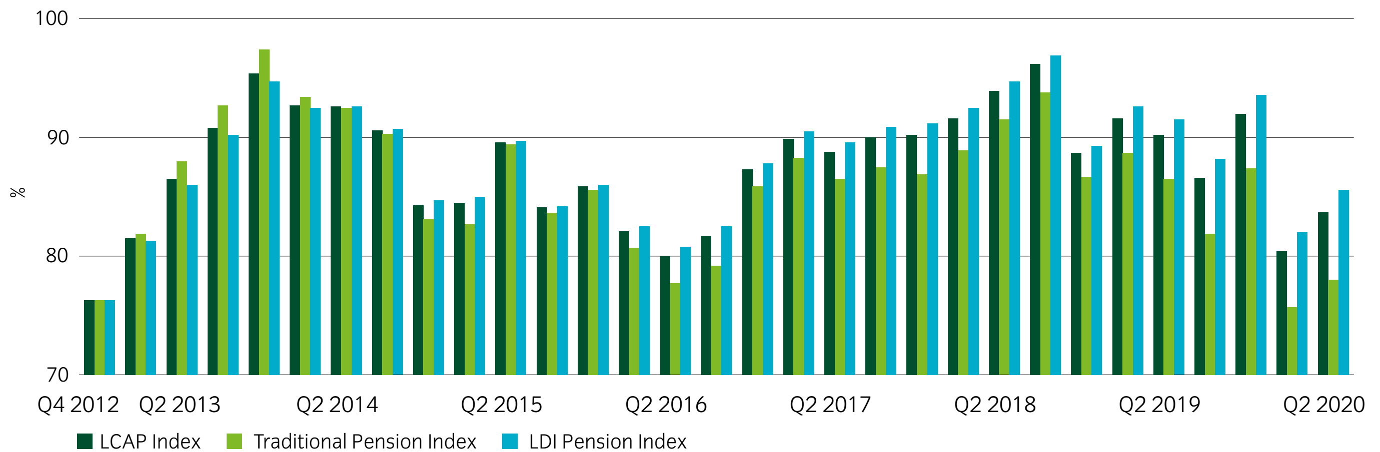
PENSION
TRENDS

PENSION FUNDED STATUS UPDATE

Pension plan funded status, as measured by Insight's model pension indices, improved during Q2. Although discount rates declined, increasing pension liabilities, growth assets recorded very strong returns[4].

Insight maintains three model pension indices. Each index aims to reflect the changing funded status ratio for pension plans following different approaches to hedging the same liability profile. The indices illustrate the effect of hedging with core fixed income versus long duration, holding constant a significant allocation to growth assets. All three funding indices saw improvements in funded status in Q2. Rates rose by 3bp over the quarter but spreads tightened by 52bp, resulting in a 49bp fall in discount rates. The LCAP and LDI indices, which contain long duration fixed income, saw improvements in funded status in excess of 3%, while the Traditional index saw its funded status improve by 2.4%.

Figure 3: Plan funding ratios[4]



[4] Source: Insight and Bloomberg. Data as of June 30, 2020. Note: Beginning in 2014, we introduced three indices to provide insight into the impact of rate and market movements on three types of pension plan investors. Large Company Aggregate Pension (LCAP) Index: The "average" corporate pension plan index we have developed which represents an asset weighted average of allocations held by S&P 500 companies' plans. Traditional Pension Index: The index reflecting those pensions that have not yet adopted LDI. LDI Pension Index: The index reflecting those who have adopted LDI in the fixed income portion of their portfolio. Assumptions behind the Insight indices include 14-year typical pension liability duration, 45% equity allocation, an aggregate 5% liability impact of updated mortality assumptions effective Q4 2014 and no external cashflows. WHERE MODEL OR SIMULATED RESULTS ARE PRESENTED, THEY HAVE MANY INHERENT LIMITATIONS. CLIENTS' ACTUAL RESULTS MAY BE MATERIALLY DIFFERENT THAN THE RESULTS PRESENTED. UNLIKE AN ACTUAL PERFORMANCE RECORD, MODEL RESULTS DO NOT REPRESENT ACTUAL TRADING AND MAY NOT REFLECT THE IMPACT THAT MATERIAL ECONOMIC AND MARKET FACTORS MIGHT HAVE HAD ON INSIGHT'S DECISION-MAKING IF ACTUAL CLIENT FUNDS WERE BEING MANAGED. ALSO, SINCE SUCH TRADES HAVE NOT BEEN EXECUTED, THE RESULTS MAY HAVE UNDER OR OVER-COMPENSATED FOR THE IMPACT, IN ANY, OF CERTAIN MARKET FACTORS, SUCH AS LACK OF LIQUIDITY. SIMULATED TRADING PROGRAMS IN GENERAL ARE ALSO SUBJECT TO THE FACT THAT THEY ARE DESIGNED WITH THE BENEFIT OF HINDSIGHT. MODEL RESULTS ARE ACHIEVED THROUGH THE RETROACTIVE APPLICATION OF A MODEL. MODEL RESULTS SHOWN DO NOT REFLECT MANAGEMENT FEES, TRANSACTION COSTS AND OTHER EXPENSES THAT WOULD REDUCE RETURNS. THIS IS A HYPOTHETICAL MODEL. THE QUOTED BENCHMARKS DO NOT REFLECT DEDUCTIONS FOR FEES, EXPENSES OR TAXES. THE BENCHMARKS ARE UNMANAGED AND DO NOT REFLECT ACTUAL TRADING. THERE COULD BE MATERIAL FACTORS RELEVANT TO ANY SUCH COMPARISON SUCH AS DIFFERENCES IN THE VOLATILITY, AND REGULATORY AND LEGAL RESTRICTIONS BETWEEN THE INDEXES SHOWN AND THE STRATEGY. INVESTORS CANNOT INVEST DIRECTLY IN ANY INDEX.

- **Pension investment confirmed as new battleground in dispute with China**

  The Federal Retirement Thrift Investment Board (FRTIB), which manages close to $600bn in assets for 5.9m federal workers, has announced that it will halt its plans to change the benchmark for its international equity exposure to the MSCI All Country World ex US Index. This move was controversial as the index includes a sizable allocation to Chinese companies.

  A move to stop the plan from changing its benchmark was initiated last year by Republican Senator Marco Rubio and Democratic Senator Jeanne Shaheen, but the final decision appears to have occurred after a direct intervention by the US administration.

  Labor Secretary, Eugene Scalia wrote to the FRTIB to warn that the move would put “billions of dollars in retirement savings in risky companies that pose a threat to U.S. national security”. A supporting letter was reported as stating that there were “grave concerns with the planned investment on ground of both investment risk and national security”. It was also reported that the letter went on to say that some of the companies in the index could “present significant national security and humanitarian concerns for the United States, which increases the risk that they could be subject to sanctions, public protests, trade restrictions, boycotts, and other punitive measures that jeopardize their profitability”.

- **Public pension plans warned they will run out of assets[5]**

  A study by the Center for Retirement Research at Boston College has warned that if markets are slow to recover, several public pension plans with low funded positions could run out of assets by 2028. The plan of most concern is the Chicago Municipal plan, with a funded position projected to fall to just 6.8% by 2025. When analyzing the 20 worst-funded plans, the average ratio of assets to benefits was projected to decline from 5.9 times in 2020 to 4.5 times in 2025, meaning that on average, those plans would have sufficient assets to cover less than 5 years of benefits. During the quarter, Austin City Council Audit and Finance Committee voted to grant itself legislative powers to take over the city’s employees retirement system and the Austin Police Retirement System which together are reported as having around $2bn in unfunded liabilities.

- **With a focus on how to generate returns, Calpers chooses leverage**

  The Chief Investment Officer of California’s $400bn public pension fund has recommended that the fund needs to increase its leverage in order to meet its 7% long term annual return target. An internal study suggested that without an increase in leverage, the fund had only a 39% chance of meeting its target over the next 10-years.

- **Proposed rules regarding ESG investment**

  The Department of Labor (DOL) has recently proposed amendments to the regulation on investment duties of plan fiduciaries. These amendments would make it explicit that ERISA requires plan fiduciaries to select investments and investment courses of action based solely on financial considerations relevant to the risk-adjusted economic value of particular investment or investment course and not non-pecuniary (such as ESG) considerations. Some news outlets and other commentators have expressed that this may prevent investment in otherwise financially desirable ESG labelled funds as plans are reluctant to appear in conflict with this proposal. The DOL does, however, acknowledge that ESG analysis can identify significant risks to investments and can be a reasonable exercise of fiduciary duties. We will be publishing more on the potential impact of this ruling in the coming months.

[5] https://publicplansdata.org/wp-content/uploads/2020/05/Market-decline_May-2020_.pdf

SOLUTIONS: ACHIEVING FULL FUNDING IN THE CURRENT ENVIRONMENT

FUNDED STATUS ROLLERCOASTER

The recent crisis period saw large swings and declines in funded status. Peak-to-trough falls were as high as 15% to 20% for traditional 60:40 investors, as equities sold off and yields fell.

LDI STRATEGIES LARGELY HELD UP

Plans with higher allocations to LDI experienced significantly lower volatility (50% or less on average) and funded status declined only marginally throughout the crisis period. Allocations to long-dated credit, STRIPS and overlay strategies performed particularly well[6].

However, there have been some questions raised:

- **Do we need to re-think how we plan for liquidity?**

  The freeze in Treasury bond markets was acute and it became difficult to trade for an extended period. The market experienced a very material increase in bid/offer spreads leading even to large price differentials within bonds of similar credit quality and risk.

  To prepare for future crises, we need to think much harder about liquidity strategies. This will only become more important as maturing plans increasingly enter the 'decumulation' stage and become cash flow negative.

- **Did the effective hedge ratio perform as expected?**

  We observed during the crisis that effective hedge ratios can move greatly in response to volatility in Treasury and credit markets while trading in cash markets can be very inefficient.

  As such, we believe that hedging strategies should also consider:

  – the liquidity of the underlying instruments being employed and how they behave in a stress environment

  – while recognizing that risk positions can change, and value can unintentionally be lost as yield curves re-steepen

  We think it makes sense to consider adding some component of overlay and completion hedges in order to manage hedge effectiveness and cost while avoiding being exposed to unintentional and unwanted risks as rates fall or rise.

- **How does tail risk affect long-term costs?**

  We believe that many plans think about tail risk through the lens of an accumulation strategy, where the timing of returns or path-dependency is not a major consideration. Therefore, implications of tail risk on long-term costs of defeasing liabilities in the decumulation phase may be overlooked.

  As such, we believe that plans should take the opportunity to revisit tail risks and understand the range of potential solutions.

  This could include puts, calls and/or collar strategies across equities, rates and/or credit markets.

- **Are rebalancing strategies fit for purpose?**

  Many plans seek to control risk through traditional asset allocation strategies with periodic strategy rebalancing. However, we observed that the rebalancing amount and the trading costs become very high during the crisis leading to sub-optimal trading costs and asset-liability risk exposure. We believe that strategies can be better optimized and made more fit for purpose for LDI investors.

OTHER SUGGESTIONS[7]

1. Understand liability target and future service costs
2. Revisit required returns needed to close funded gap
3. Update hedging strategy – consider dynamic approaches to interest rates and synthetic equities
4. Discuss contribution policy with internal stakeholders

[6] Source: Bloomberg, Insight calculations. Based on representative 100% funded plan with a duration of 11.5 years as of December 31, 2019 and assumes that this asset allocation is unchanged in 2020. Where model or simulated results are presented, they have many inherent limitations. Model information does not represent actual trading and may not reflect the impact that material economic and market factors might have had on Insight's decision-making. 1) Asset allocation as of December 31, 2019 : 70% US Corporate fixed income (50% Long, 20% Intermediate) and 30% Treasury fixed income (15% Long, 15% Intermediate) with 100% hedge ratio for rates and spreads. Monthly rebalancing. 2) Asset allocation as of December 31, 2019: 45% STRIPS 5-10 years, 35% STRIPS 10-20 years, 20% STRIPS. Daily rebalancing to proxy overlay. Monthly recalibration of interest rate hedge ratio to 100%. Each account is individually managed and could include results that are higher or lower than what is presented herein. Past performance is not indicative of future results. [7] Opinions expressed herein are as of June 30, 2020 and subject to change.

THE ADDITIONAL CONTRIBUTION DILEMMA

When discussing contribution policy there are various arguments for and against, presenting a dilemma for many corporate sponsors. An uncertain future means that many will want to increase liquidity buffers, but at the same time asset prices have fallen and this could represent an opportunity for long term investment. We outline the key arguments for and against additional pension contributions at this stage:

ARGUMENTS FOR PENSION CONTRIBUTIONS[8]

- ✔ Lowers Pension Benefit Guaranty Corporation insurance premium
- ✔ Funding contributions via issuance of long-term debt at low yields can make sense in certain circumstances
- ✔ Declining funded status can be an additional pressure for rating agencies to downgrade
- ✔ Asset prices have fallen, which could present long-term investment opportunities
- ✔ Benefit from tax-shield and long-term compounding of returns inside the pension
- ✔ Signals strength to the market

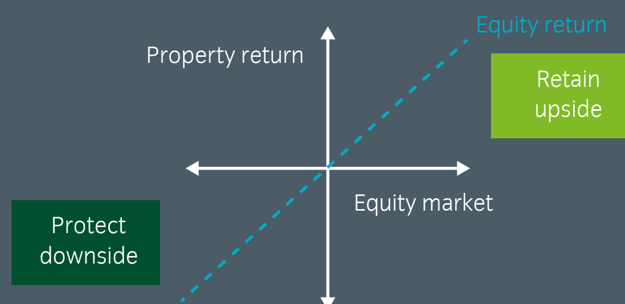
ARGUMENTS AGAINST PENSION CONTRIBUTIONS[8]

- X Holding easily accessible liquidity can be critical during periods of business uncertainty
- X Underfunding can be viewed as ‘cheap debt’
- X Volatility in asset markets may make investment timing difficult
- X Credit spreads may be too expensive to issue debt to fund contributions
- X Rating agencies may view an increase in deficit as temporary and not adjust ratings
- X Tough sell with the Board during an unprecedented period of challenge

Fragile sentiment could make it an ideal time to consider asymmetric payoff strategies

Asymmetric strategies may not be new to plan sponsors, but we believe they can help manage risk more efficiently across both equity and interest rate markets. This may be an opportune time to introduce them. The near-term and long-term economic environment is highly uncertain. A V-Shaped, U-Shaped and even a W-Shaped recovery cannot be confidently predicted. Strategies aimed at protecting against this downside, risk particularly through volatile markets, often impose an expensive premium and are frequently overlooked as a result. However, we believe several strategies can reduce costs, such as collars or other dynamic strategies.

Figure 4: Retaining upside while protecting downside[9]



[8] Opinions expressed herein are as of June 30, 2020 and subject to change. [9] Source: Insight, for illustrative purposes only.

ECONOMICS
AND MARKETS

KEY MARKET MOVEMENTS: Q2 2020

Long-maturity Treasury yields drifted higher over the quarter as sentiment recovered from Q1 extremes. The US Federal Open Market Committee's 'dot plot', which signals members individual forecasts on interest rates, suggested the consensus was that rates would remain unchanged until 2022.

Corporate credit spreads tightened significantly, with the Bloomberg Barclays Corporate Index spread ending the quarter at 150bp, 122bp tighter than where it started. Spreads at the longer end of the curve underperformed.

US equity markets recovered a large part of their previous losses, with the S&P 500 Index gaining 20% to just under previous highs. The tech heavy NASDAQ Index broke to new all-time highs.

The US dollar broadly depreciated over the quarter, with the US Dollar Index falling from close to all-time record highs.

Figure 5: Q1 2020 Fixed Income/Equity Index Returns (%) and Volatility Index Levels[10]

Index	Q2 2020 total return	YTD 2020 total return	Q2 2020 excess return	YTD 2020 excess return
Barclays Treasury	0.48	8.71	–	–
Barclays Intermediate Treasury	0.54	5.82	–	–
Barclays Long Treasury	0.25	21.20	–	–
Barclays Corporate	8.98	5.02	8.51	-3.69
Barclays Intermediate Corporate	7.63	4.23	7.09	-1.59
Barclays Long Corporate	11.36	6.34	11.12	-14.87
BofA Merrill Lynch High Yield	9.61	-4.78	9.13	-13.49
S&P 500 Index	20.54	-3.08	–	–
MSCI Emerging Markets Equity Index	18.08	-9.78	–	–
VIX[11]	30	–	–	–
MOVE[11]	54	–	–	–

ECONOMICS: THE TRUE EXTENT OF THE CORONAVIRUS IMPACT BECOMES CLEAR

Forecasts for global growth collapsed over the quarter as data releases started to clarify the extent of the economic damage being caused by lockdowns across the world. Consensus is now that the global economy will contract by over 3% in 2020, with developed markets experiencing contractions in excess of 6%. Growth is then expected to recover in 2021. Inflation forecasts have declined for both 2020 and 2021, and in major economies inflation is expected to be below 2% through the period.

Figure 6: Consensus GDP and CPI expectations[12]

Real GDP	Consensus*			Change over Q2	
	2019F	2020F	2021F	2020F	2021F
United States	2.3	-5.6	4.1	-6.7	2.1
Euro area	1.2	-8.1	5.5	-7.1	4.0
Japan	0.9	-4.9	2.5	-4.1	1.4
China	6.1	1.8	8.0	-2.2	1.8
Developed markets	1.7	-6.1	4.2	-6.5	2.4
Emerging markets	4.2	-0.3	5.0	-3.6	0.1
Global	**3.0**	**-3.7**	**5.1**	**-6.2**	**1.8**

CPI	Consensus*			Change over Q2	
	2019F	2020F	2021F	2020F	2021F
United States	1.8	0.8	1.7	-0.9	-0.4
Euro area	1.2	0.4	1.1	-0.6	-0.3
Japan	0.5	-0.1	0.2	-0.6	-0.4
China	2.9	2.8	2.2	-0.5	0.0
Developed markets	1.7	0.8	1.5	-0.8	-0.3
Emerging markets	3.9	3.7	3.5	-0.4	0.0
Global	**3.0**	**2.0**	**2.5**	**-0.8**	**-0.3**

F=Forecast. *Bloomberg consensus forecast.

[10] Source: Barclays and Bloomberg. Data as of June 30, 2020. [11] VIX and MOVE are actual value at month end.
[12] Source: Insight and Bloomberg. Data as of June 30, 2020.

DERIVATIVES

Pre-cessation triggers adopted in ISDA fallback language

Earlier this year, we wrote to a number of clients and consultants asking for their support in an ISDA consultation on How to Implement Pre-cessation Fallbacks in Derivatives. Pre-cessation triggers will allow regulators to announce the cessation of an IBOR if it believes that the published IBOR is no longer representative, even if it still technically exists. This would help to avoid a scenario where, for example, the rate continues to be published by ICE based on a significantly reduced number of bank quotes.

The results of the consultation have now been published and we are delighted that a significant majority of respondents supported position that pre-cessation fallbacks be adopted. We believe this is important because the clearing houses had already started to include pre-cessation triggers in clearing documentation and this result will help to ensure consistency between the cleared swap market and the bilateral swap market. We believe that this consistency should help preserve market liquidity, and standardization should ensure fair treatment of all interest rate swap holders. The consultation was unusual in that it required a large number of non-bank respondents to take part for pre-cessation triggers to be adopted.

TREASURY MARKETS

The curve steepens marginally as sentiment improves

Treasury yields were largely anchored over the quarter, but yields drifted upwards in very long maturities. This caused the Treasury yield curve to marginally steepen. The 2-year maturity Treasury yield declined by 6bp, the 10-year maturity Treasury yield declined by 7bp and the 30-year maturity Treasury yield rose by 4bp.

Unprecedented levels of issuance raise concerns

At its May presentation, the US Treasury Borrowing Advisory Committee estimated that H1 FY2020 tax receipts rose by $96bn (6% year-over-year), versus a $149bn (7% year-over-year) increase in outlays. They warned that “given the abrupt changes in the fiscal outlook posed by the COVID-19 outbreak, nearly all sources of revenue are expected to be lower over the next two quarters” also warning that outlays are expected to be “significantly higher”.

It was noted that the Treasury had already increased financing significantly, with nearly $1.5 trillion of net issuance completed so far in Q3 FY2020 (post the data presented) through a substantial increase in bill issuance. Borrowing needs for FY2020 were now expected to reach and unprecedented $4.5 trillion.

Figure 7: The yield curve steepened marginally

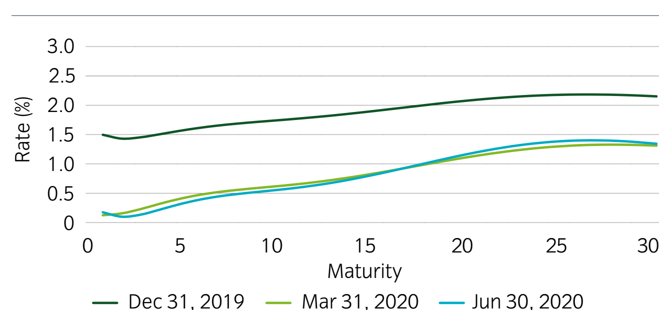


Figure 8: US Treasury net marketable borrowing[13]

Market ($bn)	2018 FY	2019 FY	Q1 2020	Yr/Yr change
Bills issuance	438	137	40	-307
Floating rate issuance	26	55	17	16
2-5yr Treasury issuance	210	403	129	195
5-10yr Treasury issuance	139	206	37	-10
Over 10yr Treasury issuance	176	191	60	23
5-10yr TIPS	32	33	47	22
Over 10yr TIPS	19	20	0	-3
Buybacks	0	0	0	0
Total	**1,040**	**1,045**	**330**	**-65**

//

The committee noted there are “inherent risks” given the expected increase in Treasury supply in the coming months.

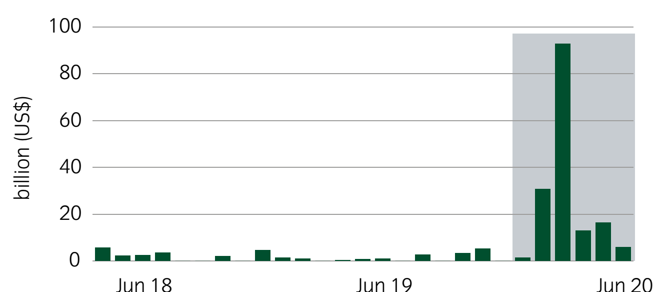
//

[13] Source: Insight and US Treasury. Data as of May 31, 2020. Yr/Yr change is May 31, 2020 vs. May 31, 2019.

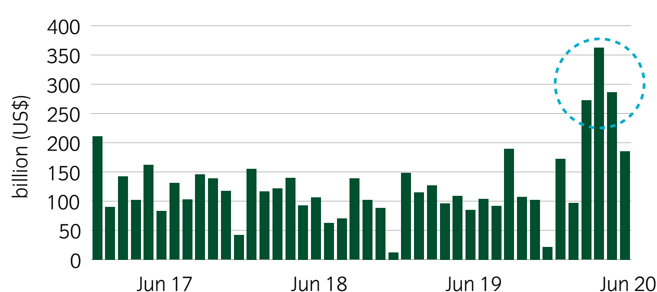
CREDIT MARKETS

Corporate issuers take full advantage of support from the Federal Reserve

A wave of investment grade downgrades[14]...



...doesn't stop a surge in investment grade issuance[14]



Smashing through $1 trillion

US corporate credit markets have experienced a frenzy of issuance in the first half of 2020, with gross investment grade issuance at $1.38 trillion. Issuance initially surged as corporates were prepared to issue even at elevated spreads in order to build liquidity buffers to take them through the coming period of coronavirus impacted activity. As spreads have contracted, a further way of issuance has been ignited, supported in part by Federal Reserve purchases of corporate debt funds, as issuers seek to take advantage of historically low interest rates to lock in funding levels. We continue to believe that this could be an opportunity for careful investment, but with consideration of companies' liquidity positions and financial flexibility and looking for names that may be more insulated from wider economic events. One notable change during the quarter was in the energy sector, where a number of large issuers were downgraded to high yield, but higher rated companies increased issuance, with some coming to the market multiple times. This has significantly changed the average credit rating of the energy sector within investment grade indices as a result.

Issuance breakdown

Q2 saw the surge in investment grade corporate issuance continue, with total issuance in the first half of 2020 in excess of issuance for the whole of 2019. According to data from Refinitiv, the previous record for high grade issuance was $1.37 trillion in 2017, and 2020 is now likely to become a new record year. Early in the quarter we observed a period where a number of issuers were prepared to issue at yields in excess of secondary market levels. These market conditions were potentially highly advantageous for a careful stockpicker and we were able to play a very active role in new issuance markets during this period.

Figure 9: New U.S. bond issuance in $billions[14]

Market	2018 total	2019 total	H1 2020	Yr/Yr change (%)
US Investment Grade	1,208	1,297	1,376	72.6%
US High Yield	171	263	203	76.0%

In US high yield credit, Barclays estimate that $5.7bn of debt was upgraded to investment grade, with $35.1bn of debt downgraded into the high yield bracket. New issues added $131.9bn, offset by $53.7bn in debt that was called or falling below 12 months to maturity and $42.3bn in defaulted debt. Demand for high yield debt rebounded, with Lipper estimating that high yield mutual funds and exchange-traded funds had inflows of $48.6bn, taking H1 inflows to $31.1bn.

Credit Market Performance

Credit spreads tightened in Q2, with aggregate US corporate spreads ending the quarter 122bp tighter than where they began. Longer-maturityspreads underperformed, tightening by only 72bp. BBB-rated issues generally outperformed given more positive sentiment.

Figure 10: Average spread (bps) of Corporate Bonds[14]

Barclays Index	06/30/19	03/31/20	06/30/20	Change Q2	Weight (%)
Corporate	115	272	150	-122	100
Intermediate	91	271	119	-152	66.1
Long	160	274	202	-72	33.9
– Long AAA	84	149	111	-38	–
– Long AA	100	179	139	-40	–
– Long A	119	211	156	-55	–
– Long BBB	199	345	249	-96	–

[14] Source: Insight and Bloomberg Barclays. Data as of June 30, 2020.

MARKET OUTLOOK

DON'T FIGHT THE FED!

Without doubt, the COVID-19 shock has been a challenging environment for markets, with the speed of the shock and resulting policy response leaving little time for strategic planning. Credit markets were initially driven by a lack of liquidity, but then snapped back as the Fed stepped in to purchase corporate bonds. Any fundamental judgements of fair value remain difficult given the extreme uncertainty ahead.

There are certainly reasons to be optimistic, consumers have repaid close to $100bn in credit card debt and we believe the saving rate has increased by approximately 5% - raising the potential for significant pent up demand as the economy reopens, a trend which may already have started to become apparent given the 18% surge in May retail sales data. But there are also reasons to be pessimistic, with unemployment at levels unseen since the great depression and with a future still clouded by the potential for future waves of the virus.

To try and make sense of the best approach we have undertaken a simple exercise. We assume that the Fed can sustain a carefully balanced status quo for the coming 12 months. Treasury yields should be anchored by easy monetary policy with assurances that overnight rates will remain low for a prolonged period. Spreads should benefit from further stimulus measures and the Secondary Market Corporate Credit Facility, which will see the Fed purchase up to $250bn of eligible corporate bonds. For investment grade bonds we assume that $100bn of debt is downgraded below investment grade in H2, and that those bonds widen by 100bps as a result. For high yield, we assume that 10% of issuers will default as a result of the pandemic (3% have already defaulted, so we have incorporated a further 7% into our calculations) and that recovery rates on defaulted bonds are 30%.

Figure 11: Scenario testing the outlook for credit[15]

Investment grade credit		High yield credit	
Investment grade spread	1.46%	High yield spread	5.36%
Impact from fallen angels	-0.12%	Loss from defaults	-4.90%
Expected excess return	**1.34%**	**Expected excess return**	**0.46%**

This exercise suggests that investment grade credit may outperform high yield credit in the year ahead, and if spreads remain capped by central bank purchases, should also provide a return in excess of Treasuries.

> // Any fundamental judgements of fair value remain difficult given the extreme uncertainty ahead. //

[15] Source: Insight, 10 June 2020. Assumes buy-and hold passive investment at current spread level. Does not factor in mark-to-market risks. Manager makes no assurances that performance targets will be achieved. Please refer to the targeted returns disclosures at the back of this presentation. The quoted benchmark does not reflect deductions for fees, expenses or taxes. The benchmark is unmanaged and does not reflect actual trading. There could be material factors relevant to any such comparison such as differences in the volatility, and regulatory and legal restrictions between the index shown and the strategy. Investors cannot invest directly in any index. WHERE MODEL OR SIMULATED RESULTS ARE PRESENTED, THEY HAVE MANY INHERENT LIMITATIONS. MODEL INFORMATION DOES NOT REPRESENT ACTUAL TRADING AND MAY NOT REFLECT THE IMPACT THAT MATERIAL ECONOMIC AND MARKET FACTORS MIGHT HAVE HAD ON INSIGHT'S DECISION-MAKING. Actual results may vary. This model is based on many assumptions that may not reflect past, current or future market events.

MARKET OUTLOOKS

Investment grade credit: Although we remain tactically positive on investment grade credit, we have become more cautious given the rally over the quarter. Spreads have returned to levels historically seen during moderate recessions. Given the significant uncertainties ahead, this suggests that there is less strategic value left in markets and, unless there is a substantial breakthrough on a vaccine, the prospect of further meaningful gains seem limited. At the same time the liquidity being provided by global central banks should limit the scale of any selloff, and we don't believe that spreads will revisit the levels seen during the worst point of Q1 without a significant deterioration in the economic outlook from here. As a result of these two opposing factors we would expect income to be the main driver of returns until markets have greater clarity on the pace of recovery and the risks stemming from any second wave of the virus. We continue to advocate a large degree of caution in terms of security and sector selection, focusing on high-quality issuers. High volumes of issuance have provided a good way to exploit market dislocations – with issuers prepared to pay above market yields to build their liquidity buffers. We will continue to exploit opportunities such as this as they become available.

High yield credit: The high yield market has benefited from investors insatiable demand for yield as it has become apparent that interest rates are likely to remain low for a prolonged period. Although spreads tightened over the quarter from the elevated levels seen during the heights of the COVID crisis, they remain at levels we would regard as attractive, but the need for intensive credit work has never been so apparent. Business models need to not only demonstrate that they will survive the current downturn, but also need to have the ability to withstand a secondary lockdown. Certain segments of the economy are being disproportionately impacted, and we expect defaults to rise as a result, but focused on those companies that are most exposed. As ever, there is a need to focus on cashflow, and ensuring that companies have sufficient resources and liquidity even in a scenario where there is only a gradual recovery through 2021. The regular dialogue that we have established with management teams over time becomes critical during periods such as this, and we remain vigilant on cashflow forecasts, debt profiles, revolving credit facilities and underlying business operations.

Emerging markets: Emerging market central banks have followed their G7 counterparts with supportive measures including reducing interest rates and providing liquidity in local rates and currency markets. Emerging market credit, largely denominated in US dollars, has benefited from the search for yield as market sentiment has turned more positive, but the cheapness of market risk premium post the volatility seen at the end of March and start of April is no longer as compelling, especially given the still significant uncertainties ahead. If spreads remain anchored by central bank activity, income should be the main driver of returns over coming quarters. In local rates we are selectively positive, looking for central banks that are still playing catchup to their developed market counterparts and have the potential to ease rates further. We would avoid the longer end of yield curves however, as we worry about deteriorating fiscal outlooks and the still unproven use of quantitative easing in emerging market economies. We also remain cautious on emerging market currencies. Although many are cheap on valuation basis, they are not at extreme levels and the global economic backdrop is unlikely to be supportive for some time.

Structured credit: We continue to focus on higher-quality assets with greater liquidity as the credit enhancements within these structures are substantial, which should mitigate the impact of any underlying loan defaults. We are not overly concerned about defaults in the short term, as declining interest rates and the various government measures introduced to support households and corporates is likely to soften the economic pain. In the longer term, a material increase in unemployment and reduction in earnings is necessary for consumer delinquencies to rise, which would likely require the recession to be significantly longer and deeper than we currently expect. In contrast to corporate credit markets, supply has fallen dramatically as spreads have widened, with issuers refusing to issue at wider levels. This creates a strong technical backdrop and reinforces our view of the asset class as fundamentally defensive in nature.

KEY MARKET RISKS

A STOP-START RECOVERY WOULD NOT BE GOOD FOR CORPORATES

The huge package of fiscal and monetary easing that has been implemented across the world should help to underpin a rebound in economic activity, but the pace of that recovery remains highly uncertain. One problem facing politicians is that implementing a second lockdown could prove extremely difficult given the cost of the first and the lockdown exhaustion facing many populations. The disruptive effects of minor outbreaks could make it difficult for activity to return as rapidly as expected and place considerable strain on corporates in affected areas and industries.

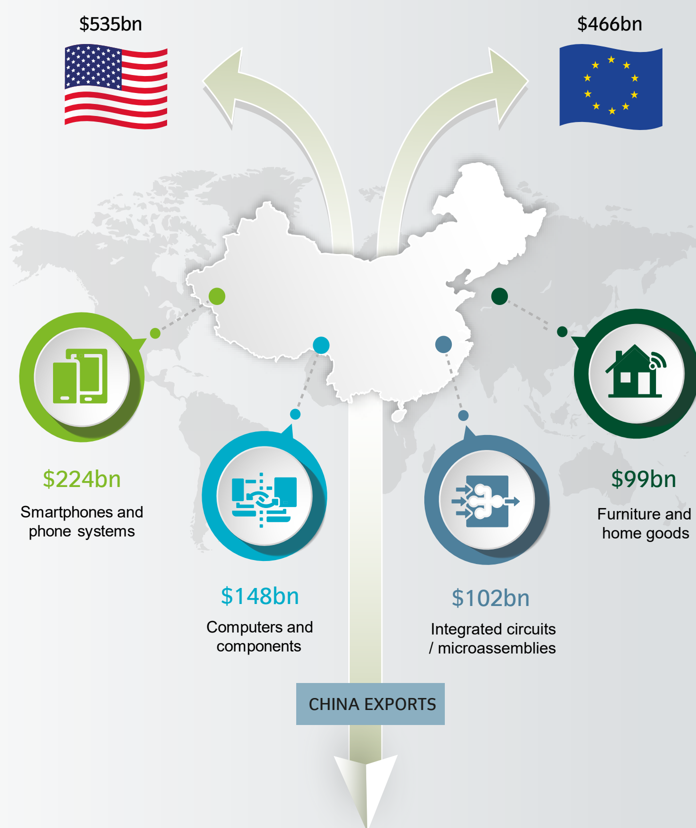
ELECTION UNCERTAINTY IS LIKELY TO SHIFT INTO FOCUS

With markets firmly focused on the coronavirus, the US election campaign has had little impact so far, but this could change dramatically as we move into the third quarter. President Trump faces a challenging economic backdrop, but the strength of his base means the election is likely to be impossible to call until the votes are counted. The US has taken a confrontational approach on trade and withdrawn its full support from several international bodies, from the World Trade Organization to the World Health Organization. As the election campaign moves into its final stage, markets should get more information on how each of the candidates intends to approach both the domestic recovery and the US's role on the international stage.

THE ROLE OF CHINA IS INCREASINGLY UNDER QUESTION

The impact of the coronavirus has further strained relations between the US and China but has also arguably shifted other major countries towards the US position. China has a key position in the world as an exporter of goods – from basics such as toys and furniture, to high tech goods such as smartphones and computer components.

As these international powers struggle for dominance it is likely to raise geopolitical risks. In recent months China has introduced a new security bill in Hong Kong, effectively seizing direct control of the region, entered into a border conflict with India and embarked on a sabre rattling exercise with Taiwan. Such events could become more common if Chinese authorities shift to a more insular position and decide to assert their regional dominance.



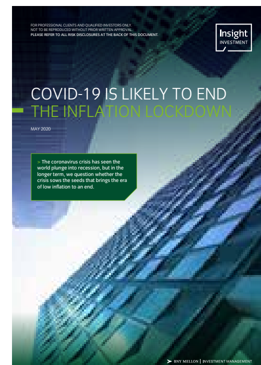
EDUCATIONAL:
INFLATION POST CORONAVIRUS

For now, COVID-19 and the economic crisis that it has triggered, have given investors another reason to think that inflation is dormant. The global economy has experienced a 'sudden stop', and it is possible that the resulting recession will be deeper than that experienced during the global financial crisis. Investors have understandably focused on the immediate impact and soaring levels of excess capacity, including unemployment, have led to concerns that, if anything, inflation will be too low.

Whilst we agree that the near-term outlook appears benign, we would highlight 5 trends that have acted to contain inflation over the last few decades that are going into reverse:

1. The era of deglobalization has likely already begun
2. A technology cold war is brewing and is likely to broaden to other key sectors
3. Social distancing will impact profitability
4. Low-cost labor migration could become more difficult
5. In contrast to recent history, margin rebuilding may come via price rises

FURTHER READING



For more detail on this subject, please see our paper: COVID-19 is likely to end the inflation lockdown.

FIND OUT MORE

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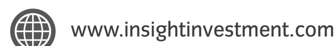

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