Investment Insights

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There Is Equity-Like Opportunity in Credit Markets, but Selectivity Will Be Key

Authors

Brian K. Mastrullo, CFA
Investment Product Specialist

Bradford Rutan, CFA
Investment Product Specialist

Robert M. Almeida, Jr.
Portfolio Manager and
Global Investment Strategist

In brief

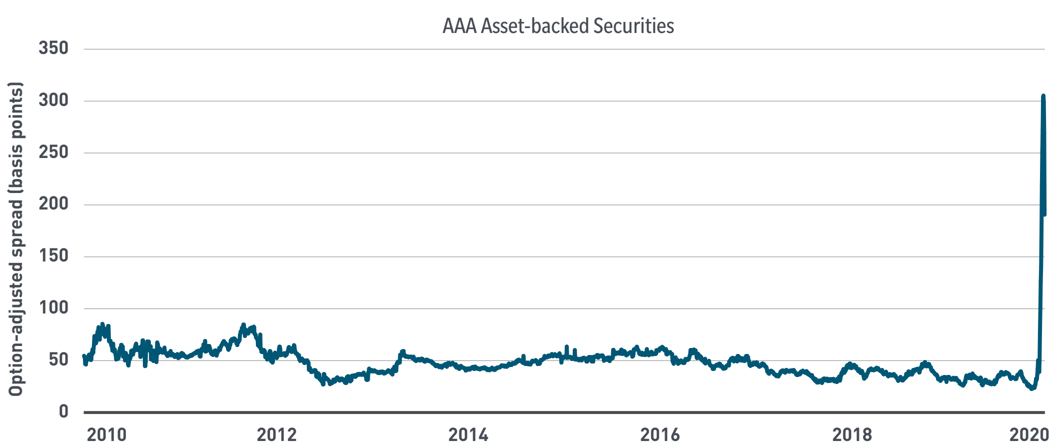
- Early in the crisis caused by the coronavirus pandemic, an unprecedented liquidity drain sparked exceptionally strong demand for US dollars, overwhelming financial markets.
- Extraordinary Fed intervention has begun to restore market function.
- However, dislocations remain: Not all credits are created equal; some will flourish while others will founder.

Global economic activity abruptly ground to a halt as the world embraced social distancing to curb the spread of the coronavirus. With business activity and revenues collapsing for many, the demand shock sparked a relentless pursuit of US dollars and an unprecedented drain in fixed income market liquidity. How did this happen and what opportunities did this create?

Given that a substantial portion of global trade is in dollars, companies around the globe rushed to raise greenbacks in order to meet obligations to suppliers. This forced non-US local banks to buy dollars for their institutional clients, draining countries' dollar reserves and forcing the US Federal Reserve to set up FX swap lines with foreign central banks in order to provide liquidity. At the same time, companies with upcoming debt maturities sought dollars by monetizing their bond portfolios, which drained liquidity and added to dollar strength. Additionally, money market and prime fund managers put out sell orders to raise dollars in order to fulfill redemption requests. In summary, the immense demand for the greenback during the crisis overran the financial system's ability to function properly.

With the most illiquid fixed income markets of our lives, forced bond sellers prioritized liquidating a position over securing reasonable or fair-value pricing. While volatility spiked in all risk markets, of note is the price dislocation in the very high-quality AAA-rated short-maturity asset-backed space, shown below in Exhibit 1.

Exhibit 1: Search for liquidity sparked market dislocation

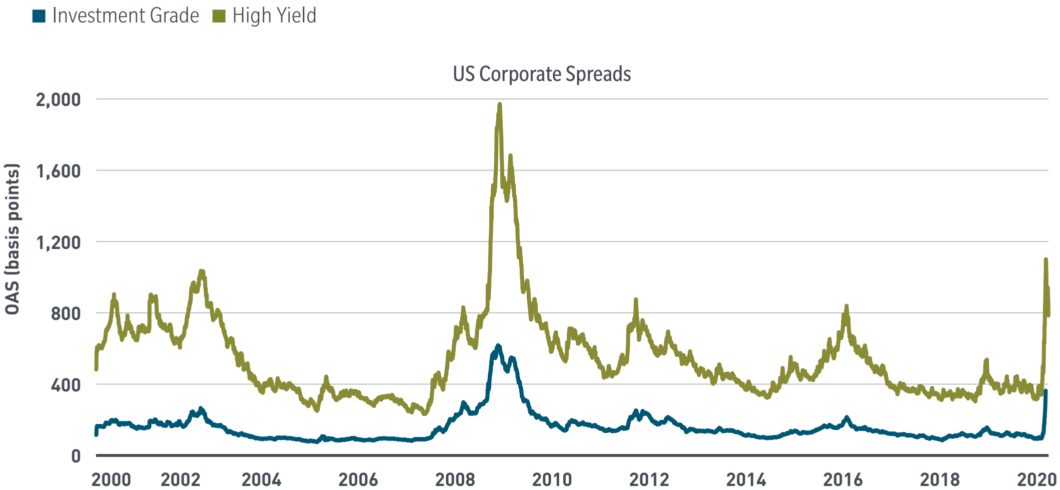


Source: Bloomberg Barclays Asset-Backed Securities AAA Index, as of 4/8/20.

In response, the Fed stepped in aggressively, rolling out facilities first created to combat the global financial crisis and creating new ones to backstop the markets and ease liquidity strains. While we still have a long way to go, this started credit markets on the path toward normalization. The market for AAA asset-backed securities referenced above, which are among the highest-quality and shortest-dated, have reversed most of the illiquidity-driven price action and have generally pulled back to par already.

Despite a partial retracement in credit spreads, particularly following the Fed's inclusion of credit ETFs on its menu of asset purchases, dislocations and opportunities remain. As shown in Exhibit 2 below, investment-grade and high-yield spreads remain well above normal. However, issue selection should be a priority, as default rates and downgrades will likely take a step-function shift higher in the coming weeks, months and perhaps quarters.

Exhibit 2: Corporate valuations are attractive relative to history



Source: Bloomberg Barclays US Corporate Bond Index and US High Yield Index, as of 4/9/20.

During recessions, corporations typically seek to fix balance sheet excesses. But this cycle's imbalances are greater than most, given the historic levels of leverage utilized to drive profits. So the top priority today is securing liquidity, with the next priority balance sheet repair and profits an afterthought. Emphasis has shifted toward what is important to creditors and away from what is important to shareholders, the inverse of the past dozen years.

While we hope and believe we have moved beyond the initial liquidity crisis, which we saw in February and March, what remains is a potential solvency crisis in which a large number of companies face an evaporation of revenues and funding gaps so large you could drive a bus through them. Not everyone will survive, and not all corporate bonds will pull to par like we saw in the AAA short-duration asset-backed markets over the past few weeks.

We believe the credit markets today offer unique and once-in-a-generation opportunities for bond investors to earn equity-like returns. Seeking to do this is not without risk, of course. There will be credit rating downgrades, missed coupon payments and restructurings. But there will also be opportunities for those who undertake judicious research and security selection. In this environment, avoiding mistakes will be critical since not all credits are created equal.