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Expecting an uneven recovery for investment-grade bonds

Companies will not benefit equally from a recovery, making credit selection essential in picking the winners

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When financial markets woke up to the coronavirus pandemic's likely level of contagion in early 2020, there was a disorderly flight to safety. Fortunately, though, the huge international policy response that followed restored confidence and markets rebounded.

From peak to trough the FTSE Global Equity Index Series was down more than 20% early in 2020.[1] Bond markets were hit, too, as high yield and investment-grade bonds were initially sold off. Indeed, the months of March and April 2020 were noted for their massive redemptions of both high yield (HY) and investment-grade (IG) mutual funds.

But just as the sell-off was both rapid and deep, so too the policy response was unprecedented. Globally, central banks pumped around US$6 trillion into the economy via quantitative easing in 2020.[2] Some central banks, such as the US Federal Reserve, also expanded their toolkit, purchasing corporate bonds for the first time.[3] Meanwhile the fiscal response worldwide has been historic in proportions, with governments in many cases furloughing salaries of employees, as well as providing tax breaks and state guarantees of lending.

With 2021 well underway, bond markets are now past the distress stage and, with stimulus ongoing, are well on the road to recovery. The huge stimulus ensured that almost all fixed income asset classes recorded respectable returns in 2020: many bond yields hit all-time lows while the amount of negative-yielding bonds hit all-time highs. IG bonds also did well: global returns for 2020 as a whole were 7.7%.[4]

Credit selection will be key

But what about 2021? It is clear that an aggressive roll out of vaccines is required before the global economy can return to an environment resembling "normal". In the meantime, economies will remain reliant on stimulus measures to get the recovery up to speed.

In the short to medium term, at least, there are few signs that central banks are easing off the gas. Indeed, we expect them to continue injecting substantial liquidity throughout 2021.

Major central banks such as the European Central Bank and the US Federal Reserve have also called for more fiscal measures to aid economic recovery. In the US, we think there is a strong likelihood of additional large-scale fiscal stimulus under President Joe Biden.

Clearly, bond markets are recovering. But that recovery will be unequal, and some sectors and companies will fare better than others. In such challenging markets, credit selection will be key. This plays into our strengths at Columbia Threadneedle Investments, given our 150-strong global fixed income team[5] covering research, portfolio management and trading. We are bottom-up investors, calling upon fundamental research from a global team of in-house credit analysts.

As we enter 2021, we expect most IG bonds to weather the storm of Covid-19, despite record levels of corporate debt. Following significant debt issuance in primary markets in 2020, most IG companies have ample liquidity should unexpected pandemic-related downside risks materialise, which impede the expected global recovery.

In addition, management teams at many companies are now looking to deleverage their balance sheets by paying down debt. On our forward-looking models we see leverage coming down in 2021 and, over the course of the year, corporate leverage broadly returning to levels last seen at the end of 2019 – a major achievement given the damage inflicted to global economies by the Covid-19 pandemic.

Nevertheless, we are keeping a close lookout for warning signs – such as share buybacks, M&A or dividend increases – that management teams are being distracted from such debt reduction plans.

Stimulus is here to stay

What other potential headwinds are there? Perhaps the biggest risk to bond markets is inflation. We have seen slight upticks in prices but, so far, nothing to give us major concern.

Longer term, we are comforted by the fact that global economies face powerful structural downward pressure on prices, given deflationary phenomena such as technological advances and ageing demographics.

The withdrawal of stimulus is another worry for fixed income investors, given the huge support global policy responses have bestowed on bond – and equity – markets. A fast and effective programme of global vaccine roll-outs could set the stage for a strong economic rebound, reducing the need for policy support.

But even in such a rosy scenario, we believe stimulus measures are here to stay, at least for the short to medium term. That means they are likely to provide support for global bond markets into 2021 and beyond.

Sources:

1 Bloomberg, January 2021.
2 FitchRatings, Global QE Asset Purchases to Reach USD6 Trillion in 2020, 24 April 2020.
3 Bloomberg, Fed Will Begin Buying Broad Portfolio of Corporate Bonds, 15 June 2020.
4 ICE BofA Global Corporate Index, January 2021.
5 As at March 2021.

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