Second waves and double dips

Fixed income quarterly outlook - third quarter 2020

FOR PROFESSIONAL INVESTORS - July 2020

Key points

- Uncertainty about the evolution of the pandemic remains high, with hotspots reappearing and infections still rising to various degrees around the world.
- The better-than-expected rebound in retail sales both in the US and Europe shows the potential for economies to rebound quickly from lockdowns. But a second wave of infections could yet lead to a double dip in growth.
- We expect fiscal support to continue to the degree necessary to allow workers and businesses to survive the collapse in growth caused by the lockdowns. The challenge to the longer-term growth outlook will be the ability of governments to differentiate between where the collapse in demand is temporary versus permanent.
- Continued central bank purchases of government bonds have driven yields, and market volatility, ever lower.
- A marginally improving global economic outlook could drive real yields higher this quarter, while inflation expectations could rise as increasing consumer demand meets supply constraints.

Macro commentary

Thanks to the imposition of lockdowns across much of the world, the devastation wrought by the COVID-19 coronavirus has been much less than feared. Projections made in March by the Imperial College London were that a 'do-nothing' strategy could result in 550,000 deaths in the UK and 2.2 million deaths in the US. To avoid this outcome, it was advised that a combination of mitigation measures such as school closures, household quarantines and social distancing, maintained for several months, could reduce deaths to 48,000 in the UK over a two-year period and about 200,000 in the US. So far, the UK has suffered about 45,000 deaths and the US around 135,000. While distressing, these figures are similar to those seen during the Hong Kong flu in 1968 and the Asian flu in 1957.

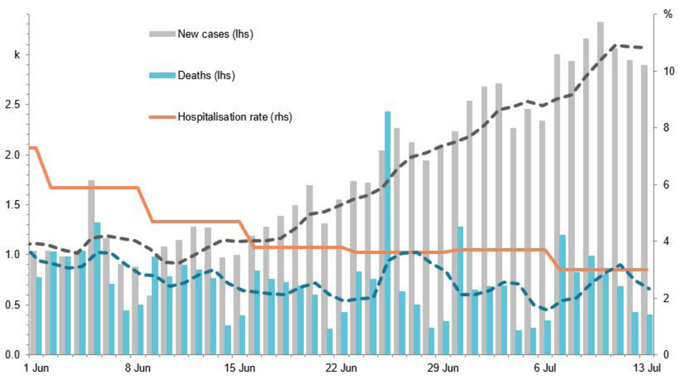
Uncertainty about the evolution of the pandemic nonetheless remains high. Infection rates have fallen significantly in Asia and Europe, but are rising to various degrees in many countries around the world. As containment measures are removed, new infections increase. Europe is opening its borders and the tolerance of its citizens for maintaining containment measures is waning. Two countries considered to have managed the pandemic well – China and Australia – have had to re-impose lockdowns on major cities (Beijing and Melbourne, respectively).

The worry is that a continuation of this pattern will necessitate re-imposition of the lockdowns, curbing economic growth and further boosting debt levels as governments extend fiscal support measures. This scenario is not compatible with the current level of equity markets, though arguably it is with core government bond yields.

While we recognise this risk, we expect countries to be able to manage a continued exit from lockdown conditions, albeit fitfully. While infections are indeed rising, deaths have not risen commensurately as countries have been able to expand healthcare systems and treatment improves (see Figure 1). Vulnerable parts of society are better protected. The recent rise in infections in the US is more concentrated among younger cohorts where the mortality rate is far lower (only 7% of deaths have occurred in those younger than 55).

Fortunately, this means that economically costly measures such as school and business closures are not required to keep deaths relatively low. Activity in some parts of the economy, for example bars and restaurants, particularly in countries with higher infection rates, will likely remain depressed until a vaccine is found, but this sector only accounts for 3.5% of US GDP, for example. We expect consumer demand to continue to recover even as its composition changes.

Figure 1. US weekly new infections, death & hospitalization rate

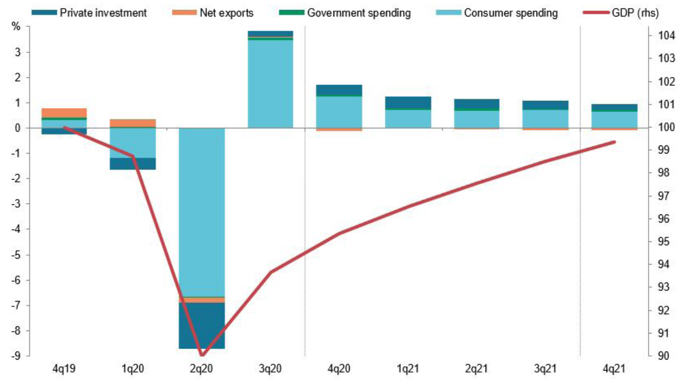


Data as at 13 July 2020. Source: Johns Hopkins University, BNP Paribas Asset Management

In contrast to the global financial crisis (GFC), where the collapse in GDP was driven mostly by business investment, this time consumption has been the key sector. Most of the expected 9% drop in US GDP in the second quarter stems from falling consumer spending, and the subsequent recovery equally depends on both the willingness and ability of individuals to consume (see Figure 2).

Figure 2. Contribution to US GDP growth

Forecasts from 2q20

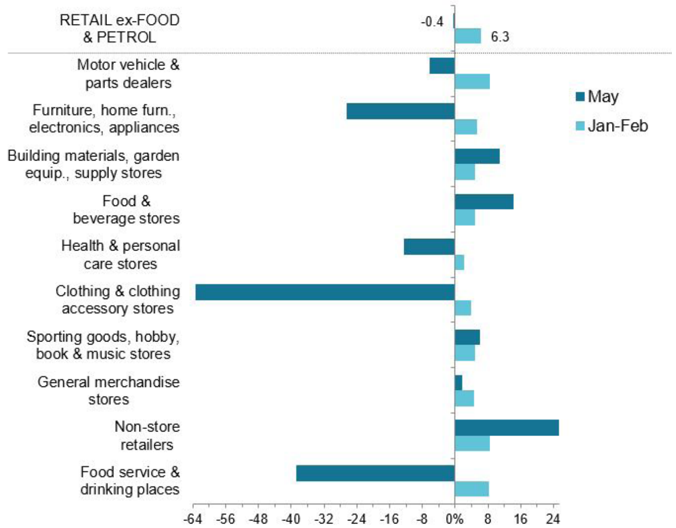


Data as at 10 July 2020. Source: Bloomberg, BNP Paribas Asset Management

One reason that GDP growth estimates have been rising is that retail sales have bounced back quickly after collapsing during the lockdowns, indicating that consumers remain willing to spend. Consumer sentiment surveys tell a similar story. In the US, UK, and the eurozone, core retail sales fell by 12-15% in April, but rebounded in May by 10-18%, significantly beating expectations (the Citi US Economic Surprise index is at record highs). Inevitably, the composition of demand has changed (more books and fewer restaurant meals), as did the means of consumption (more online via non-store retailers than in shops). And even if consumption recovered strongly in May, the year-on-year growth rate in the US was flat compared to the 5-6% growth rate before the lockdowns (see Figure 3), so there is still much catching up to do.

Figure 3. US retail sales

Year-on-year change, May 2020



Data as at 30 June 2020. Source: US Census Bureau, BNP Paribas Asset Management

The willingness to consume is evidently still there, while the ability has stemmed from furlough schemes that have allowed many workers to continue receiving salaries or from generous unemployment benefits. The concern is that if economies recover more quickly than expected, governments may withdraw the support before unemployment has fallen by enough. This mirrors the worry that business aid to prevent bankruptcies will similarly be curtailed prematurely.

This is less likely to happen in the US as in an election year, few politicians will be keen on being blamed for letting the economy fall over the edge. In the richer parts of Europe, governments have already spent a great deal of money on support that would be wasted if all it did was to delay instead of prevent bankruptcies.

Thus we would expect fiscal support to continue to the degree necessary to allow workers and businesses to survive the lockdown-induced recession. The challenge for the longer-term growth outlook will be whether governments are able to differentiate between those parts of the economy where the fall in demand should be temporary (e.g., restaurants) and where it will be permanent due to structural changes (e.g., demand for office space). At some point, businesses do need to fail if they no longer have a profitable future and workers will need to find jobs in those parts of the economy that are growing.

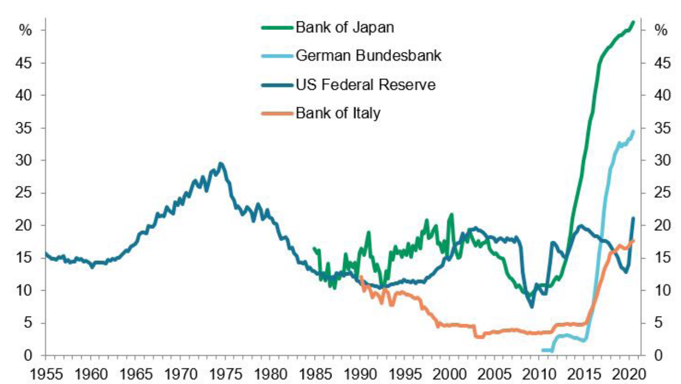
Government bonds and inflation

Continued central bank purchases of government bonds have driven yields, and market volatility, ever lower. Thirty-year UK Gilt yields are now on par with those on JGBs. Ten-year US Treasury yields were most notable for their stability, moving in a narrow 20bp range for most of the quarter even as equity markets posted one of the biggest gains in decades.

Though most governments have increased their bond issuance significantly to finance the economic rescue packages, central banks have more than kept up. In the US, the Federal Reserve's ownership of Treasury bonds has risen to levels not seen since the 1970s, though it is still well behind Japan, or even Germany (see Figure 4).

Figure 4. Central bank holdings of government bonds

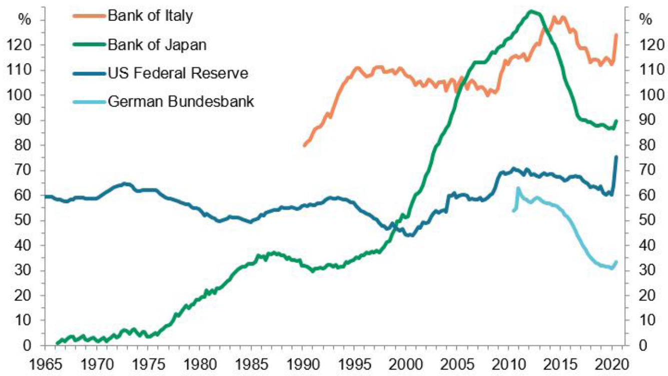
Share of total government debt securities



Data as at 2 July 2020. Note: Germany and Italy holdings include those of the ECB. Source: US Federal Reserve, US Treasury, Bank of Japan, ECB, BNP Paribas Asset Management

The – at least temporary – monetisation of government debt helps explain why bond yields remain so low despite significantly larger budget deficits. If one subtracts the amount of government debt held by the central bank from the overall debt burden, debt-to-GDP ratios become less worrying. Instead of a 200% debt-to-GDP ratio in Japan, the ratio adjusted for central bank holdings is just 90%. Italy's ratio drops from 138% to 120%, not much higher than the pre-GFC ratio (see Figure 5).

Figure 5. Government debt-to-GDP ratios adjusted for central bank holdings



Data as at 2 July 2020. Source: US Federal Reserve, US Treasury, Bank of Japan, BNP Paribas Asset Management

As long as inflation remains benign, there seems to be little incentive for central banks to release this debt back into the market aside from the banks' own preference not to own such a sizeable share of the market. While the Fed, for example, would like to resume running off its balance sheet, it is unlikely that it will be able to do so, or if it does then only very slowly if rising interest rates risk choking off economic growth.

As in the US, most other core government bond yields moved within a narrow range throughout the quarter. The most notable outliers were the UK 30-year bond, which dropped by about 20bp, reflecting renewed Brexit concerns, sustained demand from institutional investors, and a bigger-than-expected economic slowdown due to the coronavirus. The other outlier was Japan, where the 30-year JGB yield rose by about 20bp to its highest since January last year as rising issuance was met by less demand from the Bank of Japan. Hence the surprising convergence in 30-year yields of these two countries.

The outlook for upcoming quarter may be similar. A marginally improving global economic outlook could drive real yields higher, while inflation expectations could rise as increasing consumer and business demand meets supply constraints. At the same time, the likelihood that governments will be battling the coronavirus for many more months if not quarters, with occasional setbacks in that battle, means both real yields and inflation expectations could suffer periodic falls.

Breakeven rates have already risen after the rally in March and have settled 20-40bp lower than their pre-crisis levels. This seems appropriate given the currently depressed levels of demand. Nonetheless, the risks both of higher inflation, and of disinflation, have risen due to the pandemic.

Beside disrupted supply chains supporting inflation, companies in some industries may now be able to push through price increases (think personal protection equipment). There are rising calls for higher minimum wages to protect exposed and vulnerable workers at the lower end of the wage spectrum.

Disinflationary risks, however, have also gone up. These stem not only from currently depressed demand, but also from the structural changes wrought by the virus. Less travel — both for business and pleasure — as well as increased working from home will likely reduce demand for property, fuel, infrastructure, restaurants, etc., which would drive prices lower. For a fuller discussion of these risks, please see the paper "The inflation genie".

In the eurozone, ECB support suggests 'peripheral' country debt should continue to outperform core debt markets, though this view is not without risks. Investors have taken heart from Germany's conversion to the joys of deficit-funded fiscal stimulus, the ECB's stepped-up Pandemic Emergency Purchase Programme (PEPP), and particularly the proposed Next Generation EU programme.

Each has its limitations, however. German stimulus will primarily benefit Germany, whose economic outlook was already better than it was for the rest of the eurozone. The medium-term rewards of the PEPP depend on whether one believes it will not only be terminated quickly once the crisis is past, but also rolled off from 2023, as the ECB says. Alternatively, the roll-off might actually not take place until a much later date if the priority is "to avoid interference with the appropriate monetary stance."

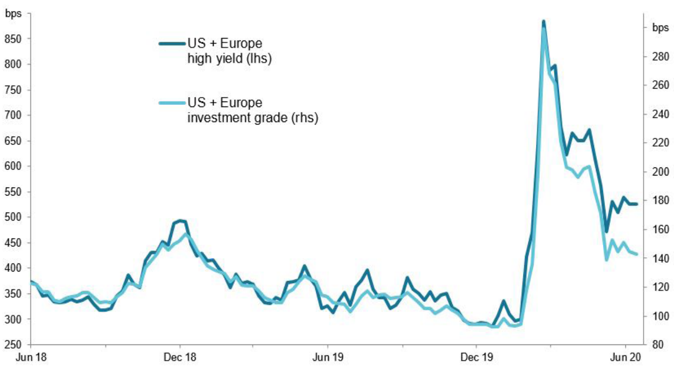
Finally, the details of the Next Generation EU programme are still being negotiated, so it is unclear how much money needy countries will actually receive, how much will be grants and how much loans, and with what conditions attached. It seems more likely that markets will be disappointed with the outcome than pleasantly surprised.

Corporate credit

The narrowing in corporate credit spreads, both in the US and Europe, after the Fed's pledge of support for the market, has been dramatic. Spreads, however, remain near the peak levels seen during the sell-off at the end of 2018. This suggests that there is still value in the market (see Figure 6).

Figure 6. Corporate bond spreads

Average US and Europe



Data as at 10 July 2020. Source: Bloomberg, BNP Paribas Asset Management

Table 1. Spreads relative to level on 31 December 2018

Basis points

Name	IG spread	HY spread
Aerospace/Defense	67	552
Airlines	302	918
Finance Companies	114	265
Independent Energy	87	217
Leisure		480
Life Insurance	(17)	513
Lodging	164	151
Office REITS	28	481
Oil Field Services	60	1,336
Retail REITS	48	850

Data as at 10 July 2020. Source: Bloomberg, BNP Paribas Asset Management

Indicators of corporate stress and credit metrics are worsening. Fitch, for example, expects the default rate in the US leveraged loan market to reach 5-6% by year-end, with some sectors seeing much higher rates; defaults in the leisure and entertainment sector could reach nearly 40% of loans outstanding.

We nonetheless remain positive on credit, as the central bank backstop should limit how far spreads could widen, with the obvious condition of avoiding outright defaults in the high-yield bracket. A key support over the next several quarters is the fact that companies have been able to raise vast amounts of cash over the last few months to shore up their balance sheets or refinance debt; USD 3.9 trillion has been raised since the start of March. Many companies were preparing themselves for lockdowns lasting up to a year when instead they were in place only for several months. Even if the pace of the economic recovery slows, we expect only the most vulnerable companies in strategically challenged sectors not to survive.

The opportunities for above-average gains are likely to be found in exactly those challenged sectors. Even if spreads for the broad indices are at levels similar to the worst of the sell-off at the end of 2018, they are much wider for several industries. Thanks to the collapse in oil prices, for example, the spread on high-yield debt issued by oil field services companies is nearly 1 300bp higher than it was on 31 December 2018. The collapse in tourism has also had a big impact on spreads for airlines and leisure industries (see Table 1).

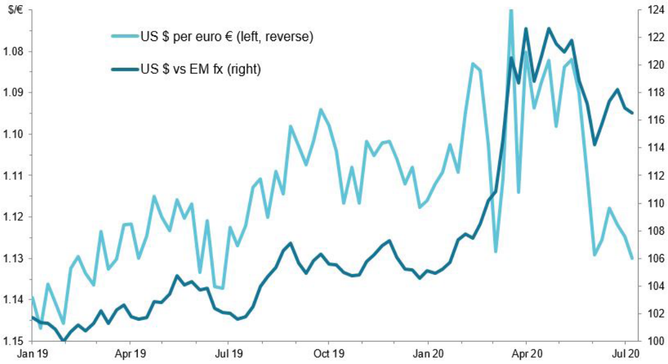
There are likely opportunities for investors with a longer-term time horizon among the more financially sound companies in these industries, particularly ones that should see a swift recovery in demand once a vaccine is found and made available on a large scale. Industries such as office and retail REITs, however, are likely to face sustained challenges as the fundamental underpinnings of their business models have been shaken by the pandemic.

Currencies

The biggest surprise in the quarter was the rally in the euro following the EU Next Generation programme announcement. It is notable that the US dollar has fallen much less against emerging market currencies than against the euro, suggesting it is bullishness about the euro, rather than extreme bearishness on the dollar, that is behind the common currency's rally (see Figure 7).

We worry that the currency may have risen too far, especially as the current level is near the top end of the range since the beginning of 2019. In addition to the concerns highlighted above both for Next Generation EU and for the duration of the Pandemic Emergency Purchase Programme (PEPP), the risks to the eurozone growth outlook are greater than they are for the US as countries in the currency block are more likely to re-impose lockdowns if infections rise more quickly. Though attention has been focused on the doubling of the infection rate in the US, a third of the countries in Europe have seen at least a 25% increase in the infection rate since the beginning of June.

Figure 7. Value of US dollar versus euro and emerging market currencies



Data as at 10 July 2020. Source: Bloomberg, J.P. Morgan, BNP Paribas Asset Management

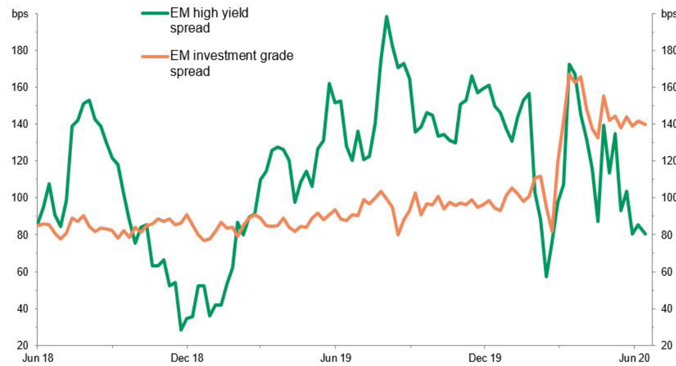
Medium-term growth outlook for Europe is typically less rosy than it is for the US, and now the gap may well widen. Many are already concerned about the divide within Europe between those countries with the fiscal capacity to offset the effects of the lockdowns and those with already elevated debt levels. The employment support schemes in Europe, while better able to cushion short-term consumer demand, come at the cost of delaying the reallocation of resources to faster-growing parts of the economy. This may limit the ability of the region to return to pre-pandemic levels of growth (and that growth rate was already lower due to the global financial crisis).

Emerging market currencies and debt

As developed market bond yields grind down, the appeal of emerging market (EM) debt rises. The limited ability of many EM central banks to pursue quantitative easing (QE) has the incidental benefit of sustaining a universe of sovereign debt with positive yields. Despite the challenging macroeconomic outlook in many countries due to lower commodity prices, tourism revenues, and remittances from citizens working abroad, the asset class generated double-digit returns in the second quarter.

Spreads on both sovereign and corporate debt are above the average over the last 10 years, and are actually relatively higher for investment-grade than for high-yield (see Figure 8). If the global economic recovery continues, commodity prices should recover (though oil prices perhaps less so). Given the generally effective response to the pandemic in Asia and in central and eastern Europe, tourism should resume there, if not yet in Latin America.

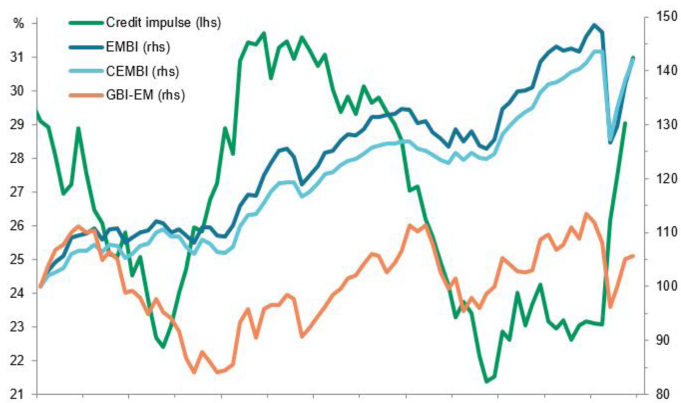
Figure 8. Emerging market corporate bond spreads versus US and Europe



Data as at 10 July 2020. Source: Bloomberg, BNP Paribas Asset Management

The significant fiscal stimulus in China should also support emerging market fixed income assets. Though there was a lag in 2015-2016 between the point spending increased in China and the point that EM indices began to turn up, the reaction was more immediate in 2019 and again this year (see Figure 9).

Figure 9. China credit impulse and EM fixed income indices



Data as at 2 July 2020. Source: Bloomberg, BNP Paribas Asset Management

Local currency investments should benefit from a continued weakening of the US dollar as global risk aversion fades and flows return to emerging market assets. Though the dollar is currently down by about 5% from the highs of April against the JPMorgan EM Currency index, it is still 10% higher than it was at the end of last year (see Figure 7). Many countries either did not impose lockdowns or are exiting them now, even if only because they can no longer afford the economic cost rather than because the pandemic is under control. This means the growth outlook should broadly improve. The risk in local currency bonds is that absolute yields are at decade lows (as they are for most developed market government bonds), while arguably, inflation risk is higher in emerging markets than it is in developed markets.

Conclusion

The worst of the coronavirus pandemic is past, but the battle will go on. The most pessimistic forecasts, both in terms of deaths and in terms of the economic impact, have thankfully turned out to be misguided. Credit markets and emerging market debt have rallied on this realisation, but spreads are still elevated. This reflects as much the uncertainties about the evolution of the virus as what measures governments will take to contain it. A second wave of infections could yet become a double dip in economic growth if broad lockdowns are re-imposed. Political leaders will continue to be faced with the trade-off between the economic cost of renewed lockdowns (as well as secondary negative health effects) and the desire to slow, if not stop, further infections.

The implications of the response of governments for sovereign bond markets and inflation in the medium term may be less significant. While debt levels will rise, so will central bank purchases. Money authorities may eventually run these acquisitions down, but that may take place much further in the future and at a much slower pace than they might like. As long as inflation remains subdued, the consequences of this monetisation may be more theoretical than real.

BIOGRAPHIES

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Dominick is Chief Investment Officer of Fixed Income for BNP Paribas Asset Management. His responsibilities include global and regional fixed income (Europe, US, Asia), including money market funds, and global emerging market debt. He has oversight responsibility for all activities relating to the management and performance of the organization's fixed income investment teams, products and portfolios. He is responsible for challenging the strategies and processes of the various investment teams. Dominick joined the firm in 2013 and is based in New York.

Prior to joining us, Dominick was Managing Director – Head of Product Management and Development (Americas) for Deutsche Asset Management where he served in a senior portfolio management capacity as Head of Fixed Income Asset Allocation. Prior to Deutsche Asset Management, Dominick held the position of Head of Fixed Income (Americas) for Robeco, Weiss Peck & Greer Investment Management where he oversaw the management of US and global fixed income assets. At Robeco, Dominick managed numerous fixed income multi-sector portfolios, with a focus on fixed income asset allocation. Prior to Robeco, Dominick held various fixed income portfolio management positions including fixed income portfolio manager for Chase Asset Management, a predecessor of J.P. Morgan Asset Management.

Dominick has over 30 years of investment experience. He earned his BS in Economics from State University of New York, SUNY – Oneonta. He is a member of the New York Society of Securities Analysts and the CFA Institute.

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Daniel is a Senior Investment Strategist at BNP Paribas Asset Management. He is responsible for promoting collaboration between investment teams and formulating alpha-generating investment views across asset classes.

Daniel joined our company in 2015 and is based in London. Prior to joining us, Daniel was Managing Director, Global Investment Strategist at TIAA-CREF, Global Market Strategist at JPMorgan Asset Management, Senior Equity Strategist at Lombard Street Research, and US Equity Strategist at Bank of America Securities.

Daniel has 23 years of investment experience. He holds a BA in Mathematics from Pomona College, an MA in International Economics and Latin American Studies from Johns Hopkins University, as well as an MBA from The Wharton School of the University of Pennsylvania. Daniel is a CFA Charterholder.