May 2020

Income and Growth Q&A

By Income and Growth Investment Team

Summary

- The indiscriminate sell-offs in March have created opportunities in high yield and convertible bonds, although the picture for equities is more unclear.
- Diversifying exposure across high yield bonds, convertibles and equities has historically achieved fair performance and managed downside risks.
- In uncertain times, a broader toolkit of income-producing securities could help striving potential income and meeting long term objectives.

Active is: Hunting for Income

6 rules on hunting for income

- Multi-Asset Supplement
- High Yielding Variations
- Unconstrained Approach
- Quality Bias
- Short Duration Approach
- Multi-Asset Diversification

Q: Do markets now offer good value after the steep declines in March? Can we expect greater volatility going forward? How would the "Hunt for Income" approach perform in this environment?

A: In March the short-term trajectory of the global economy and corporate profitability became highly uncertain. This uncertainty led to indiscriminate selling pressure across most US asset classes and created dislocations in credit markets. At quarter-end, the high-yield market was priced at 85.8 cents on the dollar and the spread was 877bp (down from nearly 1100bp earlier in the quarter)[1]. According to JP Morgan, a spread of 800bp has historically led to attractive return opportunities, but the case is even more compelling above 900bp[2]. This backdrop may offer an attractive entry point for long-term investors with significant total return potential given the market's discount to par. Corresponding with the sharp decline in the stock market, many convertible bonds have approached their bond floors. Given this, the market downside risk should be much more contained going forward. When the underlying equities recover, we believe convertible bonds are well positioned to participate in the upside. Lastly, US equity valuations on a forward earnings basis have also retreated markedly from elevated levels seen earlier that neared the upper bounds of their historical range. For certain securities, these levels may offer compelling entry points for longer-term investment, yet, investors should still be cautious and prepared for the potential market volatility.

Value. Shared.

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In an uncertain environment such as this, income investors need to broaden their toolkit to ensure a consistent stream of income while also securing enough income to meet their long-term objectives. This is especially critical today given severely depressed and even negative yields globally. Investors would be wise to "re-risk" their portfolios and consider a range of income-generating strategies that have historically held up well during down markets, offering both stock-like potential returns and helping to moderate volatility. The bottom line for investors is that they must not allow short-term market uncertainty to derail their long-term goals.

Q: The Federal Reserve Board (Fed) has gone "all in", deploying a full range of tools such as asset purchases, zero interest rates and lending programs to cope with the public health crisis. Was this enough to re-ignite demand for risk assets? Did the rescue programs effectively shore up the markets? Are we returning to "Don't fight the Fed"?

A: The Fed's actions in response to COVID-19 were extraordinary in terms of swiftness, scope, and willingness to do more. The Fed's policy response began with aggressive interest rate cuts followed by a reduction in reserve requirements to free up liquidity in the banking system. Addressing the overnight funding markets was also a priority. Additionally, a number of facilities were reinstated, one of which allowed primary dealers to take 90-day loans. Further measures included a commitment to purchase $500 billion in US Treasuries and $200 billion in mortgage backed securities before making the program open-ended to support the functioning of credit markets. Just days later the Fed took unprecedented action by establishing two facilities to address the primary and secondary credit markets for investment grade corporates. The impact of these initiatives was immediate with US investment grade corporate new issuance setting a monthly record in March. The Fed then increased the size and scope of both facilities to include high-yield credit on a select basis. In response, the high-yield bond market reported one of its strongest single-day returns in history and high-yield funds reported record inflows.

Q: Undoubtedly the US economy will be hard hit by the coronavirus pandemic. How could the situation be monitored for signs of recovery?

A: The near-term outlook for the global economy and corporate profitability is uncertain and evolving due to the headwinds associated with the COVID-19 outbreak. The situation continues to evolve very rapidly and requires close monitoring, especially in light of the massive confluence of central bank intervention and government stimulus. While the duration and severity of the economic downturn is unknown, the extraordinary monetary and fiscal policy measures instituted by the Fed and the US government aim to not only help stabilise financial markets but also accelerate the recovery.

Q: With unprecedented unemployment and a series of devastating blows to business, dwindling earnings and rising defaults seem inevitable. What would you expect from corporate earnings and default rates in your investment universe? Which sectors might be benefitted?

A: Looking at fourth-quarter financial results, the majority of management outlooks reflected strong fundamentals, healthy balance sheets and ample liquidity exiting 2019.

These data points had less utility as the quarter progressed. The supply-side shock and demand disruption due to travel restrictions, lockdowns and other directives to contain the spread of the virus significantly altered the near-term path for earnings and sales. By the end of the quarter, most companies were highly focused on cash management and liquidity, accessing lines of credit, controlling variable costs, deferring capital investment and suspending dividends and share repurchases.

The COVID-19 pandemic is expected to impact all high-yield issuers and cause defaults to increase. However, the asset class remains well diversified across many industries. Healthcare, energy, telecommunications, cable & satellite TV and technology are among the top industries in the universe. Energy industry issuers are likely to face a higher rate of default, but risk should be concentrated in the most distressed credits within the E&P and oil field equipment & services subindustries.

The Income and Growth Investment Team *(from left to right)*

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Source:
[1] ICE Data Services; ICE BofA US High Yield Index; 31 March 2020.
[2] JP Morgan; North American Credit Research note, 20 March 2020.