Lessons learned: one year on

How has the investment landscape shifted?

April 2021

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- Now that more than a year has passed since markets first felt the impact of COVID-19, what lessons have investors learned, and what potential opportunities – and pitfalls – could the investment environment hold?
- Jim Leaviss, CIO of Public Fixed Income, and Eric Lonergan, Macro Fund Manager, discuss the aftermath of the global pandemic, including the likely strength of the recovery, the effects of fiscal and monetary policy developments, and portfolio positioning

Should we be braced for post-pandemic 'scarring'?

Jim Leaviss: There's no denying that the pace of post-pandemic recovery is now extremely strong, particularly in the UK and the US. The US Institute for Supply Management (ISM) recently found that the US services and manufacturing sectors, for example, recorded record growth in March. There is a strong sense of optimism and job creation is very strong – especially in COVID-19-sensitive sectors, such as hospitality, travel and restaurants. As economies unlock, vaccine programmes progress and lockdown restrictions start easing, people are finding their way back into service sector jobs.

There is some debate as to whether there could be a permanent loss of skills due to unemployment, making long-term unemployment structural in nature and therefore difficult to break, as in the 1980s manufacturing recession, for example. However, the current recession is very much a services sector recession, where the transferability of skills is much higher. So, there is an argument that the degree of scarring this time around will be far less than what we saw in the 1980s, and therefore the unbottling of the economy will be a lot stronger.

How do you see the outlook on Fed rate hikes?

JL: The US Federal Reserve (Fed) is very keen on the idea that flexible average inflation targeting (FAIT) means that it's prepared to allow the economy to run hot over the next few years. However, markets increasingly disbelieve this; they are now anticipating the tapering of quantitative easing (QE) purchases, potentially towards the end of this year, and there are up to four rate hikes priced in by the market by the end of 2023. The headline numbers for almost all the economic statistics on a year-on-year basis for the remainder of 2021 look exceptionally strong, simply because of base effects. This, coupled with the planned second round of stimulus, means that you can argue that something has changed fundamentally since FAIT was announced. Nevertheless, I would say that, for the foreseeable future, the market has perhaps got a bit ahead of itself in terms of the number of rate hikes priced in.

How is the US likely to tackle unemployment?

JL: The counterargument to the idea that there will be no scarring – in the US or elsewhere – is the missing jobs. Despite huge job creation so far, there are still millions of people out of work. The Fed has talked a lot about looking not only at headline unemployment, but also at the U-6 measure, which looks at people not working as many hours as they would like to.

The Fed is also considering how to address disproportionate wealth losses for racial minorities by analysing unemployment rates for different minority groups, rather than just the headline figures, which obscure the extent of inequality within the recovery. I think this will be a key discussion for the Fed over the coming months.

What is your view on credit markets?

JL: Corporate bond spreads are back to the levels we saw at the beginning of 2020, and for many parts of the market we are at all-time record low yields; credit spreads are the lowest they've been since the Global Financial Crisis (GFC). Some of the riskier behaviours we saw in the run up to the GFC are starting to re-emerge in our markets now, so there are perhaps some signs of credit 'bubble-y' behaviour coming back, with valuations no longer looking very attractive. While there doesn't seem to be a great deal of value left in corporate bonds, default rates remain exceptionally low. One development we have seen is that downgrades in US investment grade bonds have outweighed upgrades, and the biggest cohort of downgrades we saw in the first quarter of 2021 included those that dropped from an A to BBB rating, so there haven't been many 'fallen angels' so far. However, the BBB cohort – i.e. the most vulnerable to falling into high yield territory – has increased and is now the biggest cohort of corporate bonds.

How has the global economy changed since the pandemic?

Eric Lonergan: Ultimately, in my opinion, not much has changed in terms of how markets behave and the structural features of the global economy. When it comes to the main key pre-pandemic trends such as trends in neo-nationalism, declining real interest rate structures, financial market fragility in response to monetary policy, the fact that we can't generate any inflation, and the phenomenal responsiveness of the supply side of the global economy – many of these features are still there or have even accelerated.

Not much has changed structurally in China and Europe. If anything, underlying tensions such as neo-nationalism coming out of China, which has been exercising its geopolitical and economic weight, will be strengthened. With regard to Europe, I think the continent has doubled down on the trends that preceded the pandemic. Bear in mind that fiscal rules in Europe have just been suspended for another year or two through the use of economic stimulus. If nothing has changed after that, it is very difficult to see anything other than fiscal austerity, which would mean a huge reliance on monetary policy again.

However, I do think there has been a fundamental shift in the attitude towards fiscal policy. Importantly, from a perspective of considering global asset allocation and the role of bonds within a portfolio, this is predominantly a US phenomenon.

What has driven the US shift from monetary to fiscal policy?

EL: There are three key developments in the US that have triggered this major US policy shift.

One is the fact that Janet Yellen – now US Treasury secretary – used to run the Fed. She is acutely aware that conventional monetary policy is now pretty much futile – it doesn't deliver on the real economy in the timescales that are needed. As a result, it has to be fiscal policy.

The second feature relates to the impact of former US president Donald Trump. Current president Joe Biden's radicalism has to be seen in the context of Trump. He has absolutely terrified mainstream policymaking elites in America, to the extent that policymakers no longer view as risky policies where they would previously have done so. There is now a sense that if you don't make policies sufficiently effective so that they actually change people's lives in a tangible and attributable way, your alternative is Trump. Those factors have dramatically shifted perceptions of the relative risks and role of fiscal policy.

Thirdly – and this also applies globally – it has finally registered among the political class that real interest rate structures have collapsed. Their view is now that there is no fiscal constraint if they can borrow at negative real interest rates for 30 years. So any capital investment with a positive return actually creates value for the state.

Where do you see US Treasury yields going?

JL: I like to look at where we think very long-term interest rates should be for the US. This is obviously irrelevant to short-term issues such as who is in power in the US; whether COVID has been cured over the next five years, and so on, but entirely dependent on questions such as whether globalisation still depresses prices; wages; does technology still do the same thing; do demographic trends still result in long-term demands for safe assets and income. Many different measures show that the long-term expected interest rate for the US has been falling over the past decade.

To make an assessment, I chart the forward rate against the long-term expectations. Over the past five months, the 10-year forward rate for 10-year US Treasuries has gone way beyond even the most hawkish assessment of the FOMC (the Federal Open Market Committee). That tells me that the sell-off has quite likely gone too far, and that it might be time to start scaling back into US Treasury bond yields.

I've always been a bull on inflation, expecting it to go lower and lower – and there have been inflation scares, that have never come to fruition, and as such, I generally expect these things to be transitory because those long-term trends have remained in place. But this year, for the first time, I'm no longer as convinced that I'm going to be right in looking through this – just the sheer size of the stimulus, the unbottling and perhaps some of those technological trends including the 'Uberisation' of our economy are coming to an end. So for the first time, the risks are there that we do get a permanent change in inflation expectations. But I would also bet on the big secular trends carrying on for the foreseeable future.

After support packages start to wind down, when might potential strains on the periphery take hold?

EL: I do worry that Europe is, ironically, vulnerable to recovery. It seems to me that you only get temporary elimination of credit risk in European sovereigns when they're in a state of emergency – as long as they toe the line on fiscal policy – as the ECB underwrites their bond market, but as soon as they come out of that state of emergency they're subject to market forces again.

So I don't know when danger will strike, but I think it is likely for a lot of the more vulnerable parts of the Europe bond market now, where spreads are so tight and yields are extremely low.

As investors try to safeguard against a range of risks, is there is a danger of overdiversification in portfolios?

JL: There aren't any huge standout values in bond markets at the moment. For us, long-dated US Treasuries are the area of the market where there probably is some value, but it might be a very uncomfortable time to be there. Inflation expectations seem to have adjusted, and many markets have moved substantially higher. And we talked earlier about credit markets trading at all-time tights in many cases, or low yields for high yield. Looking around my investible universe, I don't see anything particularly standout in terms of valuation. The one area – though very volatile – is emerging market debt. Obviously there's a lot going on there, in terms of geopolitics, response to coronavirus, globalisation threats and so on that could justify the fact that those yields have not kept track with other risk assets around the world. But, taking the long view, emerging market debt appears to offer the most attractive returns, albeit with considerably more volatility than other areas. Eric, how does it look from your perspective?

EL: The landscape looks like it's going to be lively and a lot could happen in the next one to three years, so flexibility is key. For me, this means having a material amount of cash, alongside a balanced portfolio of diversified global equities and 30-year US Treasuries – a very simple portfolio. I have a relatively high degree of confidence that if something major goes wrong which precipitates a 15-20% decline in the equity market, that in that sort of environment, Treasuries will do very well. I think they are now at a level, particularly at the long end of the yield curve, where they do provide some genuine diversification and insurance against anything, other than real interest rates and inflation in the US.

Similarly, in terms of global equities, when people focus on valuations, it tends to be very US-centric. It's hard to identify where earnings growth will come from. So, for me, a mixture of diversified equities, 30-year Treasuries and cash is a strong portfolio against a world with lots of potential outcomes. It has the flexibility that, if something does happen in a given area, you are able to rebalance your portfolio in order to try to take advantage of it.

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