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Global CIO Outlook
Staying on Offense

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One must acknowledge that the world has fundamentally changed over the past year. The spread of the coronavirus has had profound consequences for humanity and governments around the world, and the global policy response and the transformation of economic policy management will have long-term implications for international trade, national defense, and the proper functioning of free markets.

That does not mean the world is going to stay the way it is right now, but it will never go back to the way it was before the pandemic. The U.S. government has a much heavier hand in controlling the economy, either via the Federal Reserve (Fed) or direct White House and congressional intervention. We spend a great deal of time analyzing the impact of these changes and how they may affect default risk in corporate credit, and asset allocation more broadly, because it is more important than ever to be alert to investment risks and opportunities. It will be easy to be lulled to sleep as markets rise with the distribution of a vaccine and the tailwind of policymakers' response to economic challenges.

Even with these risks, we may be entering what I have called a golden age for credit. Economic growth in 2021 will likely far exceed potential, which should boost corporate earnings. Meanwhile, many companies have been raising cash balances, and default rate expectations are ratcheting down. Credit markets have responded and spreads have tightened significantly in recent months.

Throughout this report our portfolio managers and sector teams discuss how we have been approaching our responsibilities during this period. We first went on offense for our clients during the March 2020 market plunge and took advantage of a multitude of opportunities. By way of illustration, as of Dec. 31, 2019, our Core Plus and Multi-Credit strategies were positioned defensively, allocating just 9 percent and 29 percent to corporate credit investments including investment-grade and high-yield bonds, and bank loans, respectively. By Sept. 30, 2020, those allocations stood at 52 percent and 57 percent, respectively. Even today, we continue to play offense.

The recurring theme in these pages is best stated by our portfolio management team: "Even as credit spreads have narrowed considerably off their widest levels, further value remains as the global search for yield has motivated investors to allocate to investment grade and high-yield corporate bonds."

The Investment Grade team states that "with much good news priced in, we expect credit spreads to trade in a narrow range. Barring a monetary policy misstep or a dramatic increase in interest rate volatility, the near-term path for spreads appears tighter."

The High Yield team points out that spreads have continued to tighten, driving the yield on the ICE BofA High Yield Index to the lowest on record. "In each of the last four cycles," the team writes, "high yield bonds have pierced through the previous cycle's lowest yield, and this cycle is proving to be no different….owing to the vast amount of policy support that continues to buttress financial conditions and, in turn, has decreased default projections."

The Fed's new policy framework, as our Macroeconomic and Investment Research Group writes, is designed to overshoot traditional notions of full employment and the 2 percent inflation target, likely ensuring that the fed funds rate will be kept at zero for several years and anchoring the front end of the curve. Regular asset purchases will also enable the Fed to influence market prices in longer maturities as well.

Market support is coming not just from the Fed, but from global investors hungry for the relatively higher yields—even on a currency-hedged basis—that can be found in the United States. "There is simply too much cash in investor coffers and too few high-yielding alternatives," writes the ABS team. In this environment, our investment focus is on creditworthy investments that can perform through this pandemic as well as future exogenous events.

In "normal" times I would be wary of such a Pollyannaish view of risk assets given how far we have come and the dramatic appreciation since March. Nevertheless, in many ways the world has changed. Washington has become more accustomed to activist monetary and fiscal policies. In the long run there will be severe consequences for profligate finances and endless monetary accommodation, but not yet. Credit spreads and risk assets have been pricier before by numerous measures. Such conditions have been maintained for years whether through continued easy market conditions, yield curve control, or policies designed to stimulate the economy and promote social justice. The larger risk is that the party may just be getting started.

Predicting a peak in long-term rates could prove a fool's errand. History points to lower rates ahead. An attempt to pick a top in rates has been a tricky business, just as it was in 2013 and again in 2018. Markets can revert quickly. As long-term yields have reached the value zone a neutral or overweight position may very well prove to be the low-risk choice.

On another note, our thoughts and prayers continue to be with those who are suffering during this resurgence of the coronavirus with deep gratitude for those fighting and serving on the front lines of this battle—the healthcare professionals, delivery workers, social services providers, and first responders. May they continue to have the strength to carry on. The end of this aberrant period may not be in hand, but it is in sight.

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