HANOVER ADVISORS

Bond Markets and the Economic Recovery

The first quarter was one of the most volatile periods on record. The coronavirus's rapid spread across the world has roiled the global economy in ways that even the Great Financial Crisis of 2008 did not. The pandemic, coupled with the collapse of energy prices caused by the drop in demand and price war between Russia and Saudi Arabia, led to a liquidity crunch in fixed income markets across the world. Investors seeking the safety of the U.S. dollar put pressure on the global bond market, and record outflows from ETFs and mutual funds forced sellers into a market already in free-fall, pushing prices lower.

Luckily, swift action on the part of the Federal Reserve helped stabilize the market and ensure liquidity. The fed, in anticipation of the coronavirus's impact on the economy, preemptively made an emergency cut of 50 basis points to the federal funds rate. This was followed by a massive quantitative easing program that saw the central bank pump more than $1 trillion into the market. Central banks around the globe implemented similar programs and were able to shore up the global bond market, ensuring that liquidity remains and credit can keep flowing.

With the immediate crisis now passed, both investors and policymakers will begin to look at how to navigate the economic fallout from a sustained economic shutdown across the globe. We anticipate that there will be two phases to the recovery. The lifting of lockdowns across the nation will likely lead to a sharp rebound in economic activity by the end of the second quarter or early in the third. From there, the recovery will be more gradual as businesses and consumers adapt to the new normal. However, it may not be until next year that economic activity returns to pre-outbreak levels.

In this moment, it is important that fixed income investors carefully select issuers and sectors in which to invest, and make sure that they are able to weather the current situation.

There is also the chance that a rapid economic recovery could lead to a correction in the bond market as investors sell off the bonds they purchased as a safe harbor because they feel other investments may be secure. In this climate duration and maturity of bond holdings become even more important, since changes in interest rates impact bond prices differently depending on their maturity.

Our position was very defensive heading into the crisis, as we preferred high-quality securities like U.S. Treasuries. These were some of the only assets to perform well during the panic sell-off, and has left us in a position to take advantage of the market restructuring. Now, as the market begins to recover, they are less attractive. Yields will likely remain low and the Treasury will be issuing a record amount of new debt to pay for the government's massive stimulus bill. We are now looking to add credit risk through attractively priced, investment-grade securities from corporations that will be able to meet the challenges ahead. Historically cheap valuations and low yields globally should continue to drive demand for these corporate bonds.

There is likely to be a wave of credit downgrades, so it is important to limit exposure to issues that could lose their investment-grade rating. That said, downgrades may offer investment opportunities in well-resourced companies, as some downgraded securities will offer attractive yields with a lower risk of default. Such an investment would require thorough credit analysis and careful selectivity, not to mention an appetite for risk. For most investors, we recommend staying with corporate bonds that are rated A or higher.

Municipal bonds saw record volatility in the first quarter. While the Fed's actions have helped stabilize the muni market, we are still cautious about munis. The main reason is the lack of liquidity in the market. Significant outflows from muni mutual funds and ETFs have made it difficult to get a reasonable price in a reasonable timeframe. That said, the repricing in the muni market has increased their yields substantially, making them more attractive, especially for investors looking for tax-exempt income. We have concerns that the drop in revenue from sales taxes and income taxes could put a strain on many municipalities, though the rate of defaults will likely remain low as local municipalities will be supported by federal aid and other accommodating fiscal policies.

Investing in fixed income assets outside the U.S. presents a unique challenge, as each region will grapple with the economic fallout differently. In emerging markets, the countries that were most economically vulnerable before the pandemic will struggle the most to recover. Generally, we prefer high-quality securities from issuers that are well positioned to weather the economic downturn, but there are attractive opportunities with riskier securities with higher yields that can be purchased at low value.

As the immediate fallout of the coronavirus begins to be better understood and dealt with, investors will need to reconsider the long-term implications of both the crisis and our attempts to deal with it. The dust will begin to clear, and the path forward will become visible. This will require a reassessment of long term investment strategies, and we are confident that we will be able to identify attractive investment opportunities moving forward.