Purple Rain: What the Election Result Means for Credit

October 2020 Commentary

A Biden victory and new vaccine information coincide to provide a boost to credit spreads. Financial markets have embraced the indicated US presidential election result as a "goldidilocks" scenario ("not too hot, not too cold"). The long-fought contest proved to be a closer race than the polls predicted but at time of writing, Biden has been announced as the presumptive winner, having overtaken Trump in the key battleground states and achieving the 270 required seats. However, this was no "Blue Wave" and Republicans are still on track to maintain a majority in the Senate, which could limit the size of any potential stimulus package and reduce the chances of subsequent tax increases and regulatory change for certain industries longer-term. All of which suggests less volatility in general and is positive for corporate credit. The current expectation is that additional fiscal stimulus is likely either in December or more realistically, in January 2021, and it could be between $1-1.5 trillion in size. Also important in dampening the volatility of markets is the current speculation about President-elect Biden's choice of cabinet members, which is leaning to the conservative side if the latest press reports are to be believed.

Pfizer's update that its COVID vaccine has prevented infection in around 90% of trial participants is a major positive longer-term. While the headline numbers around higher infection rates across the US, Canada and Europe continue to rise, and hospitalization data trends could be concerning in the near term, Pfizer's announcement on Monday that its COVID-19 vaccine trial had seen very positive results in vaccinated individuals of around 90% at seven days after the second dose is another milestone in the path to normalization globally. While in the near term, cases, hospitalizations and deaths could continue to tick upwards, and we expect to see more containment measures implemented in North America and Europe in due course, we continue to believe that full lockdowns are unlikely, especially in the face of the vaccine developments. It is important to recognize that this vaccine will not be available to the public yet (most likely before year end or in early 2021) and not broadly until 2H2021 but shift in sentiment is important and this reduces tail risk around the COVID worsening in recent weeks.

In response to the election result, interest rates moved lower and credit spreads tightened. Interest rates had moved higher (and equities and credit spreads also weakened) leading into the election in anticipation of the blue wave outcome leading to more stimulus and potentially more inflation (the US 10-year yield moved from a localized low of 0.50% in August to 0.90% on the eve of the election). Credit spreads also reacted positively to the election results – suggesting that the credit market was focused on the long-term implications of higher tax rates on corporations, rather than the near-term benefits of stimulus. This makes sense as corporate bonds still have the Federal Reserve backstop supporting the market no matter who is in office. We also saw the removal of hedges put in place by investors in the run-up to November, which again pushed credit spreads tighter. Taken together, the markets have embraced an outcome that's a little messy from a political perspective, but in theory keeps the Democratic white house in check.

The Supply / Demand picture for corporate bonds continues to be supportive. There continues to be a lot of cash sitting with bond managers and investors waiting to be deployed (with money market fund assets increasing pre-election). In the coming weeks we may see an uptick in corporate bond issuance as companies pre-fund 2021 maturities given lower government bond yields and narrower credit spreads. Given pent-up demand, a global lack of yield, manageable issuance volumes and the supportive presence of central banks – our thesis remains that demand may outstrip supply in the final two months of the year when it comes to high quality corporate bonds (investment grade mutual funds and ETFs have seen $205B in year-to-date inflows while high yield has seen $42B in year-to-date inflows). It remains to be seen how institutional investors react to the drop in yields experienced post-election – many large global pension plans were waiting for the increase in yields as a result of the blue wave to put capital to work in fixed income at more attractive levels. While this sustained jump in yields may not come to fruition, we are seeing favourable dynamics for international buyers of U.S. credit which should continue positive demand coming from international participants. We continue to believe that being selective is key and so we're focused on investing in sectors and companies where we have high conviction.

We had added risk into the election in expectation of a longer-term vaccine solution and are positioning our portfolios to benefit from the best risk-adjusted opportunities we see in the marketplace. Our focus has not changed – we continue to carefully weigh risks given the still uncertain economic backdrop, including risks that remain such as the vaccine trials and Brexit. This year we have seen significant volatility in corporate bond markets, but this volatility has presented opportunity. The investment team remains focused on positioning the portfolios in such a way that we can deliver value for our investors. As we enter the final two months of the year, we remain constructive on credit and excited by the opportunity set.

Important Information

Data as at October 31, 2020. Source: Bloomberg.

The information presented herein is for informational purposes only. It does not provide financial, legal, accounting, tax, investment or other advice, and should not be acted or relied upon in that regard without seeking the appropriate professional advice. The information is drawn from sources believed to be reliable, but the accuracy or completeness of the information is not guaranteed, nor in providing it does RP Investment Advisors LP ("RPIA") assume any responsibility or liability whatsoever. The information provided may be subject to change and RPIA does not undertake any obligation to communicate revisions or updates to the information presented. Unless otherwise stated, the source for all information is RPIA. This document does not form the basis of any offer or solicitation for the purchase or sale of securities. Products and services of RPIA are only available in jurisdictions where they may be lawfully offered and to investors who qualify under applicable regulation. "Forward-Looking" statements are based on assumptions made by RPIA regarding its opinion and investment strategies in certain market conditions and are subject to a number of mitigating factors. Economic and market conditions may change, which may materially impact actual future events and as a result RPIA's views, the success of RPIA's intended strategies as well as its actual course of conduct.

RPIA investment strategies may be available to eligible Canadian investors by way of private pooled investment funds, publicly offered mutual funds and/or separately managed accounts. The available investment vehicle for a particular strategy may differ based on the nature of the investor, minimum investment requirements, offering documents or management agreements and applicable regulatory considerations.