Restart and Reset

Q4 2020 Market Commentary

Corporate bond markets performed well in Q4 2020 – capping an extraordinary year. Back in March it was hard to imagine that financial markets would end 2020 at or close to all-time highs - yet that is exactly what happened. For financial assets, the COVID-crisis will go down as the fastest crisis and recovery we have ever seen. Despite facing severe drawdowns, credit markets rebounded strongly to end the year in positive territory. Central bank policy played a critical role in this reversal – as did a collapse in government bond yields across the globe. Lower Treasury yields led directly to price appreciation in fixed income securities, and indirectly helped corporate bonds as investors rotated out of government bonds into credit to capture additional yield.

As we enter 2021 the public health backdrop is reminiscent of March last year. COVID cases, hospitalizations and deaths continue to rise and many economies are falling back on draconian lockdown measures. This is certain to act as a drag on Q1 2021 economic activity. However, his time there is "light at the end of the tunnel" in the form of vaccines being deployed globally, albeit at different rates. With respect to the pandemic, the risks at this juncture are (1) Execution risk around vaccine deployment, and (2) Mutation of the virus in such a way that vaccine effectiveness is impacted. We continue to follow the public health developments carefully and will actively adjust our risk exposures in response to developments.

From a political perspective, the Democratic victories in the Georgia Senate race last week were a "game changer". Following Biden's win in November, most commentators expected the Republican party to retain control of the Senate. This was interpreted as a "goldilocks" scenario ("not too hot, not too cold") whereby Congress would act as a check on the incoming President's policy agenda. With the Democrats now controlling both the White House and Congress, President Biden now has more latitude to enact his legislative program. Near-term this means more stimulus measures to boost the economy as the country continues to struggle with the impact of COVID-19. Indeed, financial markets have reacted favorably to the Senate results for exactly this reason. Our credit research team will continue to analyze what the new political reality means for industries and corporations.

Unlike March of last year, corporate issuers are better positioned for this new round of lockdowns and its impact on revenues. During 2020 U.S. investment grade corporations raised a record-setting $1.8 trillion. This capital was used to refinance existing bonds at new, lower interest rates and increase the amount of cash held on balance sheets. This activity peaked in Q2 2020 when U.S. investment grade corporations held over $1 trillion in cash, pushing cash-to-asset ratios to the highest levels we have seen in recent memory. This was not limited to companies struggling during the pandemic. Even companies which maintained strong positive free cash flow took the prudent steps to raise cash while markets were open and receptive. The result is that many corporate issuers now have the wherewithal to manage through further lockdowns and resulting revenue declines.

As vaccine deployment progresses and as economies re-open in 2021 it will be important to see what corporations do with all this excess cash. Prudent corporations will use these balances to redeem debt and take leverage levels back down to more normalized levels. Inevitably, there will be companies that use some or all of the debt proceeds to fund shareholder-friendly activities, such as stock buybacks and dividend increases. We will focus on identifying and investing in issuers looking to de-leverage against an improving economic backdrop and avoiding those acting less responsibly.

Investors need to address valuation headwinds with new approaches to fixed income. At the end of Q4, the average credit spread for the U.S. Investment Grade bond market is within 7 bps of the tightest levels seen pre-COVID. The risk around rising rates is also hitting all-time highs with the interest rate sensitivity / duration of the U.S. investment grade index sitting at almost 9 years. This pushes risk-adjusted spreads (spread per unit of duration) down to levels we have not seen since 2005/2006. Together these factors suggest that a passive approach to corporate bonds will likely fail to deliver the return investors have come to expect in recent years. Now, more than ever, it's imperative that bond managers are highly selective in their approach to risk taking and take advantage of tools to add additional return in this environment.

We are increasingly focused on mobility-sensitive investments that are poised to benefit as economies re-open later in 2021. While broad market valuations leave little to be desired, they do not reflect underlying levels of dispersion seen across industries and markets. Digging into these bifurcations is where we believe we will add value this year. Coming into 2021, we view sectors and issuers in three main categories. Firstly, those the fundamentally stressed / distressed areas of the market with low chance of repair. Our goal is to avoid investments of this type, recognizing the seismic shifts that have been accelerated by the pandemic. Secondly, there are high quality, mature corporations which have already performed well through (or owing to) the crisis. We continue to invest in businesses of this type but today this requires a more active approach as valuations in many cases are "priced to perfection". Finally, there are sectors and corporations with depressed valuations but that are well-positioned for an economic rebound. We are increasingly focusing our efforts in this area, looking for issuers and sub-sectors where valuations are attractive and where there is upside return potential once the economic backdrop improves following roll-out of the vaccines.

Important Information

Unless indicated otherwise, commentary, returns and portfolio data is presented as at December 31st, 2020. Index source: Bloomberg.

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