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Bond Market Movements and Potential Warning Signs

*Featuring: **Andy Sparks**, Managing Director, MSCI Research*

Adam Bass:

This is MSEI perspectives, your source for weekly research insights as investors respond to the COVID-19 pandemic. I'm your host Adam Bass and today is August 6th, 2020. This week from the effects of corporate bond supply to the impact of moves by the fed and other central banks, head of portfolio management research, Andy Sparks and team have thoroughly researched how the pandemic has hit fixed income investors. But as listeners of this program heard back in April, Andy is also a student of the markets, and it's always instructive to hear his analysis of current events, but also how he puts it all in perspective.

Andy, it's a pleasure to have you back on the show.

Andy Sparks:

Glad to be back, Adam.

Adam Bass:

As we speak, it's less than a week after the release of economic numbers that were bleak to put it mildly. US GDP fell nine and a half percent in the second quarter, Germany more than 10%, and while unemployment in the US did decline last month, it has not looked good for months. All of this, as the pandemic continues to rage in many parts of the world and the fed and other central banks, well, they're doing what they can through monetary policy and encouraging governments to continue pitching in in terms of fiscal policy. That seems like a good place to start today. Here in the US we heard from the fed last week. So briefly, what did they say and what type of impact have we seen?

Andy Sparks:

So I think the main takeaways from the fed meeting last week are number one, there's a little bit of a cautionary tone to the press conference that Chairman Powell held. It looks like the pace of the recovery has slowed. Q2 GDP was very bad, but he did note that employment growth during May and June had been quite strong, but he also pointed out that towards the mid to end of June, that it appeared that various barometers of the economy were slowing and the recovery may not have been as strong as some market participants would have liked.

He definitely underscored very much that the path of the economy to a very large extent will depend on the course of the virus. And there are limits to what governmental actions can take. And I'd say the third main take away from the press conference is that the fed is going to provide extremely accommodative monetary policy for an extended period of time.

Adam Bass:

On that note, not just in the US but there was an article in the Wall Street Journal earlier this week speaking about how back during the worst of the crisis in March and April, the fed was making loans outside the US even to other central banks. Does that change any of the analysis?

Andy Sparks:

So you may be referring specifically to the US dollar liquidity swap lines. Going back to the March timeframe, markets just seized up, and it was not just the credit markets. It was also the market in US treasuries. What many market participants would think is the deepest, broadest market in the world. Foreign institutions needed dollars. And one way they could get those dollars would be to sell US assets. Another way would be effectively for the fed to lend them dollars. And that's the course that the fed shows and as the dominant global currency across the world, actions like that by the fed actually help, I think, support the US dollar.

I think ultimately those swap lines went up close to a half a trillion at the peak, and that showed that they were definitely heavily utilized. And I think probably did contribute to some of the calming of the crisis that we saw in late March.

Adam Bass:

And speaking of that calming, when we last spoke to you, one really interesting point you made was how an announcement alone, no action from the fed was having an impact. Now that these actions have been taken and things are in motion and the fed is pretty much pulling out all the stops, what kind of reactions have you seen from issuers of bonds as well as the markets?

Andy Sparks:

What's quite interesting is that, although the fed has the firepower to buy approximately right now 350 billion of corporate bonds, they've only bought a fraction of that. I think it's approximately of the order of 12 or 13 billion now. And so this is a case of where sometimes words can be as strong as actions. And so just the mere fact that the fed said, "We are prepared to buy corporate bonds to create more stable conditions in the market and to try to allow companies that are viable firms to avoid bankruptcy," it's the mere fact that they said they would intervene if needed.

That was largely what was required. So they still have all of this firepower that they can use in terms of explicit purchases, but they've chosen not to deploy most of that ammunition because market conditions have stabilized very significantly.

Adam Bass:

Have more companies come to market as a result? It sounds like the answer is yes. What are the effects that we're seeing from that end?

Andy Sparks:

Yeah, it's the supply has been also very breathtaking. And so there was a massive, massive issuance of corporate bonds and yields began falling. It was not just spreads tightening, but just absolute level of yields fell close to 2%. There was a massive wave of issuance, and this was not just companies refinancing existing debt. It was net new issue. And so actual supply increased significantly. And so, for example, in the US investment grade corporate bond market, over the course of about three or four months, net supply increased by 10%. That's huge.

We did a little study. We looked at all the bonds that were issued during the crisis period up until a few weeks ago. And we looked at how those companies borrowing and the debt markets had fared in the equity market. And so one view is that, well, the firms that had done really well in the equity market, particularly technology firms, they might disproportionately be borrowing now because spreads have really tightened a lot on those.

What we found is that the majority of this net new supply into the corporate bond market was coming from institutions that had not done very well in the stock market that had been underperforming the stock market. And so the concern to investors is that our company's becoming more overburdened at exactly the time when the economy has weakened.

Adam Bass:

What's the warning that credit investors should heed? What do we draw from this?

Andy Sparks:

Well, I think a key thing for investors going forward is just to be paying very close attention to the strength of the economy and also what parts of the economy are doing well, ultimately paying close attention to trends, not just at the economy level, but within various sectors is very important.

Adam Bass:

So looking outside of the US, the European commission recently started issuing debt on a vastly larger scale than they have before. Clearly there's a political aspect to this, but from your perspective, why now?

Andy Sparks:

Yeah, the unique thing here is that the issuer's going to be the European Commission. It's not going to be individual countries. And so it's going to be common debt and the European Commission has issued such debt before, but the magnitude of what we're talking about is dramatically greater. And so they're going to issue up to 750 billion of Euro.

The drafters of this legislation have gone out of their way to say that this is a temporary and limited measure, but some of the debt may be outstanding for 38 years. The main focus here is just the precedent that is being set. This action does serve a reminder that the Euro area is able to act in unison, even in the midst of a crisis. And I think it has sent some calming signals throughout the Eurozone.

Adam Bass:

And it is interesting again, like when we were talking about the fed, it's the announcement, it's the power of words by the central bank to have pretty large effect on the real economy.

Andy Sparks:

Definitely. The words can be as strong as the actions and you're absolutely right, Adam.

Adam Bass:

Any final thoughts?

Andy Sparks:

Well, this is the first major crisis since the 2008 global financial crisis. I think we have seen that some of the regulatory infrastructure set up in the aftermath of the financial crisis has actually come out pretty well here. Ultimately, this is one more crisis we're going to learn from.

Hopefully we're towards the end of it, but we may not be. I think this is a good time for investors to be a little humble and to recognize that it may be appropriate to look at portfolio stressed under not just one scenario, but maybe under several.

Adam Bass:

That's all for this week. Thanks to Andy and to all of you for joining us. We hope you'll join us next week when our guest will be George [Benet 00:10:12] telling us about his team's use of artificial intelligence in the hunt for COVID related factors. Remember it takes just a moment to subscribe to the podcast, leave a comment or share with a friend and for more from MSEI, check out the ESG Now podcast each Friday. Until next week. I'm your host, Adam Bass and this is MSEI Perspectives. Stay safe, everyone.

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