Fixed Income 2021: Climate, Credit & Inflation

Jenna:

Andy, we sat down with you a year ago to discuss the future of fixed income and it was probably one of the last in-person interviews before the lockdown. A lot has obviously changed since then in all aspects of our lives and today we'd like to talk about the cumulative effects of the pandemic on the fixed income market and the emerging trends for 2021. Joining Andy for a discussion today is his MSCI research colleague, Oliver Marchand. Andy, what have been the biggest changes in the fixed income markets since the onset of the pandemic? Have vulnerabilities been exposed?

Andy:

The market response at the onset of the pandemic was definitely very swift. There were huge changes in government bond yields. (unclear) very, very significant widenings in credit spreads, and I think one of the important vulnerabilities that was highlighted was liquidity.

And so, even in what is oftentimes considered to be the most liquid capital market in the world, that is the US treasury market, we saw with the (unclear) treasury, some (unclear) spreads widening very significantly within the market. We saw different treasuries that seemingly had similar characteristics but they were trading at significant price differences.

And so, that vulnerability, I think, surprised a lot of market participants, and in response, the reaction from the federal reserve was very, very significant, unprecedented. And so, in late March, they announced a new round of asset purchases, and so they bought a huge amount of US treasuries back in March, April, May, and that's continued. It's gone down some, but it's still at a very high level. So, I think the FET's willingness to intervene quickly as it saw markets being disrupted was a very important takeaway, and it was not just the FET. The US treasury in coordination with the FET announced programs to support the corporate bond market. In Europe, the ECB has had a program to purchase corporate bonds for five years but in the US it had never been attempted, but in response to the instability, we saw, last March, April, this program to purchase corporate bonds was announced. And in response to these combined efforts of the FET as well as the treasury, it sent a very calming message to the capital markets, and we saw interest rates-- We saw government yields come down very significantly. We saw credit spreads tighten very, very significantly. And so, I think, a couple of the main takeaways from the pandemic have been, one, market liquidity is a real issue and, number two, policy makers, central banks are very willing to intervene. So we learned a lot about, call it, the FET's reaction function as well as the ability of the FET to work closely with the US government to calm markets. I think another important takeaway has to do with regulation, and particularly for ESG and climate, I think that the pandemic, in combination with perhaps the US elections in November, has really given new vigor to accelerating the pace of integrating ESG investing as well as climate investing into the investment process. So, if I look at some of what I felt are the really big changes in the fixed income market since the onset of the pandemic, those that I just mentioned, I think, are the major ones.

Jenna:

Definitely, I'm so glad that you bring up climate because I want to get your take on that, Oliver. Climate is the story for 2021. What's driving the change toward a more climate-aware portfolio and why is now the time to act?

Oliver:

Well, I think 2021 will be a significant year for climate. One of the main reasons being that we have a COP26 climate conference coming up in Glasgow. So, it's important to know that the climate conference in Glasgow was supposed to happen in 2020, but because of the pandemic, it didn't. So it was postponed, and it's exactly five years after 2015 at the Paris Agreement, and the whole process has a five-year review period where, after five years, all countries review their commitments to climate change. So, it's going to be the first time after the Paris Agreement where each of the countries, all of the countries are asked to, actually, increase their ambition. And that's so interesting. And in combination with the US rejoining the Paris Agreement and the Biden administration announcing something that is very similar, at least in terms of emission reductions, like the (unclear), we're expecting huge tectonic shifts in emission reduction commitments by countries. And then, as every year, we now see in Australia again devastating extreme weather events, that is just a given almost every year that records are being broken. And so, that's always a new cycle and just a push in the minds of people to remind everybody of what the dangers of climate risks are. And a little bit under the hood but very visible for investors, we have, as Andy has mentioned, emerging climate regulation coming up. We had France spearheading that with their Article 173, but now we have the EU, Canada, the UK coming up with each of their own versions of these disclosure requirements related to climate and, obviously, investors can't disclose on climate risks and impact overnight. So that's why, basically, every large investor on this planet is planning on disclosing climate-related information.

Jenna:

Yeah, to quickly follow up on that: given some of these developments that you highlighted, what are companies doing in response to this renewed focus on climate?

Oliver:

Well, I think the biggest movement in this space is the TCFD, the Task Force on Climate-related Financial Disclosures. It's basically a booklet by the G20 countries, what corporates and financial institutions should disclose on climate. And basically there is a race now towards who is writing the best and the most informative and the most ambitious TCFD report. But we also see that new products are being developed. You can't really be an asset manager today without a range of climate portfolios, and more importantly, even beyond the financial sector, the race for targets, climate targets, meaning by when will companies be net 0, has really started. And there are enough targets now to do sector benchmarking and to really see, is a company prepared for climate change or is it not?

Jenna:

Finally, looking ahead, what should fixed income investors expect for the remainder of 2021? How can they prepare?

Andy:

The steep and largely negative real US yield curve is one of the most striking developments in the government bond market since the onset of the pandemic. And so, market expectations of rising inflation combined with the FET's policy of keeping interest rates low has created a situation where investors, particularly at the short end of the curve, are looking at potential negative after-inflation real returns of -2.5%. That would be the worst after-inflation returns of the past 2 decades, so I think a very important question for fixed income investors is: what should be the role of fixed income in this sort of environment with largely negative real yields in the government bond markets of most-developed countries. And I think one response to that is that fixed income should partly be viewed as a form of insurance against equity market volatility (unclear) equities. And number two, within the fixed income market, I think there's plenty of room to consider relative value trades. And so, one trade could be a yield curve trade of, by the longer end of the curve, the short end of the curve, because the curve is so steep. Another possibility could be looking at emerging markets. So, for instance, the Chinese government bond market is gaining more and more sponsorship from international investors. It's been added to several of the flagship market, fixed income market indexes. So, if you look at Chinese government bond yields, they are at 3.5%, compared to US government bond yields, at least in the tenure sector of close to 1.6%. So, I think global investors are increasingly thinking in this low, low real yield environment in developed-market countries. I think they'll be taking another look at emerging markets, and then last but certainly not least, I think integrating in a much more forceful way, ESG as well as climate, into the investment process and looking at relative value plays of bond instruments that maybe have some additional protection against potential climate change or new climate policy, I think you're going to see fixed income investors increasingly focused on relative value trades as I have just mentioned.

Oliver:

Yeah, I'd like to confirm what Andy is saying. Especially climate risk assessments were traditionally limited to equity but it's now spreading across all of the sub-asset classes in the fixed income space, and that includes analysis like the change in (unclear "default risks") due to climate change, changes in ratings. And all of these tools are now available to fixed income investors and the industry is moving also into the private asset space. So that's very new for these investors that these data points and tools are available. So, I think they'll be dragged into this climate risk assessment world and we'll have to really ramp up their technical capabilities to join these TCFD efforts with their asset class.

Jenna:

Well, Andy, Oliver, thank you both so much for joining us today and great to have you.

Andy:

Thank you, Jenna.

Oliver:

Thank you, Jenna.

Jenna:

Interesting discussion there on how the pandemic has shaped the fixed income market and the emerging focus on climate initiatives as well as inflation fears as investors prepare for the rest of 2021.

TRANSCRIPT

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