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A Very Bond-Friendly Crisis

Coronavirus has sent the global economy into recession and had a big impact on markets. The magnitude of the shock and the scale of policy responses may be taking us into a new investment regime. Markets remain volatile, but the sell-off has potentially also created attractive long-term investment opportunities.

Today, asset allocators are starting to ask which asset class might perform best during the next stage of the cycle, as the global economy starts to recover from the consequences of COVID-19. As we look at the return prospects for key liquid asset classes coming out of the crisis, we believe that credit, specifically actively managed investment grade and high yield corporate bonds, presents a more attractive investment opportunity in comparison to equities.

Our conviction in favor of credit is based on current valuations, historical performance patterns in similar stages of past cycles, varying government and central bank involvement across segments of the market, and some specific characteristics of today's environment.

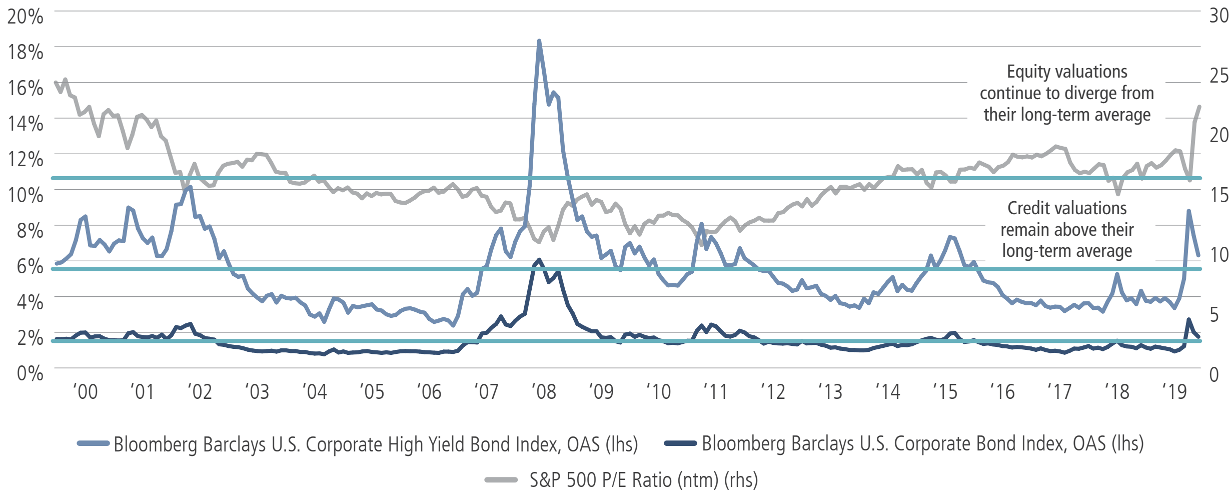
Bond-Friendly Conditions

Given the massive damage that COVID-19 has caused to the global economy, the strength and rapidity of the equity market recovery has been remarkable. From the lows of March 23 to the end of May, the S&P 500 Index has rallied by over 36%, making this one of the strongest equity market rallies on record and taking the index back above 3,000—a level it decisively breached for the first time as recently as October last year.

The combination of rising stock prices and falling company earnings has pushed the 12-month forward price-to-earnings (P/E) ratio to the highest level in almost 20 years. While credit markets have also benefitted from this recovery in sentiment, their valuations haven't been pushed to the same extreme levels (figure 2). For instance, at the end of May, the Bloomberg Barclays U.S. Corporate High Yield Bond Index was trading at a spread of around 630 basis points over government bonds, which is 80 basis points above the average of the past 20 years. The investment grade Bloomberg Barclays U.S. Corporate Bond Index was trading at 175 basis points over Treasuries, versus its historical average of 158 basis points.

FIGURE 1. WHILE CREDIT LOOKS FAIR OR CHEAP, EQUITIES LOOK EXPENSIVE RELATIVE TO LONG-TERM AVERAGES

U.S. credit option-adjusted spreads and U.S. equity 12-month forward price-to-earnings ratio

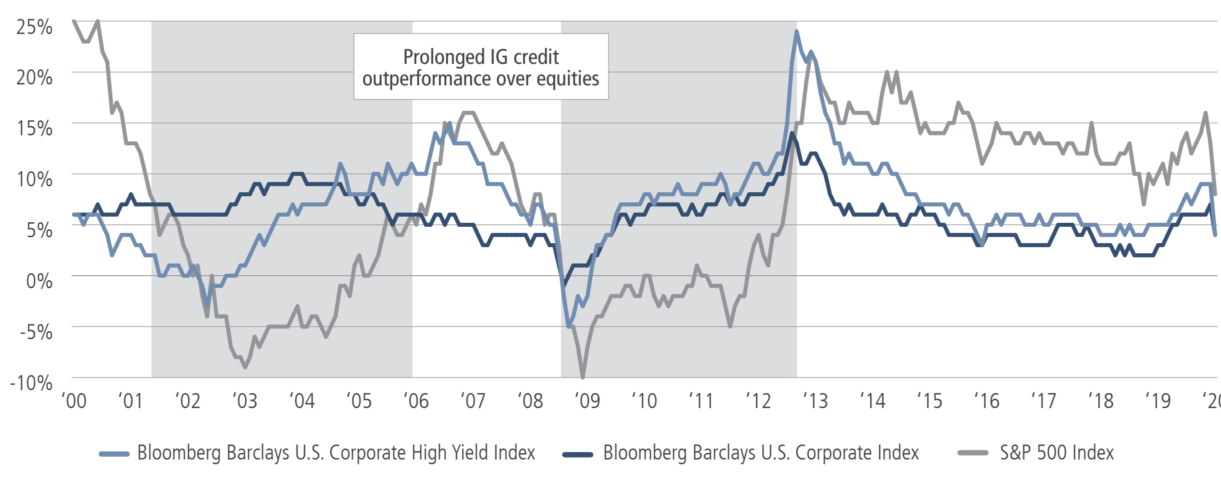


Source: Bloomberg, FactSet. Data as of May 29, 2020.

Comparing historical performance of equity and credit markets over the long term, we find that credit investors earned one or two percentage points less return per year, on average, than equity investors. Those returns have come with less than half the volatility of equities, however, and the average obscures large variations in the relative returns to credit and equities during different stages of the credit cycle. We can see that variation clearly when we plot four-year rolling returns through the post-dotcom and post-financial crisis cycles of the past 20 years, up to the current COVID-19 crisis (figure 2).

FIGURE 2. CREDIT HAS OUTPERFORMED DURING RECESSIONS AND THE EARLY STAGES OF RECOVERY

Four-year rolling returns



Source: Bloomberg.

The chart shows that both investment grade and high yield credit outperformed equities as the economy went through recessions and began its recoveries. Around the bursting of the dot-com bubble, credit outperformed equities in the four years up to late 2001 and was still ahead over the four years up to early 2006. The same pattern recurred after the global financial crisis, resulting in credit's outperformance during the four years up to late 2009, persisting into the four-year period ending in late summer of 2012. In other words, during these periods credit was able to sustain outperformance over equities for more than four years. At its extremes, this outperformance reached well into double digits.

These findings are intuitive. While equity markets rapidly begin to discount lower earnings and some companies cut or suspend dividend payments and share buybacks as recession bites, bondholders continue to receive coupon payments from the vast majority of companies that avoid default. Companies generally cut capital investment and de-lever during recessions, too, which curtails their capacity to grow earnings, but makes balance sheets less risky and leaves more cash on hand to pay bondholders. These bond-friendly conditions tend to persist for a number of years into the new cycle, until company management is confident enough to look again to the interests of shareholders with new investments, new borrowing, and increases to dividends and share buybacks.

More Conservative for a Longer Time

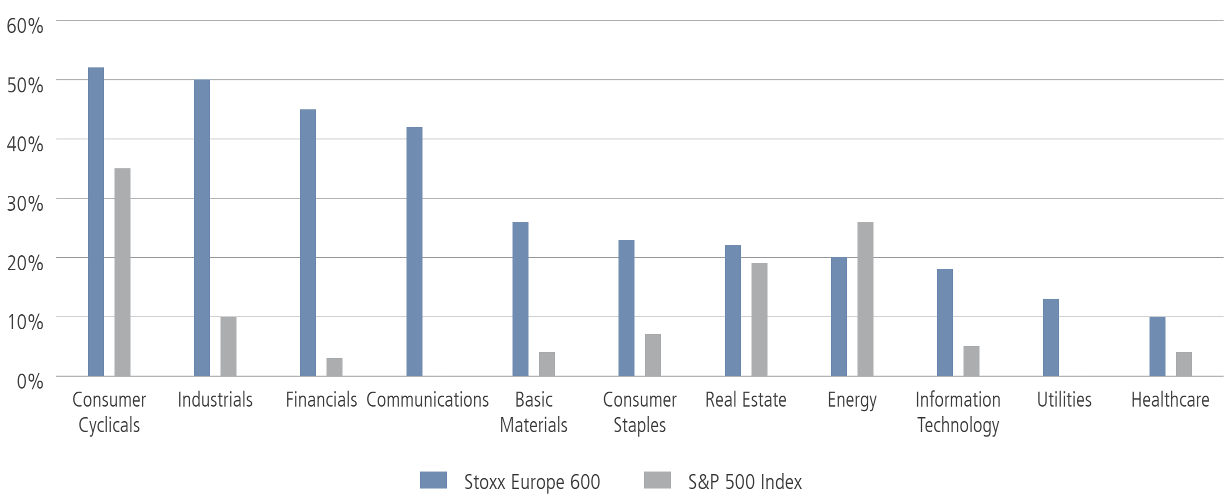
Given the current stage of the global economy and valuations in financial markets, we think that the coming years are likely to see credit outperforming equity, as it has during previous recessions and recoveries. Moreover, we think this period of outperformance could be particularly prolonged due to some specific characteristics of the current crisis.

As in any recession, margin compression and uncertainty will lead to lower earnings and reduced dividends. The uncertainty created by COVID-19 is unprecedented in both its magnitude and scope, however, at least in peacetime. A vast range of companies and some entire sectors have seen revenues virtually disappear for two to three months, and they simply can't be sure about continued demand for their products and services.

That is likely to force them to be more conservative for a longer time. Cash flows are likely to be used primarily to service or pay off outstanding debt and build liquidity buffers, in a deleveraging cycle that we think likely to exceed anything we saw in the aftermath of the financial crisis of 2008 – 09. At the end of April, Dutch oil giant Shell announced a substantial cut to its dividend for the first time in 75 years: what seemed unthinkable just recently now appears a sign of things to come for many companies, whose shares have been a robust source of dividend income to investors. That trend for cutting and postponing dividends has been particularly strong in Europe, where 35% of U.K. and Continental European large-cap companies have already announced these measures (figure 3). Of these 207 companies, 61 firms have cut their common equity dividend to zero.

FIGURE 3. EQUITY DIVIDENDS ARE BEING CUT

Percentage of listed companies in each sector that have cut, postponed or suspended dividends since March 2020



Source: Bank of America Merrill Lynch, Neuberger Berman. Data as of May 29, 2020.

The fiscal and monetary response to COVID-19 has also been unprecedented in its scale, breadth and speed. That, too, has implications for asset class outlooks. At the most basic level, central banks will likely stay committed to zero (or even negative) interest rates, while powerful disinflationary forces could prevail to keep sovereign bond yields at rock-bottom for the foreseeable future: this would help sustain fixed income markets as the worst of the crisis abates and we pass the peak in defaults. In addition, while central banks around the world are buying corporate bonds directly or taking lower-rated bonds as collateral, the wide-ranging bailouts that the corporate sector is getting from governments is likely to make it very difficult—and in some cases perhaps even forbidden—to distribute cash to shareholders for some time.

Disciplined Fundamental Research

In summary, we believe that investors looking to re-deploy risk in the current market should consider investment grade and high yield credit as the asset class of choice.

Pointing to the best performing market segment within broad credit market is a more nuanced exercise. We think credit is well-positioned for any reasonable post-COVID scenario. In general, we believe that higher quality, investment grade corporate bonds would fare better in an "L-shaped," bear-case scenario, in which serious subsequent waves of SARS-COV-2 infections arise before we develop therapeutics or a vaccine. A "U-shaped" or "V-shaped" scenario in which the disease is successfully suppressed and a more rapid economic recovery is possible is more likely to favor high yield bonds.

Given the speed with which markets are digesting news and data about the course of the COVID-19 outbreak, it may be advantageous to adopt the nimbleness that comes with an allocation via a multi-sector strategy that can range freely between the investment grade and high yield markets. These types of solution typically allow an asset manager to implement tactical allocation decisions and be flexible in moving between sectors over the cycle. Whatever part of the credit market an investor tilts to, however, we would strongly advocate for active implementation: bottom-up issuer selection, while always a key skill in credit investing, becomes absolutely paramount at this stage of the cycle, when the number of defaults and downgrades is expected to increase.

Disciplined fundamental research can help capture opportunities and enhance the return potential created by what we regard as an unusually favorable macro environment for credit.

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