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Multi-Sector Fixed Income Team

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Market Context

On March 3rd, the Federal Reserve delivered an intermeeting rate cut of 50 bps as concerns surrounding the Coronavirus outbreak continued to mount. Financial conditions began to rapidly tighten in the week leading up to the announcement, with risky assets coming under pressure across the board. Investor panic escalated as reports of COVID-19 infections spread from China to South Korea, Japan and Iran, and intensified on news that the virus had infiltrated Italy.

Market participants responded, in our view, by pricing in an increased probability of a global pandemic and an aggressive Fed response of over 100 bps of cuts over the ensuing 12 months. Policymakers were aware of the aforementioned expectations and knew that disappointing the market could potentially exacerbate the tightening of financial conditions. Consequently, Fed policymakers likely wanted to ensure that they proactively delivered emergency insurance cuts to front-run a material tightening in financial conditions that is likely to accompany the increased reporting of infections as more comprehensive testing takes place.

Similar to last year's insurance cuts against the trade war, additional Fed easing is not only on the table but likely in the coming months. Outside the U.S., the Bank of Canada, Australia's RBA and the Bank of England have all joined the Fed in easing policy in recent weeks. In addition, discussions on potential fiscal stimulus are also advancing in the U.S. and within the G7 more broadly.

The COVID-19 outbreak has had a significant impact on global oil markets, with daily demand declining as much as ~5 MMBbl/d and poised to fall further if the impact on demand accelerates in non-Chinese markets. Markets were expecting OPEC+ to agree to further production cuts during their March meeting, in an effort to offset the temporary fall in demand. Instead, Russia pushed back and was ultimately unwilling to agree to incremental production cuts. In response to the impasse, Saudi Arabia offered significant discounts on exports to the US and Europe over the weekend and effectively launched a price war, further fueling market volatility and demand for safe haven assets.

The recent rally in Treasuries has admittedly been surprising in its speed and magnitude. In terms of the Fed Policy rate, we do not see the Fed following the lead of other central banks (ECB, BOJ, etc.) and adopting negative rates. For one, doing so would place tremendous pressure on money market funds, which are essential players in the plumbing of the U.S. financial system, and the Fed would be reluctant to introduce a potential source of instability into the financial system. Additionally, we believe the Fed still has ample tools in its policy kit; with rates between 1 - 1.25%, more room exists to add stimulus through easing and the Fed's balance sheet -- while on the rise as of late -- remains below peak levels. Last but not least, the Fed has acknowledged and discussed the risks to negative rate policy in working papers.

With respect to longer term rates going negative, we believe this is a higher probability outcome than the policy rate, but it is also not our best case. In economic shocks, particularly as of late, market participants have shown less price sensitivity when buying U.S. Treasuries. Investors demand Treasuries as they provide an effective hedge to their risky asset portfolio (bond prices and stock prices are negatively correlated). Foreign investors subjected to negative rate regimes (particularly Japanese investors) have also exhibited strong demand for U.S. Treasuries as of late, pulling yields lower. The monetary policy response has certainly played a role in leading rates lower, but we anticipate that there will be a fiscal response to help support economic activity and inflation, which should help fend off sustained negative rates in the U.S.

Investment Implications

Coming into 2020, our thesis of a modest slowdown in U.S. growth, stabilization in international developed market growth (led by a global recovery in manufacturing and an attendant rebound in trade), and bouts of elevated volatility ahead of the known unknown – the U.S. election – appeared sound. However, an unknown unknown, COVID-19, has disrupted the chain of events.

We expect a slowdown in the U.S. and global growth in the first quarter and potentially throughout the second quarter. We think this slowdown could take U.S. GDP levels to negative rates for a short period of time, as both consumption and capital spending weaken. We are viewing the impact of the virus as a growth shock, analogous to other growth shocks over the past 20 years (e.g. 9/11 attacks, European crises in 2011 and 2013, and the energy issues of 2015/2016). We do not see a material permanent impact to the global growth trajectory, and while we expect markets to remain volatile, monetary and fiscal easing will stabilize the impacts of this growth shock, in our view. We would also note that one outcome of this crisis will likely be a return to approximately 0% policy rates in the U.S. and lower overall government bond yields, which will only heighten investors' need for income, particularly in high quality securities.

A key thesis of ours going in to 2020 was that volatility would be elevated and prolonged; this is playing out now and is likely to continue for the foreseeable future. In terms of how we are navigating this period of market turbulence, in multi-sector portfolios we had added duration in acknowledgement of the increased risks to the downside in the short term as well as a more dovish bias from the Fed. We believe the recent widening in spreads have made valuations in select pockets of credit more attractive. That said, we don't view this as the time to fully re-risk portfolios, and we are focused on managing through volatile markets and maintaining adequate liquidity for when that time arrives.