November 27, 2020

The case for credit remains strong

A lot has changed, but readers familiar with our previous annual outlook might experience a strange sense of déjà vu.

_ In our opinion, corporate bonds and other credit asset classes look set to offer an exceptional risk-reward profile as we head into 2021.

_ Rates on government bonds are likely to remain low for even longer than we thought a year ago as central banks try to contain the damage of the Covid crisis.

_ We expect little movement in currencies and think that it is still too early to count out the dollar just yet.

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What a year it has been! Economies have coped surprisingly well with what will hopefully prove a once-in-a-century pandemic. In recent weeks, Covid-19 infection rates in the United States and Europe have increased once again, leading to partial lockdowns. As cynical as it sounds, this seems to be good news for asset prices as it forces central banks to continue with their bond-purchase programs for a very long time. Further support is provided by three factors: (1) Encouraging (but preliminary) data from late-stage vaccine trials. (2) The likely outcome of the U.S. election with chances of the incoming Biden administration enacting major changes to the corporate tax code having receded. (3) The pandemic recovery fund established by the European Union (EU) is finally paving the way towards more fiscal integration.

So, what to make of all this? Broadly, and to paraphrase the Italian novelist Giuseppe Tomasi di Lampedusa, a lot has had to change, only so that everything could stay the same, at least in terms of the implications for fixed-income asset classes. Readers familiar with our previous annual outlook might experience a strange sense of déjà vu: we still like credit, probably more than ever. This time around, we are even more convinced that corporate bonds will offer an exceptional risk-reward profile as we head into 2021 – hopefully, without the roller coaster ride we saw in 2020.

With central banks likely keeping their foot on the gas pedal, we continue to expect interest rates to remain low for longer. Compared to the summer, our rates outlook is unchanged in Europe, the UK and Japan. For the U.S., we expect somewhat steeper yield curves at the long end (10- to 30-year bonds) as the very long end should return to more normal levels as news about the economic recovery arrive. Still, we think negative real interest rates will continue for pretty much all government bonds that can meaningfully be considered risk-free. In Japan and much of the Eurozone, even nominal interest rates have long been negative, and look set to remain so. For example, the European Central Bank (ECB) has clearly signaled that it remains vigilant and still targets additional quantitative easing (QE), leaving little if any upside potential in Eurozone yields. (Incidentally, the words "upside potential" are a bit of a misnomer. We see German Bunds a year from now at –0.5% for 10-year Bunds and –0.1% even for 30-year Bunds, so "rising" yields would mean them becoming less negative, thus inflicting capital losses on top of negative yields.)

With such unappealing "risk-free" alternatives, it should not be a surprise that the hunt for yield continues. Within sovereign bonds in the Eurozone, we keep a close eye on the EU periphery. For example, due to the more constructive outlook on Italy by the major rating agencies, these bonds remain attractive on current spread levels, given roll-down and carry, even with limited further tightening potential.

This lack of alternatives has led to a bizarre situation in the euro-denominated investment-grade (IG) corporate-bond market. The share of IG bonds with negative nominal yields is back to a whopping 35%.[1] Increasingly, we are seeing highly rated IG bonds replacing sovereigns as the anchor asset class in various client asset allocations. On the high-yield (HY) side we have seen that even issuers badly hurt by the pandemic continue to get their refinancings done, which limits the likelihood of future defaults. We expect default rates to stay low in the Eurozone and probably decline in the U.S. because of fiscal support packages and the circumstance that jeopardized business models have already gone bankrupt. The positive news of vaccines has lifted the tide further; even high-yield laggards in Covid-hit sectors have lately recovered nicely on both sides of the Atlantic.

Meanwhile, Asia in general and China in particular appears well on its path towards recovery.
The China locomotive and the Asian free-trade agreement together with stable oil prices and a stable U.S. dollar should be highly supportive for our other preferred asset class – emerging-market (EM) and Asian bonds. We expect higher yielding names in particular to benefit from the reduced tail risk and the hunt for yield.

Could things still go wrong? Well, yes. Markets have taken the Covid vaccine news and the likely U.S. election results as a sign of reduced tail risk for credit. We will leave it to medical and public-health experts to assess the likelihood of negative, or indeed further positive, surprises on vaccines, therapeutics and the impact of the increasingly wide-spread deployment of quick Covid testing. On economic policy, though, a few words of caution are in order.

The run-off elections of two Georgia Senate seats on January 5th could yet deliver unified Democratic control in Washington. In any case, investors should be wary of extrapolating from electoral events to the likelihood of just the right mix of targeted fiscal stimulus in the short term and fiscal conservatism being delivered in the longer-term. Politics is a messy and unpredictable business. And, in U.S. economic history, the quick and effective fiscal response to the economic shutdown of 2020 was very much an outlier, probably owing to a fairly unique set of political circumstances. "Legislative responses to financial crises and economic downturns have generally been limited and delayed," three leading political scientists noted in an invaluable book published after the events of 2008.[2]

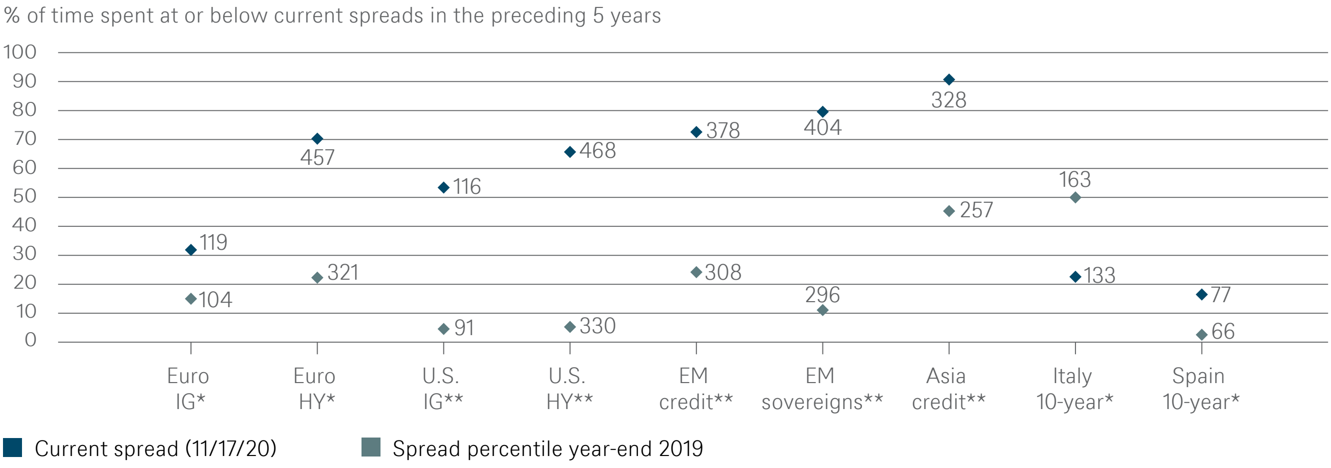
Heading into 2021, Washington gridlock would only be good news for the markets in case there would be no need for legislative action. Sanguine market assessments are based on the idea that monetary and fiscal policy have effectively introduced a put onto bonds, and will swiftly come to the rescue if and when required. This idea of such an effective put might well be tested in the coming months, if, for example, more wide-spread virus containment measures were to squeeze corporates once again.

We would probably tend to see such bouts of nervousness as buying opportunities. Overall, we have never been as convinced that credit will work out as we are for 2021. Of course, there are always individual idiosyncrasies to consider, focusing on balance-sheet strength, as well as local monetary policies for bonds, for example by emerging-market issuers, denominated in local currency. On major currency pairs, we expect little movement. While we think that it is too early to count out the dollar just yet, steady policies on all sides appear more likely to deliver comparative tranquility, rather than big swings.

1 Bloomberg Finance L.P. as of 11/17/20
2 McCarty, N., Poole, K.T. and Rosenthal, H., 2013. Political bubbles: Financial crises and the failure of American democracy. Princeton University Press. See esp. pp. 153-183.

CURRENT BOND SPREADS IN A HISTORICAL CONTEXT

For most fixed-income asset classes, current spreads remain higher than at the end of last year, putting bonds at the cheaper end of historical valuations during the last 5 years.



* Data labels show spreads vs. German Bunds
** Data labels show spreads vs. U.S. Treasuries
Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 11/17/20

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GLOSSARY

Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

Carry is a strategy in which an investor sells a certain currency with a relatively low interest rate and then buys another, higher-yielding currency.

A corporate bond is a bond issued by a corporation in order finance their business.

The credit cycle is the expansion and contraction of access to credit over time and is usually connected to the business cycle.

Default is the failure to meet the legal obligations of a loan, for example when a corporation or government fails to pay a bond which has reached maturity. A national or sovereign default is the failure or refusal of a government to repay its national debt.

The Democratic Party (Democrats) is one of the two political parties in the United States. It is generally to the left of its main rival, the Republican Party.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

The euro (EUR) is the common currency of states participating in the Economic and Monetary Union and is the second most held reserve currency in the world after the dollar.

The European Central Bank (ECB) is the central bank for the Eurozone.

The European Union (EU) is a political and economic union of 28 member states located primarily in Europe.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

In economics, a nominal value is not adjusted for inflation; a real value is.

Periphery countries are less developed than the core countries of a specific region. In the Eurozone, the euro periphery consists of the economically weaker countries such as Greece, Portugal, Italy, Spain and Ireland.

A put option is a financial security which gives the owner the right, but not the obligation, to sell an underlying asset at a specified price at a specified time (European option) or during a specified time period (American option).

Quantitative easing (QE) is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

In economics, a real value is adjusted for inflation.

The roll-down effect can form a significant component of returns in fixed income. It arises when longer-term bonds offer higher yields than shorter dated ones of the same issuer. With such a yield-curve, the yield of the bond will decrease as maturity approaches, and as a result, its value will increase, as it "rolls down" the yield curve.

Sovereign bonds are bonds issued by governments.

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.

A yield curve shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

Important Information

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