2021 Credit Outlook

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The health crisis that combined elements of the Spanish flu pandemic, the Great Depression and the GFC helped redefine what fiscal and monetary policies can achieve. The year ahead will tell us the willingness of central banks and governments to maintain the course – we think they will.

Executive summary

- "Unprecedented", "not in living memory" or "never seen before" took a whole different meaning in 2020 as the COVID-19 pandemic spread across the globe and forcing many countries into lockdown and inflicting what could have been long lasting impacts if it were not for swift and substantial responses from governments and central banks alike.
- Financial markets took the brunt of the pandemic in the early days, with substantial initial losses not too dissimilar to those experienced in the GFC but the recovery was swift, largely thanks to central banks turning the tap on and flooding markets with enough liquidity to quickly restore some level of confidence. This was strongly supported by fiscal policies aimed to counteract the effects of the new norm of life under lockdown.
- While predicting what 2021 has in store is almost impossible based on a traditional approach of assessing key drivers of the economy, governments and central banks globally have set a clear expectation that they will continue to do whatever is necessary to ensure some level of economic recovery and continued financial stability. We believe this provides sufficient clarity on what we may expect over the next 12 months, even if the means to achieve this will largely depend on how successful the containment of the virus will be.
- At a high level, we expect supportive monetary policies will continue to see spreads tightened, with the yield curve likely to steepen. This is because the short-end of the curve is now broadly anchored to what central banks have determined and the longer end will respond to (hopefully) positive renewed sentiment and large fiscal stimulus.
- While historically, rising interest rates was a trigger to favour floating rate securities, the new norm of unconventional monetary policies means there will continue to be value in fixed rate securities. Our other key takeaways include moving down the capital structure for quality issuers, target long-dated inflation securities, capture value in the Residential Mortgage Backed Securities market and maintain a high diversification in selective high yield securities. But, more than ever given the uncertainty that will no doubt continue over the coming months (not to mention an upcoming equity correction which attracts a growing number of predictions), being selective and maintaining a high degree of diversification (across maturity, issuer, rating, currency and instrument type) continues to be the key to a well-balanced fixed income portfolio.

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Review of 2020 – where should we start?

In prior editions of our Credit Outlook series, we have traditionally set the scene by reviewing the events in the previous 12 months. Last year, we primarily focused on how the US – China trade war impacted markets and global economies during 2019. There are many valid reasons to adopt this typical approach, especially as the somewhat arbitrary move from one year to the next should not, in itself, fundamentally change the economic and financial dynamics that are driving markets. But is it really possible to apply this approach this time around? What the last year has taught us is that we are in an environment where the words "traditionally" or "typically" have had to be discarded given the unprecedented nature of the events we are continuing to experience. Many have used the Spanish flu pandemic in the late 1910's or the Great Depression of the 1930's as points of comparison but we have to accept we are now in a very different world, with global economies and financial markets simply experiencing events that have never been seen or even considered before.

So, why is the COVID-19 pandemic such a one-off event? From a health perspective, many comparisons can be drawn from the Spanish flu pandemic. The impact on economies has some similarities with the Great Depression. And yet, two major factors undeniably make the current pandemic a once-in-a-lifetime event (or at least we sincerely hope). The first of these factors is that we now live in a widely interconnected world where you can go from one point on the globe to its exact opposite point in less than 24 hours, making the containment of a disease virtually impossible without drastic measures constraining people's freedom of movement. The second is that the tool box to fight the impact of such a crisis is a lot more diversified.

Australia's response to the pandemic probably best illustrates these two factors:

- As cases started to rise (mainly overseas rather than domestically), Australia introduced border controls from early February, followed in mid-March by much tighter restrictions which led to the first lockdown.
- The second factor was the ability and willingness of governments and central banks to take a 'whatever's necessary' approach to combat the impact of the restrictions imposed.

Up until the Great Financial Crisis (GFC) in 2008-2009, fiscal and monetary policies were generally relatively simple. Central banks were mainly using changes of interest rates in order to implement fiscal policy objectives (other than the Bank of Japan which started unconventional measures as early as 2001). Governments also demonstrated at times a reluctance to hike spending at a time of declining fiscal revenue.

The GFC saw the emergence of new measures to counter recession, primarily on the monetary policy front (i.e. central banks). One of the key challenges faced during that time was initially a lack of supply in credit markets, i.e. banks unlikely to lend money to individuals or companies or not on attractive terms. This supply drought would generally lead to companies not investing (as they can't borrow or not on terms attractive enough to generate an adequate return) and consumers saving or paying down debt (rather than spending) resulting in a further slowdown of the economy. By supporting credit markets, central banks can provide sufficient incentives to commercial banks to lend (on reasonable terms), thereby helping the broader economy. The traditional approach of lowering interest rates did not prove sufficient, in part because interest rates pre crisis were already low compared to historical levels.

Once rates were at or close to zero, where to from there? The answer was to implement quantitative easing, whereby the US Federal Reserve started to buy bonds and other financial assets in order to inject liquidity into the financial markets. This additional liquidity enabled banks to lend more easily (and on more attractive terms), drove yields down and asset prices up.

Governments also stepped up their response, with increased public investments and support to households. In Australia, this took the form of investment in new and upgraded road and rail infrastructure, the school modernisation programme and one-off cash payments to many households. While we are not seeking to analyse if the Australian government stimulus programme proved to deliver value for money, it is undeniable that the approach of going early and going hard delivered some clear benefits to the Australian economy. Admittedly, Australia also benefited from the very strong infrastructure investment programme in China which drove the demand for Australia's key commodities.

In short, governments and central banks last year dusted off their GFC playbook and took it a few steps forward.

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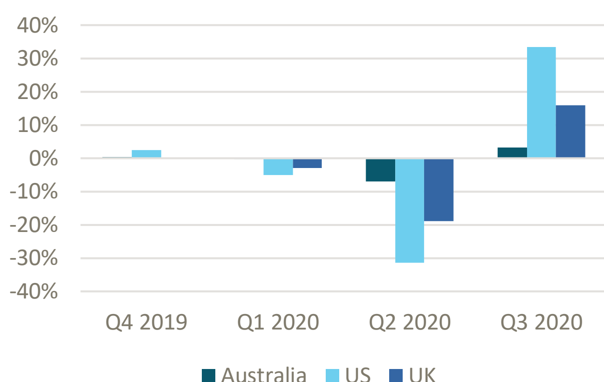
Performance of credit and financial markets during 2020

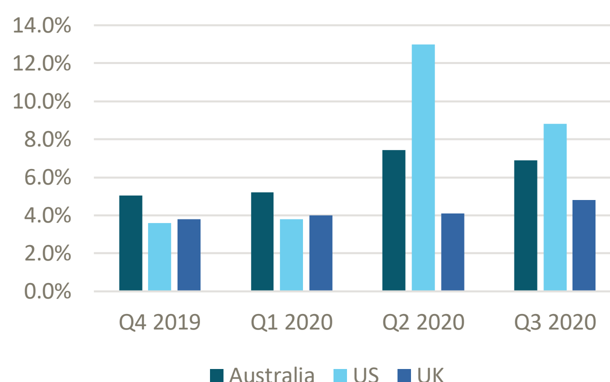
The decision by many countries to move to some form of lockdown in early 2020 resulted in a quick, drastic yet unsurprising impact on their economies. Companies were asked to close down and materially change the way they operated. In some sectors, revenue dropped in excess of 90% almost overnight, which placed significant pressure on vast segments of global economies. For many businesses, the focus turned rapidly to surviving rather than prospering. Many governments introduced immediate measures to support businesses. In Australia, the key decision was the introduction of JobKeeper, with a very wide scope, and one could argue, a very low threshold to qualify. Additional measures such as short-term lines of credit were used, all aiming to ensure that companies could continue to pay their bills and maintain as many employees as possible. The impact was nevertheless unprecedented.

Figure 1: Real GDP quarter-on-quarter change



Source: Bloomberg Business Intelligence

Figure 2: Unemployment rate



Source: Bloomberg Business Intelligence

While Australia, the US and the UK have all technically moved out of recession (defined as two consecutive quarters of GDP decline), most economies around the world will take a few years to recover to the level immediately prior to the pandemic. In this regard, the unemployment rate is probably a better measure to ascertain the current health of an economy and recent measures point to a very slow and likely bumpy ride ahead. According to the World Economic Outlook published by the International Monetary Fund in October 2020, it won't be until 2022 that the size of many economies globally will recover to their 2019 level and it will take another year before we see unemployment rates return to pre-pandemic levels.

A shock of such a magnitude, even with many government support measures, will always result in a deterioration of the credit quality of many companies. The extent of this deterioration has again varied between countries as a result of measures implemented and, to an extent, mechanisms in place for companies to operate while under financial stress (e.g. Chapter 11 in the US or the voluntary administration process in Australia).

In Australia, in light of the likely rise in insolvencies, the government introduced measures to provide temporary relief and not force companies into bankruptcy with the likely loss of many jobs. As evidenced in Figure 3 below, the steps taken have had the desired effects, with less than 400 Australian companies entering voluntary administration each month since April 2020, compared to a monthly average in excess of 650 over the 2017-2019 period. We note that the temporary leniency that allowed some companies to survive is being unwound which will likely result in an increase of companies eventually seeking to appoint a voluntary administrator, especially among the ranks of the so-called zombie companies that have survived only because of the combination of government handouts, payment deferrals from creditors, payment holidays from their banks or temporary changes to legislation. We also believe that many small and medium size enterprises were also some of the major beneficiaries of this temporary relief. Since none of these measures are permanent, there will come a point when those businesses will no longer be able to continue.

In the US, the number of companies that have filed for Chapter 11 protection (the equivalent of appointing a voluntary administrator) substantially increased during 2020 and ended the year at 7,128, the highest level since 2012 (7,789) and 30% higher than the prior year (2019) in part because the Chapter 11 process provides more flexibility, including in terms of seeking interim funding which allows the process to extend for longer periods – a significant factor given the ongoing uncertainty (in Australia, once funding runs out for a company under administration, the only outcome will be liquidation). While the increased number of insolvent companies in the US

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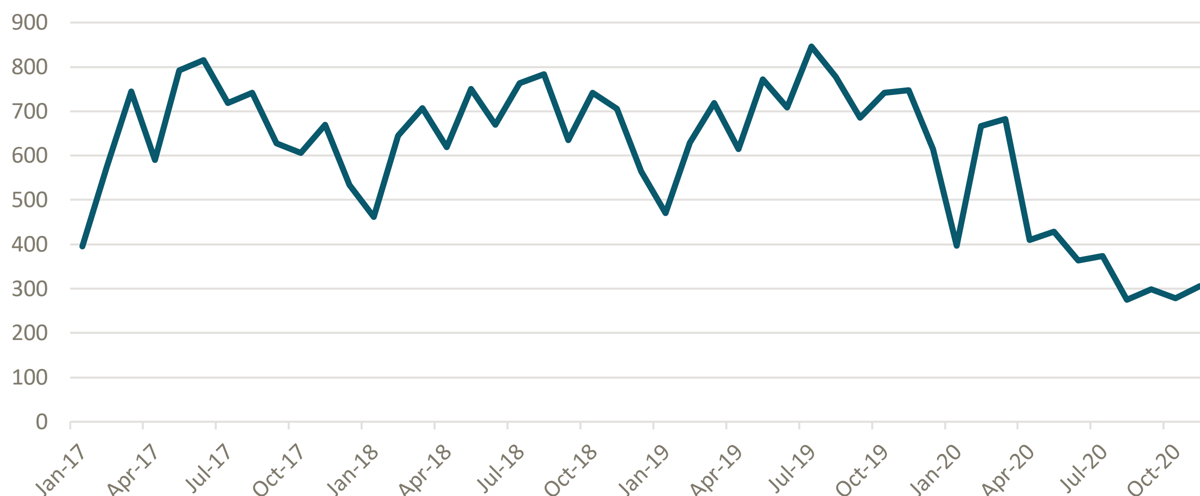
can largely be attributed to the fall in economic activity, it is likely that some companies sought Chapter 11 protection as a way of restructuring their businesses when they would not have otherwise been declared technically insolvent, thereby using COVID as an "excuse" to restructure their operations / balance sheet.

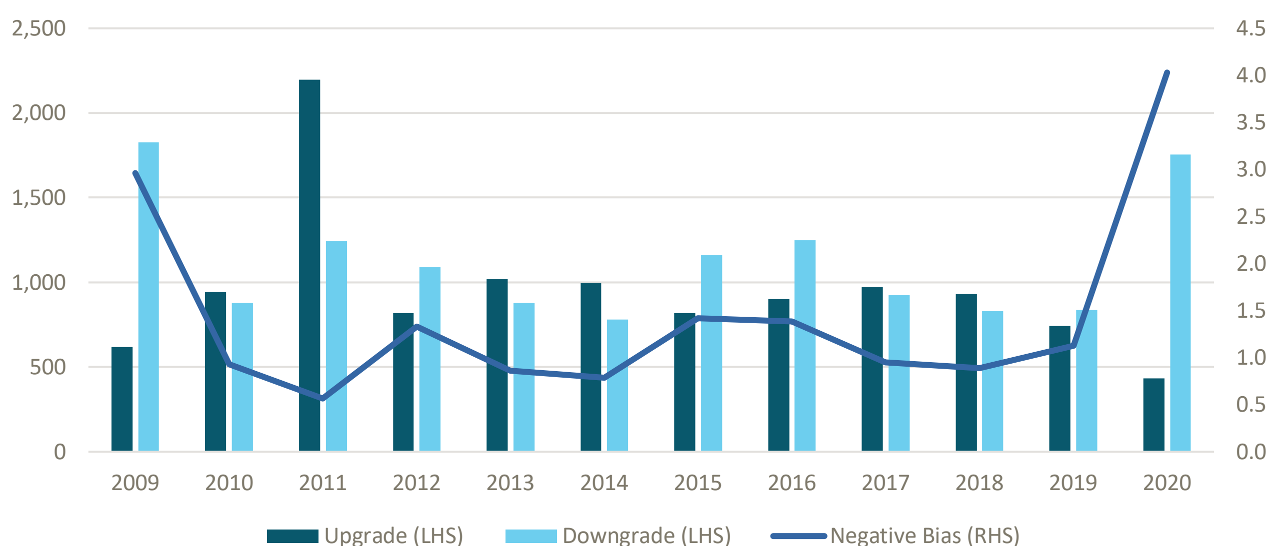
Figure 3: Companies entering voluntary administration in Australia



Source: Australian Securities & Investments Commission

As explained above, looking at the impact on credit quality that COVID has had on businesses solely through the lens of insolvency filings is perhaps somewhat misleading. Another way to assess credit quality is to observe the number of rating actions over the period. While ratings will generally provide an indication of creditworthiness for larger companies (as credit ratings are generally prohibitive for smaller companies from a cost perspective), they provide a more granular picture of how the universe of rated companies has evolved during the last 12 months.

Figure 4: Rating actions during 2020



Source: S&P Capital IQ

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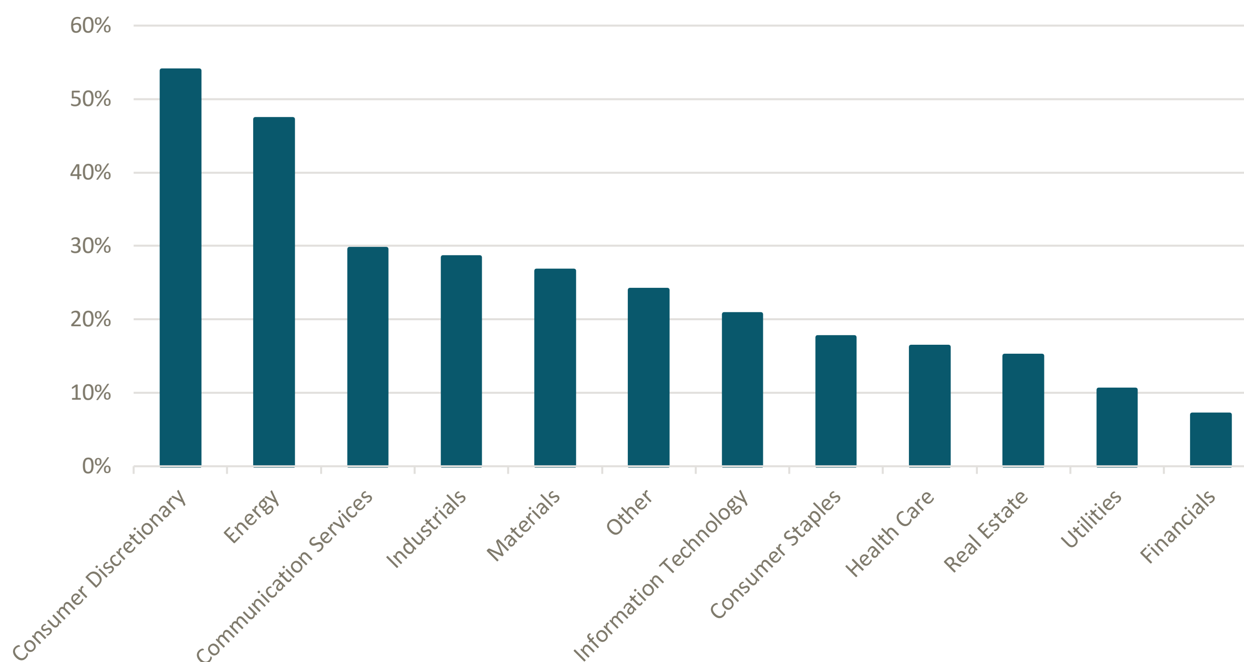
The graph in Figure 4 above shows the number of ratings upgrades and downgrades announced by S&P Global Ratings each year since 2009 (GFC). The line entitled 'Negative Bias' provides an indication of the number of negative actions against total rating actions – a factor of 1.0 shows that the number of positive and negative rating actions were the same in a given period. During 2020, S&P Global Ratings downgraded 1,753 ratings, which was only 75 less than in 2009, but interestingly, the number of upgrades was 182 lower than in 2009 (driving a negative bias of 4.0, compared to 3.0 in 2009). Even 2016, which was the last year when we saw a spike in insolvencies and defaults (due to the US shale oil crash), the number of downgrades 'only' reached 1,249 and this was compensated by 902 upgrades, pointing to only certain sectors being impacted back then.

When we look at what sectors were most affected by downgrades, it will come as no surprise to see that consumer discretionary and energy companies are leading the pack. Figure 5 below shows the number of downgrades as a percentage of total number of entities within each sector. It is important to note that an entity may have been downgraded more than once, thereby showing two entries (in the numerator) and yet only a single entry (in the denominator). In the context of the events of 2020, the bias for these two sectors is expected, as the lockdown primarily impacted people's propensity to spend on discretionary items (and rather focus on essential goods) and the sharp decline in consumer demand materially impacted the price of oil, with a flow-on impact on companies in the energy sector.

Figure 5: Downgrade by sector



Source: S&P Capital IQ

At the other end of the spectrum, utilities and financials had the lowest number of downgrades (as a percentage of the total number of entities). This again should come as no surprise given utilities are ultimately supporting services and products that are essential and financials received the benefit of very favourable monetary policies during the year.

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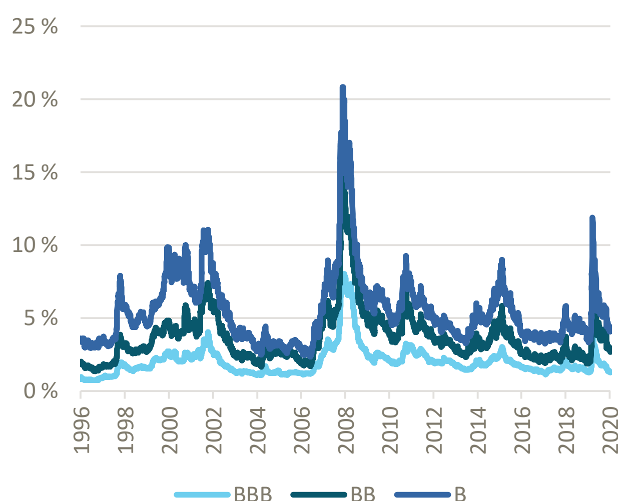
Figure 6: ICE BofA US spread – 1996 to present



Source: ICE Data Indices LLC, Federal Reserve Bank of St Louis

Figure 7: ICE BofA US spread since 1 Jan 2020

Source: ICE Data Indices LLC, Federal Reserve Bank of St Louis

Assessing movements in the creditworthiness of companies can also be achieved by analysing spread movements over a period, since these represent the risk premium that investors are requiring over and above the risk-free rates (i.e. government risk). At times of stress, spreads will widen (i.e. increase) as investors expect a higher compensation for the risks. Figures 6 and 7 above look at the ICE BofA US option-adjusted spread for entities in the BBB, BB and B categories. Figure 6 shows how these indices have fluctuated since 1996 and Figure 7 is limited to the period starting in January 2020. Unsurprisingly, risk premiums all materially increased in March 2020 as markets were trying to understand the then ever-evolving environment. While the peaks at the end of March were three to four times higher than the levels at the start of the year, they remained significantly below what occurred during the GFC and recovered a lot faster. Spreads for BB and B issuers are currently about 50bp higher than pre pandemic levels, while investment grade spreads have all but entirely recovered from the 2020 spike. By way of comparison using the GFC, high yield spreads started to increase from late 2007 and didn't reach their peaks until late 2008 and were broadly back to pre GFC level in mid-2010.

A question worth asking is why risk premiums required by investors are broadly back to pre-crisis levels when, despite the roll-out of the COVID vaccines in many countries around the world, the level of uncertainty remains very high and the situation in countries such as the UK or the US remains alarming. The answer can be traced to actions that central banks around the world are taking and primarily their respective bond buying programmes. Despite many highly technical explanations, the reason is relatively simple and it comes down to a supply-demand balance. In normal market conditions, there would generally be a finite number of bonds outstanding and those would be purchased by a relatively finite number of investors. Increase in demand (from ever increasing pension funds, for example) is broadly matched by increase in supply (with companies issuing more debt as they grow).

Bond buying programmes from central banks (and, to another extent, measures such as the RBA's Term Funding Facility or TFF) are adding new (and extremely deep pocketed) players to this equation. As central banks purchase bonds, investors who would normally hold government bonds need to find other assets to invest in (even if the supply of government bonds is itself increasing to fund current and near term fiscal deficits). A lack of supply is pushing those investors to broaden their investment horizon, purchasing assets they might not have otherwise invested in previously in order to broadly maintain their yields. This in turn disrupts the balance for the next group of investors and the ball keeps on rolling. Simplistically, government bond investors now have turned to semi-government bonds, with those investors turning to senior bank notes, with the chain continuing through bank Tier 2, bank hybrid, investment grade corporate and high yield corporate and structured finance securities. This chain reaction was further impacted by programmes such as the TFF since banks could refinance maturing senior bonds with the RBA.

This spread compression, largely as a result of monetary policies, combined with interest rates being pushed to record lows drove strong performance in fixed income markets.

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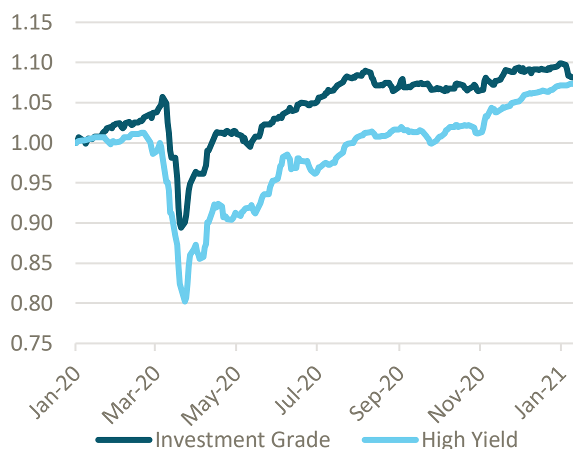
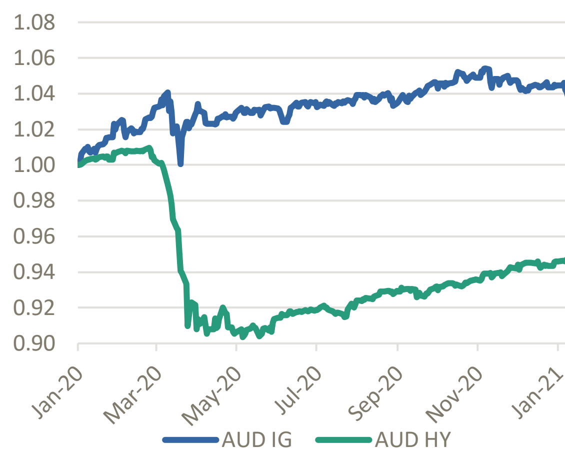
Figure 8: Bloomberg Barclays US Corporate Bond Index



Source: Bloomberg

Figure 9: AUD Bond Indices



Source: Bloomberg

Figure 8 above shows the Bloomberg Barclays US Corporate Bond (Investment Grade - IG) and High Yield (HY) Indices since the start of 2020, rebased to their 1 January 2020 levels. These are total return indices meaning that they take into account price movements as well as ongoing cash flows (unlike indices, such as the ASX 200 or the S&P 500 that only look at price movements). At a fixed valuation of its components, a total return index will increase (by virtue of ongoing income).

By way of background, the Investment Grade Index captures in excess of 6,600 fixed rate members (corporates and financial institutions) for a total outstanding of about USD5.9tr and an average rating of A-/BBB+. The High Yield Index includes 2,150 members (USD 2.1tr, BB-/B+).

Both indices have had, as one can expect, a relatively rough ride during 2020, suffering a very significant drop in value during March at which point the IG and HY indices had recorded losses of 10% and 20% respectively but these losses were broadly recovered by July for the IG index and August for the HY index (recovery is determined by assessing the date when the index value recovers to its pre COVID level). The recovery was driven by both spread compression (see Figure 7) and a marginal decrease in risk-free yields. The recovery was faster for investment grade securities as the risk-free rate compression has a greater impact on higher quality issuers.

Performance in the Australian bond market has been a bit more muted, reflecting the fact that the US bond market is inherently a lot more mature. Figure 9 shows performance for investment grade (Bloomberg AusBond Composite Index) and high yield bonds (Solactive FIIG Australian High Yield Index). Some of the drivers that drove the US markets also applied in Australia, namely initial spread widening and a decrease in risk free rates over the year. However, the investment grade AUD index did not achieve the same level of return compared to its US equivalent as the composition of that index is materially skewed towards higher credit issuers, as evidenced by the average rating of AA+, meaning the spread compression impact was a lot less prominent (and the corresponding drop in March far less pronounced). Over the year, the recovery was also not as impressive, given that risk free rates started the year at a much lower level in Australia compared to the US. At the start of 2020, 7-year government bonds in Australia were yielding about 1.10%, compared to close to 1.80% in the US, and yet both finished 2020 at broadly the same level (0.65%). Looking at the high yield space in Australia, we haven't seen the same recovery as experienced in the US because spreads haven't recovered as rapidly in Australia as they have in the US. In our opinion, this reflects that the Australian high yield market is nowhere near as deep as the US market, resulting in spread movements being a lot more gradual. In the US, spreads are a lot more dynamic because of a much larger number of investors that maintain a deeper trading pool. In Australia, it is frequent to see spreads recovering on thinly traded bonds solely as a result of credit positive news rather than more market-wide performance. Nonetheless, we expect the HY Index to eventually recover through a combination of supportive credit news and refinancing (it is important to note that fixed income indices are based on ongoing valuations and, while a bond may be valued materially below its face value, the issuer's obligation remains to repay the full face value). Finally, the HY Index hasn't recovered to the same extent due to the default of Virgin Australia, which represented about 7% of the total index value.

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What about 2021

In the same way as we had to take a different approach to look at the events of the past year, looking at the year ahead requires at best a very good crystal ball (which we don't have). What will happen with the virus? Will the vaccine be successful? Is the situation going to materially deteriorate in Europe and the US? What are governments going to do if things get better or worse?

At this stage, forecasting how global economies are going to perform is almost impossible. You will hear many commentators attempting to do it but with enough assumptions around the containment of the virus that a forecast really becomes a scenario analysis rather than a view of future performance.

In our view, it is more prudent to consider near term economic performance in the context of fiscal and monetary policies. As 2020 has clearly demonstrated, governments and central banks are willing and able to influence their policies to achieve a desired outcome. As such, it is more relevant to think about what these institutions will be aiming to achieve and assuming that they will adjust their stance based on how the pandemic evolves. In our view, we believe that the aim will be to maintain broad financial stability and start to recover economically from the impact of the virus. What does this mean?

- Simplistically, maintaining financial stability will be achieved if credit continues to flow through the economy, ensuring that individuals and companies can still borrow and spend, all of this at a reasonable cost. It also means that financial markets confidence continues to improve (although some would argue that markets are already overly optimistic, especially from an equity valuation perspective). This will fall under the responsibility of central banks.
- Economic recovery will be a function of seeing every part of the economy fully reopening, which should drive economic growth and see unemployment start to trend down. Governments and their fiscal policies will play the key role.

Interestingly, both governments and central banks are likely to face the same challenge, i.e. how to handle market expectations. The consequence of not meeting expectations is quite different between the two groups. For governments, it is about voters' expectations and, like it or not, many politicians will be driven by how their decisions will impact their chances at any upcoming elections. Will fiscally responsible budgets win the day even if it is to the detriment of a large portion of voters who would be better off with direct government support? Central banks on the other hand do not have the voters' pressure which could arguably give them a chance to play the longer game but they are facing financial markets which will react a lot faster than voters if their expectations are not met.

Interestingly, these dynamics probably make predicting the behaviour of central banks easier than the behaviour of governments. This is because central banks are nowadays heavily relying on forward guidance which provides sufficient indication as to what each one is trying to achieve. Take the RBA for example and its very clear stated goal to support employment and restore inflation. It doesn't take much to realise that the RBA will not lift interest rates until inflation has recovered to within its target band of 2%-3%. If you consider that unwinding the recent spike in unemployment will take at least until 2022 if not 2023, it would be extremely courageous to call a hike in the cash rate over the next 12-to-18 months. More likely will be an adjustment (upward or downward) to the RBA's bond buying programme in order to maintain interest rates within expectations, with short-dated government yields maintained marginally above 0% (note the RBA target yield of 0.10% for 3-year government bonds) and ensuring a gradual upward slope for the government bond yield curve (i.e. any increase in yields is gradual and moderate from one maturity to the next). The RBA will no doubt hope this will be sufficient or adequately supported by fiscal policies, although, as pointed over the years, monetary policy alone cannot restore a declining economy and needs to be complemented by appropriate fiscal policies.

The dynamics on the fiscal policy front are a little bit more complicated to predict. The Australian government sent a very strong signal at the start of the pandemic that it was willing to do whatever was necessary, with JobKeeper and JobSeeker being probably the two best examples. Since then, the government has attempted to gradually wind back those measures but has clearly shown signs of being torn between fiscally responsible policies and not creating a shock to the economy. Turning down, rather than turning off support measures has so far been successful but the longer term effects remain unknown, especially considering the last COVID-19 outbreaks in certain parts of the country. Interestingly, a major impediment to a stronger recovery in Australia which might force the federal government to continue with support measures is the continued travel restrictions around the country and yet these are controlled by states rather than centrally. While Australia has so far shied away from putting all its eggs in the vaccine basket (and instead pursuing an elimination strategy), the continued discrepancy between state policies around domestic movements might force the federal government's hands into fast-tracking the vaccine rollout.

In the US, the scene on the fiscal side is clearer. With the Democrats controlling the White House, the House of Representatives and the Senate (but only just thanks to two independents and the casting vote from the Vice President), it is expected that the recovery will be funded by government debt, through what are expected to be very large government support programmes. Unlike the RBA, the US

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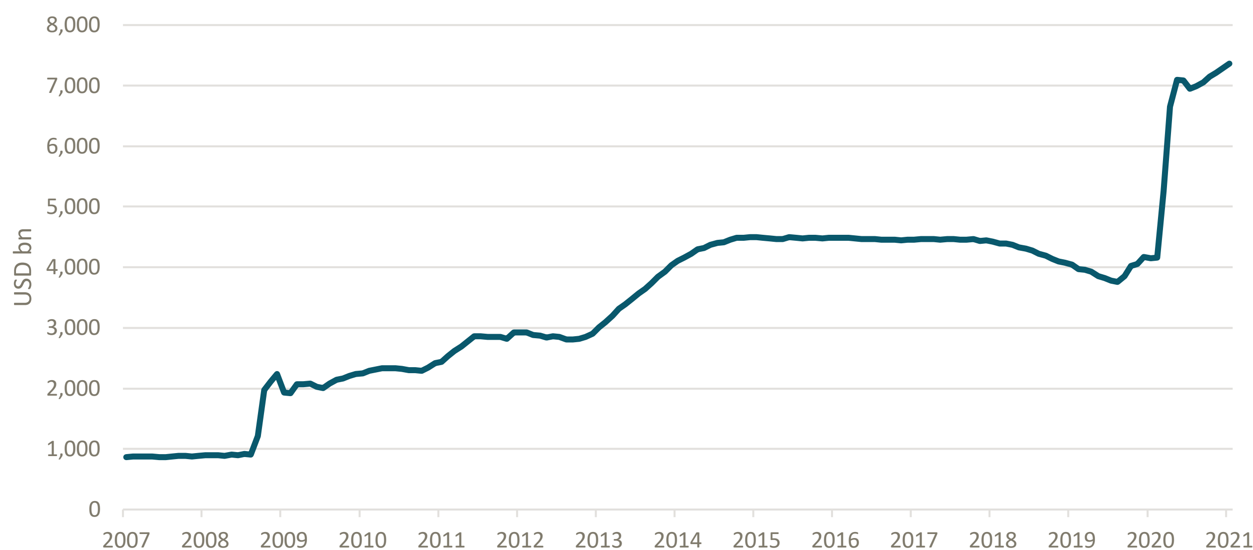
Federal Reserve is unlikely to complain that the federal government is not doing enough. The challenge in the US is that financial markets have simply become addicted to supportive monetary policies (largely unconventional).

Figure 10: US Federal Reserve Balance Sheet



Source: Bloomberg

Figure 10 above shows the size of the US Federal Reserve balance sheet since 2007, which provides an indication of the volume of bonds the central bank has bought since the GFC. Towards the end of 2008, the US Federal Reserve embarked on the first (of many) quantitative easing programmes, and except for a relative pause during 2012, this continued almost undisturbed until 2015, when it was stopped. It took another three years until we saw the start of the unwind. In effect, despite the US economy recovering relatively rapidly from the GFC, it took approximately five years until the point the bank simply stopped buying bonds. As shown above, the amount of liquidity injected by the US Federal Reserve into the markets last year has been about as much as in the previous 10 years, and if history repeats itself, one has to assume that the current bond buying programme will continue for years to come.

What does this mean for financial markets?

As explained above, focusing on economic growth and trying to forecast the increase in GDP is not so relevant if we assume governments will implement fiscal policies to deliver this. In our view, this year will be about setting a trajectory which will deliver a fall in unemployment (although it is not likely to be material until the back end of 2021 at the earliest) and a sense of return to normality. This approach may appear controversial, but let's remember that, unlike previous economic downturns, this one was the result of a health pandemic rather than a typical end-of-economic cycle recession. If successful, this should result in a strong(er) economy which will allow many companies to recover from the deterioration in credit quality experienced in the past 12 months. There is no doubt that some will not survive the unwinding of economic support measures they have benefited from but one could argue that the vast majority who weren't going to make it have either fallen over or are on the verge of doing so. The ultra-low interest rate environment that we are currently experiencing will no doubt help many companies to refinance their debt on very cheap terms which should provide support to their recovery (provided, of course, that demand follows). This in turn should deliver a broad stabilisation of credit markets, with many commentators forecasting that default rates will decline during 2021. In a recent publication, Moody's Investors Service forecast the 12-month trailing default rates to drop to 4.7% by the end of 2021, compared to 7% currently (and an expectation they will peak at 7.3% in March 2021, a reflection of the backward looking nature of the measure which creates a lag compared to actual defaults).

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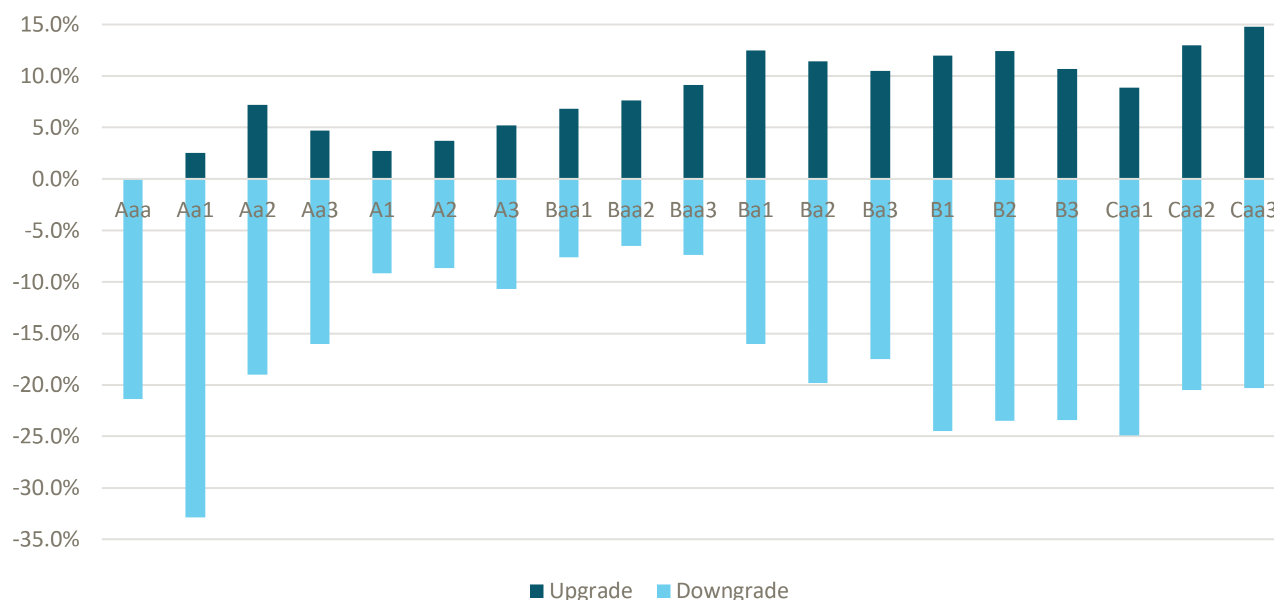
Figure 11: Forecast rating movements during 2021



Source: Moody's Investors Service

This expectation that default rates will go down should not be construed as an overall improvement in credit quality across the board. In fact, as evidenced by Figure 11 above, markets are expecting a moderate deterioration across the rating spectrum during 2021. Figure 11 shows the result of an analysis undertaken by Moody's Investors Service, which assesses current spreads of a vast number of debt instruments and derives a market-implied rating which is then compared to current actual ratings. Based on the above, markets are expecting that around 10% to 15% of ratings will be upgraded during the year, and about 20% will be downgraded. Unsurprisingly, the rating pressure will be more pronounced at each end of the rating spectrum.

While the above points to an overall marginal deterioration across the credit market, the impact on credit spreads is likely to be minimal as investors have largely already priced in this downward shift. In fact, we expect credit spreads to continue to reduce during 2021 for two key reasons. The first, as previously explained, is that we expect central banks to continue their bond purchase programme which will continue to put pressure on all credit spreads. The second driver will be what we expect to be a stabilisation of economies and greater visibility of what's to come, which should drive risk premiums back down toward their pre pandemic levels.

Government bond yields are, on the other hand, expected to rise, although it will be more pronounced at the longer end of the curve given the expectation that central banks will continue to actively manage the shorter end of the curve (i.e. maturities of three years or less) at historically low levels (as witnessed by the RBA and its target 3-year yield of 0.10%, which we see no reason for changing in the near term).

Figure 12: Implied forward yield (at year end)

	Current	2021	2022
US – 10 year	1.16%	1.34%	1.51%
US – 5 year	0.52%	0.80%	1.14%
US – 2 year	0.15%	0.31%	0.60%
Australia – 10 year	1.15%	1.34%	1.55%
Australia – 2 year	0.10%	0.14%	0.45%

Source: Moody's Investors Service

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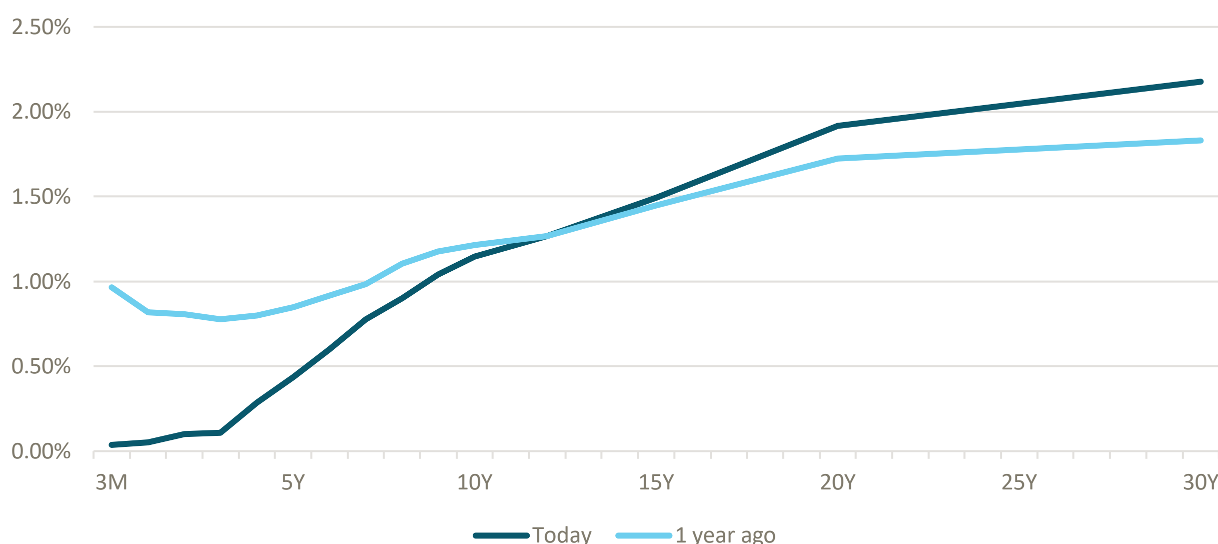
Implications for a fixed income portfolio

Conventional wisdom has in the past dictated that, in the event of an expected rise in interest rates, the broad strategy for a fixed income portfolio was to favour floating rate over fixed rate and shorter rather than longer maturity. This was to avoid positions whereby long dated low coupons were fixed and would then experience a fall in capital price (recall that, as yields rise, capital prices drop). But, if 2020 has taught us anything, long held conventional wisdom is probably no longer relevant when faced with unprecedented events and both governments and central banks are willing to go to great lengths to lessen the impact, even by implementing measures not seen before.

While it is undeniable that the consensus is for interest rates to go up (which will negatively impact capital prices), it is important to also put this in the context of the yield curve and in particular the difference in yield between one maturity and the next. At the moment and as discussed above, central banks are controlling the shorter end of the curve, while the longer end (10 years and more) is left to be determined by market dynamics. Central banks, through bond purchasing, will also intervene in the middle of that range. As optimism recovers and long government bond yields will rise, this will likely result in a steepening of the yield curve, i.e. the incremental yield from one maturity to the next will get larger. As shown in Figure 12 above, 10-year Australian government bonds currently yield 1.05% more than 2 years, but this differential is expected to grow to 1.20% by the end of 2021. Having a steep curve means that, with the passage of time (and assuming all else being equal), the benchmark risk-free yield for any given bond will decrease.

If you consider for example the current difference between the 4-year and 5-year government bonds for the Australian government, the difference is currently about 0.15%. This means that, assuming everything else is constant, an investor purchasing the 5-year bonds today at a yield of 0.438% would be able to sell those bonds in 12 months at a yield of 0.284%, resulting in a capital gain. In practice, the concept is "all else being equal" never exists but what we are likely to experience is the continued steepness of the curve and gradual rise of yields. Nevertheless, as shown in Figure 13 below, the curve steepness is the key component that investors should take into account instead of focusing on outright yields alone. This would allow investors to tap into longer dated instruments (with better yields) while at least maintaining (if not improving) valuations. In a low interest rate environment, it is important to consider returns not just from a running yield perspective but also through capital appreciation.

Figure 13: Australian Government Bond Yield Curve



Source: Bloomberg

We believe that current market conditions (and what we expect over the next 12 months) will also continue to offer opportunities where the price of certain securities doesn't necessarily reflect fundamentals or where the expected spread compression could have a comparatively greater impact. For example, we see some value in considering opportunities further down the capital structure for issuers that are otherwise exhibiting strong credit fundamentals. We would place hybrid (AT1) instruments in that category. While we

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are unlikely to see prices uplift similar to the levels seen in 2020 (such as, for example, the Westpac USD 5% hybrid perpetual, now trading about USD30 higher than its low in March last year), we still see some value in this asset class. Similarly, many corporate hybrids (which, unlike their bank equivalent, are not subject to mandatory equity conversion) are also in our view trading at a discount to their fundamental value. We also see continued value in residential mortgage backed securities, given the positive outlook on property, strong historical performance in the sector and the fact that many investors continue to shy away from that asset class (enabling the delivery of stronger yields at equivalent ratings, noting that these higher spreads also reflect the fact the securities are not as liquid as corporate bonds).

Inflation linked securities, which we believe have a place in any portfolio, are currently somewhat challenged by the relatively weak inflation outlook (when considering it against the RBA's target range), with many yielding in real terms (i.e. before inflation adjustment) less than 1%, and some in negative territory. Given the near term inflation outlook, our preference remains for longer dated instruments, especially as the ongoing maturity of existing instruments and lack of new supply should positively benefit the capital price of these instruments due to their growing scarcity.

Finally, as many investors seek income (as well as capital appreciation) from their fixed income portfolio, an appropriate and well diversified allocation to high yield securities continues to be appropriate although we continue to believe that the exposure to any single issuer should be commensurate with the inherently higher risk compared to investment grade securities.

Ultimately, and more than ever given the uncertainty that will no doubt continue over the coming months, being selective and maintaining a high degree of diversification (across maturity, issuer, rating, currency and instrument type) continues to be the key to a well-balanced fixed income portfolio. More generally, we continue to believe that an allocation to fixed income remains more important than ever. While equities performance has been stellar in recent months, the current valuation of equities simplistically assumes interest rates will remain at current levels forever. Hard to possibly believe this. The price-to-earnings ratio for the S&P500 index in the US is now higher than immediately prior to the tech bubble of 2000. What followed was a crash of the index by more than 30% in the following 9 months and it took another 7 years to fully recover. Many commentators had argued that the equity market was ready for a correction last year. COVID-19 has introduced many fiscal and monetary policies that have avoided this outcome but it is likely that the correction will eventually occur. The question on everyone's mind is when. Many indicators would point to sooner rather than later, although probably not only there is a return to some form of normality.

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