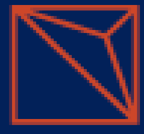

RUBRICS

Rubrics Fixed Income Update

February 28th 2020

COVID-19 – Implications & Market Outlook

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Rubrics Fixed Income Update

February 2020

Headline Thoughts

Covid-19 is making a real nuisance of itself. Since mid January we have been watching its developments in China and now the rest of the world with a high degree of trepidation. Away from the human side of this very serious situation (of course of primary importance), from a professional point of view, we are trying to assess what economic stress it can cause and the potential impact it can have on capital markets.

In the early days of the outbreak there was a real belief that the virus would be contained, the economic impact minimal and in the end even a positive for the markets - positive because of the scope for additional stimulus it might generate through fiscal and monetary expansion. They weren't wrong – the PBOC pushed nearly $750billion of credit into the system. On top of that the Chinese government added its support to several large companies like HNA as well as adding extra support to three state-controlled airlines.

The problem however is that this crisis is causing a fundamental supply side shock. All of the money printing in the world will not readily offset the closure of plants and transport routs. Given the scale of the Chinese economy today the impact of this outbreak will be much greater than that of SARS in 2003. It is only in the last few days that markets have begun to realise this and as the virus spreads globally concerns are growing throughout the wider population in both affected and non-affected areas.

The good news is that if one looks at China's most affected areas today, things appear to be coming under control. The bad news is that it is spreading quickly on a global scale. If China is the benchmark, it may hopefully be that case that the virus will be brought under control. Of critical importance is how hard it can impact markets and what kind of recovery we will see once control measures and vaccines are in place.

Market Outlook

The key point to make here is that the markets walked into this crisis with some of the most elevated pricing we have ever seen on the back of significant central bank support over the last 12 months. As a result any sort of 'black swan' event was going to cause a significant pullback. The market, it appears, has got its swan.

The broader question once the initial selling is done is what sort of recovery we will have. In many ways that is nearly the more important question to the credit markets. We have seen a marked increase in corporate leverage over the last decade and today we are starting to see signs that weaker issuers are really starting to suffer. The downgrades of Macy's and Kraft to junk is a case (or two) in point.

Initially market positioning will be a factor in the selloff. Given the true economic impact is still unknown one can only assume most managers will dial back risk simultaneously and as such force asset prices significantly lower. A 10-20% correction in the US equity market would not be out of place under these conditions. What we would look for is how the "buy the dip" rally materialises (or not as the case may be). In past crises the markets have not only regained their previous highs but also created new ones. Will they be able to repeat that small miracle once again? If the underlying state of the global economy is as weak as we suspect, the recovery this time around might not be as powerful. The fading of any recovery rally is the condition I would be more structurally concerned about rather than the current volatility which is probably as much about rebalancing risk exposure from significantly overweight to a more neutral positioning.

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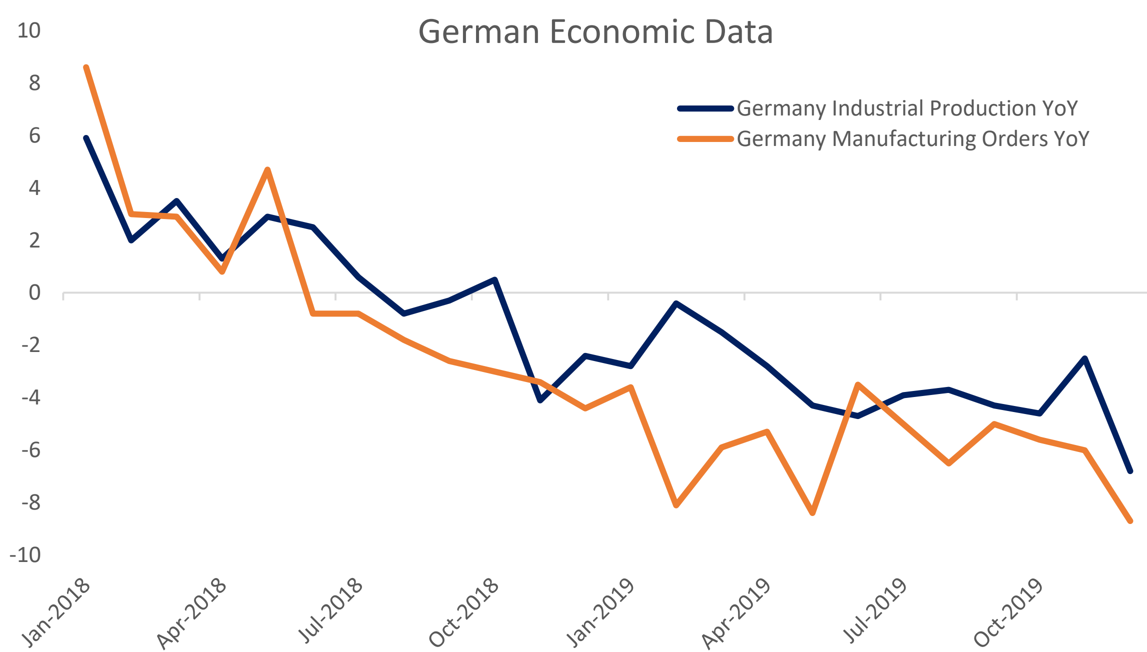
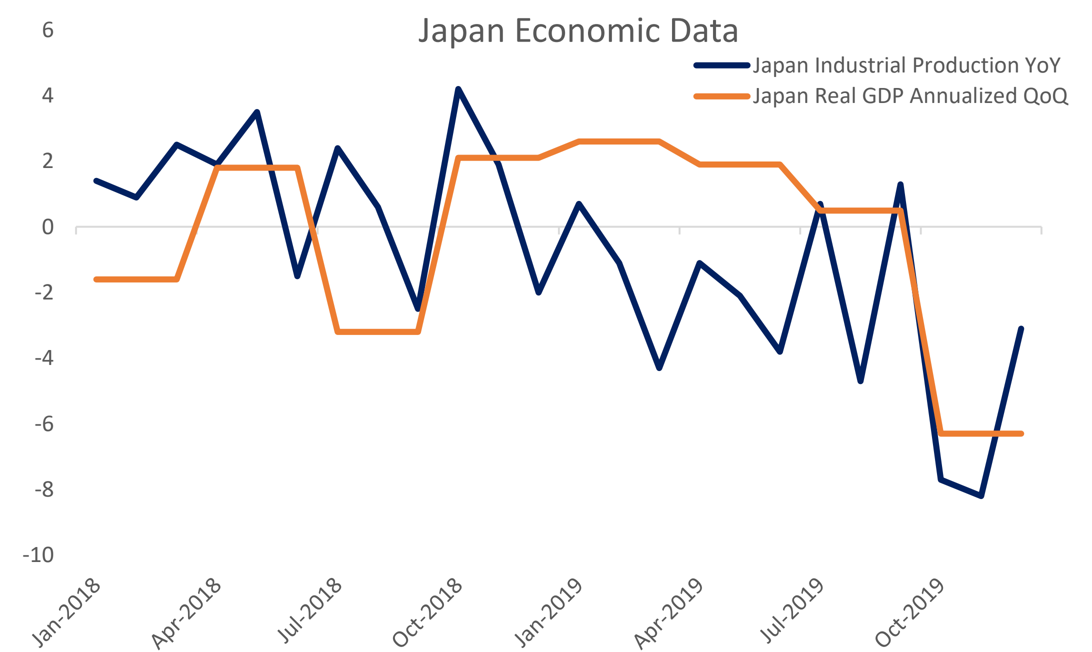
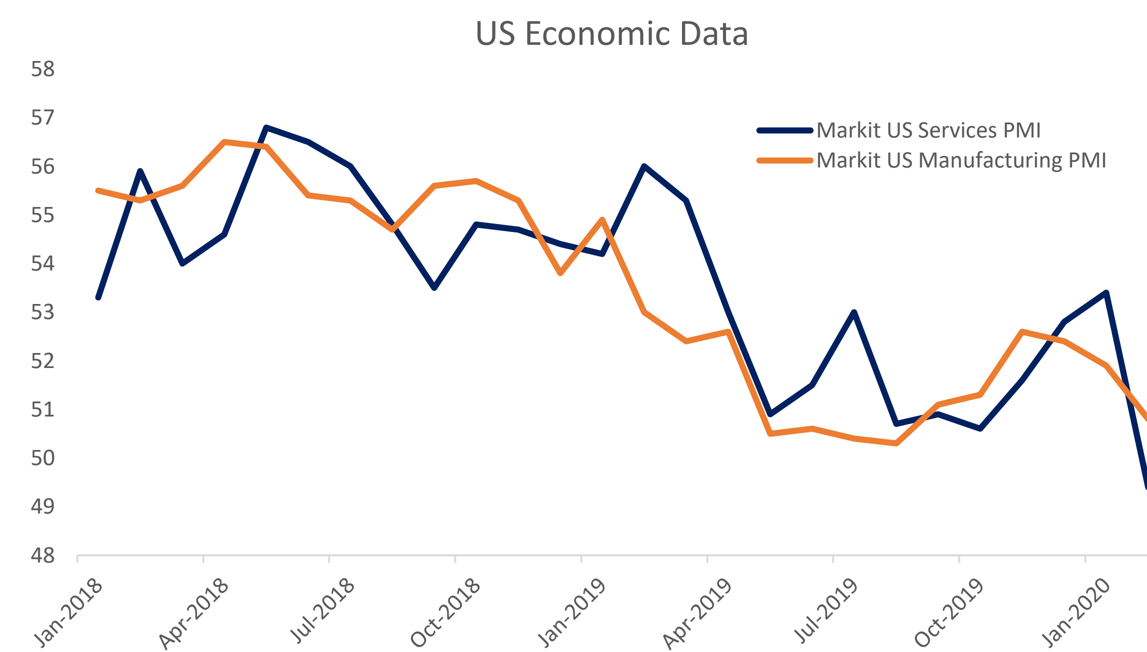
The nature of the capital markets today with all of the CTA, Algo and ETF trading means short term volatility can pick up very quickly. It's not until we see the developments and movements of underlying investors and active managers that we will get a true sense of the longer-term direction of the markets.

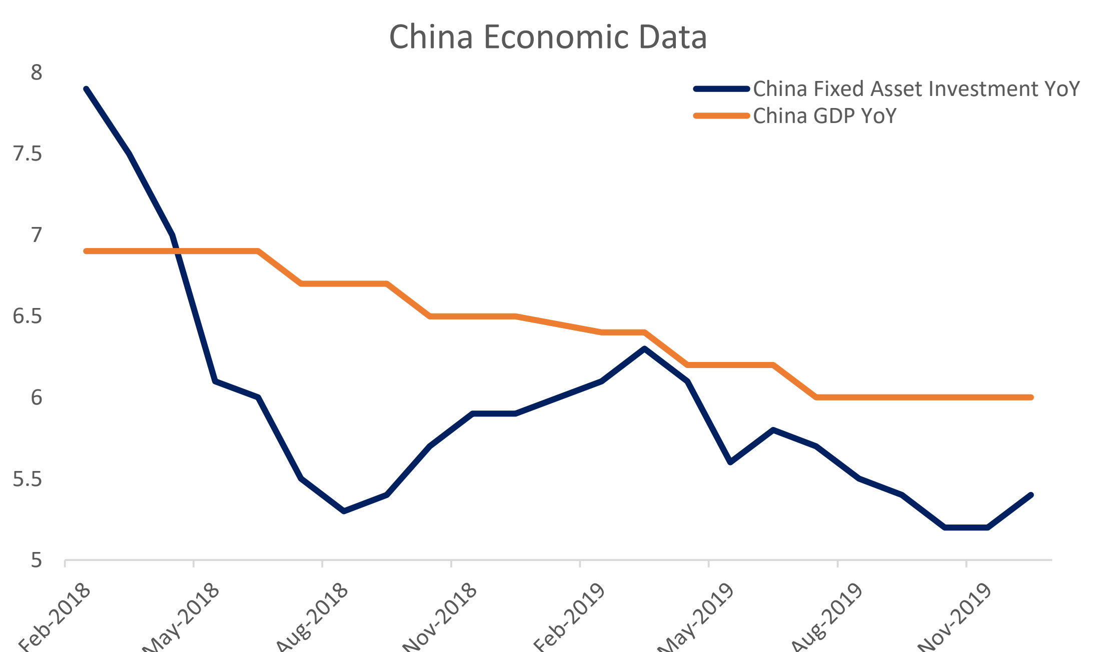
Economic outlook

What many people will have totally overlooked over the last few days is that global economic conditions were weak going into this crisis – see charts below. The areas of positivity were clearly coming from US consumer and financial market confidence. If central banks continued printing money the belief was that risk did not really exist – buy the dip. The reality is that risk does exist, and the question now is what damage this crisis will cause to the unwavering US consumer confidence. As we know it takes a long time to build confidence, but it can evaporate very quickly. The virus hitting America just might be the straw that breaks the camel's back. Given the partisan nature of US politics it looks ill prepared to deal with a significant spread of the virus. However, virus or no virus, the global economy was on a weak footing before the virus outbreak, a quick recovery from a supply side shock like this might be more difficult to achieve than the market currently expects. Indeed this underlying weakness might just be exposed, or perhaps more importantly the lack of policy options left to deal with such a problem. Our expectation is that the virus will be managed but a V shaped recovery from extremely weak first quarter economic data will be difficult. 2020 growth numbers could be sub-2019 levels which could have a significant impact on asset prices given elevated earnings expectations (as usual).









Source: Markit, Bloomberg as at 27.02.2020

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Central Banks

Going into the periods of market dislocation in early 2016 and late 2018, the global central banks had the ability to improve financial conditions by changing sharply the direction of monetary policy. Going into this potential crisis however global central banks were already all-in. The US Fed has a few rate cuts left in the locker but outside of that most central bankers have already been indicating that the global economy needs more fiscal support. What this really means is that they are nearly out of bullets. This will not stop the pretence that they have 'ample tools available' to deal with a downturn, but the reality is that their ability to affect anything other than asset prices is negligible. Tellingly neither of the last rounds of monetary stimulus from the ECB or Federal Reserve had any material impact on inflation expectations – ie markets did not believe in real economic terms that the stimulus would have any meaningful impact. In fact the current discussion in Europe amongst policy makers is strongly indicating that constant stimulus is now doing more harm than good. A view that we have held for a while. While the Central Banks will talk up their ability to support the economy and markets, what they can in reality do is unlikely to be sufficient to lift the economy out of the next downturn.

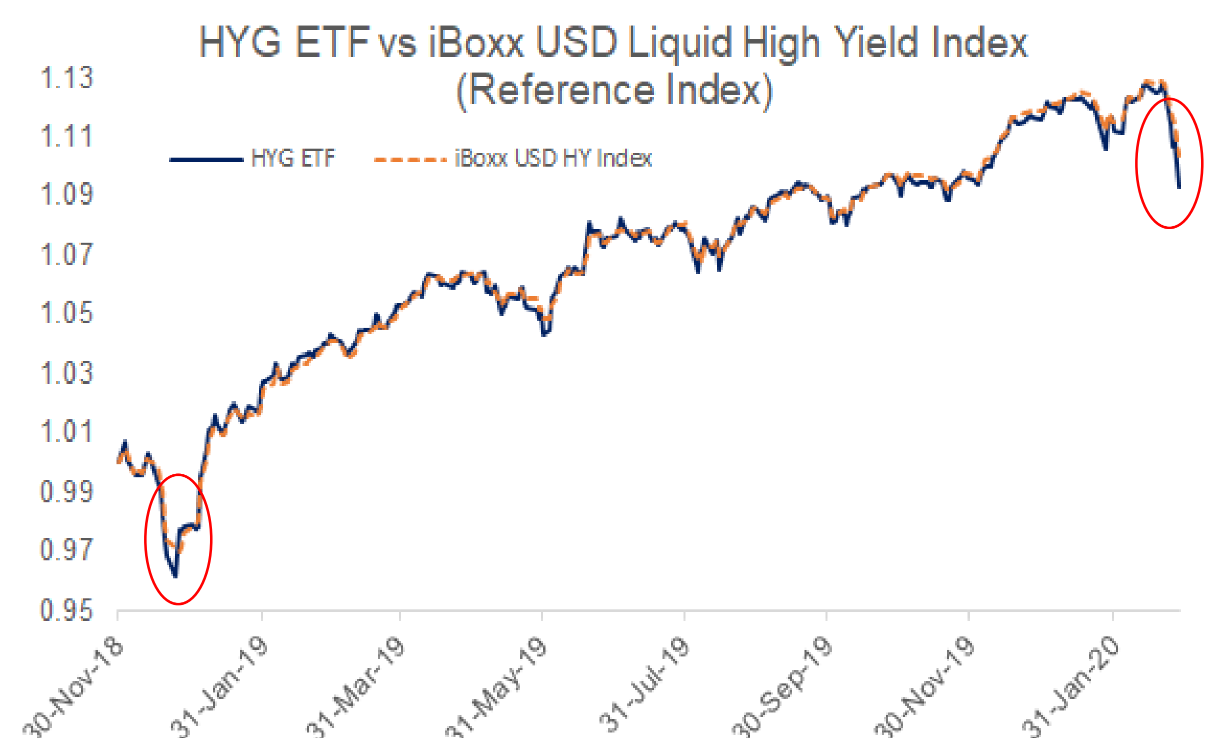
Political Outlook

Every crisis has a political dimension and this one will be no different. The impact on Chinese political stability is the most important factor here and now. The concern we have is that this crisis has exposed significant weakness in the communist party's policy apparatuses. It exposed how the secretive and regressive nature of communication is starting to backfire. It's one thing to silence so called dissidents and quite another to silence well intentioned medical doctors trying to warn the nation of the release of a potentially lethal virus. The problem for the global economy is that the most likely response of the communist party to this social unrest is to become even more regressive in its treatment of communication and free speech. As bad as that will become for China the knock on impact for the global economy might also be significant.

Flows Update

Looking at the recent flow information, high yield appears to be bearing the brunt of the activity . The combined flows of HYG (iShares iBoxx High Yield Corp ETF) , JNK (SPDR Bloomberg Barclays High Yield) and USHY (iShares Broad USD High Yield) ETFs hit $5.6 bln this week Monday through Thursday with discounts of between 67 and 79 bps. In the investment grade space EUR IG has seen outflows of approximately $1.6bln over the past 5 days while the LQD ETF (US IG) has seen approximately $1.1bln of outflows*.

The chart opposite displays the current illiquidity discount at play in the US high yield market.



*Source: Bloomberg as at 28.02.20

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Global Credit UCITS Fund (GCF) Update

The Global Credit UCITS Fund has also taken the conservative view of investing a significant portion of its portfolio into shorter dated, high quality credits. While the strategy does not participate in the short term reduction in government bond yields, longer term we believe it is a far more effective way of containing volatility in a credit portfolio, with the added benefit of providing liquidity organically. This approach has allowed the Fund over the last decade to effectively manage periods of volatility and capitalise on the opportunities they provide.

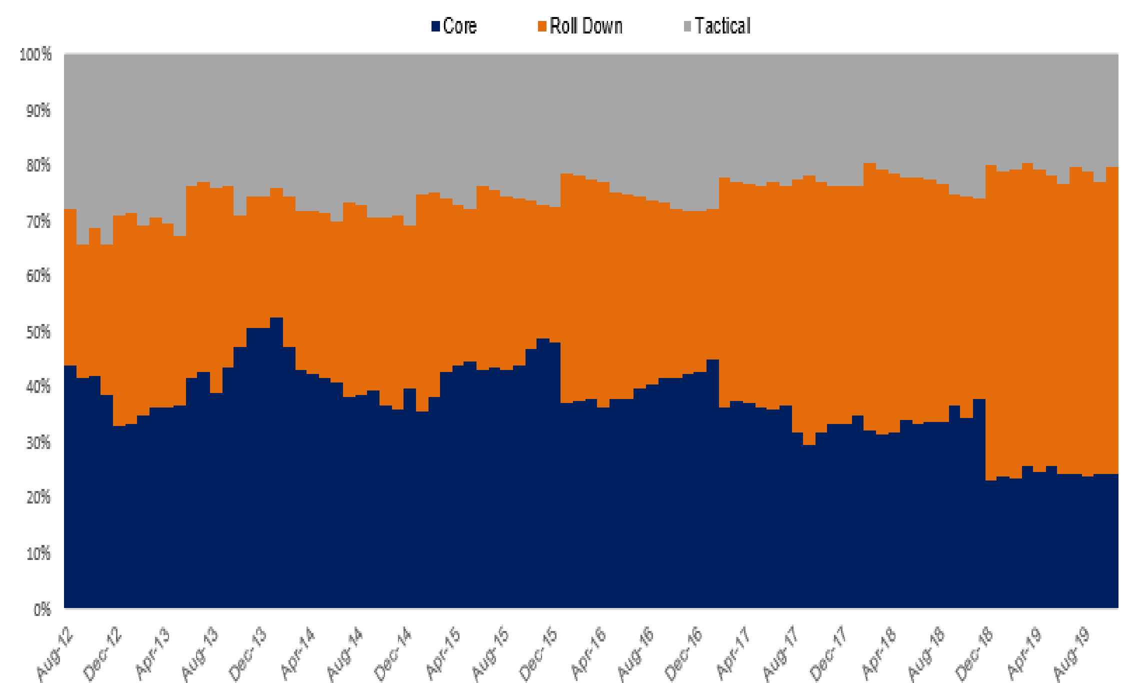
Portfolio Overview

In terms of issuers the portfolio has a strong bias towards larger corporates within the investment grade space (median market cap of approx. $20bln), with an aggregate duration range typically between 1.5 and 3.5. While this portfolio bias implicitly helps contain volatility, ***the Fund has always actively sought to allocate risk when both valuations are favourable and the macro outlook is at least relatively supportive.***

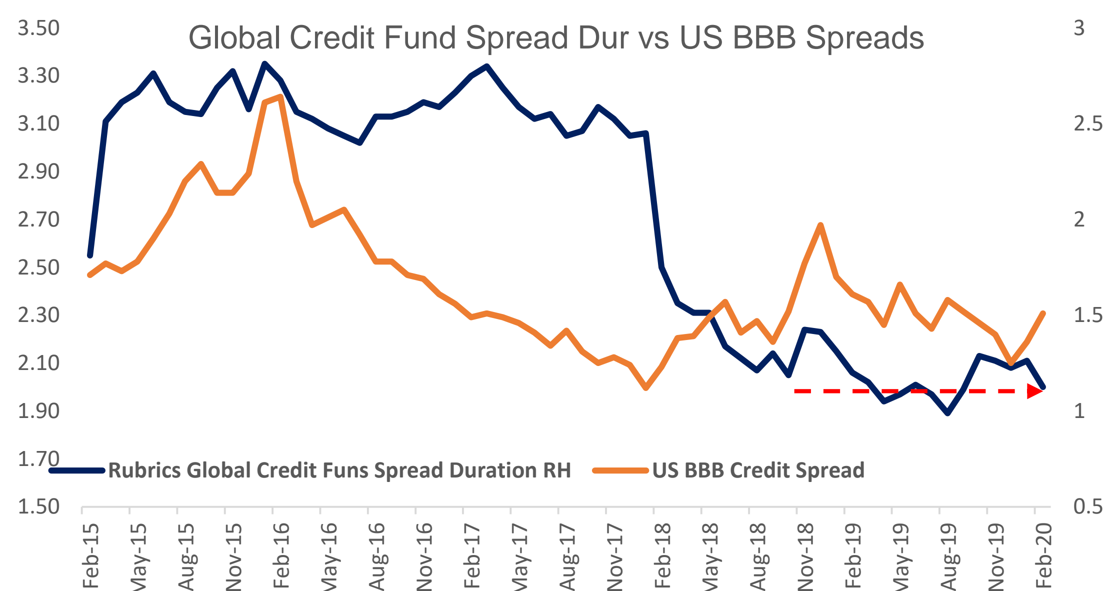
There have been occasions over the past 10 years when the Fund has taken the decision to alter the risk and liquidity profile based on a combination of the firm's macro view and prevailing market valuations. Most recently the team took the decision to reduce duration and credit risk in early 2018 which helped the Fund preserve capital throughout that period. ***By the end of 2018, we did not feel valuations had adjusted to levels which warranted an increase in the Fund's risk profile so we maintained the prevailing aggregate exposure*** (see historical portfolio duration chart). In so doing we attempted to avoid embedding future volatility through adding risk at essentially what we believed to be the wrong time.

Consequently throughout 2019 and early '20 many of the larger funds and passive strategies outperformed as both benchmark yields and spreads dropped. ***However given the volume of issuance and flows into the longer dated corporate space, we have felt for some time this is a particularly vulnerable area of the credit markets***. Additionally, the fact that benchmark yields have dropped as far as they have means there is scant duration protection left in the longer dated corporate space. As regards portfolio liquidity, ***the Fund has close to 15% of the portfolio coming due in the next 3 months***, while we may also look to create further cash should if we feel the market is providing attractive investment opportunities.

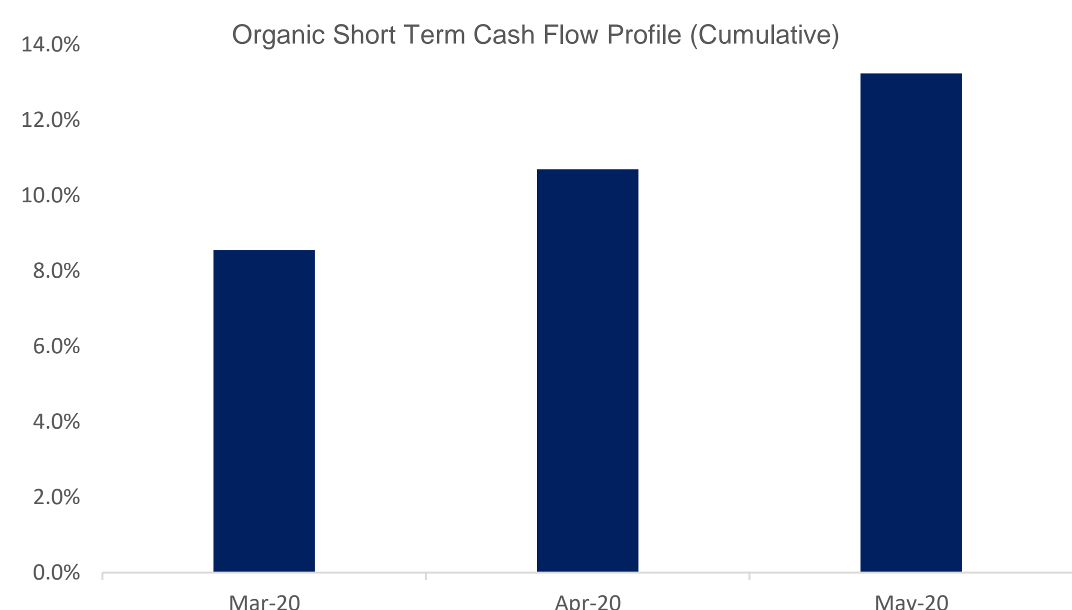
1. Historical Portfolio Allocation -
53% in Roll Down Bonds – All-time high



2. Historical Portfolio Duration -
Current duration close to all-time low



3. Portfolio Liquidity Profile –
~15% organic cash inflow in next 3 months



Source: Rubrics Asset Management as at 28.02.20

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Funds Outlook Continued:

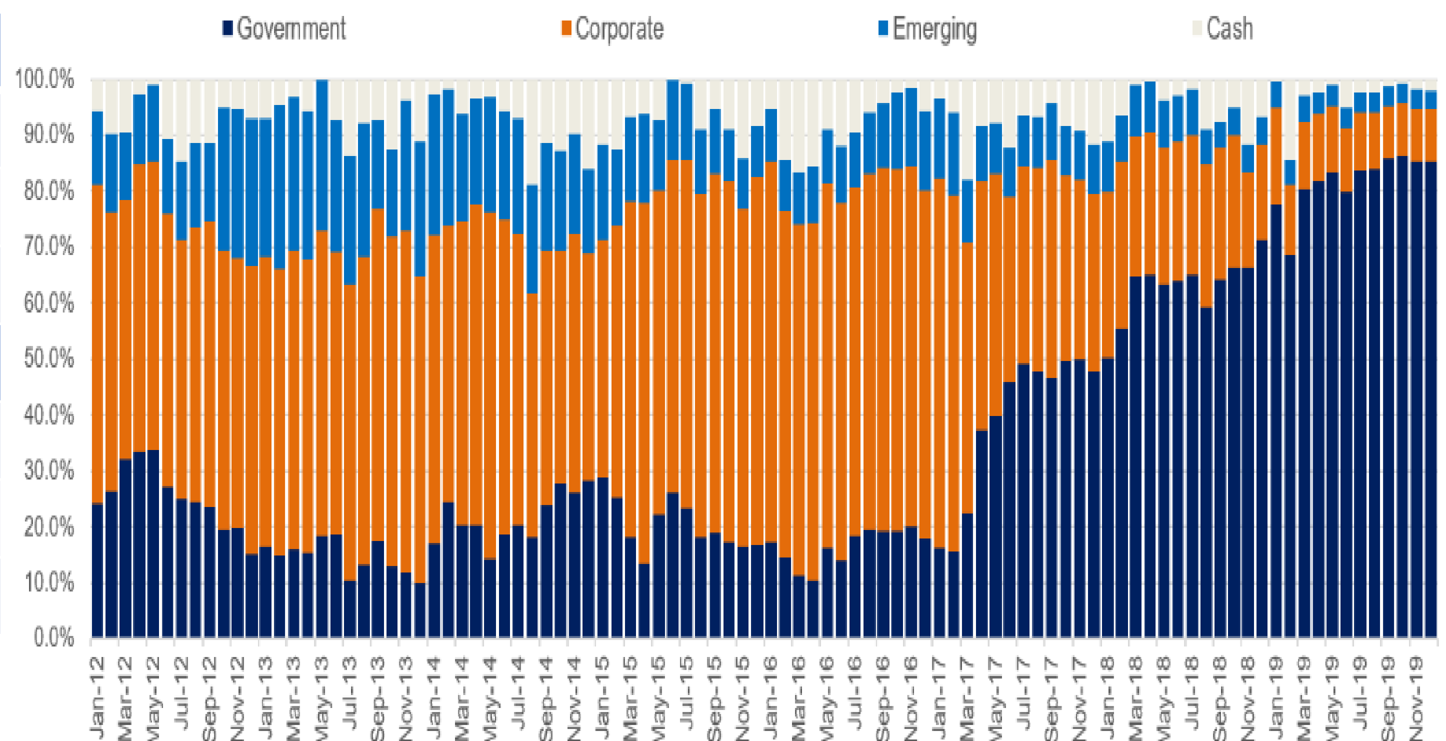
Global Fixed Income UCITS Fund (GFI)

The Global Fixed Income UCITS Fund is predominantly invested in liquid government bonds which is ideal for the type of volatility we are currently seeing. Corporate credit remains at an all time low of less then 10% of the portfolio. While we will keep an eye our for opportunities in short dated credit in the near term, we expect to see better opportunities to emerge down the line to lock in higher yields for longer. In the meantime the portfolio will continue to actively manage duration exposure through liquid government securities as the primary means of generating returns.

Portfolio Metric	GFI
Avg Credit Rating	AA
Avg Duration	5.5
Avg Portfolio Yield ($)	1.8%
Bucket Breakdown	
Government	88%
Corporate	9%
Emerging Market	3%

Source: Rubrics Asset Management as at 27.02.20

Historical Portfolio Allocation



Source: Rubrics Asset Management.

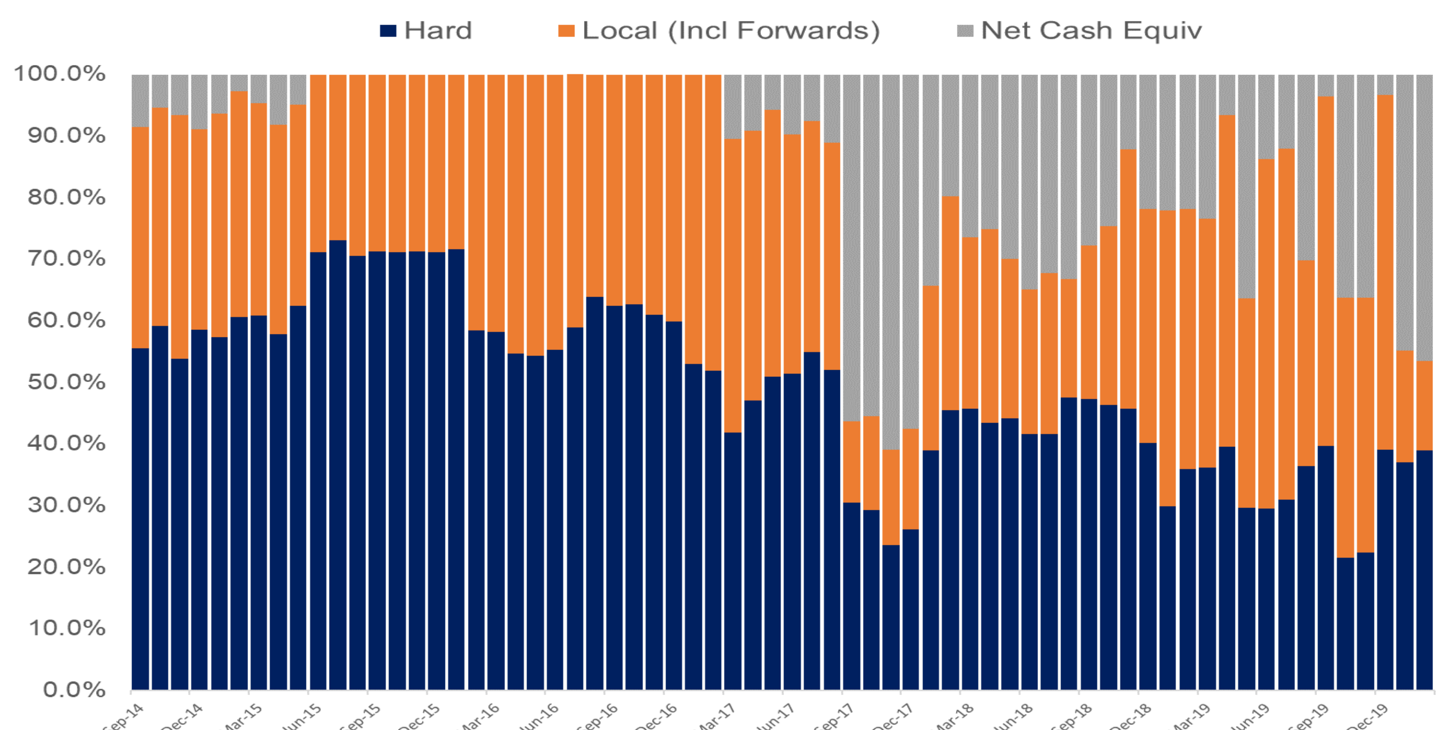
Emerging Markets Fixed Income UCITS Fund (EMFI)

Within the Rubrics Emerging Markets Fixed Income UCITS Fund, the key decision concerns the risk allocation between local and hard currency investments. On the local side the portfolio adopted a strategy of investing in a combination of short/mid duration government bonds and outright FX. On the hard currency side, the corporate exposure typically includes higher quality corporate, sovereign and quasi-sovereign paper. As a result of positioning, the Fund enjoyed a relatively strong 2018, while the extraordinary rally in hard currency in 2019 saw it underperform somewhat. Currently the fund sits with approximately 35% in hard currency investments with an average duration profile of 3, and local FX exposure at an all time low of 15%. Given the high degree of liquidity we feel we are well placed to take advantage of market weakness.

Portfolio Metric	EMFI
Avg Credit Rating	A
Avg Duration	1.5
Avg Portfolio Yield ($)	3.0%
Bucket Breakdown	
Hard Currency (Incl Cash Equiv)	86%
Hard Currency (Excl Cash Equiv)	39%
Local Currency	14%

Source: Rubrics Asset Management as at 27.02.20

Historical Portfolio Allocation



Source: Rubrics Asset Management.

IMPORTANT INFORMATION

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