April 2020

Taking advantage of tomorrow

Recent volatility reveals unprecedented levels of fear while markets struggle to gauge the extent of Covid-19's economic damage.[1] As investors turn to safe haven assets for liquidity[2] and pandemic-fueled lockdowns create a grim outlook for companies, as well as their ability to pay back debt, is there still a place for fixed income?

Fear-induced trading has impacted almost all markets as the ability for global economies to rebound from lengthy lockdowns remains unclear. Despite this, there may be pockets of opportunity amid the uncertainty, says Scott Zaleski, senior portfolio manager of the BNY Mellon Global Fixed Income Fund:

"We look for areas where dislocations are more market-based than fundamental, especially as the government steps up to support the economy," he says. "In primary credit markets, we've seen bonds issued at a discount to the existing secondary issues."

According to Zaleski, recent central bank action could be an important determinant in the strength of certain credit sectors. In March, the Federal Reserve (the Fed) announced a plan to address liquidity issues and default risks—and subsequently expanded the list of eligible securities it can purchase. In other words, while it initially focused on injecting liquidity into treasury and mortgage markets, it can additionally purchase: [3]

- corporate bonds (in both primary and secondary markets);
- municipal bonds;
- securitized products (including commercial-mortgage backed securities and collateral loan obligations);[4]
- and high yield ETFs[5]

"This brings the Fed's actions closer to the quantitative easing policies of other regions such as Europe and Japan. Additionally, loans to small businesses are expected to reduce layoffs and bankruptcies until the economy is set to rebound."

While Zaleski believes this is helping some areas of US fixed income, he acknowledges other problems have yet to be addressed, or may have unintended consequences, and adds that some assets, which are still not eligible for purchase, have lagged broader markets. As a result—he and the global fixed income team are strategically allocating assets, taking into account the uncertainty of the crisis while still positioning for an eventual rebound.

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[1] *CNBC:* Wall Street's fear gauge closes at its highest level ever, surpassing even financial crisis peak. March 16, 2020

[2] *Marketwatch:* Why are bonds failing to act like a safe haven as stocks sell-off. March 18, 2020.

[3] *Morningstar:* Sizing up the Fed's historic coronavirus crisis intervention. April 7, 2020.

[4] *S&P Global Market Intelligence:* Federal Reserve adds AAA CLOs to liquidity playbook. April 9, 2020.

[5] *ETF.com:* Federal Reserve will buy junk bond ETFs. April 9, 2020

“We continue to look for bonds in the securitized market, which we believe can withstand severe stress scenarios and are trading at attractive levels following a volatile few weeks,” Zaleski says. “We also believe exposure to high-quality US and European corporate bonds can help us participate in a rebound without leaving us susceptible to large market selloffs in areas such as high yield.”

In emerging markets, allocations have been tailored toward hard-currency debt and investment-grade bonds, Zaleski adds.

Irrespective of region, it’s fair to say the team is focused on high-quality issuance. At times of increased market stress, this can help mitigate default risk and lower overall volatility. And if the team is correct—in its expectation that global growth will undergo a shallower rebound than the initial drop (which Zaleski likens to a Nike swoosh)—this approach may be even more prudent.

“We’re maintaining our skew toward higher-quality bonds as we believe the frequency and severity of defaults in lower-quality securities will increase, especially if the rebound takes longer and we fail to reach the level of growth we had before the downturn,” he says.

Commenting on the flexibility of investing globally, he concludes: “The benefit of the global strategy is that it’s well positioned to benefit from the lack of coordinated lifting of social restrictions, differentiated fiscal and monetary policy responses, as well as the different speed at which countries and economies return to a normalized level of growth.”

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