Market Watch

Bonds: Opportunities amid dislocation

Summary

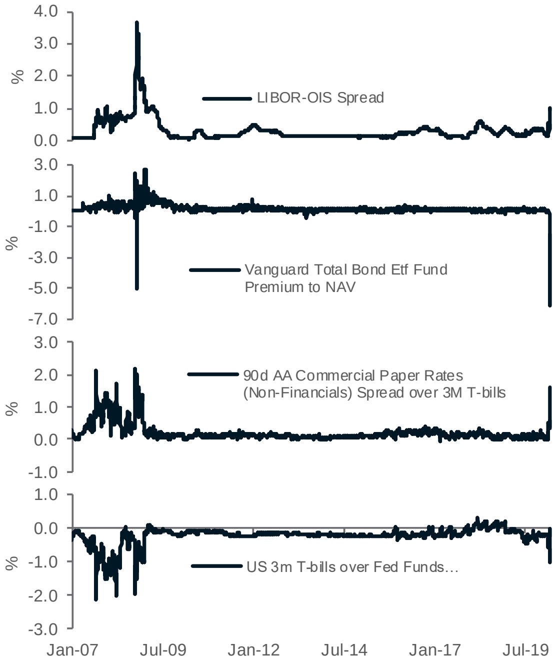
- **US short-term funding markets have been a major source of recent market stress as a surge in demand for, and dwindling supply of, US dollars created dislocations**
- **How this stress evolves is key for corporate bonds, many of which are already pricing a 2001-style recession**
- **Pricing and Fed policy suggest we may be close to a buying opportunity for long term bond investors. We highlight specific opportunities**

Why does short-term US lending market liquidity matter to bond investors?

- Money markets serve the important purpose of ensuring the supply of short-term money (lending) is matched to the demand for short-term money (borrowing). The Fed sets the price of short-term money through its policy rate, and a well-functioning market efficiently transmits this price across various funding markets.
- Today, this pricing mechanism has been dislocated. As the charts on the right illustrate, the Fed's 150bps in interest rate cuts have not been efficiently transmitted to money markets. The explanation, in our view, lies in a sudden, and severe, US dollar demand-supply imbalance that followed fears over the impact COVID-19 could have on the economy.
- Demand for short-term borrowing has surged as the demand for cash has risen, either because of shifting preferences (a preference for 'liquidity' when asset markets are volatile) or from a precautionary perspective (a corporate drawing on a credit line). On the other side, supply has reduced, either because those usually willing to lend are hoarding cash, or because an inverted yield curve (very short-term rates being higher than slightly longer-term rates) meant money market funds, a key source of US dollar supply, are less willing to lend.
- Liquidity in these market matters because of the knock-on effects it can have on the rest of the economy and markets. For example, if banks are not able to easily obtain short term financing, they are less likely to lend onwards. If corporates are unable to access short-term financing, they may eventually be forced to curtail business or default.
- Some signs of this concern are visible in mainstream bond markets. As the second chart on the right illustrates, corporate bond spreads (yield premiums over Treasuries) now closely resembles those at the peak of the 2001 recession.
- These linkages explain why much of the Fed action has been focused on alleviating liquidity-related stress in short-term funding markets. So far, the Fed has taken steps to improve liquidity in (i) the overnight repo market, (ii) the commercial paper market and (iii) money markets.

Short-term liquidity risk indicators are flashing red, though central banks are responding

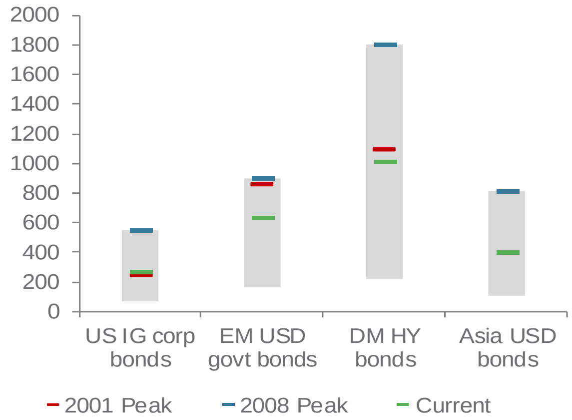
Select indicators of lending market stress



Source: Bloomberg, Standard Chartered

IG and HY corporate bond spreads have widened towards 2001 recession peak levels

Bond asset class spreads (yield premiums over Treasuries); current vs. range since 2000



Source: Bloomberg, Standard Chartered

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Has this created a buying opportunity?

- Yes, in our view, in specific areas of the bond market:

  i. **European financial and insurance sector subordinated bonds** – Being a relatively riskier type of bond, this sub-asset class has weakened significantly, as it often does when markets are volatile. However, we believe the banking and insurance sector remains well capitalised, causing us to see current yields as attractive.

  ii. **Asia USD bonds** – This asset class has retained its low volatility characteristic throughout the current sell-off. This, together with today's more attractive yields and valuations, makes this an attractive asset class, in our assessment.

  Within this, we see opportunities within the Asia quasi-sovereign sector as the implicit sovereign guarantee means we see a low likelihood of defaults as long as government backstops remain credible. The China high yield sector may also offer selective opportunities, in our view.

  iii. **'Oil-input' sectors** – Not all energy sub-sectors should suffer from falling oil prices. Refiners, for example, should benefit from lower crude oil prices.

  iv. **High-quality bonds** – The global USD investment grade universe offered a below-2% yield at the start of March. Today, the yield is closer to 3.4%. This means an investor has to take on less risk to earn a given level of yield.

Are there any areas to avoid?

- At this time, we would be reluctant to add to the following:

  i. EM local currency bonds – one of the key risks of a dislocated USD funding market is US Dollar strength. Given this bond asset class tends to be highly sensitive to currencies, we believe risk/reward is not compelling.

  ii. Energy sector – with the exception of the 'oil input' described earlier, the energy sector remains vulnerable to further oil price weakness and/or a rise in defaults, in our view.

  iii. Travel and tourism sector – while there may be individual exceptions, the sector is likely to be hardest hit in an economic shutdown, worsening credit quality.

Should investors hold on to existing bonds investments?

- Largely yes, in our view, subject to rebalancing in line with the opportunities and risks we highlight in the earlier two sections.
- As the 'fear ratio' chart on the right illustrates, the scale of the sell-off in Investment Grade and High Yield bonds is now approaching that of the 2001 recession. This suggests that the risk of selling at, or close to, the bottom is rapidly rising. Instead, we would focus on efforts to:

  i. Maintain holding power: short-term movements in illiquid markets can be unusually large, but can quickly reverse if policy efforts have their intended impact

  ii. Rebalance towards opportunities: as highlighted in the first part of this document, where appropriate.

The current bond market sell-off is approaching 2001 in terms of scale

'Fear ratio': Peak-to-trough spread widening: Current (since 12-Feb-2020) as a % of 2001

	2001	YTD	Fear Ratio*
Volatility			
VIX	45.1	76.45	170%
MOVE	166.5	124.1	75%
CVIX	10.9	12.69	116%
Fixed Income			
EM USD sov bonds	860.9	634.4	74%
Global HY bonds	1095.7	1016	93%
US IG Corp bonds	241.0	264	110%

Source: Bloomberg, Standard Chartered

* For bond markets and volatility indices, the ratio compares the current level versus the 2001 peak level

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