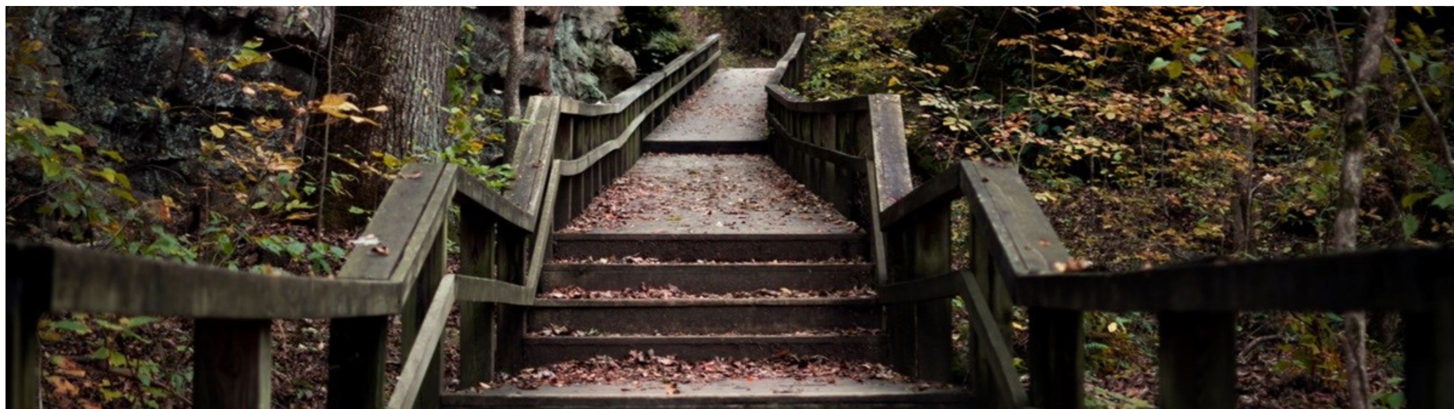
Perpetual

BENIGN OR FOREBODING – CREDIT AND FIXED INCOME MARKETS IN THE TIME OF COVID



PERPETUAL INVESTMENTS

23/09/2020

While 2020 has been a tale of two halves thus far for equity markets, it's been a different story for fixed income and credit. The huge monetary and fiscal measures implemented by central banks and governments to respond to the COVID-19 crisis resulted in official interest rates either staying low or moving lower. Some economies, such as the US, returned to printing money.

Mid-2020, it seemed the worst was behind us and economies around the world began to reopen. The improved economic data strengthened a more optimistic view that the worst was behind us...until resurgences in COVID case numbers prompted some regional governments in the US, Europe, Asia and Australia to reinstitute shutdown policies.

While Australia's second wave shows signs of slowing and Victoria looks close to emerging from lockdown mark two, a second wave is now cascading through parts of Europe. In the US, the first wave continues to wreak havoc and the Republicans continue to dispute the quantum of a second round of stimulus.

Credit and fixed income markets

While financial markets continued to rally over August, credit spreads tightened; credit spread contraction was the key component of fixed income return, offsetting rising yields.

Telecommunications and utilities spreads outperformed, approaching pre-COVID levels. Infrastructure, airline, university and consumer REIT spreads remain impacted.

Major bank senior spreads, supported by the RBA's Term Funding Facility, have eclipsed their pre-COVID levels. August saw tier two spreads tighten and credit curves steepen as investors increased risk and took advantage of attractive valuations relative to the senior curve.

Government bond yields rose during August. The domestic yield curve steepened as a result of the Federal Reserve relaxing its inflation target, a move that impacted bond markets globally. The RBA maintained its cash rate at 0.25% and recommenced its purchase program of government bonds as part of its ongoing yield curve control operations.

Primary issuance was robust during August, notable for a number of tier two financial deals following earnings announcements. Demand for primary issuance was strong with a number of deals oversubscribed.

The Perpetual Diversified Income Fund – a diversified exposure to floating rate fixed income

The Perpetual Diversified Income Fund is an active, diversified portfolio of high quality, floating rate debt investments, designed for investors seeking predictable outcomes. These include above cash rate returns, consistent income and capital stability.

The Fund invests in floating rate assets because we believe that capital preservation is important. When interest rates rise, floating rate assets may better protect investors' capital and allow for higher income generation. Floating rate investments are a natural complement to traditional fixed rate securities, such as government bonds and term deposits.

The Fund:

- Delivered a 0.73% net monthly return and 1.82% annual return for the period ending 31 August 2020*
- Continued to collect running income in excess of the benchmark across all corporate and collateralised sectors.

Looking ahead

The credit outlook remains cautious. 'Normality' is unlikely to return until the pandemic is behind us. While many commentators are busy predicting the extent of economic damage being wrought by COVID-19, the only certainty is that no one knows exactly how the economic landscape will look.

In the shorter-term, valuation indicators remain balanced. Domestic and international spreads remain in range of medium-term averages and cross currency swap levels are currently supportive for the valuation outlook. Domestic swap spreads are negative at a number of tenors, detracting slightly from the valuation outlook.

Macro indicators remain negative. Economic growth remains the largest impediment to credit spreads, with a number of global economies recently recording their worst year on year GDP contraction for the June quarter. Credit downgrades still significantly outnumber upgrades, and issuers with a negative credit watch classification are at their highest of all time.

Supply and demand factors have turned slightly negative. The domestic primary market remains well supported, with deals attracting robust interest. The light upcoming maturity schedule and robust issuance pipeline both slightly detract from the overall outlook because each increases supply. Market positioning and technicals remain positive.

While COVID-19 has significantly impacted the global economic outlook, central bank support and improved trading conditions have supported valuations. The macro outlook remains the most significant impediment to credit performance, while supply and demand indicators also detract from the overall credit outlook.

Find out more about Perpetual's Diversified Income Fund.

FURTHER READING - COVID-19

Visit our COVID-19 Insights Hub for economic and market updates to keep you informed as the situation evolves.

** Past performance is not indicative of future performance*

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