



COVID-19 and Fixed Income Markets

How the coronavirus outbreak could impact bond investors.

February 2020

KEY INSIGHTS

- Major central banks unlikely to respond with interest rate cuts in the short term.
- Asian local bonds to outperform, while the region's currencies face the risk of further depreciation.
- Diverse impact expected within the corporate bond universe.

The outbreak of the coronavirus (COVID-19) has upended financial market forecasts for 2020. During our policy meetings, the investment team discussed the latest developments and outlined the three key investment implications for fixed income markets.

1. Major Central Banks Unlikely to Respond With Interest Rate Cuts in the Short Term

Although there is little doubt that global growth will be adversely affected by the coronavirus outbreak, it remains uncertain how long or severe the impact will be. It will take time to work through the data, so the real impact may not be known for some time. Against this backdrop, it is likely that major central banks will adopt a wait-and-see approach while keeping a close eye on how Chinese authorities respond.

"So far, China's policy response has been about crisis management," said Kenneth Orchard, a portfolio manager and member of the global fixed income

investment team. "But we could see a wave of new measures over the medium term to support growth." These measures could take the form of additional interest rate cuts, loans to support small and medium-sized businesses, or even targeted fiscal stimulus in areas such as infrastructure, Mr. Orchard added.

Within global fixed income, the outbreak of the virus has driven markets to quickly move from pricing in the possibility of reflation to pricing in emergency rate cuts. This has pushed yields down sharply, with the front end of the U.S. curve now reflecting expectations that the Federal Reserve will lower interest rates by September.

Mr. Orchard did not agree with the market consensus, however. "It is too early at this stage for markets to imply that major central banks will start delivering interest rate cuts in 2020," he said. "The inversion of curves in the U.S. and Germany makes holding government bonds in these core markets an expensive value proposition at present."

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Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

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Portfolio Manager

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Portfolio Manager

2. Asian Local Bonds to Outperform, While the Region's Currencies Face the Risk of Further Depreciation

The ripple effects from the expected growth slowdown in China will be felt across Asia. To cushion the blow, several central banks in the region are likely to relax their monetary policy and supply liquidity in the market. “With inflation broadly subdued in surrounding Asian countries, there is room for central banks to take action to support growth,” said Mr. Orchard. “Central banks in Thailand and Indonesia have already cut interest rates, and we expect more in the region to follow suit in the coming months.”

These could include South Korea and Malaysia, as their economies have links with China through trade and tourism. From a fixed income perspective, the combination of well-behaved inflation and the likelihood of interest rate cuts in the future is conducive for local currency bonds and should likely drive outperformance of the region.

Aside from interest rate cuts, some countries may also announce fiscal stimulus measures. Singapore, for example, recently unveiled a USD 4.5 billion package to help weather the economic impact stemming from the virus. More countries may follow, including South Korea and Malaysia, according to our sovereign analysts.

Despite these measures, the region's currencies are at risk of further depreciation. “We could see weakness of certain Asian currencies continue in the short term as a result of the virus threat,” added Mr. Orchard. This includes the Japanese yen, which has traditionally acted as a safe haven but has recently come under pressure because of Japan's proximity to the epicenter of the virus.

3. Diverse Impact Expected Within the Corporate Bond Universe

The impact of the coronavirus will vary from industry to industry. Our credit and equity analysts believe that the auto sector looks vulnerable as the closure of factories in China will interrupt its supply chain, particularly for companies that have parts produced in the Hubei province. Meanwhile, the effect on technology companies is expected to be varied depending on their supply chains.

For commodity companies, the sharp fall in prices in anticipation of slowing global growth has been a significant headwind. “Commodity companies have been hit hard, but if the virus is contained, there could be some attractive opportunities in this space,” said Mr. Orchard, adding that this would also be the case for Chinese property development companies.

Broadly, the Asian high yield sector looks attractive for investors willing to look beyond short-term volatility. Curves are steep and valuations attractive in this space relative to Asian investment-grade and other segments of the high yield market, including emerging markets. The technical backdrop is also supportive as gross supply is expected to trend downward in 2020, while the investor base is largely domestic with a longer-term investment time horizon in mind.

“Asia high yield looks appealing, but it will be on a case-by-case basis that we add a position and only when our bottom-up research identifies an attractive company from a medium-term perspective,” said Mr. Orchard.

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