Views on the Dynamic Post-Pandemic Trading Environment

Trading team insights are a key input for portfolio positioning.

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KEY INSIGHTS

- Our global fixed income trading team provides valuable insights that inform the positioning in our fixed income portfolios.
- These views on upcoming issuance, demand trends, dealer balance sheets, and liquidity conditions can help shape portfolio positioning in a variety of ways.
- The trading team also keeps portfolio managers informed about liquidity issues that could impact our ability to efficiently reposition portfolios if needed.

With the economic recovery progressing, our global fixed income trading team continues to provide valuable insights on upcoming issuance, demand trends, bond dealer balance sheets, and liquidity conditions that inform the positioning in our fixed income portfolios, including the Total Return Bond Strategy. Traders specializing in segments ranging from U.S. Treasuries to investment-grade corporate credit to asset-backed securities can pick up on trends and signals that may affect the relative value and volatility of those sectors. In light of the unique challenges of fixed income investing, the trading team also keeps portfolio managers informed about liquidity issues that could impact our ability to efficiently reposition portfolios if needed.

Given all the attention to the recent equity market volatility triggered by the forced liquidation of large stock positions related to a leveraged[1] hedge fund, some observers wonder if a similar event could occur in fixed income markets. In our view, leverage in bond markets is not high enough to generate this type of major event. Our observations indicate that fixed income dealers have relatively modest exposure to risk and can continue to efficiently manage client flows even if a major investor would need to unwind large positions.

Broad Repositioning for Economic Rebound Appears to Have Ended

Looking at broad trends in the investment-grade corporate credit market, at the beginning of 2021, market participants seemed to continue the repositioning for an economic

[1] Leverage involves investing using borrowed funds.

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> **— Dwayne Middleton**
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rebound that began following the U.S. elections last November. That repositioning into more cyclical market segments appears to have ended around the middle of the first quarter, with most market participants keeping their investment-grade credit positioning relatively stable in recent weeks. It appears that some participants have taken profits on individual credits that posted steep gains in anticipation of the economy more fully reopening, such as movie theater chains.

Healthy Demand, Moderating Issuance to Support Investment-Grade Corporates

U.S. dollar-denominated investment-grade corporate bond issuance in 2021 through April 23 was about 18% lower than in the year-earlier period,[2] when issuance sharply accelerated as firms scrambled to raise cash at the onset of the pandemic. Around 40% of the new supply matures in five years or less, so the amount of duration[3] entering the market has been relatively modest, and more than half of the year-to-date issuance was in the relatively high-quality financials sector, limiting the impact of supply on the broader market.

Merger and acquisition activity could increase later in 2021, presenting a risk to the technical picture as companies tend to issue new bonds to fund their acquisitions, which would add to supply. However, many firms raised ample cash last year, which could reduce their need to come to market with new bonds.

We are confident that demand will remain strong enough to absorb new issuance—Asian and European investors in particular are eager to buy U.S. investment-grade corporates because they provide a relatively attractive yield when hedged back to their local currencies. In addition, rising rates have caused the longer-term liabilities of pensions and insurance companies to increase, bolstering demand from these investors for new investment-grade bonds.

Bulk of High Yield Supply Used to Refinance Existing Debt

Unlike the investment-grade corporate market, issuance volume in the high yield bond market in 2021 has been much higher than in the comparable period last year as sub-investment-grade companies rush to secure new funding at low rates. The bulk of the new high yield issuance has been from low-quality CCC rated companies in industries that are related to energy or that are most exposed to the pandemic.

While some observers see this as a sign of increasing leverage and credit risk, the majority of year-to-date 2021 high yield issuance has been to refinance existing debt, so the net effect on the market has been much smaller than the gross supply data indicates. Companies, including those in troubled industries, have been taking advantage of easy access to capital to extend maturities and increase balance sheet liquidity, helping keep default risk subdued.

Better Liquidity in Credit Derivatives

We have observed that there is abundant liquidity in corporate bonds that trade daily, but liquidity declines in less commonly traded issues. In light of these liquidity constraints, credit derivatives can provide a more liquid way to access credit markets. Credit default swaps[4] (CDS) tend to be meaningfully more liquid than the corresponding cash bonds.

[2] Source for investment-grade corporate issuance data: Morgan Stanley.
[3] Duration measures a bond's sensitivity to changes in interest rates.
[4] A credit default swap involves regular payments from the buyer to the seller in exchange for repayment of principal value to the buyer if the issuer experiences a credit event such as default.

An index of credit default swaps, known as CDX, is an instrument that has become commonly used to take positions that would benefit from changes in credit spreads[5] on the underlying corporate bonds. In our view, flows into CDX—driven by hedge funds and other market participants trying to capture small pricing differences between the cash index and the derivative—are likely to anchor the prices of these instruments near their current levels.

Trading Insights Applied to Portfolio Positioning

These observations from the trading team help portfolio managers across our fixed income strategies identify trends that may not be readily evident and could impact broader markets. This can help shape portfolio positioning in a variety of ways, ranging from strategic to tactical. For example, although corporate credit spreads are relatively narrow by historical standards, we have maintained material exposure in the Total Return Bond Strategy, a position informed not only by our fundamental analysis but also by the strong technical picture from our trading team.

WHAT WE’RE WATCHING NEXT

Mainly as a result of their relatively high coupons, non-investment-grade bonds have historically been less sensitive to the negative price effects of rising interest rates than investment-grade debt. However, our discussions with bond dealers indicate that market participants anticipate that high yield bonds may now be more susceptible to rising rates than they have typically been in the past because their coupons have decreased as issuers have refinanced higher-coupon bonds.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material:

Debt securities could suffer an adverse change in financial condition due to a ratings downgrade or default, which may affect the value of an investment. Fixed income securities are subject to credit risk, liquidity risk, call risk, and interest rate risk. As interest rates rise, bond prices generally fall. High yield debt securities are generally subject to greater risk of issuer debt restructuring or default, higher liquidity risk and greater sensitivity to market conditions.

[5] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

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