Fixed income markets continued to heal, but is the easy part over?

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Boston - Risk assets extended their rebound into the third quarter, driven by better-than-expected economic data and unprecedented support from the Federal Reserve.

Uneven recovery in the third quarter

Markets were choppy in September as Congress failed to pass additional fiscal stimulus, COVID-19 spiked in parts of Europe and the US, and the pivotal US elections drew closer. Nonetheless, third-quarter returns were broadly positive across the US fixed income market.

The US economy continued to benefit from the easing of coronavirus restrictions, as well as the aggressive actions taken by policymakers in March and April to blunt the impact of the global shutdown. Manufacturing and services sector surveys were strong throughout the quarter, July retail sales topped pre-pandemic levels and the unemployment rate fell to 8.4% in August. That said, the recovery remained uneven. Industries especially hard hit by the virus — like leisure and hospitality — remained very depressed.

Aggressive Fed action to support markets

US monetary policymakers held the federal funds rate between 0% and 0.25%, while implementing the lending and bond-buying programs rolled out earlier this year. The Fed's commitment to supporting the bond markets as a price-insensitive buyer of last resort, coupled with ultra-low rates, fueled record corporate bond issuance and massive flows into US fixed-income funds.

In August, the Fed announced that instead of pre-emptively raising interest rates to head off higher inflation, it would let inflation run "moderately" above its 2% target for "some time" following periods of persistently below-target inflation. This move to an average inflation-targeting strategy signaled lower rates for longer.

After quick rebound, slower healing can still continue

The fast, initial snapback — typically the easiest part of any recovery — is mostly over. Yet we still believe the broad US economy should continue to recover given unprecedented monetary support, the cumulative fiscal assistance provided so far and the prospect of more fiscal stimulus by year-end. We also think the US is beginning to adapt to living with COVID-19 until the health crisis recedes. So in our minds, the worst of the economic shock is behind us, even if there is another wave of the virus.

Our economic outlook, combined with Fed buying and demand for income, makes us constructive on investment-grade corporate credit. As the Fed's response to COVID-19 encouraged companies to raise large amounts of liquidity, gross leverage has increased significantly. But with a substantial amount of cash still sitting on corporate balance sheets, net leverage has not increased at the same pace. We believe many companies will use their cash to reduce debt and repair their balance sheets, rather than maintain the focus on shareholder returns that has characterized much of the low-rate environment over the past decade.

Bottom line: Now that fiscal stimulus is fading and may not be replenished soon, we could see a shift in the financial health of the consumer. Consequently, we would avoid consumer-focused securitized credit, as valuations have rebounded. We prefer asset-backed securities (ABS), where we favor areas with more attractive long-term fundamentals, such as deals backed by renewable energy loans and data centers.

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