BERENBERG Markets

FOCUS

08 July 2020

In *Focus* we comment on extraordinary market events and analyse capital market related special topics.

Corporate bonds – 2020: a year of extremes or the new normal?

2020 is already a year that can largely be described in superlatives: a negative oil price and the fastest and shortest equity bear market of all time, followed by a record recovery. The bond markets have not been spared. On the contrary, there the distortions were even more extreme. In March, corporate bonds in euros and US dollars recorded the weakest performance ever (see Figs. 1 and 2). There were unprecedented outflows in bond funds amounting on average to 2-3% of assets under management per week, and to as much as 3-4% in emerging market funds, for several weeks. By comparison, emerging market equity funds only experienced outflows of 0.7% of total assets under management per week at the peak of the COVID-19 concerns in capital markets this year, while outflows only made up 0.3% of equity funds overall.

COVID-19 merely the trigger

The COVID-19 shock was ultimately only the trigger for these developments. So what are the root causes of the extremes since the beginning of the year?

Three fundamental factors behind the extremes

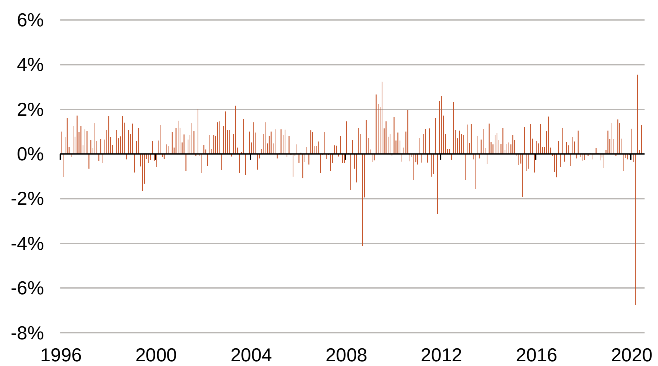
With regard to the bond markets, three fundamental factors should be mentioned to begin with: firstly, the extremely low risk premiums before COVID-19; secondly, the barely positive current yields after years of "hunt for yield"; and thirdly, the on average longer maturities of outstanding bonds. All of these factors have caused bond prices to react much more negatively to a widening of risk premiums than in the past. In addition, the liquidity needs of uniformly and one-sided positioned investors (see below) led to the sale of government bonds to obtain cash. Yields on safe bonds thus rose in March in some cases. The usually inverse behaviour of risk premiums and yields on safe bonds was temporarily absent.

Changed market structure

Most importantly, however, the structure and behaviour of capital markets have changed significantly over the past decade. For example, investors are increasingly acting in a uniform and trend-reinforcing manner, with rule-based investment strategies playing an important role. More important in the bond markets, however, is

Fig. 1: March was the weakest month ever for euro corporate bonds...

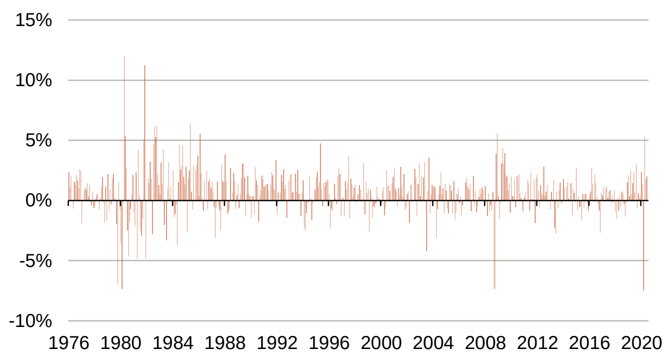
Total return per calendar month of euro-denominated, investment grade corporate bonds



Time period: 01/01/1996-30/06/2020
Source: ICE, own calculations

Fig. 2: ...and for US dollar corporate bonds

Total return per calendar month of euro-denominated, investment grade corporate bonds



Time period: 01/01/1976-30/06/2020
Source: ICE, own calculations

the one-sided positioning of investors after years of expansive central bank policy and the growth of ETFs. And last but not least, fundamental market liquidity has changed.

Investor positioning and behaviour

Cash holdings and government bonds were increasingly replaced by riskier, less liquid investments

In an environment of negative key interest rates and large bond purchase programmes by central banks, liquidity and government bonds yielded mostly negative positive returns. Investors therefore increasingly replaced them with riskier investments. In doing so, they not only assumed the associated economic risks, but also moved into less liquid asset classes. As a result, multi-asset portfolios today often have higher equity, credit and liquidity risks than in the past. The portfolios have become much less diversified and thus more vulnerable. As a result, as market risks rise, investors increasingly reduce risk positions pro-cyclically to limit losses.

Role of ETFs

ETFs made it easier to take positions in less liquid corporate and emerging market bonds

The rise of ETFs has supported the shift from cash and safe haven bonds to higher yielding but less liquid corporate or emerging market bonds (see Fig. 3). ETFs make it possible to invest easily and at supposedly low cost in asset classes that are usually rather difficult to trade and less liquid or have too large denominations.

In a "normal" market environment, ETF market makers, as intermediaries between ETF buyers and sellers in the secondary market, provide sufficient liquidity. Transactions that issue new ETF units or redeem ETF units in the primary market account for only a fraction of total turnover. Buying and selling ETF shares appears to be unproblematic.

Bid-ask spreads of bond ETFs widened significantly in March and April and at times ETFs traded well below their NAV

However, if, as has recently happened, one of the two sides, the buying side, fails for the most part and many investors sell ETF units at the same time, traders have no choice but to liquidate units and sell the securities on which an ETF is based, the so-called physical underlying of the ETF. This added to the turmoil in bond markets in March and April. Bid-ask spreads on bond ETFs widened significantly. At times, they even traded well below their NAV (net asset value), ie the market value of the securities on which the ETFs are based (see Fig. 4). Whether this is due to an incorrect valuation of the ETFs or an unrealistic, ie non-tradable, NAV is irrelevant for the time being.

On the positive side, however, it should be noted that ETF shares could be sold, albeit at prices well below the NAV. Moreover, the costs of selling illiquid assets underlying the ETFs, in some cases at dumping prices, do not have to be carried by all shareholders, i.e. these costs are not "socialised". Only the current ETF sellers bear the liquidation costs. Evidence of this is that, as markets calmed down, the trading prices of such ETFs returned closer to their NAV.

Machines instead of humans

In addition, the increasing regulation of banks, declining profitability and the availability of extremely fast computers have led to a decline in the number of traditional traders. The trading capacity of these traditional bond traders at banks has fallen sharply, while at the same time the markets have continued to grow strongly. The number of fundamentally-orientated investors who sometimes buy counter-cyclically has also fallen.

Electronic trading platforms often close the gap left by traditional traders. In normal times, machines may be the better traders, especially computer-based high-frequency traders (HTFs). These HFTs even improve liquidity under normal market conditions. However, when there is uncertainty, these systems tend to pull back or shift the focus from market-making to directional (momentum) strategies precisely when they detect a trend. As a result, they do not only fail as providers of liquidity but even demand liquidity themselves.

Change in quality of liquidity

Lessons for investors

Firstly, it is fundamental to recognise that the ever lower yields and risk premiums at the beginning of the year probably did not offer sufficient compensation for the risks assumed.

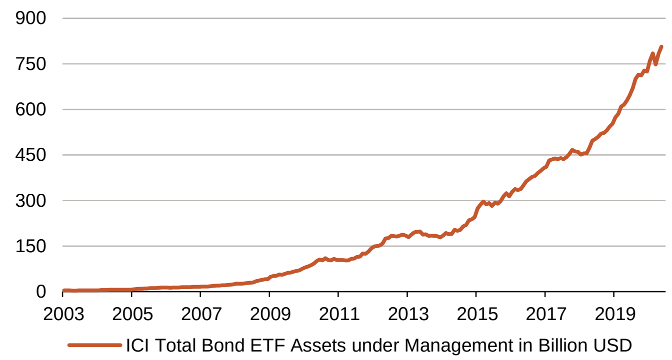
Secondly, investors in multi-asset portfolios should not subordinate their diversification to the goal of profitability. This leads to a one-sided, insufficiently diversified positioning. As a result, investors may have to liquidate portfolio positions precisely when they should avoid doing so because everyone else is trying to do just that.

Thirdly, investors should adopt a proactive approach to liquidity management so that they are not forced to sell bonds or bond ETFs in times of financial market stress.

Finally, investors should be aware that ETFs based on a less liquid underlying will increase liquidity in a normal market environment, but should not be under the illusion that this liquidity is also available in times of distress.

Fig. 3: Bond ETFs have become increasingly important

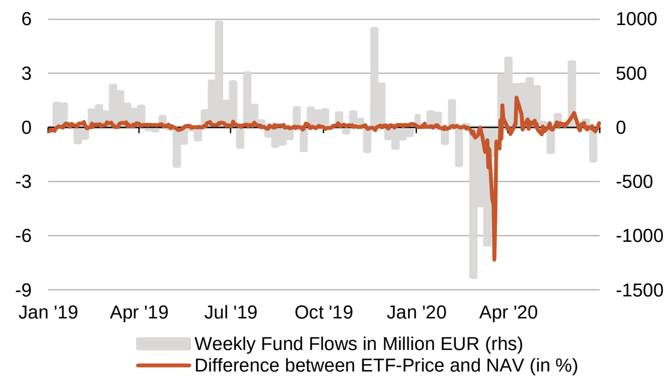
Development of assets under management of US dollar bond ETFs and global bond ETFs in the US including government, corporate and high yield bonds



Time period: 01/01/2003–30/06/2020
Source: Bloomberg, ICI, own calculations

Fig. 4: ETF prices traded at massive discounts to their NAVs

Selected ETFs with more than EUR10bn assets under management aiming to track the Bloomberg Barclays Euro Corporate Bond Index



Time period: 01/01/2019–30/06/2020
Source: Bloomberg, own calculations

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Date: 8 July 2020

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