MERCER

Bond Markets during Periods of Market Turmoil

March 2020

welcome to brighter

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Past Crises and COVID-19

The term '**Financial Crisis'** is applied broadly to a variety of situations in which some financial institutions or assets suddenly lose a large part of their value. In the 19th and early 20th centuries, many financial crises were associated with banking panics and many recessions coincided with these panics. Other situations that are often called financial crises include stock market crashes and the bursting of other financial bubbles, currency crises and sovereign defaults. Financial crises directly result in a loss of paper wealth and they do not directly result in changes in the real economy unless a recession or depression follows.

Table 1: List of major Financial Crises since 1920

Period	Event
1929	Wall Street Crash, followed by the Great Depression
1987	Black Monday: largest one-day percentage decline in stock market history
1989-91	United States Savings and Loan crisis
1990	Japanese asset price bubble collapsed
Early 1990s	Scandinavian banking crisis; Swedish banking crisis; Finnish banking crisis of 1990s
1992-93	Black Wednesday: speculative attacks on currencies in the European Exchange Rate Mechanism
1994-95	Mexico Economic Crisis: speculative attack and default on Mexican debt
1997-98	Asian Financial Crisis: devaluations and banking crises across Asia
1998	Russian Financial Crisis
2001	Bursting of dot-com bubble: speculations concerning internet companies crashed
2007-11	Global Financial Crisis (GFC), including the 2010 European Sovereign Debt Crisis

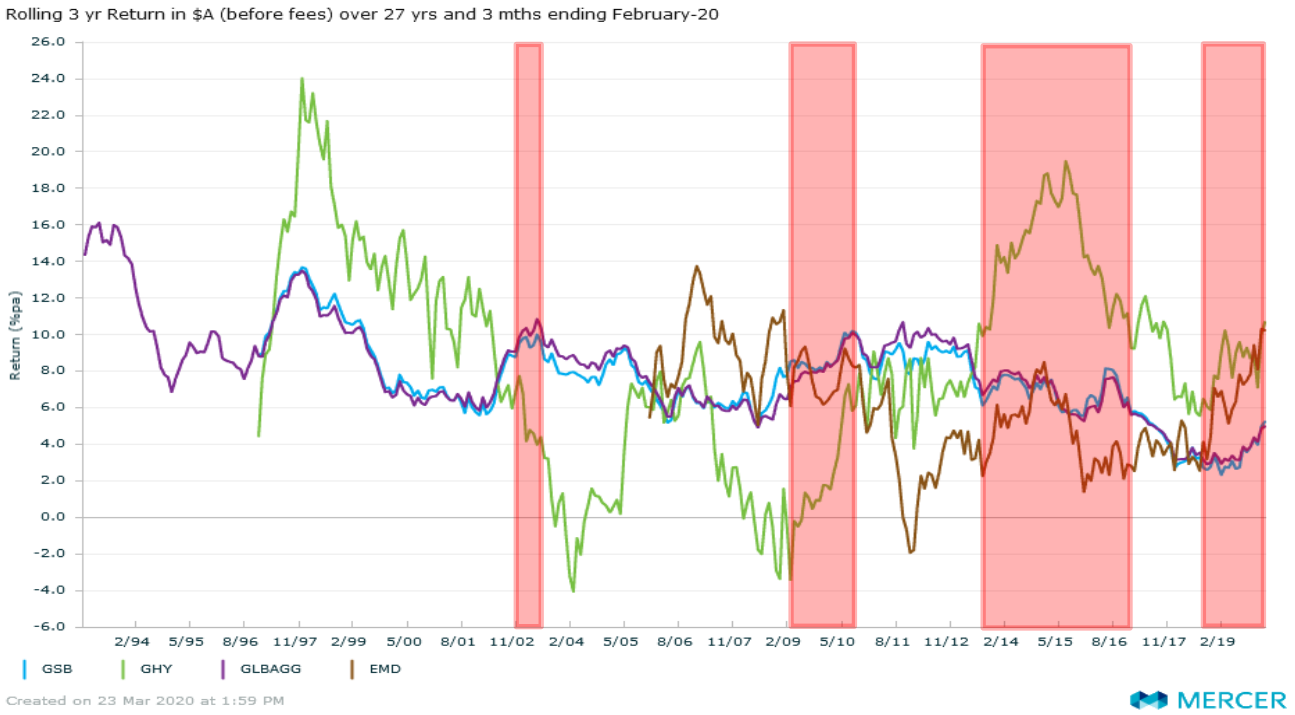
The current market turmoil that we are seeing across financial markets has been triggered by the COVID-19 outbreak. As such, whilst previous financial market crises may provide us with some idea of how markets behave, it is more relevant to look at how previous epidemics affected financial markets in an effort to anticipate how the coronavirus outbreak could affect global markets. Much work is largely done on equity markets, however, this paper will focus on bond markets, what we can understand of how bond portfolios have behaved in past epidemics and what we are witnessing in the current environment.

Table 2: List of high profile epidemics since 2000

Period	Event
November 2002 – July 2003	SARS
March 2009 – August 2010	Swine Flu
December 2013 – June 2016	Ebola
March 2015 – November 2016	Zika Virus
December 2019 – Present	COVID-19

The chart below illustrates the performance of global fixed income markets over time, highlighting periods of global epidemics with a red shaded box. It is clear that global high yield has been the most volatile of the global fixed income sub-asset classes presented, which is unsurprising given its inherently risky nature. Broadly speaking, global sovereign and global aggregate indices have remained relatively steady, however decreasing in return over time.

Chart 1: Rolling 3-year returns of Hedged Global Sovereign Bond, Hedged Global Aggregate, Global High Yield and Emerging Market Debt Indices since 1994



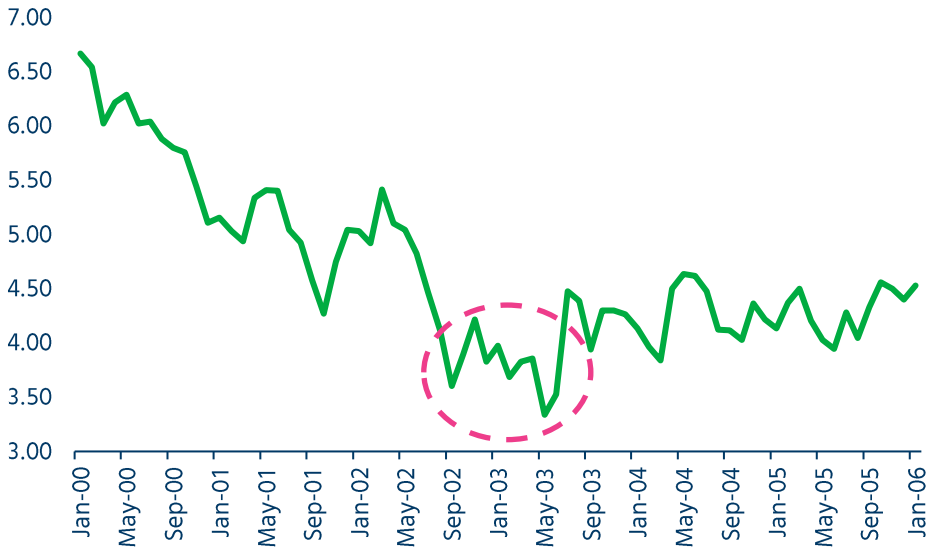
Note: *Global Sovereign Bond (GSB) represented by JP Morgan Global GBI (Hedged) AUD TR, Global Aggregate (GLBAGG) represented by Bloomberg Barclays Capital Global Aggregate HDG AUD, Global High Yield (GHY) represented by Bloomberg Barclays Global High Yield, and Emerging Market Debt (EMD) represented by JP Morgan GBI-EM Global Diversified.*

SARS

During the SARS epidemic that occurred between November 2002 and July 2003, there was a significant impact on U.S. Treasuries, typically perceived as the global safe-haven, as panicked investors sought shelter in government bonds.

In the eight months following November 2002 when the first SARS case was reported, the yield on the 10-year US Treasury Note plunged as much as 80 basis points to hit a low of 3.07% in June 2003.

Chart 2: U.S. Treasury Benchmark Bond 10 Year Yield



COVID-19

In terms of policy response to the Coronavirus, we are currently seeing a combination of three things:

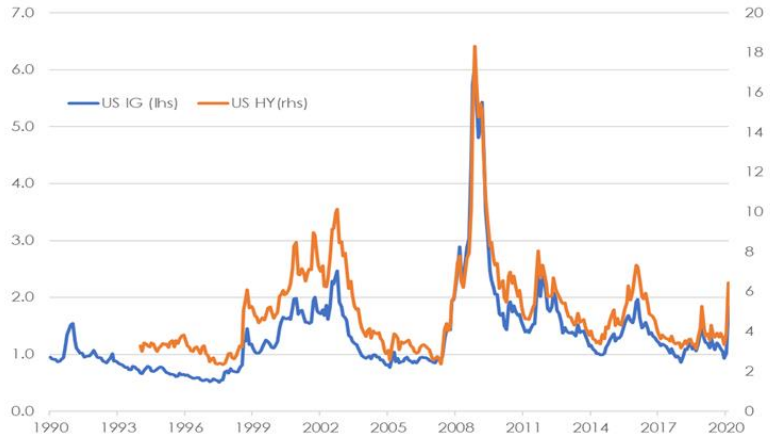
- Monetary easing to keep liquidity running and secure control of the yield curve by central banks;
- Fiscal easing to attend the public health response and assist those who will lose income;
- Social distancing to stop the spread of the virus.

Given that monetary easing is already in place, fiscal policy is now the main policy instrument at the government's disposal to attempt to manage the effects of COVID-19, and stimulate economies. This is slowly getting together but there is more to be done. As a direct consequence of enacting fiscal policy, there will be a substantial increase in bond supply. It is also worth noting that the current debt-to-GDP levels of most countries remains quite high, so the ability of many nations to take on more debt in the hope of providing fiscal stimulus and reprieve remains questionable.

Banks and investment banks also have less of a role to play in terms of stabilising prices, as they run much lower inventories compared to prior crisis periods. This is primarily due to the changes made to capital adequacy regulations and the need to hold greater capital, following the Global Financial Crisis.

In response to COVID-19, we have witnessed rising stress in credit markets particularly, with a widening of spreads across both investment grade (IG) and high yield (HY) markets, but still nowhere near GFC levels. The sectors most severely impacted in the credit markets to date include energy, tourism, retail, hospitality, hotels and airlines.

Chart 3: US IG and HY OAS



CDX (Credit Default Swap Index) spreads for IG (Investment Grade) and HY (High Yield) have risen considerably since the beginning of March 2020. Interbank spreads while contained still reflect some stress, as evidenced by the FRA-OIS (Forward Rate Agreement – Overnight Index Swap) spread but stabilised shortly after Fed intervention.

Chart 4: FRA-OIS Spread

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Understanding Bond Markets

There are some noticeable differences between Bond and Equity Markets, and it is worth highlighting these differences as the backdrop to understanding how bond portfolios fare during financial market turmoil.

Financial institutions, such as banks, asset managers, hedge funds and insurance companies, rather than households, predominantly make trades in debt markets. Another key feature of markets in debt instruments is that whenever a trader wishes to make an investment, it must first raise money, either through a sale of existing financial assets or by borrowing funds from another party. If funds can be raised relatively easily and quickly, debt markets should function smoothly.

However, during a financial crisis, often funds cannot be raised easily or quickly. In such a setting, the fundamental values for certain assets can become separated from market prices for a time, with consequences that can echo into the real economy.

Liquidity remains a key concern for fixed income investors, particularly in times of crisis. There has been a dramatic deterioration in liquidity across bond markets resulting in higher trading costs when selling fixed income assets. Due to the volatility in investment markets arising from the COVID-19 pandemic, several fixed income managers have recently undertaken a review of the costs associated with buying and selling of assets within the funds to ensure that buy/sell spreads charged on application and redemption continue to be reflective of current market conditions. This has resulted in an increase in sell spreads (more than 30bps and up to over 160ps) from a number of fixed income managers due to rising transaction costs.

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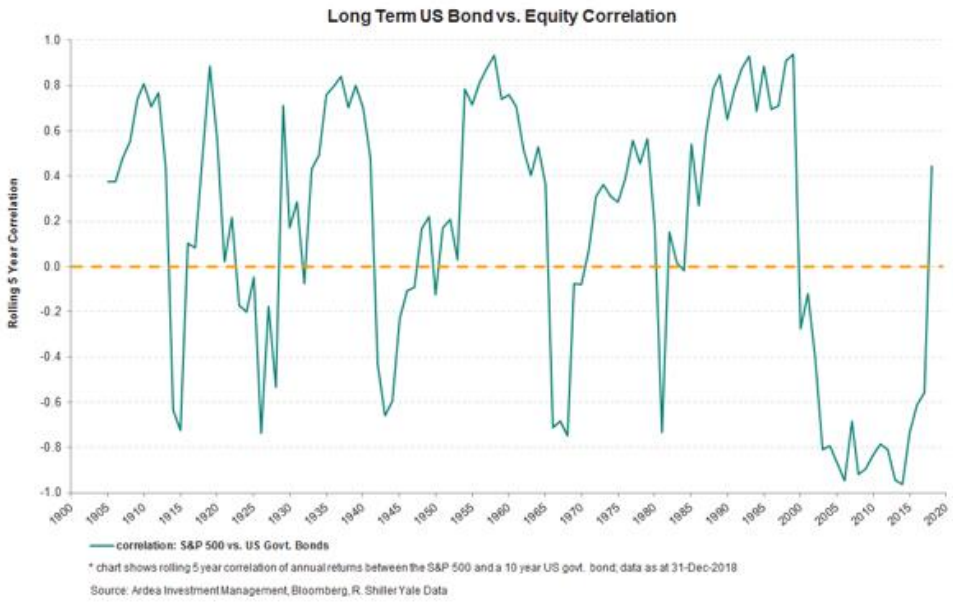
Bonds don't always diversify Equity risk

Most conventional bond investments rely on interest rate duration as the central diversification play. This is reliant on a negative correlation between equity and bond prices, which therefore will ensure that bonds provide downside protection when equities incur losses. The negative correlation assumption holds when the catalyst for the equity sell-off are consistent with the conditions that lead to lower interest rates/bond yields.

If the assumed negative correlation does hold, when the starting point of bond yields is already very low, duration becomes far less effective as a diversifier against equity risk. The experience of 2018 in particular, showed that the bond-equity relationship is not stable and as a result, bonds do not always diversify equity risk. The negative correlation assumption can also fail when the speed of, and/or the catalysts for, rising bond yields hurt equity markets, causing bonds and equities to incur losses at the same time.

Chart 5: Correlation between S&P500 and 10 year US Government Bonds since 1900



The correlation assumption though typically does hold in recessionary scenarios and in a 2008 financial crisis type scenario. Under these scenarios, it is likely that central banks will cut interest rates in response to recession risk or in a 'flight to safety' dynamic, resulting in higher capital flows to bonds causing bond prices to rise/yields to fall.

It is important to note, that this dynamic works best when the starting point of interest rates and bond yields are relatively high. When interest rates and bond yields are very low (as evidenced in the current environment), there is simply less room for yields to fall further and therefore bonds don't provide as much downside protection.

There is no real way of telling when a market recovery will come and this current volatile environment will end. Traditional safe haven assets, such as government bonds, are extremely richly valued at present. As such, there is a preference to hold cash or cash-like investments, with a neutral view on risk markets in general. Given the current market environment, it should be noted that defensive assets can no longer guarantee portfolios the same level of downside protection they traditionally did in the past and as such defensive fixed income allocations should be carefully monitored and revisited as necessary.

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