23 March 2020

Update: fixed income markets & the Payden Global Income Opportunities Fund

At the risk of stating the obvious, these are strange times.

Not only are financial markets in turmoil but some long-standing tenets of the relationships between the prices of various financial assets aren't performing in a manner that might have been expected:

- High quality government bond yields have behaved erratically with episodic sharp spikes in yield even when equity markets have been in a tailspin. Returns from government bonds during March have been relatively modest given the risk backdrop.
- Gold hasn't quite behaved with its usual 'safe-haven' attributes.
- Perhaps assisted by a confused policy response (ranging from "nothing to see here" to a "fiscal bazooka") the USD sold off then rallied hard.
- Of course, some markets followed the script when it comes to behaviour during times of acute stress in risk markets:
- Corporate bond markets, high-yield debt, emerging market debt and securitised debt market spreads to government bonds soared and liquidity seized up.
- The AUD fell of a precipice and hit a 17-year low.
- Policymakers were slow to the table but ratcheted up the action as the unnerving magnitude of the crisis and its economic fallout become all too evident.

In some sense some of these unusual reactions are capable of rationalisation.

Take government bonds. For years monetary policy has been the primary macro policy weapon with fiscal policy taking a back seat (albeit briefly assuming a form of "co-primacy" during the GFC).

But now the monetary policy well is dry and the policy authorities have all rolled out fiscal responses ("bazookas"?) to respond to the crisis. Bond markets fear that may mean massive government borrowing and, fearful of the concomitant increase in the supply of bonds, have marched bond yields higher, albeit modestly so and from historic lows.

Gold may not have done quite as well as expected but that might be because it is in many instances one of the more liquid parts of investor portfolios and in order to raise cash, investors have sold the more liquid parts of their portfolio first. Gold is highly liquid and probably being "non-core" has therefore been an easy sell, if only in the short term.

Those assets that followed the script are easier to explain.

The AUD is highly leveraged to the global economy given that that the Australian economy is on a global scale and, according to the textbooks, a "small, open economy". Global recessions abetted by disruptions to global supply chains hit Australia harder than most.

With China at the epicentre of the current crisis and the RBA cutting rates to the "floor" of 0.25% and embarking on quantitative easing, then perhaps it is not so hard to see the AUD hit 17-year lows.

The spreads of corporate, high yield, emerging market and securitised debt always suffer in times of acute market stress. For one thing, investors desert less safe and less liquid assets. These assets suffer from not being traded on an exchange, and low broker / market-maker inventory since the GFC mean that price-making ceases, causing these markets to seize up and/ or spreads to widen sharply and the prices of these assets to plummet.

Just as equity markets have been in a tail-spin decline, so to have spread markets in the fixed income space. In the current circumstance the sharp downward move in the price of fixed income 'spread' sectors (IG credit, high-yield, emerging markets, securitised etc.) cannot easily be mitigated by monetary policy measures. First, as mentioned above, prior to the onset of the crisis monetary policy was exhausted and secondly, and perhaps more importantly, the crisis itself was of an exogenous nature rather than attributable to an endogenous variable (such as 'excess liquidity, leading to a credit bubble).

The forgoing has seen unusual fixed income (and other) market dynamics. Because of the urgent requirement to access liquidity (or 'cash'), investors have sold out the most liquid parts of the portfolio in an almost indiscriminate or price insensitive manner (similar to the circumstance surrounding gold mentioned above). For example, AAA-rated collateralised loan obligation (CLOs) have been sold at historically wide spreads versus indicated spread levels on AA or A CLOs. Credit curves have inverted as investors are selling short tenor 'liquid' assets.

The following table outlines the returns on a number of fixed income assets.

Broad Market Total Returns

Asset Class	MTD*	YTD*
S&P 500	-18.3%	-25.1%
EM B Sovereign	-23.1%	-24.8%
HY 1-5yr CCC	-22.1%	-23.5%
BB CLO	-20.0%	-21.4%
EM BB Sovereign	-19.9%	-18.9%
HY 1-5yr B	-17.1%	-18.3%
BBB CLO	-14.4%	-13.9%
Bank Loans	-16.6%	-17.3%
HY 1-5yr BB	-12.8%	-13.8%
CRT Mezz	-38.6%	-39.4%
EM BBB Sovereign	-14.6%	-12.0%
CRT Last CF	-18.5%	-18.8%
US IG Credit	-6.3%	-4.8%
AAA CLO	-4.4%	-4.3%
Legacy NARMBS	-9.9%	-9.1%
CRT Front CF	-5.3%	-5.4%
Government	0.9%	3.0%
**As of 19/3/2020*		

What has this meant for Payden's Global Income Opportunities (GIO) Fund?

The unusual confluence of indifferently performing government bond yields and sharply rising spreads of other bonds has had a marked detrimental impact on return. A similar circumstance has also attached to conventional bond funds.

Going forward, the portfolio management team is focused on the following:

- Aligning the portfolio to issuers, industries, and collateral that might weather a prolonged virus outcome, including protecting the portfolio via CDX High Yield to manage overall portfolio beta as spreads widened meaningfully across asset classes.
- The portfolio team have created a relative value dashboard of major fixed income asset classes which looks at the range of spreads dating back to 2008. Currently, the dashboard is indicating that despite spreads in general being at their widest level, certain anomalies exist. For example, high-yield corporates are short of their historic wides compared to AAA CLO. We therefore are comfortable positioning in 'top of the stack' CLOs versus high-yield corporates.
- As credit curves have inverted, the team will seek to opportunistically buy AAA CLOs and high quality, less than 3-year maturity, investment-grade corporates at deeply discounted levels.

Despite the trying investment backdrop where financial asset prices are performing poorly and the usual pricing dynamics are corrupted, it is important the bear in mind the key tenets of investing, the most critical of which is the benefits a diversified portfolio. We believe the Payden Global Income Opportunities Fund is an important foundation of an overall diversified portfolio and that it will offer diversification benefits versus other portfolio assets. Its strong track record in that regard is a testament to that.

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