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Investing in Times of Conflict

Fixed Income Macro and Market Outlook

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The key question in the macro context is whether the current crisis will create a sufficient global growth shock to derail high inflation in the medium term.

In brief

- **Macro** – The war in Ukraine and the related sanctions are expected to impact inflation more than growth.
- **Monetary policy** – Central banks will proceed with caution but are unlikely to derail plans to normalize monetary policy and raise rates. Investors should expect rate increases unless growth declines to a level at which inflation ceases to be an issue.
- **Credit** – Large dislocations are starting to emerge in the credit markets, where there is more uncertainty given the illiquid over-the-counter nature of the market.
- **Volatility** – In times of conflict and war, market volatility is par for the course and leads to dislocations that can offer investment opportunities for active investors with a longer time horizon.

There has been no shortage of challenges for the global economy and markets in recent years. "When sorrows come, they come not single spies, but in battalions," to quote from *Hamlet*.[1] Significant geopolitical upheaval centered around Russia's invasion of Ukraine has followed on the heels of the pandemic. Recent developments in Ukraine have led to many questions regarding the implications of the geopolitical conflict for global growth, inflation and the markets.

Macro implications

The key question in the macro context is whether the current crisis will create a sufficient global growth shock to derail high inflation in the medium term. It is clear the war in Ukraine is leading to increased inflationary pressures via the energy and commodity markets as well as a slowdown in growth, renewing fears of global stagflation. Historically, wars tend to be associated with higher inflation and higher bond yields.

These supply-side, exogenous shocks are not ones central banks should react to, but going into the crisis inflation was already uncomfortably high and persistent. Headline inflation will undoubtedly rise. What the potential impact on growth will be is less straightforward. The magnitude of the global growth shock is as yet unclear. It will depend on the severity and duration of the war, sanctions (which are escalating) and the announcement of any new fiscal spending.

Global growth was on a very solid footing before the war in Ukraine. The key risk now is significantly higher commodity prices, which in the worst case could trigger a global recession. In general, at this point, we believe the war and sanctions will take their toll more on inflation than on growth. Consequently, we expect central banks to tread more carefully but not change their plans for rate hikes. Fat tail risks persist that could potentially materialize as a growth shock that then leads central banks to reverse course.

There will be clear regional divergences, though, because countries will be affected differently by the energy markets (importers vs. exporters) and the trade channel, as well as varying fiscal and monetary policy tools available to governments and central banks.

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Europe

Europe is clearly the region most exposed to Russia's invasion of Ukraine. We are likely to see a technical recession in Germany with two quarters of negative growth (fourth quarter 2021 and first quarter 2022). Nevertheless, the eurozone began the year with a relatively high degree of growth expected for 2022 (a little over 4% in GDP growth consensus forecasts) as the output gap in the economy continued to close at a healthy pace following the post-COVID reopening. It is difficult to say if all this expected growth will be wiped out or not. It will likely depend on whether there is a further escalation of sanctions (*e.g.*, oil or gas embargoes) given the reliance of the eurozone on Russian energy (particularly gas, for Germany and Italy).

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The associated decline in real disposable incomes is likely to lead to demand destruction. Stagflation — a simultaneous increase in inflation and stagnation of economic output — is a real concern for the eurozone. It will be key to analyze the March consumer sentiment and business confidence indicators to assess the magnitude of the demand shock. Stagflation is traditionally bad for long-duration nominal assets and not conducive to positive real returns in either fixed income or equities, particularly when there are high starting levels of valuations.

In this context, the European Central Bank (ECB) has the toughest challenge of the major central banks ahead. It may defer taking action on rate hikes for now and insist on complete flexibility to deal with the uncertainty ahead with a strong focus on data dependency. The sequencing of first ending purchase programs and then hiking will be maintained and the PEPP (Pandemic Emergency Purchase Program) will end as expected with the APP (Asset Purchase Program) also likely to end later this year. New policy tools may be introduced to deal with any potential fragmentation within the eurozone (*e.g.*, higher funding costs for periphery versus core countries) or unwarranted tightening of financial conditions.

A close eye needs to be kept on the new ECB staff projections, which should be an early indicator of the implications of the geopolitical situation for growth and inflation. The ECB will be monitoring the path of the euro. The euro-US dollar exchange rate is currently heading quickly to levels not seen since the height of the pandemic in the spring of 2020.

United States

Growth in the US, unlike growth in the eurozone, is relatively well insulated. While higher oil prices and tightening financial conditions will likely lead to a slowdown in real economic activity, the US arguably started from a position of overheating demand and with a positive output gap, a reason many deemed the US Federal Reserve behind the curve in taking liquidity out of the system and tightening financial conditions to address persistent high inflation. We must remember that the Fed is still engaged in quantitative easing.

The US became energy-independent through the shale revolution, though it continues to import certain types of oil better suited to its refineries. It is now an oil exporter as well. Households are in a much stronger position emerging from the pandemic, with lower leverage and higher savings and wealth thanks to generous fiscal support over the past couple of years. Thus, we expect the Fed will continue taking accommodation out of the system as long as recession does not become a serious concern. With rates so low and with a bloated Fed balance sheet and high inflation, we see no other alternative but for the Fed to continue down this path. Goods inflation is still high, though likely to come down sharply in the second half of 2022 due to base effects and as consumers shift purchases from goods to services.

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Supply chain bottlenecks, while easing, are still elevated and may last longer as the pandemic gives way to the effects of the Russia–Ukraine conflict due to the importance of the region in supplying key parts and materials to different sectors, as well as agricultural commodities. In addition, services inflation (a much larger component of overall inflation indices) continues to trend higher even before the pandemic imprint has subsided. Stickier components of rent and owners' equivalent rent, as well as services wages and earnings are likely to go higher still.

In our view, the strength of the US economy and the higher inflation outlook demands urgent Fed action. If the Fed does less now, it will likely have to do more later in the year. On the positive side, long-term inflation expectations appear well-anchored, implying that there is no need to hit the brakes right now, which would likely lead to a recession. This enables the Fed to continue with its narrative of a gradual approach to tightening.

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China

The current conflict in Ukraine has renewed the focus on China's intentions regarding Taiwan. While an intervention is possible, we see this as a medium-term rather than short-term risk. In the meantime, China continues to ease policy to support what has been sluggish growth, and the country will likely have to step up the momentum of its monetary and fiscal (local government) easing initiatives in the face of the current global instability. China's recently announced goal of 5.5% growth for this year is higher than expected (the IMF forecast less than 5%) and will require more proactive easing.

Growth has been severely impacted by the exogeneous COVID shock (and self-imposed zero-COVID policy) as well as the domestic clampdown on the property sector. The Ukraine situation, similar to other countries, represents a new food and energy security risk, which can't be resolved through central bank intervention. Government measures will likely be needed to address supply-side constraints. Economic stability is crucial for President Xi Jinping as China later this year heads into the 20th Communist Party National Congress, from which Xi is expected to emerge as China's leader for an unprecedented third term.

As a result, China remains the one large economy injecting monetary/liquidity stimulus while other key central banks are reducing accommodation. We expect some increased infrastructure spending, though China will likely continue to proceed at a measured pace given its ongoing concerns about financial stability and the overall debt levels in the economy. All in all, the increase in COVID cases remains the key concern when assessing China's macroeconomic development.

Global dynamics

With regard to other global economies, the growth and inflation dynamic will vary depending on whether these countries are oil importers or exporters and how much room to maneuver they have on both the fiscal and monetary front. Some central banks (*e.g.*, Norway, New Zealand, South Korea, UK) are ahead in the hiking path while others have yet to start (*e.g.*, Australia, Sweden). It will be important to watch the path of the US dollar when considering emerging market central banks. They proactively raised rates last year, but if the US dollar breaks out stronger, they may need to do more, particularly with increased inflation in food and energy. Laggards will need to catch up quickly.

Fixed income markets

We expect elevated levels of broad-based volatility as long as the war in Ukraine continues. Rates volatility, as measured by the MOVE Index, has shot up to levels almost as high as those seen during the worst of the pandemic in March 2020. Equity volatility, as measured by the VIX, remains more muted in comparison, though still at elevated levels. While developed equity markets are down across the board, not surprisingly, the European equity markets have taken the brunt of the impact and are bordering on bear market territory. German market volatility has not been at this level since March and April 2020. Implied credit volatility is also very high as investors look for liquid hedges through the CDX and iTraxx indices.

Credit

Large dislocations are starting to emerge in the credit markets in the current uncertain landscape.

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Emerging markets (EM) *Hard currency sovereign and corporate EM* are still absorbing the impact of sanctions. There are considerable security selection opportunities, with the dispersion among winners and losers driven mainly by energy and food import dependency. Continued outflows in the asset class could lead to further contagion, and markets remain wary of a potential escalation of sanctions.

High-yield corporate market *US high yield* has performed better than other parts of the high-yield corporate market. This is not surprising given the strong US economic conditions, the sector comprising mostly domestic issuers, and many energy companies enjoying the tailwind of higher oil prices. High- yield companies generally have enjoyed robust financial health, good liquidity and solid balance sheets, having benefited in the past few years from the huge fiscal and monetary accommodation that has led to extremely low levels of default rates.

In fact, most of the spread-widening we have seen in US high yield year to date has not been the result of Russia–Ukraine but stems rather from the concern that the Fed could prove too aggressive and make a policy mistake. If the US economy weathers the crisis well, fears of the Fed's actions will return and we could again see pressure in the higher-quality segments of the US high-yield market, leading to them underperforming shorter-duration lower-quality buckets. However, if growth concerns are serious enough for the Fed to reconsider its hawkish position, recession fears will be the key driver of wider spreads in high yield. In this case, we believe BB-rated issues would likely outperform within the asset class.

Euro corporate bond markets Bonds in these markets have been large underperformers with these companies more significantly impacted by the looming drop in demand and higher input costs. Companies' ability to pass through cost increases via higher pricing, as they have been able to up till now, is open to question in view of the real income squeeze. European high-yield issuers are more exposed to energy cost increases and, in many cases, direct exposures to the regions most affected by the military conflict. The European investment-grade credit market has a higher weight in financials as well, with the markets clearly focused on the direct and indirect exposures of European banks to Russia and sanctioned entities. (Austrian banks appear to be the most vulnerable.)

Spreads have widened sharply, though partially in response to a large move higher in euro swap spreads because European credit is priced off the swaps curve. We have seen steady outflows from credit in Europe, but also relative calm in the corporate bond markets as the ECB continues to actively purchase corporate bonds, and investors started the year with healthier cash levels in anticipation of a busy new issue market. There has been a dearth of new bond supply since the conflict erupted, a positive for the market.

US corporate investment-grade market In contrast to the euro corporate market, the US market has seen ongoing supply, with healthy new issue premiums that have been relatively well absorbed, albeit leading to pressure on overall spreads and relative risk-adjusted underperformance versus high-yield bonds. A risk is a pickup in retail fund outflows that could lead to forced selling and put pressure on the cash markets. Increased dispersion across sectors and issuers offers active security selection opportunities. We prefer attractive valuations in sectors that should benefit from a cyclical recovery in services as economies reopen and those that have a narrower set of cash flow outcomes despite the current economic uncertainty.

Securitized/structured credit market Given the correction in spreads of mortgage passthroughs and the pricing in of quantitative tightening,[2] we would see further spread widening as an opportunity to add to our current position. This is particularly the case given the high quality of the sector and the structural strength of the US housing market. With the sharp correction in corporate spreads, we now find parts of the structured credit markets less compelling and will look at the new issue market for price transparency as these new deals price with concessions. We tend to favor the short duration, floating-rate structure of the CRE CLO market, but relative valuations and lower liquidity make us even more selective. In general, we would rather allocate an incremental dollar of capital to high-quality investment-grade corporate than allocate it to structured credit. Overall, the consumer remains in good health, so fundamentals here are less of a concern, but we are starting to see some increasing signs of stress in the lower-income cohorts that warrant close monitoring as the Fed begins its hiking cycle.

Rates

If we look through the current turmoil, we expect the front end of yield curves to continue to move higher as the need for continued hikes becomes clearer. The recent slumps in rates have been the result of a risk-off sentiment due to the uncertainties related to the Ukraine war. They have also stemmed from technical market elements associated with stop losses being hit because of volatility and VAR (value at risk) limits and large short positioning needing to unwind. In the near term, we expect yield curves to continue with their flattening bias and the 10-year part of the curve to reflect risk off/risk on sentiment in the market. While we still believe the news will likely get worse before it gets better, the range of macro outcomes will eventually narrow, and some curves will return to steepening.

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Yield curves and global rates markets are currently moving in a synchronized fashion, creating interesting opportunities as the moves become less aligned with the macro fundamentals of the different markets. This represents an opportunity for active global fixed income investors, with country and curve dislocations offering better long-term risk/reward than outright duration. It will be interesting to see if central banks continue with synchronized hiking paths as it will impact the US dollar outcome. If the paths diverge, it could lead to a stronger US dollar, which would tighten financial conditions in the US, necessitating less aggressive action by the Fed.

While local EM rates markets have performed well under the circumstances, the concern around a US dollar breakout higher leaves us somewhat cautious regarding what is otherwise an attractive opportunity set as these markets generally enjoy higher real rates and very flat curves.

FX markets

Commodity exporters have done reasonably well, supported by the terms of trade and higher commodity prices, as well as a rotation out of Russia. In this context, Latin American FX has performed well despite the rising US dollar. FX volatility has also increased materially, with a particular focus on the euro/US dollar exchange rate with huge options volumes going through as investors have used it as a liquid risk-off hedge. Asia FX has been extremely steady, particularly the Chinese yuan (CNH), which has behaved almost like a flight-to-quality currency. If we get bigger moves and a more drawn-out crisis, we expect all EM FX to be negatively affected.

Portfolio management

A great deal will depend on how long the geopolitical shock lasts. The longer it lingers, the larger the impact on growth, inflation and positioning.

As we look ahead, we know markets tend to overshoot in terms of risk premia, but the preexisting macro backdrop matters. A great deal will depend on how long the geopolitical shock lasts. The longer it lingers, the larger the impact on growth, inflation and positioning. So, it remains important not only to monitor markets for signs of stress, particularly bank funding stress, but to also keep an eye on measures of volatility and options volumes on liquid hedges. Additionally, investors should be on the lookout for a scarcity of high-quality collateral and signs of further physical disruption in commodities markets while staying apprised of upcoming sentiment/confidence indicators and guidance from companies on the likely impact on cash flows and earnings.

Geopolitical risks are difficult to gauge and never really priced in. The major stress test in this situation is examining what happens as sanctions ratchet up. This involves looking for the weak links and trying to assess what the counterparty risk exposure would need to be to create a systemic event. Otherwise, the risk remains regional and largely idiosyncratic.

The energy shock is important. By monitoring futures markets in oil and other commodities, investors can detect signs of potential stress in the market and indications of geopolitical issues that are becoming more systemic than regionalized.

Conclusion

Investors should continue to expect rate hikes going forward until there is a clear indication that global growth will decline sufficiently to remove inflation as an issue. In the absence of this clarity, central banks will continue to hike, especially those such as the Fed that are behind the curve.

The bigger challenge is what is priced into the credit markets given that credit is an illiquid over-the-counter asset class. The levels on a screen are not necessarily accurate. Until you see transactions taking place, it is very unclear what the index level is. Liquidity is a key question in the current market context and leads us to adopt a cautious stance. We are more likely to add to credit markets through the new issue pipeline because there is pricing transparency and a new issue premium.

Market volatility is to be expected amid geopolitical tensions and war. While it can be tumultuous, the dislocations that occur during these periods create opportunities for active fixed income investors, particularly those with a longer investment time horizon.

Endnotes

[1] William Shakespeare, *Hamlet*, Act IV, Scene V.

[2] A mortgage passthrough is a security created when one or more mortgage holders form a collection (pool) of mortgages and sells shares or participation certificates in the pool. The cash flow from the collateral pool is "passed through" to the security holder as monthly payments of principal, interest and prepayments.

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