



ASSET MANAGEMENT INC.



2020

# COMATOSE

MAXIMIZING FIXED INCOME OPPORTUNITIES IN  
DECOUPLED MARKETS

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Maximizing Fixed Income Opportunities in Decoupled Markets  
August 2020

As heroes on the healthcare frontlines tirelessly work to save lives, policymakers are working to save livelihoods. The COVID-19 pandemic continues to inflict trauma throughout the world, yet financial markets are decoupling and becoming non-responsive to this risk. At times, inducing comas can aid the recovery of trauma patients and, likewise, a policy that induces a comatose-like state in financial markets can aid the recovery of economies. This decoupling of markets from economies is not 'wrong' but is a consequence of the mismatch between what the economic situation needs vs. the available policy tools.

The efficacy of the treatment for economies and markets depends on the dynamics of the economic problem and the usefulness of the policy tools. Policymakers have a clear understanding of the economic problem they face and the appropriate treatment, but the scale required is uncharted territory and the side effects to markets and economies are material.

In this report, we describe the dynamics of the economic problem, the expected policy treatment and the consequences to credit and interest rate markets. This is our current thinking and as always we welcome feedback from our clients.

Adam Tuer  
**Head of Research**

**“this is not a normal recession”**

BOC Governor, Tiff Macklem

**“more like a natural disaster”**

Former BOC Governor, Stephen Poloz

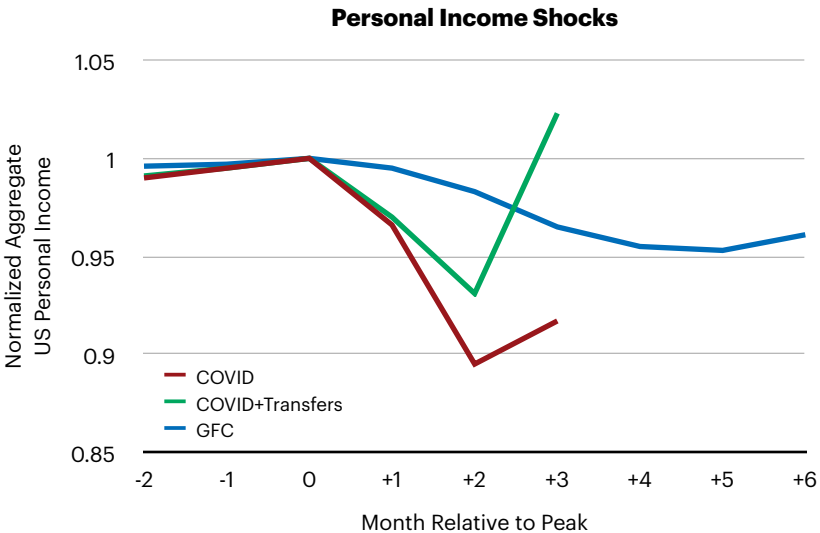
## **THE SITUATION**

COVID-19 rapidly overwhelmed regional hospital capacities, forcing governments to mandate restrictions on non-essential social and economic activities. The problem is, one person’s *non-essential* spending is another person’s income; income that is needed for their *essential* spending. Society is not impacted homogeneously. For many, as activity halted, incomes vanished and with it their ability to spend. Nowhere in the sequence is there an unwillingness to work or to spend, but simply an inability. This is akin to a natural disaster where the destruction caused by a large-scale weather event, like a hurricane or tsunami, inhibit production and spending in the affected region. When this happens, activity is shocked lower, unemployment claims spike higher and external support or local borrowings is required for a recovery.

Normal recessions differ primarily in the role credit plays. Credit at its heart is nothing but promises and trust. If borrowers can’t or won’t make new promises to repay later, or lenders don’t trust in the borrower’s ability to make good on their promises, credit can’t grow and spending can’t be pulled forward. The feedback process of credit slowing, spending slowing, then incomes slowing is more gradual than the income shock from a natural disaster (Fig. 1). In a normal recession, if trust can be restored and the cost of credit creation sufficiently reduced, there’s capacity for credit to once again grow and the recovery to take hold. The cleansing of ‘bad’ promises (i.e. unproductive credit), allows trust (i.e. loan capacity) to be utilized for new ‘good’ promises (i.e. productive projects). This cleansing of ‘bad’ credit,

creating opportunity for new credit growth is a principle difference between a normal recession and the current crisis.

During the COVID crisis, credit is increasing to maintain productive capacity, not to expand it. We wouldn't call it 'bad' credit because it is necessary and the alternative would be worse, but it is unfortunate that this credit could crowd out future 'good' credit opportunities. Higher levels of credit increase the recovery's dependence on income growth. Income is dependent on employment levels and employment levels depend on business confidence. Meaningful improvement in employment and confidence requires the pandemic to end – unfortunately, without a viable vaccine this storm has yet to fully pass.



**Figure 1:** Shocks to US Personal Income during the Great Financial Crisis (GFC) and the COVID crisis with (COVID+Transfers) and without Government Transfers (COVID). Source: Federal Reserve.

**“At the Federal Reserve, we are strongly committed to using our tools to do whatever we can – and for as long it takes”**

Federal Reserve Chairman, Jerome Powell

# THE POLICY RESPONSE

The goal of policymakers is to bridge the economy to the other side of the pandemic. The issues they are facing are: 1) a sharp decline in incomes, 2) risk of elevated lasting unemployment, and 3) the prospect of sluggish private credit growth during the recovery phase.

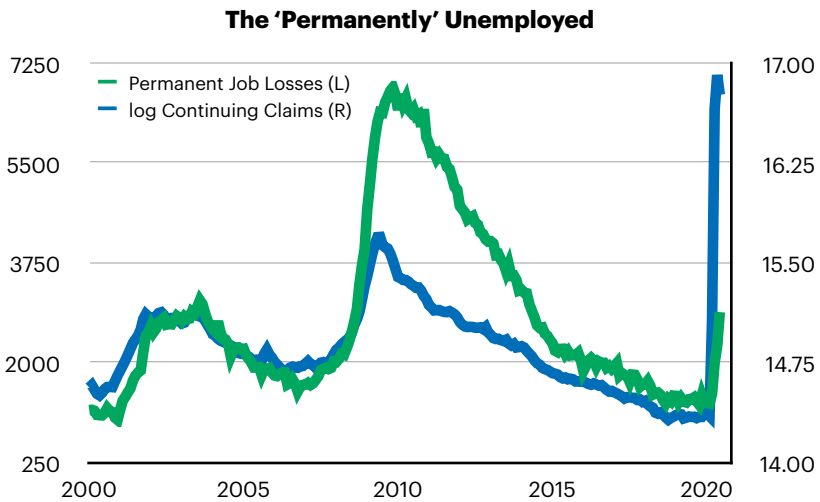
**Table:** Government Policies Options to Counteract Economic Issues

Issue	Short Term	Medium Term
1) Income decline	Government transfers	Back to work (vaccine or herd immunity)
2) Elevated unemployment	Maintain employer-employee relationship	Back to work / Public spending
3) Sluggish private credit (no 'bad' credit cleanse)	-Government transfers and guarantees -Bank capital relief -Subsidized bank funding	Public spending

The requirements for managing the situation in the short term is different than what is required to solve it over the medium term. Over the medium term, the objectives must be to restore aggregate income levels and increase credit growth. Achieving this requires everyone to return safely back at work, either with the development of an effective vaccine or herd immunity. However, returning everyone to work is not yet safe; thus, fiscal capacity is best spent providing a bridge to incomes.

Government transfers in the form of increased and extended unemployment benefits are vital, better still are employer subsidies that maintain the employer-employee relationship, e.g. furloughed

employees and the Payroll Protection Plan (PPP). If the employer-employee relationship breaks, persistently elevated unemployment is likely. We are monitoring the employer-employee relationship by comparing continuing claims to 'permanent' job losses (Fig. 2). The Bureau of Labor Statistics asks people if they think they're going to get called back to work. If the answer is 'yes', then they are not considered a permanent job loss. Permanent doesn't mean they'll never find a new job, it means they likely won't be returning to their old job.



**Figure 2:** Logarithm of weekly continuing claims outpace monthly permanent job losses. Source: US Bureau of Labor Statistics (BLS).

The more people permanently unemployed, the slower the recovery and the more government support will be required. Internally, we've called this the **Red Bull recovery**, like a student feeding on a continuous supply of energy drinks to hold off the 'crash' until after completing their study session; a continuous supply of income support from governments will be required to avoid the income crash, for as long as unemployment remains elevated.

The consequence of appropriate government policy, in the short and the medium term, is larger fiscal deficits, requiring large increases in

government bond supply. If this supply were to cause interest rates to rise, it would be counterproductive to *Issue 3*) sluggish private credit growth. To eliminate the threat of higher interest rates, central banks are aggressively implementing expansionary balance sheet policy and/or the forward guidance nuclear option, Yield Curve Control (YCC).

How long these policies are pursued depends on the pace of the employment recovery, not on the growth recovery. Federal Reserve governor Brainard guided, *“looking ahead, it likely will be appropriate to shift the focus of monetary policy... to accommodative by supporting a full recovery to employment”* and *“policy should seek to achieve employment outcomes with the kind of breadth and depth that were only achieved late in the previous recovery”*. In other words, as the economy improves the Federal Reserve will maintain, or possibly increase, the level of accommodation to support a full recovery in employment.

This crisis has also encouraged central banks to hop further down the rabbit hole of directly influencing private credit. Funding for lending schemes, long-term refinancing operations benchmarked against bank loans, or direct purchases of public corporate debt are the most popular programs. Federal Reserve Chairman Powell protests that the Federal Reserve’s corporate purchases, *“are lending powers not spending powers”*. No matter, these are potentially powerful tools, particularly for an independent institution. The scale of their use has been modest but looking forward, post upcoming strategic reviews, central bankers will surely find these to be the zero lower bound tools of tomorrow – if governments allow.

At scale, these tools would be most useful in Europe where political fragmentation impairs fiscal coordination. ECB President Lagarde noted, *“TLTRO has been a great, great success”* and further opined that, *“climate change has an impact on inflation dynamics”*. Should any of us be surprised when we see an ECB ‘Green’ Targeted Long-Term Refinancing Operation (TLTRO) benchmarked against loans given to environmental projects in the the years to come?

These credit tools are potent because they can directly influence spending in the *real* economy and, in that sense, the bank lending tools

are more powerful than the corporate purchase program for economic outcomes. Quantitative Easing (QE) and YCC policies are wonderfully effective at influencing financial markets but woefully inadequate at influencing real economic outcomes. **This asymmetry in policy effectiveness and the dependence of central banks on these zero lower bound tools are why markets decouple** from the economic environment and appear non-responsive – the comatose state.

The duration of the coma will depend on two key variables: **unemployment** and **fiscal policy**. If fiscal support is found wanting, elevated unemployment will persist, encouraging the use of central bank policies that are much more effective at influencing financial markets than economies – resulting in further decoupling. The more effective fiscal policy is at bridging incomes and returning workers to work, the less central banks have to resort to ineffective tools. The balance of burden between fiscal and monetary will determine the extent of decoupling or re-coupling. For now, continued decoupling is our base case because of the political challenges of passing ongoing meaningful fiscal packages compared to the relative ease of finding central bankers eager to unanimously vote for additional monetary accommodation.

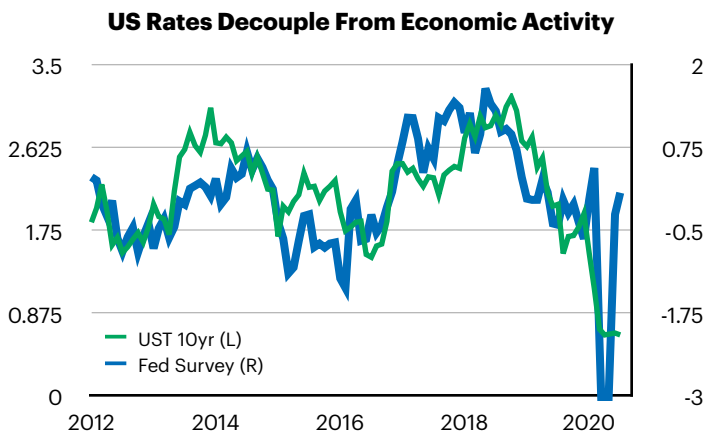


**“the market, of course, is supposed to react to good and bad economic news... the way to protect against it is to tie down forward guidance”**

March 2014 Transcript, Federal Reserve Chairman, Jerome Powell

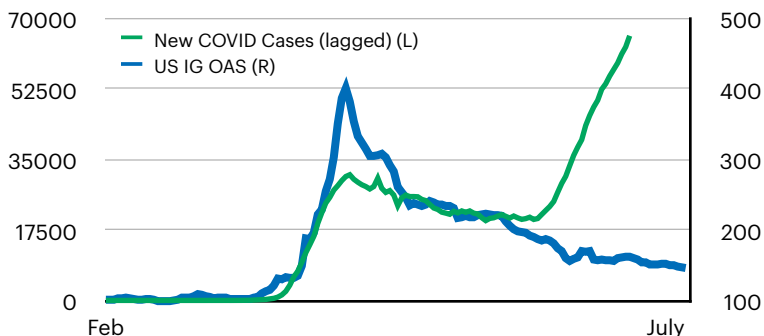
## MARKET CONSEQUENCES

There’s nothing inherently wrong with policies that suppress volatility. However, to the extent investors are still driven by carry, and capital can still move freely, financial instabilities will develop. The more the mark-to-market volatility fails to reflect the volatility of underlying economic drivers, the greater the valuation diverges from ‘real’ risks (Fig. 3, Fig. 4). If ever markets were left to their own devices, the distance to ‘reality’ should induce vertigo in many investors. If left indefinitely this ‘decoupling’ policy mix will produce financial instability concerns. But at present, the concerns surrounding the recovery far outweigh any future financial instability worries.



**Figure 3:** Yield of 10-yr UST vs. the avg. regional Fed survey new order subindex.  
Source: Federal Reserve FRED, Marret’s Calculation.

### US Credit Decouples From COVID Cases



**Figure 4:** US investment grade spreads vs. US 5d avg. new COVID cases lagged 2 weeks. Sources: ICE BAML US Corp Index (COAO), European Centre for Disease Prevention and Control (ECDC).

If decoupling dominates, carry opportunities will diminish while benchmark risk sensitivities are at historical highs – not ideal for the passive investor seeking returns while managing their risks. At the extreme, consider the YCC strategies implemented in Japan and Australia, where carry is essentially pegged at 0% and 0.25%, respectively. If the targets are successful there should be no volatility and an infinite Sharpe ratio, but if investors don't want to use copious amounts of leverage, there's also no opportunity for reasonable returns. Navigating these volatility-suppressed fixed income markets will require skilled active managers who are able to creatively and aggressively seek out opportunities.

### Finding Tactical Opportunities in Fixed Income

It's not that we expect zero volatility and no carry because fortunately, not every market is impacted equally. The more direct the policy intervention, e.g., in US government bonds or US investment grade credit, the greater the gravity on the potential returns relative to the inherent risks. Drawdowns in those markets will be limited and the carry offered will reflect that fact. **Tactical allocation shifts will need to be more frequent and respond more aggressively** to smaller drawdowns than normal. Additionally, we think there will be active opportunities in

the areas of credit that are less directly influenced by policy invention. For example, if the Federal Reserve decides later this year to implement front-end YCC and only focus on high quality credit, then a combination of long duration government bonds and high yield credit should provide greater volatility and offer more opportunities to be tactical than a 10-year investment grade bond while also generating more carry. In addition to long duration government bonds and high yield, we expect tactical opportunities in commodity-sensitive credits, lower quality investment grade, currencies, and inflation-linked government bonds. For fixed income portfolios to prosper and generate excess returns, active managers must maximize these opportunity sets.

Finding investment managers with frameworks that are able to identify fixed income opportunities and have the required mandate flexibility to meaningfully shift exposures is important. Our view is that a tactical fixed income mandate is the only way to participate in the fixed income markets, while still thoughtfully managing the risks that many will lose sight of in the shadow of central bank purchases.

For more information on Marret's tactical fixed income products, please reach out to:

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Data Sources: Federal Reserve FRED, US Bureau of Labor Statistics (BLS), European Centre for Disease Prevention and Control (ECDC), ICE BAML US IG Corporate Index (COAO).

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