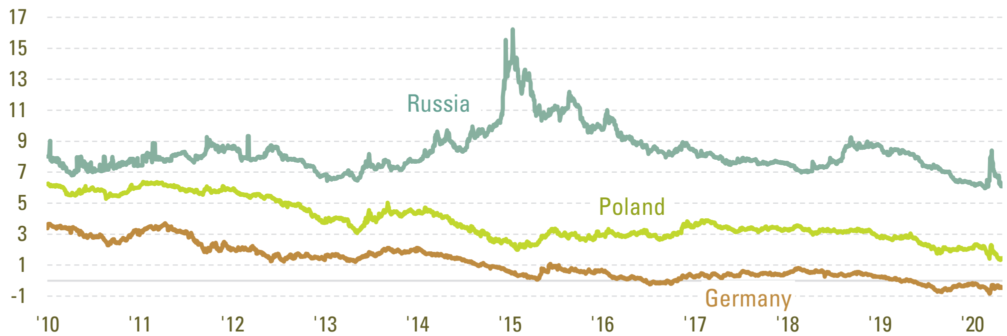
COVID-19 Research Update

Global Fixed Income Themes & Market Conditions

Relative value opportunities in Europe have been scant over the last several years; however, the regional and global economic slowdown and related European Central Bank (ECB) intervention have created some interesting entry points within fixed income markets. Prior to these contemporary opportunities, we have been primarily interested in regional emerging market opportunities, such as those in Central Eastern Europe. **Figure 1** plots the 10-year yield on Russian and Polish sovereign bonds versus the German Bund's risk-free rate.

Figure 1 10 Year Government Bond Yields
%, As of 4/29/2020



Source: Brandywine Global, Macrobond

These government bonds have paid attractive real yields before, during, and since two major events: the European sovereign debt and Russian financial crises. Notably, Russia exploited an era of strong Brent prices to restore bond investor confidence while on the precipice of default by reducing its external liabilities to eventually run a current account surplus. Both Russia and Poland have standout central bankers, while the latter has managed to leverage tight labor market conditions to produce inflationary pressures. **Figure 2** highlights how inflation has been notoriously elusive across most of the eurozone.

Figure 2 Euro Area Consumer Price Index
Annual % Change, As of 3/31/2020

Source: Brandywine Global, Macrobond, ECB

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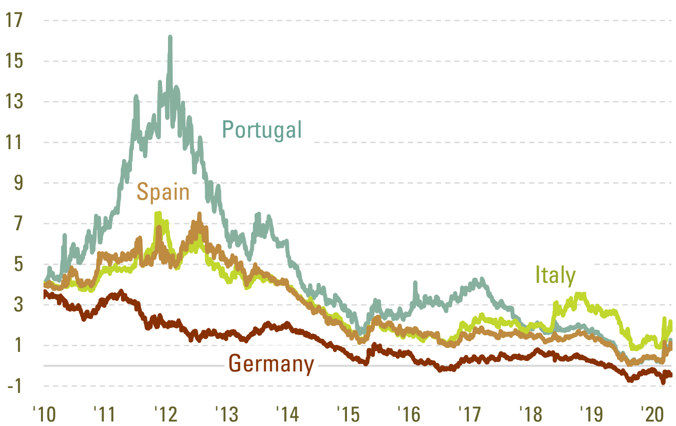
The absence of inflationary pressures and a chronically low-rate environment generally eroded relative value opportunities in most core- and peripheral-European sovereign debt—until now. Select peripheral yields such Spain, Portugal, and Italy now look attractive as a result of the coronavirus-related economic slowdown, as shown in **Figure 3**.

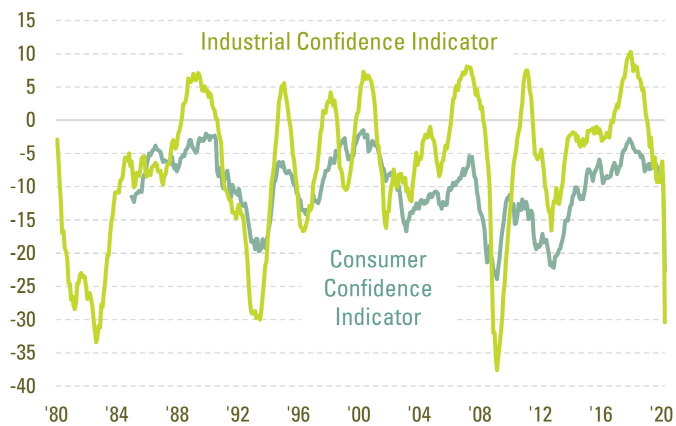
Although Fitch joined Moody's on April 28 by downgrading Italian bonds one notch lower to BBB-, the country's outlook was upgraded to stable. We believe this news was already priced into the bonds. We have opportunistically initiated exposure to BTPs and these other sovereign bonds over the last several years across Global Fixed Income strategies. This time around, we believe ECB action will provide a backstop for these bonds. These countries also have different profiles and should be less correlated with one another. Lastly, these peripheral economies may be further along in the process of managing COVID-19 and should be poised to benefit from the rebound in Chinese economic activity. While industrial confidence contracted sharply in **Figure 4**, regional consumer sentiment has not yet experienced the same decline.

Figure 3 10 Year Government Bond Yields
%, As of 4/29/2020



Source: Brandywine Global, Macrobond

Figure 4 Euro Area 19: Industrial and Consumer Confidence Indicators
%, As of 4/29/2020



Source: Brandywine Global, Macrobond, Eurostat

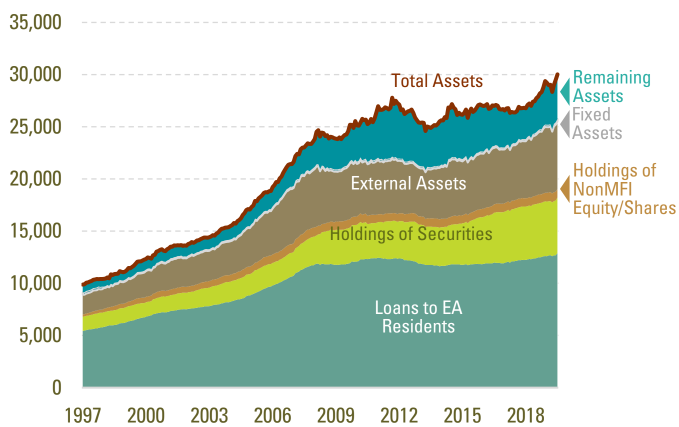
The divergence in sentiment indicators could be partly explained by how consumers/households were positioned prior to the current crisis. Wages and incomes were rising while the unemployment rate was at a 20+ year low (see **Figure 5**). Prior to the global pandemic, we believed that a rebound in consumer sentiment would precede the return of business confidence; perhaps the same will be true in terms of optimism as the eurozone and world rebuild after the economic shutdown.

While European Union (EU) member countries continue to work out the details of fiscal stimulus, the European Central Bank (ECB) has resurrected its "do whatever it takes" policies to lend support to financial markets. **Figure 6** breaks down the composition of the ECB's balance sheet.

Figure 5 Euro Area Unemployment Rate
%, As of 2/29/2020

Source: Brandywine Global, Macrobond, Eurostat

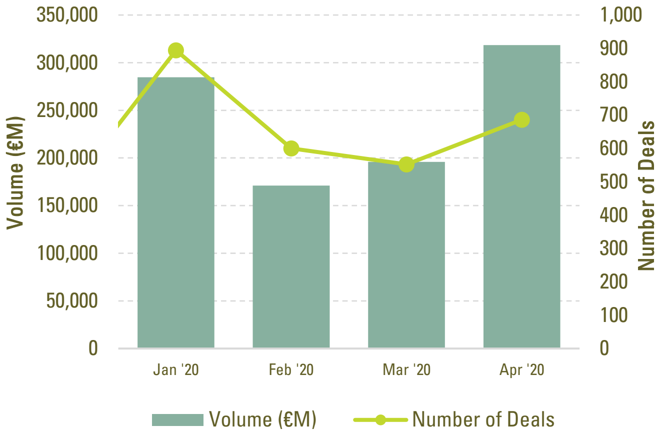
Figure 6 ECB Consolidated Balance Sheet of Euro Area MFIs: Assets
NSA, Billions of EUR, EOP, As of 3/31/2020



Source: Haver Analytics

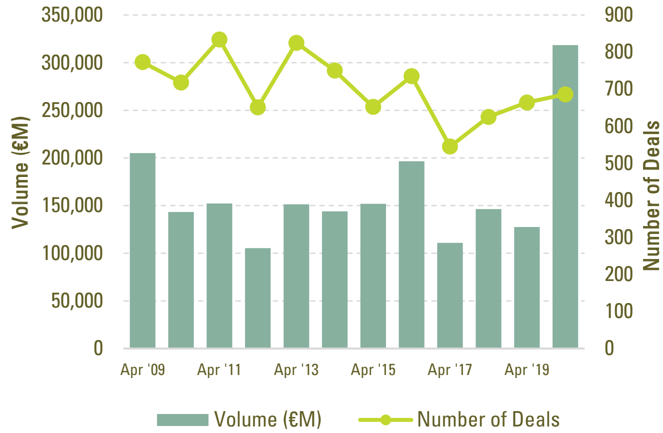
The scope of the ECB's purchases continues to widen with new programs announced on April 30. This massive central bank intervention could restore optimism to the private sector. In April, the European investment grade new issuance market responded in kind to ECB policy—matching and perhaps even exceeding activity seen in the U.S. See **Figure 7** and **Figure 8**. Nevertheless activity within European credit markets has been on par with the U.S. since the onset of this current crisis.

Figure 7 Monthly Rolling New Euro Issuance
As of 4/29/2020



Source: Bloomberg (© 2020, Bloomberg Finance LP)

Figure 8 Year-Over-Year Rolling New Euro Issuance
As of 4/29/2020

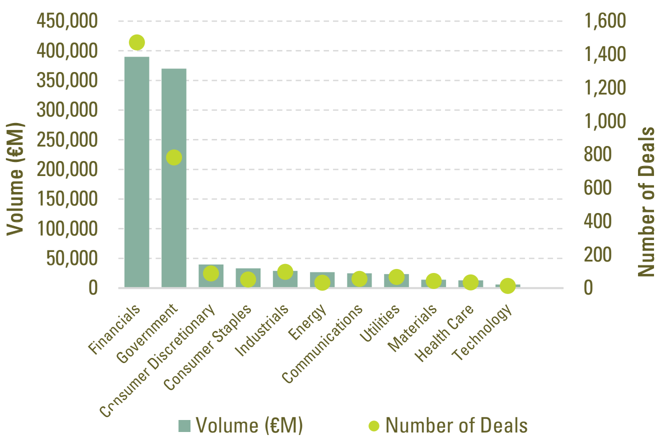


Source: Bloomberg (© 2020, Bloomberg Finance LP)

Similar to the U.S., European financials have led new issuance activity within the investment grade universe (**Figure 9**). However, unlike their U.S. peers, European banks have not been required to adhere to the same stringent capital requirements. Instead, the ECB and European Commission have relaxed capital requirements in the wake of the pandemic. European banks have remained vulnerable to non-performing loans since the Great Financial Crisis; this will continue to pose an issue to regional financial institutions, particularly as some EU member governments will no longer have the fiscal latitude to purchase them as a backstop.

Spreads on European investment grade did not widen to the same degree as their U.S. counterparts, perhaps because the ECB chose to intercede in corporate credit markets earlier than the Federal Reserve did. Therefore, these credit spreads widened by about 250 basis points as shown in **Figure 10**—about half the spread widening initially seen in U.S. investment grade credit.

Figure 9 New Euro Issuance by Sector
As of 4/29/2020



Source: Bloomberg (© 2020, Bloomberg Finance LP)

Figure 10 ICE BofA Euro Corporate Index Government OAS
As of 4/28/2020

Source: Bloomberg (© 2020, Bloomberg Finance LP)

Although peripheral European sovereign debt continues to present the best value at this time, there may be opportunities to purchase high-grade, euro-denominated corporate credit over the next 3-6 months. In general, we will likely avoid issuance within the financials sector in favor of large, multinational industrials that stand to benefit as manufacturing comes back online.