A rapidly changing world

The outbreak of the coronavirus across the world has sent financial markets into shock. This article provides an update on how recent market turmoil has impacted fixed income assets, the core holdings for most insurers.

In general we maintain a cautious stance in the short term, since it is unclear at this moment how long the current health crisis will last. At the same time, overall yields have increased markedly as a result of the sharp move wider in credit spreads. This is especially evident in high yield bonds. With central banks and governments having taken unprecedented measures to support the economy, we think it is likely that rates on cash are anchored at very low levels for the foreseeable future. Credit spreads are now discounting a material global economic slowdown. Whilst this now appears inevitable, we expect this to be transitory, and the impact on credits to be manageable.

Background

The financial markets were slow to react when the initial outbreak emerged in Wuhan in January. This was perhaps due to past experiences with less transmissible coronaviruses such as SARS and MERS. However, since it has become clear that this coronavirus is more contagious and is unlikely to be contained, markets have been swift to fall, pricing in severe disruption to the world economy. See Figure 1 below for an illustration.

Performance per asset class

Figure 1: Development of different asset classes before and during the coronacrisis (31-12-2019 = 100).
Source: Aegon Asset Management.
Figure 2 shows the gross yield versus the SCR for spread risk for a range of fixed income asset classes on 31 March 2020, compared to 31 January 2020 when the WHO declared coronavirus a global emergency and the first cases outside China were reported.

**Fixed income assets : Gross yield vs. SCR as of 31-Jan-2020**

Source: Bloomberg, Aegon Asset Management, La Banque Postale Asset Management. January 31 2020 & March 31, 2020. The bullets in the chart are for illustrative purposes and do not represent exact calculations. Also, the graph does not take the capital charge for interest rate risk into account. Sovereign bonds are Core Eurozone bonds (rating of AA- or better). European Sovereign Bonds and Corporates EUR have ratings of BBB- or better. Gov. Guaranteed Loans have a similar rating as core Eurozone bonds. Private placements are assumed to have a spread of 75 bps over corporate bonds. US Short duration focuses on the 1-3 year BB-B index. with a correction for currency hedging. US High Yield primarily invests in US high yield bonds, but may include opportunistic allocations to investment grade bonds, bank loans, emerging market bonds, and cash / cash equivalents. Infrastructure Loans are represented by the target portfolio (target return of 200 bps over Euribor -equivalent to BBB loans-, estimated weighted average life of 10-12 years). Emerging market debt (EMD) invests in fixed income securities in US Dollars issued by entities in emerging markets. Short-dated investment grade bond proxy taken as ICE BoA 1-5 year global large cap corporate index. Money market EUR has a weighted average remaining time to maturity of up to one year. Dutch mortgages represents a large mortgage pool with an internal rating of AA and a focus on long fixed-term mortgages (the duration is about 8.5 years).
Opportunities and threats
Central banks and governments have reacted swiftly and decisively to support the economy, however, the success at a local corporate level is as yet uncertain. The charts illustrate the increase in yields witnessed over recent weeks for fixed income assets in response to this global market uncertainty. This change has been particularly evident with liquid fixed income assets and is particularly pronounced at the short-end of the curve and with high yield bonds.

As at close on 31 March, the yield on euro investment grade corporate bonds and global high yield bonds were 2.1% and 6.8% respectively, around 1.6% and 3.9% higher than at 31 January. The yield on short-dated corporate bonds and short-dated high yield bonds were 2.0% and 6.6% respectively, around 2.7% and 4.7% higher than 31 January.

Whilst yield has increased materially, it is important to note that liquidity within traditional liquid fixed income markets has reduced considerably. At the same time, default and downgrade risk has increased. The ability to manage these risks will be key. If managed well, credit markets could provide insurers with a very attractive pull to par and return on capital.

Conclusion
Recent market turmoil could represent an opportune time for insurers to phase in an increased allocation to credit, especially at the short-end or indeed high yield if capital budgets and risk appetite permits. There is no doubt, however, that default and downgrade risk has increased materially whilst liquidity has fallen.

An asset manager that can help you navigate these risks going forward is essential if the attractive yields and return on capital currently available are to be fully achieved.
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