Navigating the Status Low

In January, the US 10-year Treasury provided a yield of 1.92% and global corporate credit spreads hovered around 102bps. Today, the US 10-year yield is below 1%, while global credit spreads are at 109bps, having reached an intra-year high of 341bps.

Source: GSAM, Macrobond, ICE BofAML Global Corporate Index. As of December 14, 2020. Based on option adjusted spread.

Introduction

We will enter 2021 with low policy rates, low government bond yields and low fixed income spreads. To navigate this "status low," we seek to **access and diversify** across the **broad fixed income opportunity set** including corporate and securitized credit alongside emerging market (EM) debt. We also look for openings to **capture risk premiums** created by **market inefficiencies**; locating these will be important as vaccine-driven cyclical improvements alongside a friendly policy mix creates a risk-on environment where potential return opportunities can swiftly evaporate. We also see value in utilizing **currencies as a hedge** for risk asset exposures. Last but by no means least, we advocate a **sustained focus on environmental, social and governance (ESG) analysis**, which 2020 has emphasized is a "bear market necessity" not just a "bull market luxury."

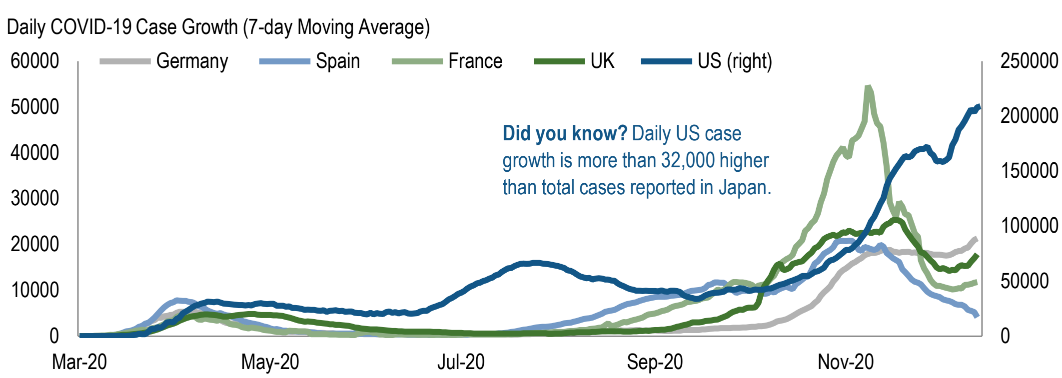
The Macro Backdrop

In Short: Economic activity has rebounded but we have yet to cross the growth recovery line. A reorientation of the macro policy mix and green investments could create a cyclically strong expansion that generates inflation but we are not there yet.

Growth: Winter Speed Bump to Spring Reacceleration

The global economy grew at an annualized pace of 40% in the third quarter, reversing three-quarters of the decline that occurred in the second quarter. Economic rebounds reflect considerable country-level dispersion. China and surrounding export-oriented Asian economies such as Taiwan have returned to pre-virus growth paths due to successful virus containment and global goods demand. Meanwhile, countries highly exposed to the services sector—such as Spain—or those who experienced prolonged stringent lockdowns—including the UK and India—continue to exhibit a large growth shortfall.

Exhibit 1: Growth will hit a winter speed bump due to virus spread



Source: Macrobond, WHO. As of December 14, 2020.

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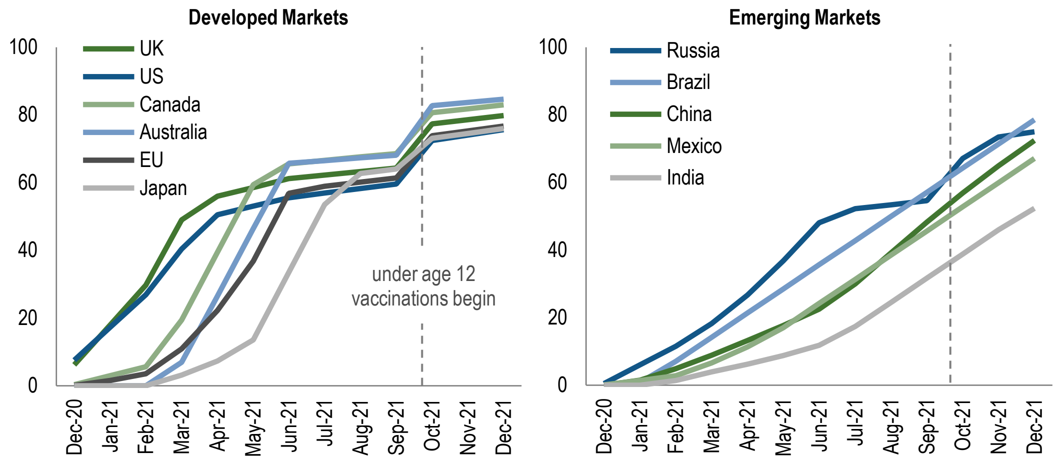
We expect virus spread (Exhibit 1) to slow growth over the winter months before economic recoveries reaccelerate in the spring as mass immunizations (Exhibit 2) allow the job-rich services sector to recover. This would go some way to closing the output and labor market gaps that exist today by restoring opportunities for consumer spending on both goods and services. Added growth supportive factors include accommodative macro policies (see The Policy Picture, page 3) and limited evidence of economic scarring (Box 1).

Exhibit 2: Vaccine rollout to pave way for spring growth acceleration

Expected Vaccine Timeline (% of Population)



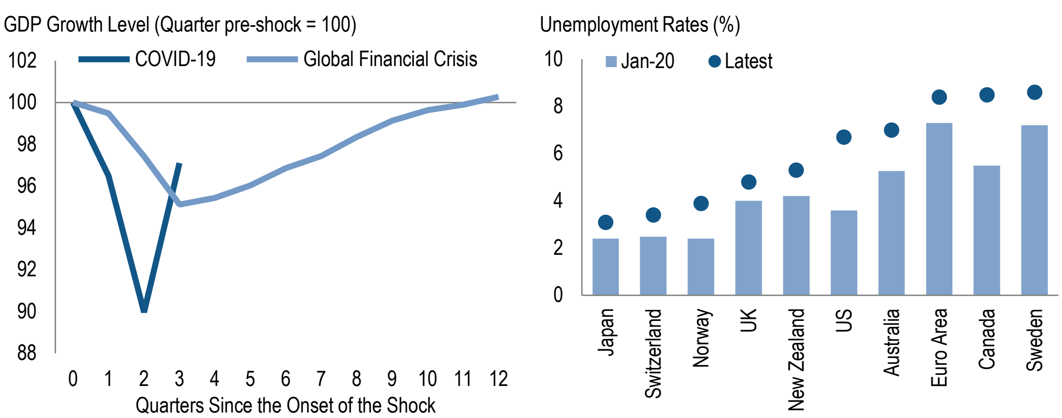
ource: Goldman Sachs Global Investment Research. As of December 14, 2020. **Based on**: Vaccine supply guidance being achieved, vaccine demand reflected in Ipsos surveys and a distributional constraint of no more than 20% of a population vaccinated in a given month.

Inflation: Low for Longer

Notwithstanding vaccine-driven growth improvements, the underlying inflation reality will remain benign due to slack in both economic output and employment (Exhibit 3). Global GDP remains 3% below its pre-pandemic level and even in a stellar growth scenario, this gap would not close until 2024. Upside inflation risks from supply chain disruptions have subsided and loose fiscal policy is unlikely to revive inflation until the cyclical backdrop is tight.

Further out, a reorientation of the macro policy mix to addressing social issues—such as income inequality and minority unemployment—alongside green investment spending could create a cyclically stronger expansion than observed following the global financial crisis. This setup could be inflationary but we are not there yet.

Exhibit 3: Lowflation for longer due to slack in economic output and labor markets



Left Source: GSAM. As of December 7, 2020. Right Source: GSAM, Macrobond. Based on data releases as of December 14, 2020. The economic and market forecasts presented herein are for informational purposes as of the date of this presentation. There can be no assurance that the forecasts will be achieved. Please see additional disclosures at the end of this presentation.

Box 1: Limited evidence of permanent economic scarring

We see limited signs of permanent economic scarring that could lead to long-term declines in supply potential or living standards.

- **Job losses** have been temporary or centered in professions where permanent skill erosion is limited.
- **Banking system** stress has been averted by macroprudential policies, substantial policy support (including access to financing on favorable terms) and the absence of excessive lending pre-pandemic.
- **Businesses** have coped with the downturn better than expected, with investment holding up and bankruptcies restrained.
- **Households** faced no pressing need to clean up balance sheets, unlike the aftermath of the housing crisis in 2007. In fact, savings rates have edged higher owing to extensive stimulus.

Investment Implications

Pro-cyclical rotations. We expect vaccine discovery to drive the economic recovery and, in turn, demand for pro-cyclical fixed income spread sectors including high yield corporate credit, EM debt and securitized assets exposed to commercial and corporate loans.

The Policy Picture

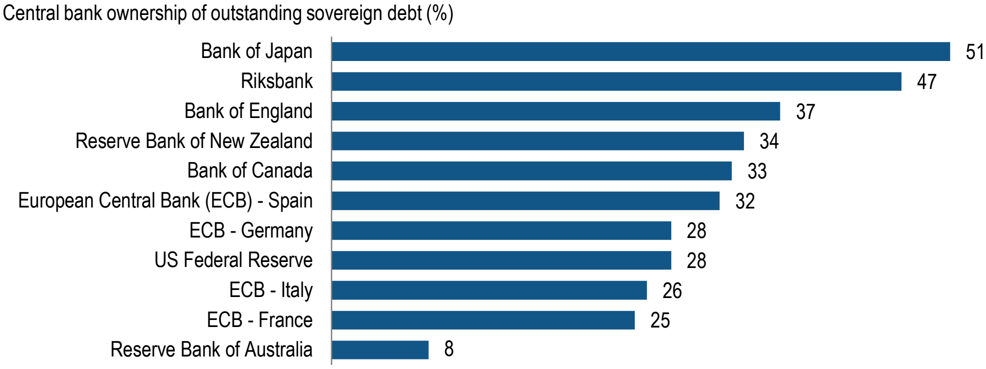
In Short: Central banks will maintain the policy rate “status low,” while modulating asset purchases to maintain easy financial conditions. At the same time, the fiscal impulse is set to remain relatively friendly.

Monetary Policy: On Easy Autopilot

Across G10 economies, central banks delivered a cumulative 655bps of rate cuts this year and all but one policy rate is at an all-time low[1]. This rate easing pales in comparison to the more than 2,900bps of rate cuts observed during the global financial crisis, which is why asset purchases have also been turbocharged[2]. Next year, we expect central banks to continue to modulate asset purchases to ease financial conditions and mitigate upward pressure on sovereign yields from supply-related aspects of fiscal expansions. The Bank of Japan’s more than 50% ownership of outstanding sovereign debt demonstrates there is ample room for other central banks to expand their market footprint further (Exhibit 4).

Exhibit 4: Central bank footprints in sovereign bond markets

Central bank ownership of outstanding sovereign debt (%)



Source: Goldman Sachs Global Investment Research. As of December 4, 2020. For countries excluding the Euro area, bill holdings and purchases are excluded. For Australia, semi-government bonds are excluded.

[1] Source: GSAM, Macrobond. As of December 14, 2020. Sweden’s Riksbank raised its policy rate from its all-time low of -25bps to 0% in January prior to the onset of the health crisis and has not delved further into negative rate territory, opting for asset purchases as an easing tool instead.

[2] Based on cumulative G10 central bank rate cuts between 2007 and 2009.

Fiscal Policy: Friendly into 2021

On the fiscal front, we believe governments are inclined to roll forward stimulus programs until the post-vaccine economy is on solid footing. We expect additional US fiscal stimulus in early 2021, while in Europe, fiscal tightening plans have been scaled back. In both regions, low rates are expected to reduce interest expenditures over the coming years.

Investment Implications

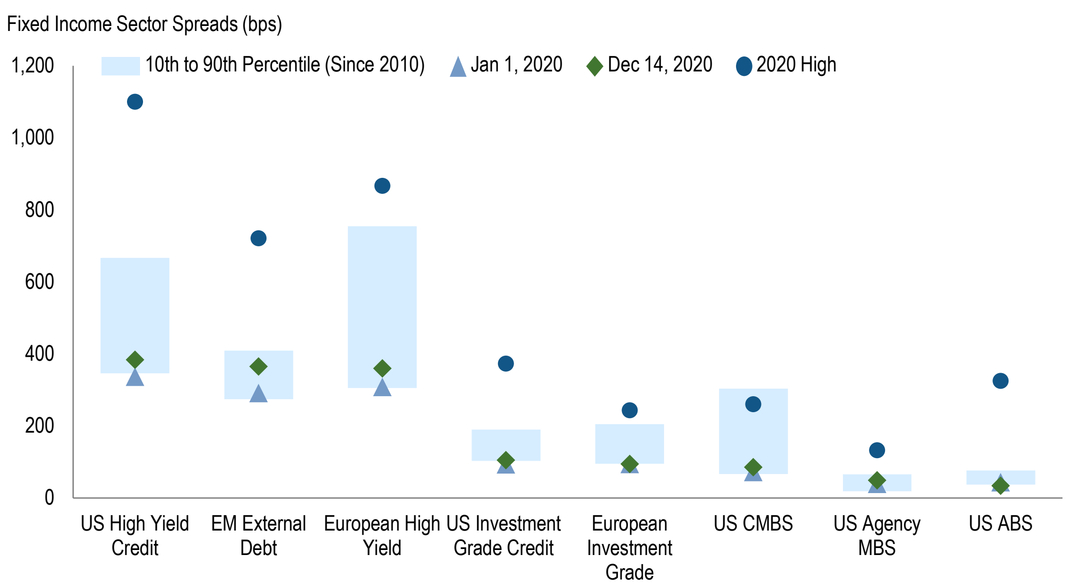
- **Strengthened search-for-yield motives.** Sizeable monetary easing has extended the negative yield challenge in developed market bond markets. Dovish central bank outlooks will prolong insatiable demand for yield, benefiting corporate and securitized credit.
- **Range-bound yields, steeper curves.** With front-end rates anchored by easy monetary policies, macro improvements will drive long-end rates higher. Beyond the US, discussion around moving policy rates into (or more deeply into) negative territory could also widen the distribution for long-end rates and have implications for yield curve views and G10 currencies. We are biased to lean against a rise in yields in markets where inflation is subdued.
- **Dollar downtrend.** We see depreciation in the dollar continuing into 2021 for three key reasons. First, real yields are deeply negative and the US Federal Reserve has committed to keeping rates low to generate inflation, implying negative real yields will persist next year (and possibly beyond). Second, valuations are extended, having been boosted by economic outperformance and US asset market strength in recent years. Finally, the US runs a current account deficit that requires dollar depreciation to finance. Liquidity dynamics and virus news flow may influence the timing of dollar weakness, but not necessarily the medium-term downtrend.

Navigating the Status Low

1. Access **the broad fixed income opportunity set.**

   Whilst friendly macro policies have lifted all financial assets in 2020, there is valuation dispersion across fixed income markets (Exhibit 5). Amid an improved growth outlook, we see opportunities across EM debt and corporate credit, particularly high yield. We also favor agency mortgage backed securities (MBS) that benefit from central bank buying and exhibit lower sensitivity to cyclical setbacks.

Exhibit 5: Fixed income markets are a broad opportunity set



Source: GSAM, Macrobond. As of December 14, 2020. US indices: Bloomberg Barclays. EM index: J.P. Morgan. European indices: ICE BofAML. European investment grade spreads were on par with January 1, 2020 levels on December 14, 2020. **Past performance does not guarantee future results, which may vary.**

2. **Diversify across and within asset classes**[3]

   Fixed income is not a homogenous asset class and even within fixed income sectors there can be differentiation. The EM debt landscape demonstrates this. Asia will enter the second phase of its recovery in 2021 having benefited from forceful policy stimulus and effective virus containment, while parts of Latin America continue to contend with economic, political and social challenges.

   While we are cognizant of stretched policy positions, we also see pockets of value in EM assets. An improved global growth picture will boost commodity prices, benefiting several EM export-oriented economies. Demand from China may also bring certain EM countries into the unique growth orbit that it has operated in this year.

3. **Capture risk premiums created by market inefficiencies.**

   In March, we captured a "liquidity premium" informed by our knowledge of market structure and trading intelligence[4] which led us to gain exposure to corporate credit through credit derivatives pre-pandemic. The onset of the global health crisis saw the basis between credit derivatives (CDX) and cash bonds in both investment grade and high yield widened materially due to illiquidity in cash bonds. We were able to swiftly rotate out of CDX positions into cash bonds, providing liquidity to the market at a time when the liquidity premium was elevated. In fact, the liquidity premium was at a post-financial crisis high.

   Spread sectors have staged an impressive recovery since their first quarter sell-off, but sector-level moves can conceal security-level opportunities. For example, through the pandemic we have captured a 'COVID-19 spread premium' evidenced in issuers from sectors deemed to be severely negatively exposed to virus mitigation measures such as Airlines and Hotels. In our view, the market differentiated sectors based on COVID-19 sensitivity but did not distinguish underlying issuers based on corporate fundamentals such as balance sheet positions.

   In these examples we spotlight risk premiums created by credit risk or liquidity dynamics. As discussed at the turn of the year, we believe a data-driven and technology-oriented investment approach can enable us to identify future market inefficiencies efficiently, while allowing us to implement views with high precision. The tech-celeration brought about by the pandemic reinforces our conviction in this investment philosophy.

4. **Utilize currencies as a risk asset hedge.**

   To ensure our fixed income portfolios are balanced and resilient when faced with risk-off market episodes, we have typically hedged our corporate credit exposures with rates. With rates at low levels, their efficacy as a hedge is somewhat blunted. In recognition of this, we have diversified our hedge to include a basket of currencies that exhibit a negative correlation with credit, similar to rates. In addition, we dynamically adjust our hedge based on market conditions.

5. **Sustain focus on ESG analysis as a core investment principle.**

   The pandemic has highlighted that ESG factors are a "bear market necessity" not a "bull market luxury." As credit spreads further compress, management of ESG risks that can present material downside risks is essential given the asymmetric return profile of bonds. We view ESG as an evolving theme shaping investment decisions, policymaking and financial markets, with the cost of capital for both corporates and sovereigns increasingly guided by ESG traits. ESG integration is therefore crucial for issuer selection decisions, portfolio construction and risk management.

[3] Diversification does not protect an investor from market risk and does not ensure a profit.
[4] Combining internal and external data yields trading intelligence. This intellect allows us to implement investment decisions with speed and cost-effectively through lower transaction costs or by being rewarded for providing market liquidity.

What to Watch

The Pandemic

Scientific discovery has provided an exit route from the pandemic, but as recently discussed with a health expert during our daily investor Forum, vaccinations will entail “an unprecedented requirement for cooperation, coordination, synchronization and integration.”

Encouraging developments on the vaccine front include rapid vaccine approvals, mobilization of public resources and for certain EM economies, experience with annual vaccine drives. Downside risks include regulatory approval delays (or subsequent reversals), logistical challenges (due to double dose regimen and cold storage requirements) and insufficient demand (amid safety and side-effect concerns).

The Macro

Potential downside growth risks include health setbacks such as delayed vaccine rollout and renewed case growth alongside subdued demand as households and businesses constrain activity in order to shrink debt accumulated in 2020. Bankruptcies and defaults could also trend higher as forbearance draws to a close.

We are also mindful of policy hiccups. Modest US fiscal stimulus or a premature pivot away from policy support as the cyclical backdrop improves could generate financial market volatility. Through 2021, we will be closely monitoring inflation expectations and labor market improvements in order to gauge whether less accommodative policy rhetoric is more ‘bark than bite’. Elsewhere, we will also be monitoring central bank views on the climate transition and societal inequalities, both of which have potential to influence policy actions.

The Markets

In a world of compressed risk premiums and rapid change, the implication for investors is simple: don’t blink. We believe steering risk sentiment with speed will drive alpha. A constrained opportunity set can result in attractive investment openings swiftly closing during bouts of risk-on investor sentiment, with crowded positioning dampening return potential. Meanwhile, risk-off episodes may present selective buying opportunities.

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