Market Pulse: Portfolio Manager Perspectives

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Portfolio managers examine the impact of COVID-19

We share three diverse views on asset allocation strategy, US municipal bonds, and global equities

By **Kristina Hooper**

As the number of COVID-19 cases continues to rise, so do unemployment rates. And so the world continues to look for balance between implementing public health measures, offering fiscal and monetary stimulus, and opening up economies.

At the same time, investors are looking for ways to position their portfolios in this environment. In this piece, we hear from three portfolio management teams with diverse perspectives on ways that COVID-19 has impacted their areas of investment expertise. The first discusses three potential scenarios for the year ahead and what they could mean for asset allocation decisions. The second examines how the Federal Reserve's response to this crisis has helped bolster the US municipal market. And the third eschews market outlooks altogether in favor of a different question pertinent to global equities: "How is the world changing?"

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- **Jacob Borbidge,** Portfolio Manager and Head of Research for the Invesco Investment Solutions team
- **Mark Paris,** Chief Investment Officer and Head of Municipal Strategies for Invesco Fixed Income.
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Asset allocation: Gauging the investment implications of three COVID-19 scenarios

Alessio DeLongis & Jacob Borbidge. It took 11 years, but the longest lasting bull market on record has ended. Years from now, hindsight may suggest that the closing of the US and European economies, a previously unimaginable concept, was all but inevitable to contain COVID-19. But in reality, the outbreak took markets by surprise. The question, of course, is where do we go from here? While it is impossible to make predictions about COVID-19 related medical advancements, Invesco Investment Solutions has focused our attention on possible scenarios pertaining to the duration of the pandemic and how its impact on economic data and growth expectations may drive our investment process. Specifically, we have embedded the expectation of a U-shaped recession as our "base" case. Our objective is not to identify the most likely scenario and position our portfolios accordingly for the next 12 months; rather, it is to evaluate the most likely range of market outcomes, their associated risks and investment implications.

Base scenario: In this scenario, economic recovery would begin in the third quarter, but we would expect sideways markets with bouts of volatility as lack of a vaccine presents the risk of a second wave outbreak in the fall.
Investment implications: In this case, we would favor average risk exposure, with an overweight to credit assets and an underweight to equities and government bonds. Within fixed income, we would consider overweighting high-quality credit (such as investment grade corporate and municipal debt) or a combination of riskier credit (such as high yield) and long-dated, longer-duration government bonds — while reducing exposure in short- and medium-term government bond maturities. Within equities, we may favor US stocks over other developed markets and emerging markets, growth over value, large caps over small caps, and defensive factors such as quality and low volatility.

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Bear scenario: In this scenario, we could face a prolonged contraction of more than a year if the effects of COVID-19 are more severe than anticipated and the economy struggles to reopen.
Investment implications: In this case, we would expect broad-based risk aversion and outperformance of (relatively) defensive assets. We would favor below-average risk exposure, with overweight positions in long-duration government bonds and high-quality credit, favoring US dollar or US dollar-hedged assets given the potential for further US dollar appreciation. Other considerations include underweighting riskier credit assets, especially emerging markets local currency and hard currency debt, or underweighting equities, especially in emerging and developed markets outside of the US. Within equities, we would favor the areas highlighted in our base scenario (US stocks, growth, large caps and defensive factors).

Bull scenario: In this scenario, the news around COVID-19 would be positive, with a drop in cases and/or the emergence of medical developments. A recovery could take hold in the second half of 2020 and into 2021 as people return to work and the effects of previous stimulus measures provide support.
Investment implications: In this case, we would expect broad-based outperformance in cyclical and risky asset classes. We would favor an above-average risk posture, with overweight exposures to riskier credit assets and equities, and underweight exposures to government bonds and high-quality credit. Within credit, we would favor high yield, structured credit, emerging market hard currency and local currency debt with the expectation that the US dollar depreciates. In equities, we may favor emerging markets and international developed markets over US stocks, value over growth, small caps over large caps, and underweight positions in factors at risk of short-term reversal effects such as low volatility and momentum.

Municipal bonds: Fed programs help bolster the market after March's volatility

Mark Paris: The municipal bond market has seen historic volatility since the beginning of the COVID-19 crisis. In mid-February, municipal investment grade yields were lower than their Treasury bond counterparts up and down the curve — which is typical given the tax-exempt status of munis. But by late March, rates for 10-year muni bonds were three times that of the corresponding Treasury note, and rates for 30-year munis were two times that of 30-year Treasuries.[1] Why? Muni issuers did not have access to the market and liquidity was extremely thin. The mandated stay-at-home practices meant that as a society, we were not using the essential services that the muni market finances: Public transportation, airports and toll roads had their utilization greatly slashed, and therefore their revenue and fees as well. Also, hospital bonds were under pressure as COVID-19 cases overwhelmed their staff and put pressure on their balance sheets. The fear of downgrades and defaults and the flight to cash caused a major liquidity crunch as too many sellers and not enough buyers drove prices down. Muni funds went from positive flows to now negative numbers not seen since the Taper Tantrum sell-off of 2013.

However, the Federal Reserve has instituted some programs to help both the municipal market and issuers. The Fed's purchase of short-term municipal floating rate notes relieved some pressure on short-term tender option bonds, which many muni managers utilize for leverage. The Municipal Liquidity Facility (MLF) plan is scheduled to launch soon as well, whereby the Fed will directly loan to certain municipalities for up to three years, but it is limited in scope as to which issuers are eligible. Funding for hospitals has been part of the early bills passed by Congress, but now there is heightened talk of a more comprehensive package that is targeted for municipalities. All of these actions have helped to somewhat stabilize the muni market in late April and the start of May. In addition, we believe that many muni issuers have come into this crisis from a period of strength as the economy was growing steadily beforehand. General obligation bond issuers had well-funded rainy-day funds, issuers such as airports and toll roads typically carry a large amount of cash on hand, and sales tax from internet purchases is still being collected even as many businesses are closed.

We believe the price dislocation in the muni market has been too drastic and that there is a disconnect between the fundamental credits and where they are trading in the marketplace. This is especially true for the high yield market, where we believe investors can earn a significant coupon in the short run while potentially gaining price appreciation in the longer term as spreads between munis and Treasuries tighten when economic growth recovers. In addition, as stimulus programs are instituted and the US government spends more, the potential for higher tax rates also looms large for individual US investors, which could again create positive flows into tax-exempt munis. While this crisis continues to play out, we believe thorough credit research will be key to finding value in both investment grade and high yield muni issuers so that US investors looking for tax-exempt income can potentially benefit from the market fluctuations.

Global equities: COVID-19 expected to accelerate several structural growth trends

Randall Dishmon: I get asked all the time about my "outlook" for the market. My answer has been the same for nearly 20 years: "I don't have one." I don't … for good reason. I've not yet met the person who can consistently predict what the market is going to do, but even more importantly: I don't buy the market. In my view, the question itself is the real problem. I believe it shows a critical flaw in a person's thinking — the only reason to ask that question is to attempt to time the market … a perfect example of what I call "cyclical thinking." I don't like cyclical thinking. I believe it is one of the main enemies of the successful long-term investor.

Successful investors, in my view, have to be expert at recognizing the difference between cyclical and structural trends. At the core of my investing philosophy is this: I look for structural trends. Simply put: "How is the world changing?" A perfect example that I've been investing in for my entire career is the rise of ecommerce. That's represented a steady change in the way business is done — it's not a cycle that leads to four years of ecommerce being favored and then a mean-reversion to four years of brick and mortar retail outperforming. That's the difference: Cyclical change separates markets into growth companies and value companies. Structural change separates the market into winners and losers. Losers don't mean revert — they go bankrupt. Like I said, it's important to recognize the difference.

So, here's my outlook, but not for the market … for the structural growth trends that I believe are changing the world.

- **Move to the cloud.** I believe the shift toward cloud-based tools and services will continue stronger than before. Prior to COVID-19, it was considered a "nice to have." It is now considered essential. As one CEO recently told me, "If I don't get to the cloud like yesterday, I don't have a business tomorrow." I see this as a once-in-a-generation type shift that is changing the way every company on the planet does business. Not many things do that.
- **Rise of ecommerce.** Ecommerce is accelerating. It has become the only option in a COVID-19 world, and post-COVID behavior will likely still favor not going to the store as much. Every crisis in the past 20 years has sped up the market share gains of ecommerce. I don't expect this to be any different.
- **The electronification of money.** This trend actually started in 1950 with the first credit card, and it has grown globally unbroken at a rapid rate for over 60 years. I expect it to accelerate during this COVID-19 environment and continue afterwards. Why? Ever look at money under a microscope? Don't.
- **Diagnostics and research.** It's been on the rise for two decades and will again accelerate as a result of this environment, in my view.

I expect all of these trends to continue for at least the next decade — that kind of compounding makes short-term concerns meaningless to my investment process.

Authors

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Kristina Hooper has 25 years of investment industry experience. Prior to joining Invesco, she was the US investment strategist at Allianz Global Investors. Prior to Allianz, she held positions at PIMCO Funds, UBS (formerly PaineWebber) and MetLife. She has a BA degree cum laude from Wellesley College; a J.D. from Pace University School of Law; an MBA in finance from New York University, Leonard N. Stern School of Business, where she was a teaching fellow in macroeconomics and organizational behavior; and a master's degree from the Cornell University School of Industrial and Labor Relations, where she focused on labor economics. She holds the Certified Financial Planner, Chartered Alternative Investment Analyst, Certified Investment Management Analyst and Chartered Financial Consultant designations.

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1 Source: Municipal Market Data (MMD) Services

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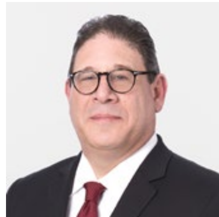
Mr. Dishmon joined Invesco when the firm combined with OppenheimerFunds in 2019. His previous positions at OppenheimerFunds included serving as co-manager of the global multicap growth strategy and senior research analyst for the global equity strategy. Before joining OppenheimerFunds, Mr. Dishmon served for two years as a management consultant with Booz Allen & Hamilton. He also served for four years as a manager with UtiliCorp United and for seven years as a vice president and division chief with KCI Technologies.

Mr. Dishmon earned a BS degree in engineering from North Carolina State University, an MS in engineering from Johns Hopkins University, and an MBA from the University of Michigan.



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Mr. Paris entered the financial industry in 1990 and joined Invesco in 2010 when the firm combined with Van Kampen Investments. Prior to joining the firm, Mr. Paris was a trader and then a portfolio manager on the municipal fixed income team at Morgan Stanley/Van Kampen, which he joined in 2002. He also was previously a trader and portfolio manager at Oppenheimer Funds, head underwriter at Chase Manhattan Bank, and a trader and underwriter at NatWest Bank.

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