Goldman Sachs Asset Management

Fixed Income

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The Recovery Line

This summer was meant to commemorate the opening of the Olympics in Tokyo, but instead marked the reopening of economies globally. The policy backdrop remains supportive and we remain overweight fixed income sectors in the path of central bank buying.

IN THIS ISSUE

The Economy: Moving Towards the Recovery Line 3-4

Global growth sprinted forward in the third quarter but remains below its pre-COVID-19 level. Growth will not cross the recovery line until the services sector normalizes.

Policy: Changing the Game 5

Central banks and governments have added new tools to their kit. With monetary policy on “easy policy autopilot”, we expect fiscal policy to drive changes in the outlook.

Fixed Income Views 6-7

We believe policy measures will address severe market dislocations and keep left tail risks in check. With a “search for liquidity” paving way for a “search for yield”, we are overweight Agency mortgage-backed securities (MBS) and corporate credit.

Executive Summary

The Economy: Moving Towards the Recovery Line

- **Global growth** sprinted back in the third quarter but remains below its pre-COVID-19 level. In other words, it is not yet over the recovery line. The recovery will remain incomplete until services sector activity normalizes.
- High **unemployment** and **negative output gaps** suggest **inflation** will remain subdued. The pandemic has fast-tracked trends from telemedicine to e-commerce and remote working to automation that will influence the make-up of the global economy and its workforce as well as inflation dynamics. There are potential drivers of higher inflation outcomes in the years ahead but as recently discussed, we are not there yet.

Policy: Changing the Game

- Several **new economic policies** made their debut at central banks and governments globally in 2020, from corporate bond buying by the US Federal Reserve (Fed) to government subsidies for short-term work in the UK.
- The Fed also announced a new **average inflation targeting** framework—which cements its dovish policy stance—and evolved how it will assess labor market performance, taking into consideration racial and income disparities. We think this evolution in policymaking, with greater regard for **social issues**, will extend beyond the US.
- With central banks on "easy policy autopilot", we expect **fiscal policy** to be a key driver of changes in the macro and market outlook going forward. The cyclical environment and low rates support the case for additional fiscal spending.

Fixed Income Views

- Among **G10 rates**, we favor cross-market or curve shape views. For example, we are overweight higher and steeper yield curves in Australia relative to the low and flat European yield curve.
- We remain overweight **Agency MBS** and **corporate credit** on both sides of the Atlantic given the supportive policy backdrop. We believe the Fed has ample room to respond to market dislocations and keep left tail risks in check.
- As markets have progressed from a "search for liquidity" to a "search for yield", we also see value in adding exposure to **high yield** corporate credit.
- Within corporate credit, we are also selectively overweight issuers that are perceived to be severely or modestly exposed to COVID-19 developments given attractive risk-adjusted return potential.
- We are broadly neutral on **EM assets** which we believe require a healthier pace of global growth to perform.

Source: GSAM. As of October 2, 2020.

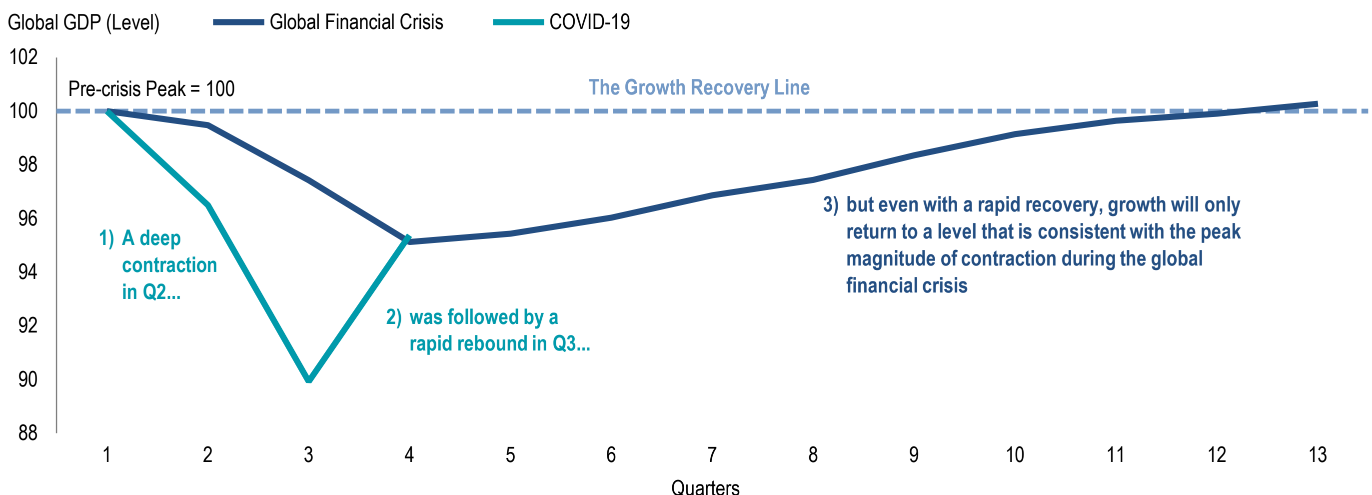
The Economy: Moving Towards the Recovery Line

This summer was meant to mark the opening of the Olympics in Tokyo, not the **reopening of economies globally**. Following a plunge in growth in the second quarter, a relaxation of virus containment measures alongside policy support helped the global economy sprint forward in the third quarter. Global growth is expected to have grown at a more than 30% annualized pace between July and September. This would be the strongest single quarter expansion on record. But even with this remarkable bounce, global GDP will still be 4% below its end-2019 level (Chart 1). In other words, it is not yet over the recovery line.

The COVID-19 shock is unique in both its magnitude and **sector impact**. Unlike prior recessions, the services sector has been most hard hit by the downturn. The recovery will remain incomplete until the services sector normalizes. And the services sector will not normalize until we adjust to living with COVID-19. This will require many things including a widely available vaccine (that is safe and effective), improved treatments to reduce the number of severe cases and fatalities, mass testing, efficient track-and-trace systems and ongoing behavioral measures including social distancing, mask mandates and increased hygiene.

China serves as an optimistic roadmap for economies once they control virus spread. Its virus infection curve has remained flat since April, manufacturing activity recovered during the second quarter and services sector activity more-or-less normalized last month. But there are reasons this experience may not translate to other countries, at least on a similar timeline. First, China had a head start on reopening due to faster virus containment. By contrast, major developed economies are experiencing second virus waves. Second, fiscal stimulus has directly boosted its construction sector. Elsewhere, policy measures have been focused on averting recession outcomes such as business failures and job losses. Finally, its export sector has benefited from global demand for goods such as medical supplies.

Chart 1: Global growth remains behind the recovery line even after a rapid rebound



Source: GSAM. As of September 21, 2020. Global GDP is a GDP-weighted measure based on GSAM calculations. Note: Q3 GDP Growth is based on Bloomberg consensus economic forecasts. 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.

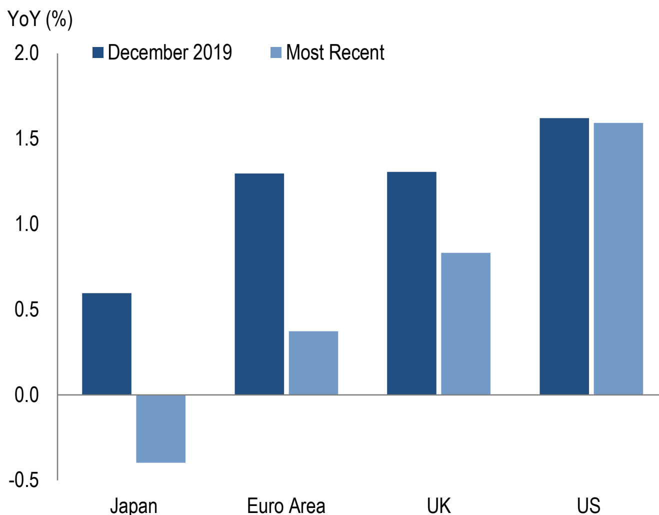
The Economy: Moving Towards the Recovery Line (Cont.)

Looking ahead, we believe **key headwinds** to the near-term growth outlook include more stringent virus control measures, low employment growth and continued weakness in the services sector. The services sector is a large job-generator so ongoing softness will exacerbate problems of joblessness and inequality. That said, there are several **growth-supportive factors** that will cheer the recovery on. Household savings rates are high, financial conditions are accommodative owing to central bank policies (see **Policy: Changing the Game**, page 5), and housing market valuations—a key source of household wealth—remain strong.

Against this backdrop, it is difficult to foresee a rapid rise in **inflation**. When the pandemic first hit, concerns around supply disruptions generated expectations for higher inflation. Then when policymakers responded to the severe downside shock in dramatic fashion, substantial fiscal spending reinforced calls for higher inflation. But what we've observed over the last six months is that disinflationary forces have dominated. Every major economy has seen its core inflation rate decline relative to late 2019 (Chart 2).

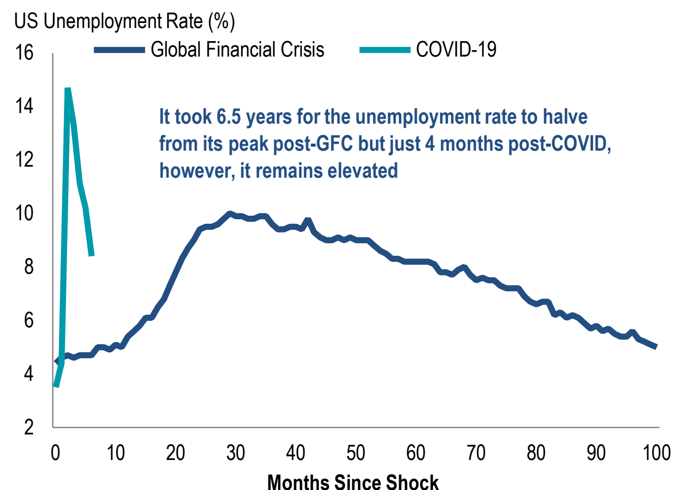
Negative output gaps and **labor market slack** (Chart 3) suggest that wage growth and broader price pressures will remain subdued. In addition, the last expansion taught us that even when unemployment is low and growth is steady, inflation is not guaranteed. Current economic and labor market constraints add to structural factors that have helped to tame inflation in recent years. These include elevated youth unemployment, reduced wage bargaining power and technology advances. The pandemic has fast-tracked trends from telemedicine to e-commerce and remote working to automation. This will alter the make-up of the global economy and its workforce; jobs lost may not be the ones regained and workers losing jobs may not (yet) possess the skills required for these jobs. There are potential drivers of higher inflation outcomes in the years ahead—such as greater fiscal spending even when we move beyond the pandemic and localization of supply chains—but as recently discussed, we are not there yet.

Chart 2: Moderation in core inflation



Source: GSAM, Macrobond. US inflation reflects core personal consumption expenditures. As of October 1, 2020.

Chart 3: The unemployment rate has considerable room to fall



Source: GSAM, Macrobond. As of September 2020.

Policy: Changing the Game

Whilst karate, rock climbing and skateboarding did not get to make their debut at the 2020 Olympic Games, several **new economic policies** made theirs at central banks and governments globally. The Fed launched a corporate bond buying program and the UK government funded short-term work. European Union (EU) leaders agreed to issue EU bonds to fund the region's Recovery Plan[1], while a flurry of central banks joined Team Quantitative Easing (QE) and Australia adopted yield curve control.

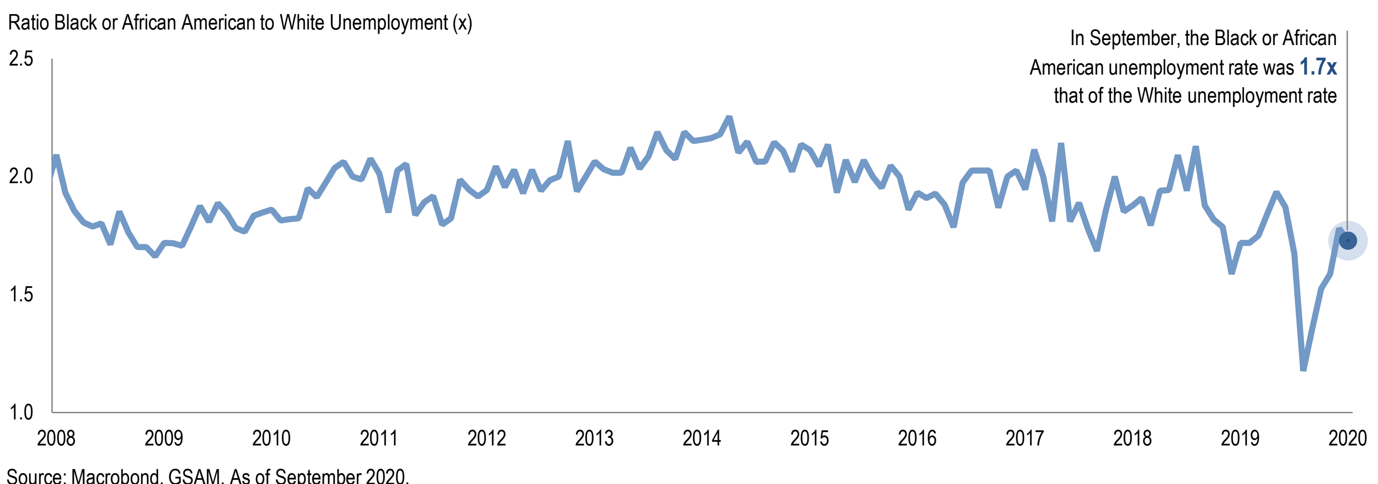
Advanced economy central banks were considered to be running up against limits on monetary policy in 2019, yet they managed to deliver more stimulus in a matter of months (or even weeks) than they did over several years following the global financial crisis. But with policy rates now anchored at **lower bounds**, we expect additional easing to entail expanded asset purchases and lending facilities rather than rate cuts.

In August, the Fed reinforced its dovish outlook by committing to keep policy easy until inflation is "**moderately above 2 percent for some time**". The central bank also adjusted how it will assess labor market performance to ensure the economy does not leave "low- and moderate-income communities" behind. Maximum employment will be viewed as a "**broad-based and inclusive goal**". In other words, the decision to withdraw policy support will take into consideration income and employment disparities (Chart 4). We think this evolution in policymaking, with greater regard for **social issues**, will extend beyond the US, as policymakers seek to foster a more equitable economic recovery.

With central banks on "**easy policy autopilot**", we expect fiscal policy to be a key driver of changes in the macro and market outlook. We anticipate additional fiscal spending in the US, irrespective of the election outcome. The magnitude of spending—both in response to the COVID-19 shock and broader spending plans—will be informed by the alignment of political party incentives. In Europe, four major economies—Germany, France, Spain and Italy—will be providing continued labor market support into 2021, while the UK will replace its Job Retention Scheme with a Job Support Scheme from next month.

This new economic policy stance, involving ultra-low interest rates alongside fiscal spending has triggered a debate about the longer-term implications of this policy combination. For now, we think the cyclical environment and low rates support the case for fiscal spending. Historically high government debt alongside historically low interest rates amount to a historically average cost of debt. But as the economic recovery progresses and virus experiences diverge, we expect the policy mix to vary by economy, giving way to macro investment opportunities across interest rates and currencies (see **Fixed Income Views**, page 6).

Chart 4: The Fed's decision to normalize policy will take into account labor market inequalities[2]



Source: Macrobond, GSAM. As of September 2020.

[1] The formal parliamentary ratification of the European Recovery Plan is still pending. EU bonds will entail several (but no joint) national guarantees i.e. if one country fails to honor its guarantee, other countries would not be required to contribute more to the EU budget. [2] A tight labor market at the late stage of the last expansion was characterized by a gradual reduction in racial and income disparities in the labor market.

Fixed Income Views

Rates

Given low yields and low rate volatility, we are neutral to bearish global duration. That said, government bonds can still present investment potential through views on cross-market rate moves or yield curve shapes. For example, we currently favor Australian versus European rates. The Australian yield curve is both higher and steeper than the European yield curve and therefore offers better carry and roll potential. In addition, the Reserve Bank of Australia (RBA) is engaged in QE which benefits front-end Australian yields. Australia's inflation process was weak before the pandemic ended its 28-year stretch of uninterrupted growth, and the outlook from here warrants additional RBA easing. Meanwhile, we see limited prospects of deeper negative rates in Europe in the near term.

Spread Sectors

The policy picture remains supportive for **Agency MBS** and **corporate credit** on both sides of the Atlantic, hence our overweight exposures. We are broadly neutral on **EM assets** which we believe require a healthier pace of global growth to perform.

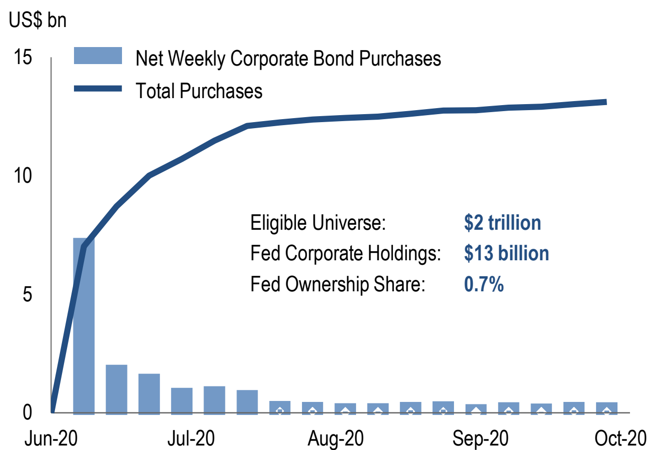
Corporate Credit

The Fed commenced corporate bond buying in June and whilst its purchases have been underwhelming in terms of size, it has ample room to respond to market dislocations and keep left tail risks in check. The Fed owns just 0.7% of its eligible purchase universe (Chart 5). By contrast, the ECB—which expanded its QE envelope by €1.35 trillion this year—owns just over a quarter of the eligible European credit universe. Given the supportive policy backdrop, we've used recent market weakness as an opening to add exposure to **US high yield corporate credit**, as the sector provides an attractive spread premium relative to investment grade (Chart 6). In addition, we are selectively overweight corporate credit issuers that are severely or modestly exposed to COVID-19 developments given attractive risk-adjusted return potential. All exposures are informed by astute bottom-up security selection, with consideration of underlying credit fundamentals. Importantly, we have exposure to issuers that we consider to have sufficient cash flow to withstand a challenging economic environment through early 2022.

Agency MBS

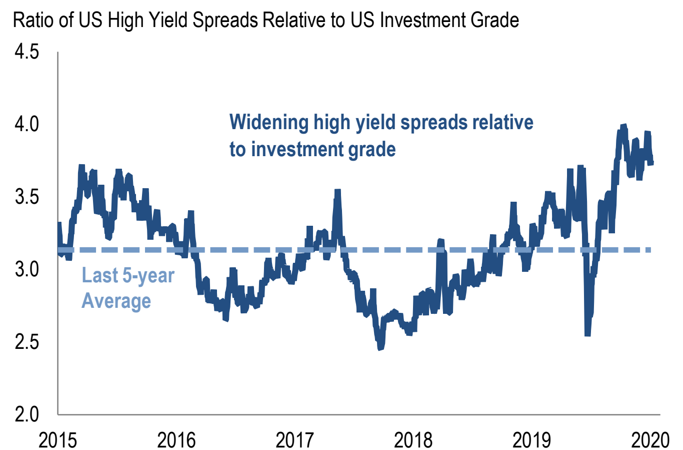
The Fed has added $1.1 trillion of Agency MBS to its balance sheet over an incredibly short period of time, accumulating over $600 billion in March and April alone. This demonstrates its steadfast resolve to calm market stress and support the sector. In the coming months, we believe the sector will benefit from both demand and supply tailwinds, with bank and Fed buying accompanied by a reduction in new mortgage supply through to the first quarter of 2021.

Chart 5: The Fed has ample room to expand its corporate purchases if needed



Source: GSAM, Macrobond, Fed. As of week beginning October 5, 2020.

Chart 6: US high yield provides an attractive spread premium relative to investment grade



Source: GSAM, Macrobond, ICE BofAML. As of October 2, 2020.

Fixed Income Views (Cont.)

Currencies

We are bearish on the US dollar and see a case for medium-term weakness given negative real interest rates (reinforced by the Fed’s dovish stance), high valuations and potential for an unwind of overweight positions among foreign investors and reserve managers. A recovering global economy can also weigh on the dollar. Elsewhere, we favor emerging market (EM) currencies that provide carry from economies that run a current account surplus such as the Chinese yuan, Korean won and Singapore dollar. We also have overweight exposure to the Mexican peso and South African rand given attractive valuations and carry. We are also overweight the Japanese yen—a perceived safe-haven currency—given potential for near-term political volatility surrounding Brexit negotiations and the US election.

Dynamic Hedging

To seek 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.

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