A Country Bond Can Survive

In January, we borrowed As Good As It Gets as the subtitle of our quarterly Fixed Income Outlook. Little did we know how right we were. A trade deal with China was all but done, the unemployment rate was at the lowest level in nearly 50 years, and the economy was humming. Stocks were high and bond valuations tight. Since then the financial markets have made unprecedented moves to say the least. Stocks (S&P 500) peaked on February 19 only to drop 35%* by March 23, though some of those loses have been recovered. Bonds have exhibited a similar level of fear and panic, culminating in a liquidity crunch that stretched across sectors leading to a massive rally in Treasury bonds.

Only two other occasions come to mind that compete with the sudden shock and fury that has unfolded: October 1929 and October 1987. In the former, excessive financial speculation combined with serious fiscal, tariff, regulatory, and monetary policy mistakes led the country and the world into the Great Depression. In the latter, reacting to a spike in interest rates didn’t even register a minor recession. We haven’t forgotten about the 2008-2009 Financial Crisis—or Housing Crisis if you prefer—culminating into the Great Recession and a decade of slow recovery. That downturn started as a slow, gradual slide that was a year in the making caused by excessive leverage, fueling a housing bubble.

This time the culprit, the COVID-19 pandemic, is an altogether different global issue—a health crisis—with no easy, short-term answer to the threat of overwhelmed hospitals and healthcare resources. The near-term solution—government-ordered shutdowns of vast segments of the economy— is to slow the virus’ progression and buy time. The economic implications have not only shaken the stock market, but also spilled over into the bond market and threatened a liquidity crisis. Bond investors across sectors have found themselves to be forced sellers to cover liquidations, no matter the price.

While Treasury bond prices rallied (yields fell), this high road has been bumpy...very. As the most efficient and liquid instrument to trade, this was where many forced sellers turned, creating a rather peculiar and unexpected occurrence. While bid-ask spreads for newer “on-the-run” Treasury bonds held relatively tight, bid-ask spreads for older “off-the-run” issues widened substantially, reaching very costly levels despite record low yields. Even more worrisome for the future, yields on some T-bills fell into negative territory on the offer side. Investors who bought these instruments were paying—yes paying—to have their money held by the government.

The trading activity was also notable among investment grade and high yield corporate bonds. Yield spreads to Treasuries widened and bond prices fell dramatically as concerns mounted about the length and severity of the expected downturn, not to mention a growing list of downgrades by credit rating agencies and quickly diminishing repayment prospects. Fearing that the door to capital access was closing, companies drew down their credit lines and, those that could, priced new issues at hugely generous spreads. These new bonds were met with overwhelming investor demand, while liquidity in the secondary market of these very same issuers was drying up.

Other bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spared either. Spreads on mortgage-backed securities (MBS) swung wildly as margin calls and fund outflows created forced sellers that flooded the market with bid lists. Municipal bond market segments were not spare...
On the monetary front, the Federal Open Market Committee cut the federal funds rate twice in March down to a range of 0.0-0.25%. More importantly, it opened the liquidity spigot (or firehose) by rapidly increasing its purchases of Treasuries and agency MBS and rolling out a series of liquidity facilities from the Financial Crisis, even creating some new ones. These facilities will support primary dealers, backstop money market funds, and purchase asset-backed securities, commercial paper, investment grade corporates, and municipals. Team Powell has basically pledged to do more if needed.

So, where does this leave us? Fallout from COVID-19 will endure for months, probably longer, as restarting the economy will likely be slow and measured. In the meantime, we see government deficits ballooning to $2+ trillion for the foreseeable future, possibly pressuring longer-maturity Treasury yields higher. Inflation could also spike as we come out of this non-declared recession, given the scale of the fiscal and monetary stimulus. In the long run, however, yields will likely trend lower because of demograph ic and technological advances. As for negative rates, the FOMC will do all it can not to go there, but it remains a possibility despite its problems.

Great opportunities are being created in spread product, especially corporate bonds. Yes, the rating agencies will continue to downgrade corporations and municipalities, and those already at the lower rungs of investment grade may very well fall below investment grade. Such a drastic decrease in economic activity means a drop in revenues, earnings, cash flows and therefore the capacity to service debt. Default rates will also step up, particularly in the energy complex. Energy producers are being hurt not only by the demand shock of COVID-19, but also the supply shock of a market share war between Russia, Saudi Arabia, and, indirectly, U.S. shale producers. Travel-related businesses, restaurants, and retailers without a significant online presence are at serious risk, as well. Still, these market conditions are creating rare opportunities among other corporate bond sectors.

At the risk of sounding preachy, we are only beginning to understand the short-term and long-term health, societal, political, and financial/ economic consequences of COVID-19. Technologically enabled trends that were already in place will accelerate, such as remote working, learning, healthcare delivery, and socialization. The consequences of these trends for location-based businesses such as offices, schools and universities, and sports/entertainment venues will likely be significant. Finally, the fiscal and monetary actions our political leaders are taking now will mold how we view the financial and economic landscape and the government’s role in it.

We look to be positioned for these changes. In the long run, the financial markets and the economy will recover and the volatility we are seeing today will subside, benefiting “Country Bond” investors. We’ve been here before albeit under different circumstances. The key is to stick to your financial plan, have an appropriately balanced portfolio, and adjust as needed.

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### FIXED INCOME OUTLOOK

#### Sector Performance as of 3/31/2020

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Source: Bloomberg

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**Fixed Income Ideas**

1. **High Yield Sector**: With corporate spreads widening, select high yield credits are becoming more attractive. We continue to focus on high quality credits with strong covenant protection and favorable structural features.

2. **Municipal Sector**: While municipal credit remains attractive, we continue to monitor the impact of economic uncertainty on yields and credit quality.

3. **Real Estate-Linked Securities**: The sector continues to be attractive with many credits showing strong covenant protection and favorable structural features.

4. **Structured Products**: We continue to focus on structured products with strong credit fundamentals and robust credit enhancement.

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**Fixed Income organizer, Bloomberg Barclays US Aggregate Index**

- **Gauges market sectors performance across fixed income sectors.**
- **Includes money market funds, and purchase asset-backed securities and corporate bonds.**

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