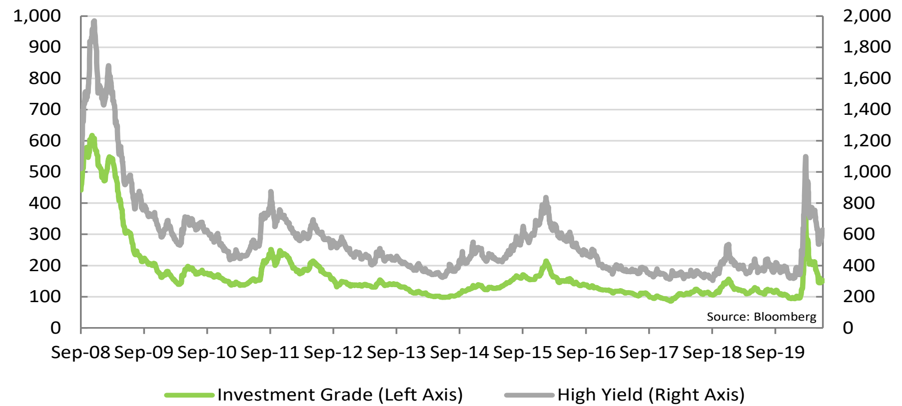
FIXED INCOME OUTLOOK

REGIONS
INVESTMENT MANAGEMENT

"The Seven Trillion Dollar Man"

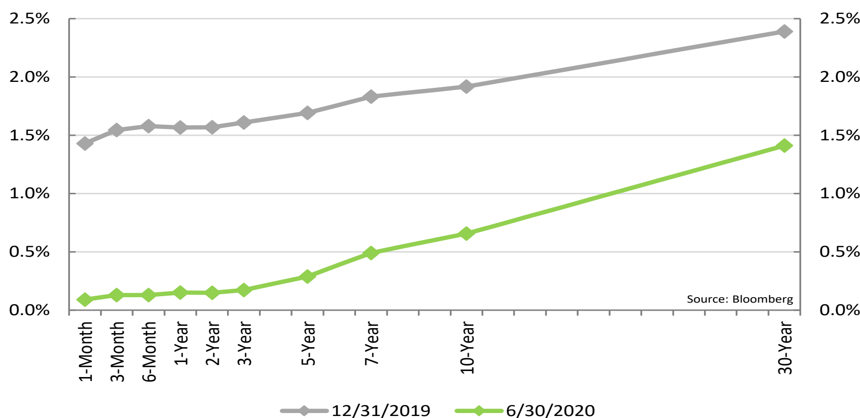
July 2020



The old adage, Don't Fight the Fed, couldn't have been truer over the last three months. Federal Reserve bond buying and promises to do more have continued to drive both the bond and equity markets irrespective of the daily COVID-19 case counts and business re-openings/re-closings. Whether one foresees a V-shaped, U-shaped, W-shaped, or our favorite, the Nike swoosh-shaped economic recovery, the rally since March can largely be attributed to one factor: government intervention. The $2 trillion fiscal stimulus package aside, we believe the Fed's massive injection of liquidity into the markets and its near-zero fed funds rate are the main driving forces. All told, the Fed, led by Chairman Jerome Powell, has swollen its balance sheet to $7 trillion, up from around $4 trillion at the start of the year.

If needed, the free money won't stop there. The Fed has promised to buy a whole range of assets to ensure that markets continue to function properly. Not only did the Fed return to direct buying of Treasuries, agencies, and agency mortgage-backed securities as it did in the years following the financial crisis, it also restarted and enhanced lending facilities to support corporate bonds, asset-backed securities, and commercial mortgage-backed securities. Notably, Team Powell's corporate buy list includes below investment grade bonds a.k.a. high yield/junk bonds. On the scale of riskiness, buying junk bonds is as close as an investor can get to buying stocks outright. In the event of a default, bondholders can suffer from huge haircuts in valuation and possibly end up owning the company in a restructuring. The actual or implied support from the Fed has been dramatic as investors have sought to front-run the tidal wave of cash and charged back into corporate bonds as well as stocks.

After peaking in March at a level not seen since the 2008-2009 Financial Crisis, yield spreads on investment grade corporate bonds have collapsed from 373 bps to 150 bps at the June quarter end, driving bond prices higher. True to form, equity-like high yield bonds were even more volatile with spreads reaching 1,100 bps before settling in at 626 bps at the June quarter end. All the while, default rates continue to push higher led by energy companies and "brick and mortar" retail chains. Unfortunately, we expect more defaults in the coming months as the COVID-19 shutdown and its lingering effects accelerate the long-term economic challenges already in place for many industries which have been slow to change to evolving economic realities.



Looking forward, we continue to believe the economic fallout from COVID-19 will endure for several more months spilling into 2021. Given the scale of the monetary and fiscal ($2 trillion CARES Act and probably another $1 trillion-plus round) stimulus, it is possible that inflation could re-ignite as the economy improves. However, it is worth noting that the Personal Consumption Expenditures (PCE) Core Deflator registered a modest 1.0% year-over-year increase in May down from a range of 1.5% to 1.8% over the last year and a half. This indicator is Team Powell's preferred measure of inflation and suggests that, at least in the Fed's view, inflation has been and remains well under control. The real question is: will asset price inflation perpetrated by the Fed's bond buying program eventually find its way into

the prices of goods and services (i.e., the things consumers buy) in a meaningful way?

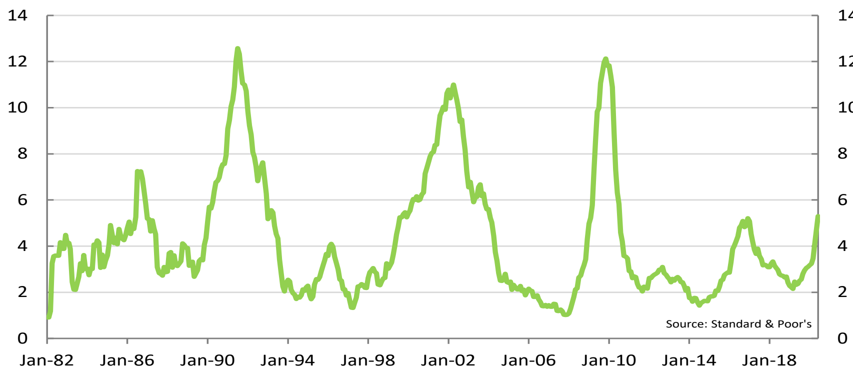
In the long run, we have our doubts. While the fiscal and monetary policies cited above tend to be inflationary, the U.S. dollar remains the currency of choice for global trade and U.S. Treasury yields remain relatively attractive compared to many other developed countries. In addition, technological advances and demographic trends will likely remain overriding factors. Arguably, the pandemic just accelerated both trends and instead the real risk is deflation. As for negative rates, the Fed will do all it can not to go there and has pledged such, but it remains a possibility despite the inherent challenges it creates.

Given the still shaky near-term economic outlook, the almost complete recovery in asset prices raises several uncomfortable questions. Has the Fed's intervention interfered with one of the key features of the markets which is price discovery? Could/should Team Powell use its balance sheet to decide Corporate America's winners and losers? Will the flood of debt issuance enable some companies with broken business models to live on as zombie companies? What are the risks of moral hazard if the Fed is going to inject liquidity every time the markets falter and investors get a perpetual lifeline? With unemployment at depression-era levels, is it fair that investors are made whole while everyone else gets $1,200? The potential answers to these questions are unsettling, as our Seven Trillion Dollar Man's actions may save the U.S. economy in the interim only to set us up for much larger market, economic, and societal problems for future generations to face. Stay tuned.

Sector Performance as of 6/30/2020

	QTD	YTD
Bloomberg Barclays US Aggregate Index	2.90%	6.14%
Bloomberg Barclays US Treasury Index	0.48%	8.71%
Bloomberg Barclays US MBS Index	0.67%	3.50%
Bloomberg Barclays US Corporate Index	8.98%	5.02%
Bloomberg Barclays US High Yield Index	10.18%	-3.80%

Source: Bloomberg



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