PUBLIC FIXED INCOME

Quarterly Commentary

Second Quarter 2020

The second quarter of 2020 witnessed a strong rally in risk assets as the federal government utilized every tool imaginable to stabilize markets following the COVID-19 related selloff in March. With funds from the original COVID-19 relief package (the CARES Act) running low, Congress passed the Paycheck Protection Program and Health Care Enhancement Act in April, making an additional $320 billion in aid available to small businesses. More importantly for risk assets, on April 9th the Federal Reserve announced additional programs ostensibly designed to backstop credit markets, including its intention to purchase corporate bond ETF's and certain fallen angel debt, provided it met certain criteria.

While the Fed can help support asset prices, it cannot produce cash flow or prevent defaults. With COVID-19 infections rising in some states, the question now becomes whether more lockdowns are in store and what the shape of the recovery will look like.

MetLife Investment Management

Investment Grade Credit[1]

The second quarter began with investors still woozy from the historic volatility and almost non-existent liquidity that plagued the first quarter; not to mention a slew of unknowns concerning COVID-19 and its long-term impact on global economies. However, as stay at home orders started to lift around the world and central banks instituted policies to support markets, optimism began to inch back. Despite some softening in June as fears of a second wave of COVID-19 dampened expectations of economic recovery, a sharp rally through much of April and May resulted in positive returns across investment grade credit. For the quarter, the Bloomberg Barclays U.S. Credit Index returned an impressive 8.22%, for an excess return of 7.71% over similar duration Treasuries. By the end of the quarter, spreads narrowed from their historic March 23rd wides of 341 basis points to close at 142 basis points. Corporate credit posted an even more impressive return of 8.98% for the Bloomberg Barclays U.S. Corporate Index as non-corporate sectors, namely Supranationals and Foreign Agencies, failed to keep pace with the broader market. Treasury yields fell for the most part and the curve steepened with 2, 5, and 10-year Treasury yields declining 10, 9, and 1 basis point, respectively. As a result, both the 2s/10s and 2s/30s curves widened to 50 and 125 basis points, respectively. Similarly, the Bloomberg Barclays U.S. Credit Index yield declined; falling 118 basis points to close the quarter at 2.05%.

Of course, markets were also helped by the Federal Reserve buying programs that have provided support to various sectors. Two key programs supporting corporate credit are the Secondary Market Corporate Credit Facility (SMCCF) and the Primary Market Corporate Credit Facility (PMCCF), both of which underwent some changes in June.[2] In the SMCCF, the Fed switched from buying $250-300 million per day of corporate bond ETFs to actual bond purchases mirroring the composition of a newly created Fed Broad Corporate Market Index. Regarding the PMCCF, it was finally made available to borrowers in June; although, we don't expect a high degree of usage in the near term as investment grade companies have had little trouble bringing new issue deals to market. Further technical support for corporate bonds came in the form of significant inflows during June from both domestic and foreign investors.

Not surprisingly there was a fair amount of bifurcation among sector returns; with those sectors that bore the brunt of spread widening in the first quarter recovering well, and those sectors likely to be most impacted by widespread stay at home orders long-term, underperforming. As WTI crude oil produced a record gain of 92% in the quarter, the Energy sector rebounded significantly with Independent Energy and Refining topping the list of outperformers, posting excess returns of 36.83% and 22.56%. Integrated Energy, however, lagged with an excess return of 5.98%. Although, we note that year-to-date WTI crude is still down 36%. Autos and Metals & Mining also recorded sizable excess returns of 12.00% and 11.52%, respectively. On the other hand, the lone corporate sub-sector to post a sub 1% excess return was Airlines (+0.73%). Despite picking up in the second quarter, airline travel is down close to 50% year-over-year. Across ratings, BBBs outperformed their higher quality counterparts, posting an excess return of 10.70%, and the BBB/A spread, which got as wide as +153 basis points in the first quarter, came in to 84 basis points, but remains wider than the 50 basis point spread at the end of the year. Following the first quarter historic widening, intermediate and long corporate spreads started the second quarter with just a two-basis point spread. But as the Fed stepped in, intermediate spreads rebounded more sharply, tightening 122 basis points versus 72 basis points of tightening for long corporates, and reversing first quarter underperformance on a spread basis.

On the earnings front, corporate earnings were challenging as the uncertainties around COVID-19 caused many management teams to avoid providing forward guidance and to reduce dividends in an effort to shore up balance sheets and preserve investment-grade ratings. Further, given the unprecedented nature of mandated business closures and travel restrictions, fallen angel risk continued to be a factor. However, as credit spreads tightened from the wides of the first quarter, the pace slowed; and compared to $125 billion in the first quarter, $35 billon of investment-grade issuers were downgraded to below investment-grade in the second quarter, bringing the year to date total to $160 billion. It is important to note though that 2020 fallen angels have performed well post downgrade, tightening on average by over 100 basis points relative to other BB names - over six times the average outperformance of fallen angels.

In terms of new supply, the rapid pace of new issuance that began in March continued into the second quarter. Year to date $1.43 trillion in new supply has come, eclipsing new issuance for all of 2019 in just six months – the fastest pace since 2009. However, as issuers have been able to access the market to lock in low yields, issuance has skewed toward the long end with 64% of supply coming at 6+ years versus 58% in 2019. Although, as the Fed stepped in with their corporate bond buying, issuance at the front-end picked up materially with 3-year and shorter issuance now comprising 8% of total year-to-date issuance versus just 4% through the first quarter.[3]

	2Q 2 020	2Q 2020	6/30/2020	6/30/2020
	Total Return (%)	Spread change (bps)	OAS/DM (bps)	Yield to Worst (%)
Bloomberg Barclays U.S. Corporate Index	8.99%	-122	150	2.15
Bloomberg Barclays U.S. Long Credit Index	11.08%	-77	202	3.16

Source: Bloomberg Barclays.

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As the second quarter closes, the market feels closer to fair value, but fundamentally, there is still a high level of risk. Our strategy in investment grade credit is to focus on those companies solidifying free cash flow and that are less likely to be directly impacted by downward economic pressures and additional waves of COVID-19 and avoiding those names that are likely to continue to face headwinds. While we still anticipate spreads to be driven primarily by fundamental factors, there could be some divergence in the latter part of 2020, with higher volatility resurfacing as we inch closer to the U.S. Presidential election. The theme of sector and security-level differentiation, in our view, will continue with more COVID-19 vulnerable sectors, such as Airlines, Leisure, and Retail, likely to be under pressure unless the recovery materially surprises to the upside.

Structured Products[4]

While the first quarter of 2020 was a two-act play, the second quarter played out in one rapid act, consisting of a rally almost as unpreceded as the sell-off that preceded it. This was true across all structured products with the timing and magnitude the only differentiating factor. Despite worsening fundamentals and a virus whose trajectory is still undefined relative to a fully opened economy, various government backstops combined with low risk-free yields caused investors of all types to go all in on spread assets. “Sell what you can” in March became buy everything, with the most liquid AAA- rated sub-asset classes in structured products rallying back to near pre-COVID levels.

For the quarter, the Bloomberg Barclays U.S. Fixed Rate MBS Index posted +38 basis points of excess return. The nominal spread of the current coupon mortgage vs 5yr/10yr US Treasury blend was 109 basis points, 18 basis points tighter during the quarter. Unlike the first quarter where GNMA securities were the star performer, both GMNA and conventional excess returns settled at +35 and +36 basis points versus comparable duration Treasuries. Within the conventional coupon stack, the Fed coupons did the best, with conventional 2.5’s posting 72 basis points of excess while 3’s posted 53 basis points. Higher coupons underperformed lower coupons as slower speeds failed to materialize, resulting in negative excess returns of 3 bps for conventional 3.5s and negative six basis points for the 4% coupon. Specified pools, after underperforming in the first quarter due to forced selling from REITS found their footing, as investors’ desired call protection, given the Fed’s pledge to keep rates low for long. Finally, 15-year MBS, which were surprisingly big underperformers despite their lower volatility profile (-100 bps of excess in Q1) regained some excess, posting +62 basis points of excess return versus comparable Treasuries.

ABS and CMBS posted excess returns of +326 and +323 basis points, respectively, versus duration-matched treasuries for the quarter. Each month in the quarter was significantly positive, showing how broad based and steady the rally was in risk assets. Within ABS, as the more on-the-run sectors such as prime autos and cards rallied sharply, less-trafficked assets such as unsecured consumer loans slowly retraced their COVID-related widening. Looking at CMBS excess returns, it’s easy to see that this market was more reticent to embrace the rally as April and May excess returns averaged 83 basis points; it wasn’t until June when the grab for spread pushed investors into CMBS, allowing the asset class to post 151 basis points of excess return versus Treasuries. Turning to spreads, at the Index level, ABS started the quarter at 212 OAS and rallied into 68 OAS, an impressive move on a stand-alone basis but even more impressive relative to the wides of 325 on March 25. The Index tight was 27 basis points in mid-February. Similarly, in CMBS, the Index OAS of 188 basis points to start the quarter was considerably tighter than the March wides of 260 and as the rally continued, the OAS ended the quarter at 132. The index tight for 2020 was 63 basis points, also achieved in mid-February.

As mentioned earlier, CMBS has had a more difficult time in this new COVID-infected world. Looking at spreads up and down the capital stack it becomes apparent that investors are leery of the asset class down in credit. While the AAA-rated 8.5-year portion of the index was able to retrace 68 basis points off the 2nd quarter wides of 179, A- and BBB-rated credit bonds remain well off their year-to-date tights. The lack of transparency in the commercial real estate market is unlikely to resolve itself anytime soon, and investors are demanding significant risk premiums to go down in credit. Finally, much like other portions of the structured products market, AAA-rated CLOs saw a robust rally but also came up short of reaching 2020 tights. Despite poor leveraged loan fundamentals, AAAs rallied about 50 basis points during the quarter to close at LIBOR+250. While not all the way back to the 2020 tights of LIBOR+125, the rally has helped retrace the damage done by the unwind that took place in March which temporarily pushed spreads out into the high 300s.

	2Q 2020	2Q 2020	6/30/2020	6/30/2020
	Total Return (%)	Spread Change (bps)	OAS/DM (bps)	Yield to Worst (%)
Bloomberg Barclays US Aggregate Index	2.90%	-31	64	1.19
US Securitized: MBS, ABS, and CMBS	0.94%	-4	68	1.26

Source: Bloomberg Barclays.

In Agency MBS, we still maintain the view that the production coupons, specifically conventional 30-year 2.5s may likely be the primary beneficiaries of the opened ended QE program. While the mortgage rate has hit an all-time low, the spread between where a borrower can take out a mortgage and where the 10-year currently trades is historically wide.[5] We expect this gap to gradually normalize and allow more borrowers the ability to refinance provided 10-year rates stay anchored below 90 basis points. Many of the logistical headwinds to purchasing or refinancing a home have lessened as the economy has reopened and social distancing rules have been relaxed (for now).[6] However, underwriters are tightening standards as borrowers' employment status will be examined with even greater scrutiny despite the housing market remaining firm due to favorable technicals. The outlook for non-agency MBS is much more nuanced as forbearance and ultimately loss to the trust will impact lower-rated traches. We continue to believe that despite the economic stress in the market, AAA-rated tranches should benefit from conservative underwriting standards, with high FICOs and low LTV for more seasoned securities, including substantial accumulated HPA lowering the current weighted average LTV of the pool. One area that may be of concern is the newer RMBS issues utilizing less stringent documentation requirements. These non-QM securities as they are known, are exhibiting higher delinquencies than fully documented jumbo loans of a similar vintage.6 There may be modest declines in HPA year over year, with the technicals being supportive while the economic fundamentals may weigh on housing as expanded unemployment benefits roll off and forbearance programs gradually come to an end. Again, the path of the reopening is one of the factors dictating the direction of home prices resulting from elevated unemployment and ultimate loss in any given mortgage trust.

Within consumer related ABS, both credit card and auto delinquency numbers have remained relatively benign despite the spike in unemployment. Bank credit card 60 day+ delinquencies stand at only 1.02% and have only increased fractionally thus far. For comparison, 60 day+ delinquencies peaked near 4.6% during the financial crisis of 2008.[6] Similarly, in prime and even sub-prime autos, 60 day+ delinquencies have been volatile but muted. While this appears to be good news in the short run, we think that ultimately the disruption to the economy will work its way through, resulting in higher delinquencies even for higher quality borrowers. Why have credit metrics remained so benign? Lenders have offered generous extension and payment plans to consumers, thus far muting reported delinquencies.[6] Furthermore, government unemployment benefits have allowed borrowers to remain current on their most important consumer related debts. So, while there is good news in the reported data thus far, we expect the expiration of enhanced government benefits, combined with the wind down of payment forbearance programs, to stress the consumer and keep credit curves steep despite the technical tailwind that exists.

Turning to our outlook for CMBS, an economy that remains partially closed still poses a significant risk, especially down in credit in terms of actual loss or negative ratings migration for deals with poor performing retail and hospitality related assets. While TALF 2.0 allows for "legacy" AAA-rated CMBS to be purchased and financed cheaply, this cannot alleviate the problem of low or zero occupancy at hotels and lack of rent payments for malls due to the virus-related closings. Much like ABS, AAA conduit paper should be supported by the TALF back stop, while CMBS credit will likely languish with shutdowns continuing. The path of spreads on credit bonds from Single A and below will likely remain tethered to the re-opening of the economy, but we feel as though the damage down the stack will be hard to revert in the near-term as cashflow transparency is low. Finally, in CLOS, we view AAAs as well insulated from losses as liquidity has returned. Much like CMBS, we expect that bonds single A and below will be more tied to the reopening of the economy and its effect on the collateral underlying the trust.

High Yield[7]

Risk assets rallied in the second quarter as the Federal Reserve intervened to help stabilize markets following the turmoil caused by the initial wave of the COVID-19 pandemic in March. On April 9th the Fed surprised investors by announcing its intention to purchase select fallen angel debt and corporate bond ETF's. That news alone caused spreads to tighten nearly as fast as they were widening during the previous quarter. We also saw a record quarter for high yield issuance as companies sought to shore up their balance sheets amid the uncertainty. In addition, oil prices rebounded following the sharp sell off earlier in the year, with WTI nearly doubling from approximately $20/bbl to $40/bbl during the period. With some states beginning to reopen their economies in early May, recent jobs reports have surpassed expectations, leading some to speculate that a V-shaped recovery is possible.[8] For the quarter, the high yield market returned 9.54%, its best quarter since 2009, and the yield to worst on the ICE Bank of America Merrill Lynch U.S. High Yield Constrained Index fell from 9.25% to 6.86% by June 30th. The par-weighted U.S. high yield default rate climbed higher, reaching 6.19%. Notably, the default rate has not reached this high a level since it was 6.31% in March 2010.

	2Q 2020	2Q 2020	6/30/2020	6/30/2020
	Total Return (%)	Spread change (bps)	OAS/DM (bps)	Yield to Worst (%)
ICE BofAML U.S. High Yield Master II Constrained Index	9.54%	-232	645	6.86%
Bloomberg Barclays U.S. High Yield Ba/B 2% Issuer Capped Index	10.35%	-214	524	5.88%
S&P/LSTA Leveraged Loan Index	9.70%	-380	L+696	N/A

Sources: Bank of America Merrill Lynch, S&P LCD.

Within our High Yield Strategy we entered the second quarter with a yield disadvantage relative to the benchmark and generally maintained a cautious approach to the market throughout the period. With new issuance surging following the Fed's announcement we selectively put cash to work given what we thought were poor underlying fundamentals. By the end of the quarter our yield disadvantage had compressed considerably. With valuations now elevated following the recent rally, we will continue to remain nimble, selectively participating in new issues and consolidating positions in our highest conviction names.

Emerging Market Debt[9]

Emerging Market Debt ("EM") began to normalize with the announcement of stimulus packages across developed and emerging markets, helping alleviate liquidity fears. EM stabilized and rallied with the broader market in April but lagged developed markets. In the early stages of the rebound, the market started to actively differentiate risk as more resilient credits outperformed those with less certain outlooks across the credit spectrum, especially oil names. In May, EM continued to play catch up, with a strong recovery tone extending across the credit spectrum. Despite the extended rally, EM spreads have remained on the wider end of the historical average relative to developed markets. June has proven to be choppier with some widening over the month driven by the resurgence of COVID-19 cases and concerns around the level of recovery in global growth. Hard currency sovereign spreads (EMBI Global Diversified) tightened by 153 basis points to end at 474 basis points (still 185 basis points wider for the year). The returns for the EMBI GD Index ended the quarter at 12.26%, with HY outperforming IG by a notable magnitude, at 16.57% and 9.06%, respectively. EM corporate spreads (CEMBI Broad Diversified) ended the quarter 183 basis points tighter at 416 basis points. The returns for the Index ended the quarter at 11.15%, driven by a rebound across a number of sectors, especially commodity-driven segments of the corporate market, such as Energy and Metals & Mining.

	2Q 2020	2Q 2020	6/30/2020	6/30/2020
	Total Return (%)	Spread Change (bps)	OAS/DM (bps)	Yield to Worst (%)
JP Morgan Emerging Markets Bond Index Global Diversified	12.26%	-153	474	5.50
JP Morgan Corporate Emerging Market Bond Index Broad Diversified	11.15%	-183	416	4.70

Source: JP Morgan.

Although there has been some improvement in sentiment from what we have seen at the end of March, buoyed by multilateral support and rapid central bank actions to prop up the economies, there are still many risks and uncertainty in the market, which will likely persist in the near-term. COVID-19 will likely continue to dominate the fundamental view globally. We believe the balance of news should be more positive for the next 1-2 quarters as reopenings pick up pace, with an ongoing risk of resurgences. One of the biggest concerns is a 4Q resurgence in the Northern Hemisphere that could lead to renewed lockdowns. In our view, this scenario is not priced into markets. In the absence of resurgences, market normalization should continue to play out through the summer. In this case, we expect volatility to remain elevated, but the overall market direction to be tighter.

Endotes

1 Returns, spreads, and yields refer to the Bloomberg Barclays US Corporate Index. Issuance data provided by Barclays.

2 JP Morgan.

3 Barclays.

4 Returns, spreads, and yields refer to the MBS, CMBS, and ABS portions of the Bloomberg Barclays US Aggregate Index. Issuance data provided by JP Morgan.

5 JP Morgan.

6 Bank of America Merrill Lynch.

7 High yield returns, spreads, and yields refer to the ICE BofAML U.S. High Yield Master II Constrained Index. Issuance data provided by JP Morgan and S&P/LSTA.

8 Barclays.

9 Hard currency returns, spreads, and yields refer to the JP Morgan Emerging Markets Bond Index Global Diversified. Corporate returns, spreads, and yields refer to the JP Morgan Corporate Emerging Market Bond Index Broad Diversified. Local currency returns, spreads, and yields refer to the JP Morgan Government Bond Index – Emerging Markets. Issuance data provided by JP Morgan.

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