Short & Intermediate Duration Fixed Income

Q3 2020 Themes, Outlook & Strategy

Performance

Investment Grade Credit — Contributed positively to performance. It was broad-based, but the Energy, Technology, Electric Utilities, Banking, and Health Care subsectors were notable positive contributors.

Treasuries/Agencies — TIPS added excess return because break-even spreads rose as real rates declined. Agencies added to performance as foreign names tied to the oil sector outperformed.

ABS — Performance was positive and broad-based, but the best positions were fixed-rate auto holdings.

CMBS — Performance was positive. Agency and non-agency positions contributed positively, though non-agency positions led. Floating-rate SASB positions were the top performers.

RMBS — Mixed performance. RMBS was negative in shorter portfolios and positive in longer portfolios. The divergence resulted from variations in subsector weights. Agency CMOs detracted, but specified pools were generally flat in shorter portfolios and positive in longer portfolios. Non-agency positions were positive.

Municipals — Positive across all strategies. On an excess return basis, best subsectors included Transportation, Utilities, Housing and State and Local Governments. A few bonds within our Special Tax and Education subsectors slightly underperformed, but this was offset by other municipal holdings.

Summary

• Stimulus Measures — Despite stimulus and support measures to support markets and encourage economic growth, we are not in the “V-shaped” recovery camp. Growth headwinds may persist, with re-openings delayed until a Covid-19 vaccine or therapy becomes available. Trade tensions with China and the EU may also re-emerge. U.S. real GDP growth should rebound in the second half of 2020, but full recovery could take several years.

• Consumer — Confidence has rebounded but sits well below pre-pandemic levels. Spending has been supported by the CARES Act, enhanced unemployment benefits, mortgage forbearance as well as rent and installment payment holidays. The CARES Act has boosted real personal income, but consumers have focused on non-discretionary purchases. The jump in the savings rate suggests that discretionary spending may improve.

• Employment — Unemployment has improved but will likely remain high. Migration of workers from temporarily to permanently unemployed will likely weigh on the labor market. The ratio of unemployed workers to job openings spiked to over 4x from below 1x.1 Social distancing may persist, hurting certain sectors — lodging, leisure, restaurants, transportation/travel, and retail. Work-from-home policies could also reshape the labor market.

• Business — Small and midsize businesses continue to grapple with staffing and reopening. Declining revenues, higher costs and margin pressure, weakened credit metrics, and changes in business models are widespread. Downward ratings pressure and a higher default rate are likely despite significant monetary and fiscal measures.
## Central Banks — Monetary and Fiscal Policy
Central banks are likely to remain accommodative, and fiscal stimulus should continue. The Fed seems poised to maintain liquidity, backstop markets, and ensure access to borrowing. The Fed has pushed back against the idea of negative rates; it will focus on forward guidance before shifting to any yield curve control. Another fiscal package is expected in the U.S. before the August recess.

## November Election — Renewed spread of Covid-19 in Red states could impact political races. In the event of a Democratic sweep, a number of changes are likely: expansion of the Affordable Care Act, a public health option, changes in energy policy, growth in infrastructure spending, a rise in the minimum wage, a rollback of regulatory reforms, and higher taxes. For corporations, tax-reduced cash flows and profits could be worsened by higher labor costs.

## Residential / Commercial Real Estate — Policy responses have blunted the impact of the pandemic. Low single-digit home price growth is supported by low mortgage rates and tight inventories. Mortgage originators are increasing capacity and adapting to Covid-19. Competitive mortgage rates and rising prepayments are likely to persist. As forbearance programs phase out, delinquencies will increase. Retail and lodging metrics appear to be bottoming out, but trust delinquencies will likely rise as data comes in. Low inventories of single-family homes and rentals have supported multi-family properties. Office properties continue to face challenges from work-from-home trends.

## Inflation — Expectations in the U.S. have risen, driven by the surge in the money supply and a rebound in energy prices. Trimmed mean measures of inflation are much higher than recent core inflation prints. It may be difficult for the Fed to achieve its 2% target as labor market slack could persist. With higher prices due to on-shored manufacturing, a weaker dollar, and huge fiscal and monetary stimulus, inflation could tick up.

### Investment Grade Credit

The market snapped back from one of its worst-ever quarters, driven by Fed credit and liquidity programs. Credit spreads, which reached record wides in March, largely recovered, ending only 50 bps above 2019 year-end. Market technicals were robust; companies raised cash in the market and fortified their balance sheets while fund inflows and foreign investor demand absorbed record new issuance. In our view, the market offers an attractive source of yield or carry, given low Treasury yields, although low-quality issues merit caution.

Credit spreads plummeted such that both absolute total return and excess returns versus U.S. Treasuries for our benchmark ICE BofA 1-5 Year U.S. Corporate Index were outstanding. Total return and excess returns as of June 30th came in at 5.84% and 5.56%, respectively, both the best since second-quarter 2009. The index’s option-adjusted spread fell by nearly two-thirds, to 111 bps. All subsectors posted positive excess returns, led by Energy and other cyclical.

### Portfolio Actions
- Increased credit weightings, capitalizing on record new issuance to add fixed-rate, highly rated offerings.
- Sold names showing little potential for further spread compression.

### Outlook
Given Covid-19 uncertainties, 2020 financial estimates are little more than rough guesses. Partial shutdowns continue in Leisure/Hospitality, Restaurant, Retail, and Transportation. Many investment-grade issuers sold debt, but we remain wary of rising leverage; BBB-rated cyclical especially could struggle when support programs expire. We favor quality issuers and defensive subsectors — Communications, Health Care, Pharmaceuticals, Technology, Midstream/Pipelines, and Electric Utilities — and Banking, for its solid profits, Fed support, and robust capitalization.
Treasuries / Agencies

Treasuries yields declined while stimulative policies and stronger economic data translated into a tight trading range. The Fed signaled a commitment to near-zero policy rates, but downplayed the possibility of rates going negative. The FOMC dot plot show no change in rates through 2022. Purchases by Fed facilities began, and quantitative easing (QE) proceeded at minimum monthly purchases of $80 billion. The Fed’s Treasury holdings totaled nearly $4.2 trillion.

At the short end of the Treasury curve, the Fed remained in control, despite massive T-bill net issuance to fund stimulus programs. In response, T-bill and secured funding rates rose relative to the interest on excess reserves (IOER) rate but only to a moderate degree, as Fed liquidity injections and government money fund inflows absorbed the increased collateral. The 3-month Libor rate plummeted, coming within 5 bps of its all-time low. A selloff briefly pushed the 10-year yield above the previous range when June payrolls came in higher than expected. But after reaching 96 bps, it quickly retreated, ending nearly unchanged, at 66 bps.

Inflation expectations moved higher. Ten-year TIPS rose from an expected inflation rate of 0.93% to 1.34%. Conversely, real yields went further negative. Nominal Treasury notes finished with the two-year at 0.15%, the five-year at 0.29%, and the 10-year at 0.66%. The five-year/two-year differential ended the quarter at 14 bps, only one bp higher, and the 10-year/two-year differential moved to 51 bps, 9 bps higher. At the front end, the three-month T-bill yield rose 7 bps to 0.13%, while 3-month Libor declined by 115 bps to 0.30%.

In agencies, U.S. and Supranational, Sovereign and Agency (SSA) spreads tightened from March’s multi-year wides. Front-end, Government-Sponsored Enterprise (GSE) debt spreads fell by 13 bps, ending at 14 bps, while U.S. dollar-denominated SSA fixed-maturity spreads dropped 45 bps, finishing at 43 bps.

Portfolio Actions

- Maintained low allocation to agencies; we expect net callable issuance to be negative as redemptions increase.

Outlook

We expect to add carry by swapping out of Treasuries and purchasing high-quality, spread securities to maintain a yield advantage. Our duration posture remains neutral, but the yield curve may steepen on any positive news. Inflation is expected to tick up, so we intend to hold TIPs but may monetize some as they hit certain technical levels.

We think the GSEs will continue to use floating- and fixed-rate bullet maturity securities as their primary funding. Even with the recent movement, spreads remain slightly wider than at the start of the year. We believe GSE spreads can tighten a bit further but that other sectors offer better opportunities. We favor the SSA sector.

ABS

Spreads on short-tenor ABS tightened, as Covid-19 support programs improved market sentiment, resulting in part from the first round of subscriptions under the Term Asset-Backed Securities Loan Facility (“TALF”). Spreads on AAA-rated two-year fixed-rate credit card, prime auto, and subprime auto tranches narrowed by 45, 65 and 52 bps, respectively, to finish at 25, 30, and 68 bps over Treasuries, respectively. Spreads on 3-year floating-rate FFELP student loan tranches also shrank by 125 bps. Spreads on credit card and prime auto tranches have retraced most of the March widening, but subprime auto and other non-benchmark subsector spreads remain elevated.

New issuance totaled $32.8 billion, down half from second quarter 2019. With the market less receptive to less-liquid non-benchmark deals, “other ABS” (including cell phone payments, time shares, mortgage servicer advances, insurance premiums, aircraft leases, etc.) issuance came to $1.8 billion versus $12.1 billion in second quarter 2019.
No new credit card deals priced and outstanding trust receivables plunged. Receivables totaled $135 billion, down from over $179 billion a year ago. Better bank funding for sponsors and slower receivables growth are likely to weigh on new issuance. Credit card metrics started to reflect the pandemic; charge-offs increased 21 bps to 2.54% and monthly payments declined 329 bps to 24.39%, probably due to consumers conserving cash. But we do not anticipate concerns for short tenor, senior AAA-rated tranches, given their robust credit enhancement.¹

In contrast, auto ABS metrics have showed few pandemic effects. Year over year, the 60+ day delinquencies on the Fitch Auto ABS indices showed subprime loans falling 71 bps to 3.81%. Prime loans were flat, at 0.25%. In our view, these metrics are aided by loan servicers’ forbearance programs and government payments to consumers. Absent this aid, performance may decline, but we believe short-tenor, senior tranches have sufficient credit enhancement.

New vehicle sales bottomed out, printing at 8.6 million SAAR (seasonally-adjusted annualized rate) in April, before rebounding to 12.2 million SAAR in May and 13.1 million SAAR in June. But first half sales still dropped more than 24%. Used vehicle values rebounded, and the Manheim Used Vehicle Index reached a new high of 149.3 in June. The supply of used vehicles declined to 31 days, lower than its average of 41 days. In our view, the lower supply reflects the closure of auto auction facilities and slower new vehicle sales. With new sales climbing and auctions reopening, used vehicles should increase, which may pressure valuations.

**Portfolio Actions**

- Increased ABS exposure across the portfolios, favoring liquid sectors such as credit cards and prime autos to remain defensive and bolster liquidity.

- Added to our subprime auto, equipment and insurance premium finance holdings when spreads were attractive.

**Outlook**

We anticipate maintaining our current exposures across most strategies.

**CMBS**

Short-tenor CMBS spreads tightened, as prices recovered from March. At quarter-end, three- and five-year AAA-rated conduit spreads stood at 92 and 110 bps, respectively, approximately 98 and 87 bps tighter, respectively. With the Fed purchasing agency CMBS tranches, these spreads also tightened, with three and five-year Freddie Mac "K-bond" tranches ending at 51 and 53 bps, respectively, 34 and 41 bps tighter, respectively. Only $45 billion of new CMBS came to market, versus over $66 billion a year ago. New agency issues totaled $36.1 billion, just behind $37.6 billion a year ago. In contrast, private label volume was only $9.2 billion, most in May and June as the market began to recover, down from about $28.5 billion a year earlier. The private label market saw only two single-asset, single-borrower deals (SASB), totaling only $0.9 billion, versus over $13.1 billion a year ago.

Delinquencies continued to worsen, and the effects flowed through to trust performance, with loans in the “grace” and “beyond grace” periods moving to delinquent status. The Trepp 30+ day rate rose 481 bps, a record, to 7.15%, with almost 5% of delinquencies from loans in the 30-day bucket. In June, delinquencies reached 10.32%, just shy of the July 2012 record of 10.34%. Year over year, delinquencies rose 7.48%. With another 4.1% of June’s loans missing payments and residing in the “grace” or “beyond grace” period, delinquencies could breach July 2012’s record in the third quarter. Lodging and retail led, with 30+ day delinquencies rising by 2,277 bps to 24.3% and by 1,418 bps to 18.07%, respectively. Industrial delinquencies rose only 22 bps to 1.57%.

¹ Credit card data source: Wells Fargo Credit Card Index.
Property prices also began to reflect the pandemic, as appreciation slowed, and deal volume tumbled. The Major Metros (Boston, Chicago, Los Angeles, New York, San Francisco, and Washington DC.) lagged the Non-Major Metros, with quarterly growth rates of 0.5% and 0.9%, respectively. And according to RCA, only $9.7 billion changed hands in May, below the $13.6 billion in April. Only the industrial sector saw increases.

Portfolio Actions

- Maintained or allowed maturities and paydowns to slightly decrease our exposure.
- Exit a hotel property and increased exposure to an office building in a major metro area. The swap was driven by uncertainties about the hotel sector and the appeal of a trophy property with a high-quality tenant.
- Purchased two short tenor, front-pay conduit “A1” tranches in the new issue market.
- Added to conduit holdings from the secondary market.

Outlook

We do not anticipate increasing our exposure. We still prefer short-tenor, non-agency conduit tranches, but we anticipate worsening delinquencies and will avoid conduit deals with heavy exposure to retail or lodging.

RMBS

RMBS underperformed Treasuries. Bonds backed by 15- and 30-year collateral ended at spreads of 216 bps over five-year Treasuries, up 23 bps, and 149 bps over 10-year Treasuries, up 18 bps, respectively. The dynamic at the end of last quarter, with coupon yields on 15-year collateral exceeding that of 30-year collateral, returned; 15-year and 30-year collateral ended at yields of 2.44% and 2.14%, respectively. In our view, this reflects the Fed’s preference for generic 30-year collateral. Non-agency spreads recovered from the wides of March; non-agency prime jumbo front cashflow tranches ended at 185 bps over Treasuries, 148 bps tighter.

Supported by record-low mortgage rates and limited inventories, housing prices remained resilient. The S&P CoreLogic Case-Shiller National Index showed housing prices increasing 4.7% year-over-year in April, following a 4.6% increase in March. Despite strength in home prices, existing home sales collapsed, dropping 9.7% in May to a 3.91 million annualized pace, the lowest since October 2010. But new home sales exceeded expectations; May numbers came in at a 676,000 annualized rate, up 16.6% over the prior month and following month-over-month declines of 5.2% and 14.5% in April and March. Home builder confidence also improved in June, with the National Association of Home Builders sentiment index up 21 points over May. In our view, new home sales and home builder sentiment indicate the industry is adjusting to the pandemic.

Portfolio Actions

- Reduced exposure, reflecting the sale of some CMO holdings and paydowns fueled by low mortgage rates.
- Purchases included secondary market buys of specified pools to boost our liquidity profile.

Outlook

We continue to favor liquid subsectors, like specified pools, to enhance defensive positioning. We remain cautious in non-agencies, given the convexity effects of prepayments on premium dollar-priced positions. We do not anticipate increasing our exposure, given low mortgage rates and high prepayment risk.
Municipals

Both taxable and tax-exempt municipal bonds outperformed Treasuries, according to ICE BofA indices. While the Fed’s Municipal Liquidity Facility (MLF) has been largely untapped, its rollout boosted market confidence. Initially restricted to states, the MLF was opened to two additional issuers per state, further boosting market sentiment.

Issuance bounced back, reaching $102 billion and exceeding the first quarter by $13 billion. Taxable issuance of $28 billion also eclipsed $23 billion issued in the first quarter, buoyed by $17 billion in June. Demand rebounded, as $34 billion in mutual fund inflows offset $30 billion of first-quarter outflows. Normal outflows to cover tax liabilities did not materialize, given that taxes were not due until July.

Volumes at U.S. airports fell 95% in April but began to rebound in May and June. Enplanements were still down, and many airports allowed airlines to delay payments for April through June. Enplanements are expected to reach only 50% of 2019 levels by year end, 75% by 2021, and 90% by the year-end 2022. But this would suffice to keep operations afloat and cover debt service. Balance sheet liquidity was already strong, but funds from the CARES Act have boosted it by 90 to 180 days. We believe large U.S. hubs will benefit from both origin and destination traffic, as well as connecting passengers, as air traffic resumes. Airports with strong balance sheets and unrestricted cash will be able to continue covering expenses as revenues remain depressed during the pandemic.

Toll road revenues were down nearly 50% at the end of March and are expected to finish the year down 30%. Traffic picked up in May, and we expect that to continue. Revenues are expected to increase but remain shy of 2019 levels in 2020. With their adequate coverage ratios, reserves, and ability to raise rates, we selectively favor certain issuers.

Hospitals have weathered the storm fairly well, utilizing balance sheet cash to cover pandemic-related revenue drops, and have been able to provide more elective surgery procedures. We are monitoring upticks in virus cases and any strains on hospital systems but believe most are well-capitalized to navigate the challenges ahead.

Colleges have reduced spending, so they will not have to tap endowments or other reserves. It is too early to say if classes can be held face-to-face (FTF); most colleges are preparing for both on-line and modified FTF for the fall.

Portfolio Actions

• Active in both the primary and the secondary markets. Purchases were concentrated in the transportation and special tax subsectors, as we were able to capitalize on forced selling by some investors.

Outlook

We will continue adding to high-quality exposure via sectors and issuers that fit our defensive posture.
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