PUBLIC FIXED INCOME

Quarterly Commentary

Third Quarter 2020

The COVID-19 pandemic and shape of the ongoing economic recovery remained the main drivers of sentiment in markets during the third quarter. Economic conditions continued to stabilize during the period, thanks largely to central bank support and the gradual reopening of the U.S. economy following COVID-19 related shutdowns. Credit spreads continued to grind tighter throughout the summer, exhibiting little volatility, even as new issuance remained robust and COVID-19 cases spiked across the Sun Belt. However, as of September 30th, the unemployment rate varies widely by state. Several populous states that were hit particularly hard by COVID-19 early on have maintained strict lockdown measures and high unemployment rates.

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While conditions have improved, the recovery remains tenuous. In September, we saw the first signs of what uncertainty means for risk assets as volatility in the equity markets began to pick up, spilling over into credit. What's more, the possibility of a contested U.S. election in November has become a real threat that could inject additional volatility into markets this fall. Finally, the possibility of another surge in COVID-19 cases continues to hang over the market and threaten the recovery; some countries have already implemented a second lockdown.

MetLife Investment Management

Investment Grade Credit[1]

Sentiment in the third quarter was for the most part a continuance of the second quarter, with concerns surrounding COVID-19 and shape of the economic recovery at the forefront. In credit markets, technicals continued to outweigh fundamentals and new issuance continued to come at a historically rapid pace. While volatility in July and August was kept at bay, September brought more uncertainty and volatility in the equity markets, which spilled over into credit. Further, with a highly contentious U.S. Presidential election on the horizon, market participants began to anticipate continued bouts of volatility heading into the fourth quarter.

For the quarter, the Bloomberg Barclays U.S. Credit Index returned 1.50%, for an excess return of 1.36% over similar duration Treasuries; and spreads narrowed by 14 basis points to close with an OAS of 128 basis points. Corporate credit outperformed slightly with a total return of 1.54% for the Bloomberg Barclays U.S. Corporate Index. In terms of yields, the Treasury curve steepened with 2 and 5-year yields falling two and one basis points, respectively, and 10-year yields rising three basis points. As a result, both the 2s/10s and 2s/30s curves widened slightly to 53 and 127 basis points, respectively. For the quarter, the Bloomberg Barclays U.S. Credit Index yield declined, falling 10 basis points to close the quarter at 1.95%.

Overall, we continued to see a fair amount of bifurcation among sector returns. On an excess return basis, Financial Companies (+3.58%), Metals & Mining (+3.51%), Paper (+3.92%), Automotive (+3.03%) and Independent Energy (+4.80%) topped the list of outperformers. On the other hand, Banking (+0.80%), Communications (+1.15%), Pharmaceuticals (+0.56%), Tobacco (+1.06%), Integrated Energy (+0.93%), Midstream (+0.89%) and Refining, the only sub-sector to post a negative excess return as it remains challenged by weak demand and high inventories, failed to keep pace with the broader market. Across ratings, BBBs once again outperformed their higher quality counterparts, posting an excess return of 1.96% over similar duration Treasuries and outperforming the broader market by 0.60%. The BBB/A spread narrowed to 73-basis points but remains wider than the 50-basis point spread at the end of 2019. In response to a continued robust new issuance calendar at the long end of the curve, longer dated credit outperformed both the intermediate portion of the market and the broader market, posting an excess return of 1.93% over similar duration Treasuries versus an excess return for intermediates of 1.02%.

Finally, as earnings declined in the first half of the year, companies responded in the third quarter by adding liquidity to balance sheets in the form of new issuance of over $371 billion, bringing the year-to-date total to a record $1.6 trillion. In the quarter, issuance increasingly came from first-time issuers and has continued to be skewed toward BBBs at 42% and the long end at 62% of the year-to-date volume. Further, the average deal size has been larger with almost 30% of issuance coming from deals greater than $1 billion. Demand remained very strong with concessions close to zero and deals three to four times oversubscribed; and first-time issuers outperforming overall. In terms of fallen angels, volumes slowed significantly to $18.2 billion in the quarter from $160 billion in the first half of the year, bringing the year-to-date volume to $178 billion.

	3Q 2020	3Q 2020	9/30/2020	9/30/2020
	Total Return (%)	Spread change (bps)	OAS/DM (bps)	Yield to Worst (%)
Bloomberg Barclays U.S. Corporate Index	1.54	-14	136	2.01
Bloomberg Barclays U.S. Long Credit Index	1.97	-14	188	3.05

As we move into the last months of the year, we are mindful of the immense amount of pressure on the corporate market – the persistent unknowns surrounding COVID-19, the disconnect between fundamentals and technicals, and the ever-present uncertainties around the shape of the recovery. It would be easy in an environment such as this to adopt a draconian point of view, but we are instead intently focused on uncovering opportunities that have emerged and may emerge in the future. While many sectors and issuers have been hampered by the challenges of 2020, others that came into the year with balance sheet flexibility, the ability to access primary markets, and the mindset to alter their business model, have received a boost from a lower yield and Fed supported environment.

Looking ahead, it is clear to us that we are likely to remain in an environment where certain sectors will continue to face headwinds. However, with an improvement in economic conditions and abundance of liquidity courtesy of the Federal Reserve's exhaustive list of corporate buying programs, a backstop has been provided for many. Thus, it goes without saying that we expect to continue to see a divergence in fundamentals and spread performance, as well as a bifurcation in sector performance.

New issuance continues to set records almost daily, with the bulk of recent activity focused on reducing high-coupon debt in the form of refinancings and tender offers. So long as yields remain at all-time lows, it is reasonable to expect this trend to continue through the end of the year. On the downgrade front, we expect some additional fallen angel activity, but believe the worst is behind us.

One year ago, we wrote that we believed corporate valuations were stretched and expected corporate earnings, for the most part, to fall below expectations. Adding in the uncertainties in the market, we have preferred to remain positioned defensively and with a higher quality bias in corporate portfolios, driving alpha through active idiosyncratic positions and opportunities in the primary market. Further, while the Fed has stated numerous times that it is committed to do whatever it takes to support markets; given the current backdrop of high unemployment, vaccine uncertainty, and a contentious Presidential election, we are skeptical that the recovery currently priced-in will actually occur over the remainder of the year. Thus, we continue to believe the disconnect between fundamentals and valuations remains at levels much too pronounced to justify adding undue risk to portfolios at this time.

Like previous quarters, our focus is 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. Within IG corporate portfolios, aside from heavy participation in the new issue market, we have also trimmed positions in more cyclical names and are finding opportunities in higher quality Sovereign paper and in Taxable Municipals as valuations have become more compelling.

Structured Products[2]

After the sharp sell-off in structured products in the first quarter followed by substantial, but uneven, spread tightening in the second, the third quarter witnessed continued improvement in spreads, but in a more orderly fashion. As the economy opened from the worst of the shutdowns, the Federal Reserve continued to signal that short rates would be low for a very long time. Consumer fundamentals, which worsened due to the spike in unemployment, began to show some signs of improvement. As the third quarter progressed, spread tightening fatigue set in. Structured product investors now face a world with both low risk-free yields and spreads on high quality assets near or through their tights for the year, with a few exceptions. "Sell what you can" in late Q1 became "Buy anything" in Q2, thanks to massive stimulus, low rates and various Fed back stops. Now what remains is a search for yield that leaves us a bit uneasy given the challenges facing the economy.

We mentioned last quarter that one of the Fed's goals was to dampen interest rate volatility so that low risk-free rates could translate into lower borrowing costs. For the quarter, the 10-year Treasury started the quarter at 0.66% and ended the quarter at 0.69%. Importantly, the MOVE index, a measure of interest rate volatility, started the quarter at 54.13 and continued to decline to 39.12 at quarter end, the lowest level in the past five years. As a point of reference, on March 9th when the market was experiencing significant stress, this index touched 163.70. In structured products, as interest rates become more predictable, hedging costs for mortgage lenders fell, allowing lower rates to transmit to the end borrower. As of the end of June, the Freddie Mac U.S. 30-year mortgage commitment rate stood at 3.13%, down from its 2020 high of 3.65% during the height of the market turmoil. As the quarter progressed and volatility continued to decline, the commitment rate closed the quarter at 2.88% despite the 10-year Treasury closing three basis points higher. This allows more borrowers to refinance their existing loans and makes housing more affordable as mortgage payments fall.

> Since March, the Fed has been a consistent presence in the agency mortgage market. Our view remains unchanged. The Fed will continue to support the market so that borrowers can benefit from their "low for long" commitment.

Despite the favorable impact of lower mortgage rates for borrowers and the overall economy, those lower rates also make mortgages a more challenging asset class as supply increases and prepayments rise. For the quarter, the Barclays Bloomberg U.S. Fixed Rate MBS Index posted -7 basis points of excess return relative to Treasuries. The nominal spread of the current coupon mortgage versus the 5-year/10-year U.S. treasury blend was 92 basis points, over 20 basis points tighter during the quarter, driven mainly by the Fed's purchases moving down in coupon. While the benchmark was relatively flat overall, there was significant variation across the agencies and individual coupons. GNMA 30-year excess returns were -47 basis points, as faster speeds resulting from lower rates and the fear of forbearance related buyouts in GNMA pools took their toll. In addition, foreign demand for GNMA's abated as all-in yields continued to decline. Conventional 30-years posted +6 basis points of excess, while 15-year mortgages outperformed duration-matched Treasuries by 14 basis points. The impact of Fed purchases can be seen in the performance of the coupon stack, as the well-supported 2.5% coupon posted +61 basis points of excess, while 3s finished with -47 basis points, as the Fed ceased purchasing the coupon. Higher coupons fared well with both 4 and 4.5s posting +43 and +42 basis points of excess respectively, clawing back their underperformance over the first half of 2020. While specified pool pay-ups traded roughly in line to TBA for 3.5s and higher, faster than expected prepayments and high dollar prices weighed on demand. However, specified pools in the 3% coupon saw considerable outperformance versus TBA as the coupon widened, the dollar roll weakened, and investors shifted out of TBA.

ABS and CMBS posted solid excess returns of +65 bps and +148 basis points, respectively, versus duration-matched Treasuries for the quarter. Excess returns were positive in each month of the quarter, however as we moved into September, supply and increasingly tighter spreads began to weigh on performance, particularly in ABS. Within ABS, it was a quarter where off-the-run sectors such as AAA-rated timeshare and unsecured consumer loans rallied strongly, as the basis between these sectors and the more on-the-run sectors such as prime autos and cards, compressed. CMBS excess returns, while not as robust as Q2, did outperform intermediate financial bonds at the index level, +148 versus +109 basis points. Turning to spreads, at the Index level, ABS started the quarter at an OAS of 68 and rallied into 41 OAS, with index level OAS slowly and consistently marching tighter after the massive tightening off the wides of 325 basis points on March 25th. The Index tight was 27 OAS in mid-February. Similarly, in CMBS, the OAS was 132 basis points to start the third quarter and was considerably tighter than the March wides of 260. The Index OAS ended the quarter at 106 basis points.

As mentioned in last quarter's review, CMBS has had a more difficult time, especially hospitality and retail related properties. Despite these headwinds, CMBS rallied across the capital stack as the option for investors dwindled in other sectors offering more transparency on fundamentals. The AAA 8.5-year portion of the index was able to finish the quarter at 91 basis points, a 20 basis point move tighter. Looking further down the capital stack at A-rated and BBB-rated bonds, the move tighter was particularly strong but with levels still considerably wider than their 2020 tights. A-rated bonds finished the quarter at 476 OAS, 119 basis points tighter and posting 759 basis points of excess return. BBB's at the index level tightened 142 basis points to 981 OAS and posted 1,039 basis points of excess return. As a point of reference, A-Rated and BBB-rated points were as tight as 160 and 323 OAS in the first quarter.

Finally, much like other portions of the structured products market, AAA-rated CLOs saw a slow but consistent tightening during the third quarter. Top tier AAAs rallied approximately 45 basis points during the quarter to a LIBOR+130 area. While not all the way back to the 2020 tights of LIBOR+125, the rally is still impressive considering the unwind that took place in March temporarily pushed spreads into the high 300s.

	3Q 2020	3Q 2020	9/30/2020	9/30/2020
	Total Return (%)	Spread Change (bps)	OAS/DM (bps)	Yield to Worst (%)
Bloomberg Barclays US Aggregate Index	0.62	-4	60	1.18
US Securitized: MBS, ABS, and CMBS	0.24	-4	64	1.29

The technical backdrop for short spread product remains strong as low risk-free rates push investors out the risk curve. While supply has been robust, especially in September, it has been met with insatiable demand with front end treasury yields below 0.30% inside of four years. We expect this demand to continue as the Fed has committed to keeping short rates near the zero bound for the foreseeable future. In the third quarter, credit curves flattened dramatically both in ABS and CMBS as the alternatives at the top of the capital stack continued to compress. This compression down in credit continued despite a fundamental backdrop that has improved only marginally from a consumer credit perspective.

When taking a step back, the market appears to be pricing in the prospects of continued economic recovery. The combination of continued stimulus, the prospect of a vaccine being approved for use within the next six months, combined with a belief that the worst is behind the U.S. economy, investors are embracing risk of all types. No one can predict with certainty if any of these three outcomes will be realized, but our outlook for high quality AAA-rated structured assets is constructive, centering more on carry than spread tightening. From a credit risk perspective, we continue to run bonds through more punitive scenarios. As a result, we believe that AAA-rated securities are not only loss remote, but also downgrade remote, especially for shorter tenor ABS.

Despite an improvement in the third quarter, unemployment remains elevated. Government programs and stimulus combined with consumer lenders' willingness to offer forbearance, has thus far kept credit card and auto delinquencies at a relatively benign level. We still believe that the disruption that consumers have faced as a result of the pandemic will ultimately work its way into fundamentals, resulting in higher delinquencies even for higher quality borrowers. However, fundamentals are being overwhelmed by the technicals created by the Fed keeping short rates targeted near the zero bound.

CMBS faces many more challenges as is relates to the economic impact of COVID-19. While the consumer has benefited from government stimulus and various forbearance programs so they can better manage debt loads, commercial real estate is still on an island, with assistance being more on a property-specific basis. We expect this dynamic to continue, especially for the hotel sector and retail-based commercial real estate. Commercial office space has yet to experience large scale problems due to the longer-term nature of office leases. However, the concerns around office usage given the changing nature of office work, specifically the acceptance of work from home programs and the technology to enable it, cast doubt around the amount of office space necessary in a post-pandemic world. Therefore, despite the strong rally down in credit within CMBS, we expect volatility to continue especially in pre-COVID deals with high exposures to retail and hospitality. Again, technicals have led the market while fundamentals continue to weigh on the sector.

Since March, the Fed has been a consistent presence in the agency mortgage market. Our view remains unchanged. The Fed will continue to support the market so that borrowers can benefit from their "low for long" commitment. While mortgage rates have hit all-time lows, the spread between where a borrower can take out a mortgage and where the 10-year Treasury currently trades is still wide. We expect this gap to continue to narrow, thereby allowing more borrowers the opportunity to refinance. Low mortgage rates also allow new home buyers to enter the market despite a residential real estate market that has remained robust in the face of COVID-19's economic impacts. The outlook for non-agency MBS is much more nuanced as forbearance and ultimately loss to the trust will impact lower rated tranches. 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 LTVs for more seasoned securities, including substantial accumulated home price appreciation, lowering the current weighted average LTV of the pool. One area of concern is the newer RMBS issued utilizing less stringent documentation requirements. Non-qualifying mortgage securities continue to exhibit higher delinquencies than fully documented jumbo loans of a similar vintage. Finally, home price appreciation has been surprisingly resilient despite the economic backdrop. Supportive government policies combined with strong technicals in the housing market that still exist despite the pandemic, have allowed the housing market to continue to post gains despite the turbulence.

High Yield

The high yield market continued to rally during the third quarter, thanks largely to unwavering central bank support. While COVID-19 cases continued to rise in the United States, several states were able to begin reopening their economies. As opposed to earlier in the year, many of the new cases were concentrated in younger, healthier populations. Together with new treatments for the virus, the mortality rates have not been as high as they were earlier in the year, despite the rise in cases. Stable oil prices have also benefitted high yield due to its considerable exposure to Energy companies; WTI traded at around $40/bbl for most of the period. Lower quality bonds led returns during the quarter. The high yield market returned 4.70% over the quarter, while the yield to worst on the ICE Bank of America Merrill Lynch U.S. High Yield Constrained Index fell from 6.86% to 5.78% by September 30th.[3] Issuance of $132 billion made this the second heaviest quarter on record behind the second quarter's $146 billion.[4] In September the U.S. high-yield default rate (par-weighted) increased to 5.80%, up 317 basis points from 2.63% at the start of the year and up 326 basis points from 2.54% at the end of September last year. Including distressed exchanges, the U.S. high-yield default rate is 6.36%; excluding the Energy sector it drops to 4.33%.[7]

Like other risk assets, leveraged loans built on the strong returns posted last quarter on the back of stabilizing market conditions and improving economic data. The S&P/LSTA Performing Loan Index (the "Index") returned 4.30% for the quarter, outperforming high yield bonds. Lower rated loans once again led the rally with CCC's returning 8.51%, B's 4.33%, and BB's 2.68%.[5] Issuance rebounded during the third quarter, as stabilizing conditions and increasing investor demand drew borrowers off the sidelines. Institutional loan volume rose to $73.8 billion in the period, a 66% jump from the previous quarter. Still, at $207 billion, year-to-date institutional volume is at a 10-year low and is down 13% compared to the comparable period in 2019. Total M&A volume is down 25% from the year-ago period. While acquisition-related loan activity is down, opportunistic loan volume has increased markedly. In the third quarter, loans supporting refinancing or dividend payments accounted for 49% of total issuance while M&A accounted for just 40%.

	3Q 2020	3Q 2020	9/30/2020	9/30/2020
	Total Return (%)	Spread change (bps)	OAS/DM (bps)	Yield to Worst (%)
ICE BofAML U.S. High Yield Master II Constrained Index	4.70	-103	542	5.78
S&P/LSTA Performing Loan Index	4.30	-136	L+560	N/A

Throughout the rally that began in April we have opted to take a cautious stance on the high yield market. Fed support has helped drive valuations higher despite a much worse fundamental picture. High yield spreads are approaching levels last seen at the end of February, before the COVID-19 pandemic fully took hold in the United States. While recent economic data have improved, the country has only recovered about half the jobs lost earlier in the year[6] and restrictions in many populous states remain in effect. We expect to see volatility increase heading into year end. With COVID cases on the rise again, we wonder if further lockdowns are in store for the United States; many countries in Europe have already implemented such restrictions. What's more, the coming presidential election in November is shaping up to be one of the most contentious in history. Due to the pandemic, many more voters than normal will use mail-in ballots, which may mean the winner of the election won't be declared until well after election night. We anticipate that kind of uncertainty could lead to significant spread widening. Also, talks of a new stimulus deal, which have no doubt aided the economic recovery thus far, remain bogged down in Congress. We are concerned what no deal would mean for markets, particularly as the benefits from earlier stimulus packages wane. As such, within high yield portfolios, we will maintain a more defensive posture heading into the fourth quarter, including building a cash allocation and maintaining a yield disadvantage relative to the index. We will continue to selectively participate in the new issue market, though most deals do not offer the relative value we would like, and prefer issuers with solid fundamentals that we believe can weather a sluggish growth environment. Within loans, we believe a bout of volatility may create an opportunity to purchase loans more attractive entry points, particularly if some higher quality names dip below $80 due to technical dislocations.

Emerging Market Debt[7]

The Emerging Market Debt (EM) normalization that began in the second quarter continued well into the third. Across the world, we have seen countries showing some mild improvement in economic activity that supports investor confidence around a sustained recovery. The market has seen only two hiccups since March, one in early July when virus cases in the U.S. escalated, and another towards the end of September related to the nearing U.S. election along with some concerns over yet another resurgence of COVID-19.

Central banks continue to cut rates and provide liquidity in order to boost the economies; however, the end of substantial central bank intervention appears near and some countries may need to reverse the loosening (Turkey recently hiked 200 basis points). The IMF and World Bank's financial support to stressed countries is expected to hit record levels this year, as emergency financing was delivered to 76 countries so far, nearing $100 billion in aid.

> As we head into the fourth quarter, Emerging Markets are facing both internal and external headwinds. Countries continue to recover from the economic impact that COVID-19 has spread across the globe. Governments will likely be monitoring a potential second wave as we brace for winter and the northern hemisphere flu season.

Despite the sell-off into quarter-end, hard currency sovereign spreads (EMBI Global Diversified) ended the quarter 42 basis points tighter, but still 142 basis points wider on the year. Emerging Market (EM) high yield (HY) sovereigns lead the strength, 79 basis points tighter to end at 754 basis points, while EM investment grade (IG) contributed 22 basis points of tightening to end at 193 basis points. Both EMBI GD IG and HY were able to produce positive quarterly returns, of 2.58% and 1.99% respectively, with overall returns of 2.32% for the EMBI GD. Latin America, carried by the restructurings in Argentina and Ecuador, led the strength, 90 basis points tighter, while Africa (+23 basis points) and Europe (+8 basis points) were the only two regions to end the quarter wider.

EM Corporates continued to rebound in line with sovereign markets and even outperform in the September volatility. Many companies are using the current rate environment to do liability management and reduce short term maturities, extending their debt profile.On the back of more conservative financial behavior, down in quality corporates outperformed similarly rated sovereigns during the September sell off. Some solid EM corporates have been able to impress the rating agencies with their liability management and approaches to funding gaps, receiving upgrades in 3Q. Industries that were hit the hardest, chemicals and energy, have seen some significant rebounds in both cash flows and asset prices. Transportation remains a significant drag as air traffic continues to struggle and EM governments taking a more conservative approach to rescue financing. EM high grade and high yield corporates both contributed to the strength, 32 basis points and 54 basis points tighter respectively. Quarterly index returns for the CEMBI BD stood at 2.75%, with CEMBI IG at 2.63% and CEMBI HY at 2.90%.

Despite compelling arguments for the dollar to weaken, hard currency assets have out-paced non-dollar assets. September highlighted the weakness, as stretched positioning and increased equity volatility led local currency assets lower, with euro crosses getting sold and the ruble underperforming most other assets. Numerous aspects contributed to better dollar trading, with many factors from idiosyncratic countries adding fuel to the price action. For example, the contested election in Belarus appears to have contributed to negative sentiment for Russian assets. Further compounding the move is the possibility of a Democratic sweep of the U.S. presidential and congressional races, which may result in a less favorable relationship with Russia. GBI assets remain the worst performer for the year in EM, with YTD GBI-EM returns of -6.32% and 3Q returns of 0.61%. The global growth concerns, as well as local policy actions, have continued to weigh on EM local currency assets despite valuations reaching very attractive levels, in our view.

The asset class saw healthy inflows this quarter, with hard currency flows rebounding to $2.2 billion YTD and local currency flows at -$12.2 billion. Interestingly, September's weakness didn't coincide with significant asset class outflows, but instead led to a divergence in quality as high grade outperformed high yield. Issuers definitely took advantage of the lower yield environment, with $140 billion in corporate and $37.2 billion in sovereign issuance. Investment grade names made up the majority of issuance, but over $40 billion of high yield corporate supply was also absorbed by the market. Middle East and Africa led sovereign issuance ($14.4 billion), with Europe closely behind with $13.2 billion. Low funding costs in euros have attracted borrowers, with sovereigns raising over $80 billion YTD in euro denominated bonds.

EM specific news during the quarter was generally positive, with a few exceptions. After a long, drawn out process, Argentina was finally able to complete its debt restructuring plan on $69 billion of foreign bonds, with terms that translate to an approximate 45-cents-on-the-dollar recovery on the debt. In the same week, Ecuador got approval from investors to restructure $17.4 billion of debt at roughly 50 cents-on-the-dollar recovery. Away from restructurings, Chile passed a pension reform bill, despite opposition from President Piñera, that allowed workers to withdraw up to 10% of their retirement savings. The country has already distributed over $14 billion to almost 10 million citizens. The election season brought added volatility. Belarus held a presidential election in August, and since then has faced ongoing demonstrations around the outcome, with the opposition asserting that the polls were rigged, and that Alexander Lukashenko did not win by the 80% of votes he claims. The election in the Dominican Republic ended on a more positive note, as moderate opposition candidate Luis Abinader obtained enough votes to avoid a runoff election. We are hopeful that Abinader's clear victory may create momentum on reforms and adjustments needed in the wake of the pandemic.

	3Q 2020	3Q 2020	9/30/2020	9/30/2020
	Total Return (%)	Spread Change (bps)	OAS/DM (bps)	Yield to Worst (%)
JP Morgan Emerging Markets Bond Index Global Diversified	2.32	-42	432	5.14
JP Morgan Corporate Emerging Market Bond Index Broad Diversified	2.75	-35	404	4.26

As we head into the fourth quarter, Emerging Markets are facing both internal and external headwinds. Countries continue to recover from the economic impact that COVID-19 has spread across the globe. Governments will likely be monitoring a potential second wave as we brace for winter and the northern hemisphere flu season. While this resurgence risk is well understood, we believe it is not being captured in market pricing in all cases. The U.S. election is a mere month away and we have already seen a preview of the volatility that may be coming in November. We acknowledge the importance of this election, as its outcome could have a meaningful impact on so many investable themes including geopolitical relations, global commerce, fiscal policy, growth policy, monetary policy as well as funding for the IMF, World Bank, and sovereign foreign aid. As we acknowledge the uncertain outlook, there continues to be technical support given inflows into the asset class, along with the accommodative global monetary policies.

With Colombia's move to tap into their flexible credit line from the IMF as a funding source, it could set a precedent for strong sovereigns with liquidity needs to obtain extra funding without having to tap the external markets in the coming quarter, a development we will continue to monitor. On the political front, in Chile, the citizens will vote on October 25th on the constitutional referendum that was postponed in April due to the pandemic. There is potential for IMF programs in countries with complicated outlooks including El Salvador, Costa Rica, Sri Lanka, and Argentina. Progress on restructurings in Lebanon and Zambia is anticipated over the coming quarters. Elections in Ghana and Cote d'Ivoire are scheduled for the coming months, as we expect policy continuation in each one. In Belarus, political tensions and protests targeted at President Lukashenko are likely to linger.

As countries continue to manage through the pandemic, it will be important to monitor how they will handle the recovery phase. Romania, Colombia, Morocco, India and Uruguay will all likely remain in the sovereign spotlight, as they try to prove themselves worthy of maintaining their investment grade ratings to the agencies despite the fiscal challenges they face. Central banks continued taking aggressive moves in the third quarter towards policy easing to spark economic growth, but as we approach the end of 2020, we believe that the bulk of interest rate cuts and stimulus spending has subsided. Now we will keep an eye on if any more quantitative easing measures follow in order to trigger further growth.

Within EM portfolios, we continue to prefer positions in EM corporate credit, looking to participate in new issuance and add names we believe have strong balance sheets and can withstand the pandemic induced headwinds. In the EM corporate space, we also look to add to existing positions with a bias to buy high conviction names on weakness as we anticipate volatility ahead. The outlook for sovereign credit remains more tenuous as the pandemic has caused countries to use a wide variety of monetary & fiscal measures to boost their economies, and in return has led to weaker credit fundamentals. As such, we continue to focus on resiliency of sovereigns and are currently incorporating fresh budget figures into our 2021 assessment.

While the accommodative central bank stance around the globe has helped support the local rate markets, EM FX has been battered and the volatility ahead can present further downside pressure. Beyond global growth, the U.S. election cycle may have a bearing on the direction of emerging market currencies, and as such we continue to be positioned in local markets where we see value on a relative basis. We also continue to look to improving stories as countries that are taking constructive steps, whether in the political or policy domains, should be better positioned, in our view, to deal with the effects of the crisis.

Taxable Municipals[8]

After the sharp selloff in the first quarter and the subsequent recovery in the second, the trajectory of spreads and bond yields continued to point lower during the third quarter. The OAS of the Bloomberg Barclays Taxable Municipal Aggregate Eligible Index ended the quarter 15 basis points tighter at 176, generating 103 basis points of excess returns relative to duration-matched Treasuries. Most of the move occurred in July, with spreads then remaining anchored within a 5 basis points range in August and September. By September 30th, the Taxable Municipal Index had recovered 69% of the 146 basis points of spread widening since the beginning of the year to the peak OAS of 262 basis points on March 25th. In contrast, the Bloomberg Barclays U.S. Corporate Index widened by much more from the beginning of the year to the peak on March 23rd (280 basis points), and subsequently recovered more on a percentage basis, at 85%.

The heavy pace of taxable issuance continued in the third quarter, with $60 billion of total issuance. YTD through September 30th, the $132 billion in taxable municipal issuance is roughly 3.5 times last year's volume. The surge in taxable issuance has been driven by technical factors (low rates, flat curve) as well as the elimination of tax-exempt advanced refundings in the Tax Cut & Jobs Act of 2017. Taken together, these factors led many municipal issuers to refinance higher cost tax-exempt bonds approaching their call date with new taxable bonds. We expect the issuance trend to continue, particularly in the weeks before the elections, as issuers accelerate borrowing plans to lock in yields and sidestep potential market volatility.

	3Q 2020	3Q 2020	9/30/2020	9/30/2020
	Total Return (%)	Spread Change (bps)	OAS/DM (bps)	Yield to Worst (%)
Bloomberg Barclays Taxable Municipal Bond Index	1.71	-15	176	2.22

As of September 30th, the taxable municipal index offers an OAS pickup of 25 basis points over the corporate index, which is 19 basis points higher than the average OAS difference of 6 basis points in 2019. On a yield basis, the difference is even more pronounced at 55 basis points (2.56% yield to worst on the taxable municipal index vs. 2.01% for the corporate index). The comparison is not perfect, as the indexes have material differences in ratings (Aa3/A1 for taxable municipals vs. A3/Baa1 for corporates) and duration (11.87 for taxable municipals vs. 8.69 for corporates). Nevertheless, we believe that the taxable municipal market offers opportunities for investors seeking high quality long duration assets in an environment that faces headwinds, including negotiations on Phase IV stimulus, a potential resurgence in COVID-19 cases, and of course the elections.

From a fundamental perspective, it is difficult to identify a sector of the municipal market (or the entire fixed income market for that matter) that is in a stronger fundamental position today than it was on January 1st. But the starting point of Aa3/A1 on the Bloomberg Barclays Taxable Municipal index does not invite much room for upside even under the best circumstances. The point is that the negative outlook by S&P on all U.S. public finance sectors should be interpreted in the appropriate context. While we expect rating actions to be skewed to the downside in the next two quarters, we think current valuations can absorb some negative rating migration and still compare favorably to pre-COVID spreads or to investment-grade corporates. In terms of positioning, we are cautious on municipal issuers with binary credit trajectories that depend significantly on additional aid from the federal government (such as certain mass transit systems and GO issuers with stressed budgets and/or severe pension issues), given that Republicans and Democrats appear firmly entrenched in their respective priorities on further stimulus. With key catalysts on the horizon, we are neutral risk relative to the benchmark. We favor an above average allocation to cash with an eye to add risk on market weakness in issuers with strong market positions and robust liquidity profiles, including hospitals, airports, universities, utilities, and toll roads.

Endnotes

1. All data sourced from Bloomberg Barclays.
2. All data sourced from Bloomberg Barclays.
3. Bank of America Merrill Lynch.
4. JP Morgan.
5. All return and issuance data sourced from S&P Global Market Intelligence
6. Bureau of Labor Statistics.
7. All data sourced from JP Morgan.
8. All data sourced from Bloomberg Barclays

About MetLife Investment Management

MetLife Investment Management (MIM),[1] MetLife, Inc.'s (MetLife's) institutional investment management business, serves institutional investors by combining a client-centric approach with deep and long-established asset class expertise. Focused on managing Public Fixed Income, Private Capital and Real Estate assets, we aim to deliver strong, risk-adjusted returns by building tailored portfolio solutions. We listen first, strategize second, and collaborate constantly as we strive to meet clients' long-term investment objectives. Leveraging the broader resources and 150-year history of the MetLife enterprise helps provide us with deep expertise in navigating ever changing markets. We are institutional, but far from typical.

For more information, visit: **investments.metlife.com**

[1] MetLife Investment Management ("MIM") is MetLife, Inc.'s institutional management business and the marketing name for subsidiaries of MetLife that provide investment management services to MetLife's general account, separate accounts and/or unaffiliated/third party investors, including: Metropolitan Life Insurance Company, MetLife Investment Management, LLC, MetLife Investment Management Limited, MetLife Investments Limited, MetLife Investments Asia Limited, MetLife Latin America Asesorias e Inversiones Limitada, MetLife Asset Management Corp. (Japan), and MIM I LLC.

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