MetLife Investment Management

Update on Fixed Income Markets

March 11, 2020

The first quarter of 2020 has been challenging to say the least. The global spread of the COVID-19 virus has disrupted supply chains and instilled fear of a broad slowdown in growth. Further, the March 3rd 50 basis point cut in the Fed Funds rate did little to sooth the markets which reacted even more severely a week later as Russia decided to opt out of deeper OPEC+ production cuts and Saudi Arabia slashed its oil prices staging a price war; once again driving equities lower, credit spreads wider and Treasury yields to historical lows.

The markets remain extremely volatile and we are monitoring portfolios very closely to ensure each is positioned to weather future volatility.

Investment Grade Corporates

Investment-grade corporate spreads have widened across the curve, in many cases to levels not seen since 2016. Given the volatility in the market, liquidity has deteriorated and is widely expected to remain scarce in the coming weeks.

We expect sectors that are directly impacted by travel and leisure to struggle the most in a prolonged slowdown as a result of the virus. This includes cyclical names such as Airlines, Autos, Leisure, Consumer Services, Restaurants, Retail, and Gaming where a pull-back in these activities will directly impact corporate revenues and earnings. Additionally, as long as the volatility in energy prices continues, we expect to see strain on the Energy sector. As a result, we think it is reasonable to expect to see an increase in downgrades and fallen angels; and we are closely monitoring for these scenarios.

In terms of positioning; we entered the year with a conservative bias and a healthy allocation to Treasuries; and given current market conditions, this position remains. We stand ready to redeploy this Treasury allocation as credit valuations become more compelling and liquidity returns to the market. The market has become increasingly dislocated during this sell-off, and we will likely get an opportunity to add exposure to high quality companies at historically attractive valuations.

High Yield and Bank Loans

High Yield spreads have widened meaningfully, not only pressured by the coronavirus impact on global growth, but also further challenged by a deep slide in oil prices. Sectors that were notably under pressure include Energy, Airlines, and Leisure. Within the Energy sector, Oil Field Services and Independents have been especially under stress, with companies starting to announce a pull back on spending in response to the oil price collapse in the mid-$30s. The High Yield market has about 10% exposure in Energy, and a prolonged lower oil price environment can be especially painful. At this time, we think it is reasonable to expect future downgrades. Away from Energy, select Consumer Cyclicals have also been tested; especially companies with travel-related services, as have names in the Gaming and Entertainment sectors. However, a recent announcement by Treasury Secretary Steve

Mnuchin that the administration is considering potential measures to aid the airline industry could at least provide some respite for the Airline sector.

The U.S. Leveraged Loan market has been negatively impacted as well, with lower quality names leading the negative performance. The Fed's recent decision to implement a 50-basis point rate cut last week has also put pressure on Libor and spurred investor attention to Libor floors. As for market technicals, fund outflows from high yield and loan funds pressed on amid a flight to quality. Liquidity has been challenged over the week, with average bid-ask spreads surging.

As we headed into the year, we were positioned relatively conservatively in high yield portfolios given what we believed were elevated valuations. While the recent spread widening does present some potential opportunities, we remain cautious given the level of uncertainty in the markets.

Emerging Market Debt

Emerging markets have been pressured due to the twin shocks of a steep oil price fall and global growth fears emanating from the expansion of the coronavirus. Hard currency sovereign spreads have moved substantially wider in March, with single day spread moves as wide as ~70 basis points. The spread moves have revealed a notable bifurcation between investment-grade and high yield, with high yield spreads more than three times wider. Credit and currencies of oil exporters as well as cyclical and growth-sensitive credits have been challenged, with dispersion compared to rest of the EM cohort. With oil plunging the most in almost three decades, bonds of oil producers have continued to be under stress, along with oil-dependent sovereigns (Angola, Nigeria, Ecuador, Colombia) also widening considerably. Should this trend continue, we think it is realistic to expect downgrades in the future.

With oil already facing a demand shock from the coronavirus, and now a supply shock from OPEC, we believe prices could remain low and even fall further. There are still far too many variables in play at this moment to predict the depth and duration of a price war. No doubt there should be winners and losers from a prolonged oil price decline. Net oil exporting sovereigns could feel the stress, as we have already observed in the intense price moves, while China, as the world's largest oil importer, should be one of the biggest single beneficiaries.

As we believe the sell-off may extend for a while, we will look to add risk opportunistically and as we anticipate market stabilization. In particular, we are looking closely at potential opportunities in higher quality growth-sensitive assets in the mid-to-high BB and BBB areas. However, as there is still a heightened level of uncertainty, we are proceeding cautiously.

Structured Products

Since the end of February, spreads on high quality structured products have moved wider. High quality structured products backed by consumer receivables, such as AAA-rated credit cards and AAA-rated autos, have become the funding source for many asset managers looking to meet redemptions. As a result, spreads have widened considerably as dealers are reluctant to use scarce balance sheets to position bonds with relatively low all in yields. Spread levels on AAA-rated ABS, such as time share and rental car receivables, are also 100+ wider, but a lack of trading activity and no new issue activity makes spotting spread levels more challenging.

- The CMBS market has moved wider in conjunction with other credit sectors, and while the volatility has been more muted then the corporate sector, it has still been extreme. Spreads on new issue 10-year AAA paper have traded in a 50-basis point range as of this writing with the credit curve steepening dramatically. Single-asset, single-borrower ("SASB") AAA CMBS floaters are now quoted in the LIBOR +175-200 area.

- With 10-year notes currently trading around 70 basis points, the market is now expecting a refinancing wave that was unthinkable just a few months ago. As a result, both Agency and Non-Agency mortgages have widened considerably to account for the increased prepayment risk. Durations continue to shorten into the Treasury rally and as a result the excess returns for Agency MBS versus Treasuries is negative - despite them being considered a safe-haven asset.

- The Esoteric ABS market, which enjoyed a record issuance level in 2019, has come under extreme stress recently. The new issue market will likely drop significantly in our view and take an immediate pause for Q1/Q2. This subset of the ABS market is dominated by whole business securitizations and aircraft, both under high stress as investors reassess their expectations for the sectors. Liquidity and secondary trading are sparse with spreads significantly wider in whole business and aircraft.

- The CLO market, which has a direct link to the bank loan market, has effectively closed for new issuance. Selling pressure has been high as investors have turned to aggressive sellers and liquidity has dried up as investment banks look to limit their balance sheet. We estimate that AAA-rated CLOs are about 100 basis points wider, while lower rated assets are about 200-500 basis points wider.

Source: All market data was source from MIM or Bloomberg

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