MetLife Investment Management

Short & Intermediate Duration Fixed Income

Q2 2020 Themes, Outlook & Strategy

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- **GDP** - Effects of Covid-19 virus shutdowns will likely impact growth for at least several quarters and lead to a recession. We are not in the "V-shaped" recovery camp and believe the negative impacts could last longer than many anticipate and longer-term changes to the economy will evolve from this pandemic. In this unprecedented period, we feel economic numbers over the short run are less relevant given the nature of this self-imposed disruption. We believe severity of a recession will depend largely on the duration of the shutdown and its impact on the U.S. consumer, who has historically been the main driver of growth.
- **Business** - Black Swan events (oil price collapse and spread of COVID-19) have conspired to disrupt almost all businesses. Elevated leverage may weigh on operating fundamentals, strong debt service coverage ratios could deteriorate with declining revenue streams. Effects will vary but the Airline, Automotive, Energy, Restaurant, and Retail sectors will be likely particularly hard hit. As distressed ratios have significantly risen, we expect defaults to follow, especially of those companies needing access to capital. Historically, in the investment grade space though, it has been rare to see companies directly default. We do however expect downward ratings pressure and more companies crossing over into high yield (commonly referred to as Fallen Angels). We continue to focus on more domestically driven, non-cyclical sectors including Banks, Healthcare, Technology, Telecommunications and Utilities. While low rates, net interest margin compression and rising credit costs may pressure bank earnings, the strength of their balance sheets may leave them relatively unscathed over the coming quarters. We believe the bank regulations instituted since the financial crisis have made banks part of the solution this time around and not the cause.
- **Consumer** - Consumers entered the shutdown in very good shape and will likely be supported in the near term by generous unemployment benefits and various measures included in the rescue package recently enacted by Congress. An extended shutdown, however, would weigh heavily on both consumer confidence and household balance sheets while dampening the speed of the eventual rebound Debts may accumulate faster than jobs rematerialize. In early March, OPEC+ failed to reach an agreement which sent oil below $30 per barrel. While lower oil prices are generally a positive for consumers and industrial production, the Energy industry has also become a significant employer throughout the fracking boom years in many Energy patch regions across the United States.
- **Employment** - Feeling the immediate impact of the nearly nationwide business shutdowns, unemployment is set to spike to levels not seen since the financial crisis and likely higher. While the CARES package recently passed by Congress incentivizes businesses to retain employees, we have already witnessed an unprecedented increase in new unemployment claims, which does not bode well for the next several months. In the short run, companies may decide to furlough employees with pay but eventually we believe the realities of cash flow (or lack thereof) will hit certain industries extremely hard as "social distancing" likely lingers for some time.

- **Residential / Commercial Real Estate** - Expectations for annual home price growth rates have reset to 0-2% on a national level. Despite record low interest rates, headline mortgage rates to consumers are sticky at current levels with originators challenged by both capacity constraints and operational disruptions caused by COVID-19. We believe realized prepayments could fall below prepayment model expectations for the duration of the crisis. Forbearance programs for mortgage borrowers present financial challenges for mortgage servicers obligated to advance cash flows to securitized trusts. Retail and lodging properties stand at the epicenter of the virus with performance metrics collapsing across the board. Multi-family properties are challenged by the prospect of record unemployment and increasing pressure to provide "rent holidays". Office properties are faced with long-term demand shifts as businesses successfully implement work-from-home policies. We continue to favor AAA-rated securities with ample credit enhancement, performance triggers and/or Agency backing.

- **Monetary & Fiscal Policy** - The Federal Reserve has eased monetary policy, increased quantitative easing programs and announced several programs designed to provide liquidity to a wide segment of the market. Congress followed with a fiscal stimulus rescue package (approximately 9% of GDP) targeted to help both businesses and consumers. We believe this accommodative environment will be here to stay throughout 2020. With the experience of the 2008 still fresh in people's minds, we find the aggressiveness, speed and size of policy actions taken to date to be commendable. Still, these actions are not expected to resolve the current crisis by themselves or collectively, but having the Fed acting as a backstop or buyer of last resort for many assets may help prove supportive in the near term.

- **Inflation** - While central banks around the world have changed their playbooks for some time to spark inflation, their efforts to date have been largely unsuccessful. Market-based measures such as Treasury Inflation-Protected Securities (TIPS) breakeven rates have recently declined and at some points currently yield more than maturity-matched nominal Treasuries. A slowing of the global economy along with the recent failure of OPEC+ to come to an agreement prolongs the return to central banks' inflation targets. While the passage of the $2 trillion fiscal package and more possibly in the works may potentially augur inflation given the significant deficit financing that would be needed, we still believe inflation is likely to remain muted near term.

Investment Grade Credit

As with all corners of the fixed income market, the dislocations caused by the spread of the coronavirus and its escalating, pervasive impact came to dominate headlines and market action, when volatility reached record levels and liquidations across nearly all asset classes were taking place. Credit spreads, which started the year not far off record tights, gapped wider in March at the fastest pace on record, driving down absolute and relative returns for investment grade credit for the quarter. Substantial ETF and mutual fund redemptions overwhelmed the corporate bond market late in the quarter as market technicals deteriorated significantly. Another sign of the dislocation evident in the market was the inversion of credit curves, whereby credit spreads on a corporate issuer's shorter dated bonds were higher than longer dated issues as investors sought to sell the most liquid issues with the least impact on price. With the announcement late in the quarter of Federal Reserve programs to support the front end (1-5 year) segment of the Investment Grade market, credit curves began to normalize. After being shut for a time in March, the corporate bond new issue market reopened with record ferocity, as issuers raced to bolster their liquidity positions by selling new debt and drawing down revolving credit lines in order to build liquidity.

The shutdown of many nonessential businesses across the U.S. in addition to work-from-home policies for many workers have left the U.S. economy moving at a snail's pace. Uncertainty over when those restrictions will be eased or lifted entirely, coupled with the steep increase in unemployment and the precarious financial condition of many small and mid-size companies, presents a daunting challenge for the economy in the months and quarters ahead. In our view, the drastic moves made by the Federal Reserve and the return of financial crisis-era programs to prop up markets and restore liquidity will mitigate some of these difficulties in the near term. The larger issue is whether other efforts to support workers and companies like those from Congress through the $2 trillion CARES Act will provide a bridge sufficiently large enough to get us through this difficult period. The coronavirus-related disruptions have rendered earnings reports and even forward guidance largely meaningless in the short run with liquidity and access to capital representing the key near-term factors in evaluating companies. We believe it is prudent to maintain a defensive, up-in-quality positioning in the credit sector as well as across our portfolios overall.

The substantial decline in interest rates over the first quarter was more than offset by the dramatic increase in credit spreads in driving excess and total returns for the benchmark ICE BofA 1-5 Year U.S. Corporate Index to -2.38% and -6.41%, respectively. The index's option-adjusted spread (OAS) widened 243 basis points to 304 basis points by quarter end. No subsector within front-end Credit was spared with across-the-board negative excess returns.

In terms of credit fundamentals, as mentioned above, earnings reports will hold little meaning at this stage with some companies in certain segments of the U.S. economy or regions effectively shut down such as the Leisure/Hospitality, Restaurant, Retail and Transportation industries. With reduced revenue, companies are not focused on margins, financial policies, M&A, etc. as discussions now center on whether issuers will have sufficient ability to weather the storm via such basic means as cash on the balance sheet or the potential to tap undrawn revolving credit facilities. In the Energy space, March also saw the inability of Saudi Arabia and Russia to come to an agreement on production cuts result in plunging oil prices, exacerbated by the enormous demand destruction taking place across the globe as the virus-driven decline in economic activity unfolds. The result was oil prices collapsing to near 20-year lows, pushing some companies into bankruptcy with more to come in our view. These sharp turns in the economy caused the rating agencies to carry out a torrent of rating downgrades for issuers in March, especially across the Industrial subsectors most levered to economic growth and commodity prices. We expect U.S. economic growth will be steeply negative at least through the second quarter, approximating -20% in terms of the quarterly real GDP figure, with estimates ranging widely. With the reset in valuations, the lack of visibility over when the coronavirus-related restrictions will begin to ease and companies resume normal operations, we are focused on opportunities to add exposure in sectors less impacted by the disruption such as consumer staples, utilities, technology and pharmaceuticals. We expect to maintain our overweight in Banking as we believe the sector's fundamentals will remain solid based on robust capital levels underpinned by substantial support from the Fed and on the regulatory side as well. We will continue to be opportunistic in putting money to work in Credit either in attractively priced new issues or secondary offerings where we believe we are being adequately compensated from a risk/return standpoint in the present environment.

Over the first quarter we modestly raised our Credit weightings as well as sector duration contributions across strategies, primarily as a response to the market disruption in mid-March as credit spreads gapped wider. In terms of trading activity, in our short-dated strategies trading was a bit more balanced over the quarter mainly highlighted by some floating-rate new issue purchases earlier in the quarter and capitalizing on secondary opportunities to add high quality names in the midst of the market disruption. Given the shift in the risk environment and differing impacts on certain sectors, we also executed a few notable sales in our shorter dated strategies, including some of our low-BBB holdings whose risk profiles have risen on the operational side in addition to having greater potential downgrade risk. In the 1-3 Year strategy portfolios, activity was overwhelmingly skewed toward selling until mid-March, due to our view on valuations. Late in the quarter we were able to selectively add secondary bonds in some well-regarded issuers. A similar story played out in the 1-5 Year strategy portfolios with little but selling to speak of until mid-March when we purchased a short-dated energy infrastructure name in the secondary market and put some cash to work in the new issue market once it reopened where we saw names across various sectors issue paper at attractively priced levels. In our Intermediate portfolios, we also trimmed exposure in conducting selected sales until mid-March when we bought secondary paper and likewise jumped into the new issue market.

Performance Attribution: Negative

The dramatic widening of spreads during the quarter represented a significant drag on absolute and relative performance with all subsectors in Credit posting negative excess returns.

Treasuries / Agencies

Treasury yields were dramatically lower during the first quarter of the year as fears of a global recession due to the coronavirus intensified causing investors to pile into the Treasury market. Yields out to the 10-year maturity point were anywhere from 125 basis points to 148 basis points lower with front-end yields falling more than long-end yields. The Federal Reserve was forced to take a highly accommodative stance and reintroduced many of its liquidity-focused initiatives from the Global Financial Crisis. The Fed initially cut the Fed Funds target rate by 50 basis points on March 2nd and then followed up with another cut on March 16th which brought the rate to a lower bound of zero. They also reintroduced a program to buy Treasury bonds, initially at $500 billion and then increased that to essentially an unlimited amount. At quarter end, they had purchased close to $800 billion of Treasuries with additional buying, albeit at a slower pace, expected over the near term. Central bank easing was also accompanied by fiscal support. In the U.S., a $2 trillion package was passed by Congress and signed by President Trump at the end of March. Included were loan guarantees, aid for small to medium-sized enterprises, direct payments to low and middle-income earners, and broadened unemployment insurance. Treasury volatility during the quarter was extremely high, with the 10-year Treasury trading in a 163-basis point range (high of 1.94% and low of 0.31%) and 5-year Treasury trading in a 140-basis point range (high of 1.71% and low of 0.31%). The Fed intervening in the market helped liquidity but as of quarter end signs of stress remained. Inflation expectations, as measured by Treasury Inflation-Protected Securities (TIPS), also moved sharply lower during the first quarter. We saw 10-year TIPS move from an expected inflation rate at the beginning of the quarter of 1.78% to 0.93% by the end of the quarter and trade as low as 0.55% in mid-March. Treasury notes finished the quarter with the two-year Treasury yield at 0.25%, the five-year Treasury yield at 0.38% and the ten-year Treasury yield at 0.67%. The five-year less two-year Treasury interest rate differential ended the quarter at +13 basis points, only one basis point steeper from year-end 2019. The longer dated ten-year less two-year differential moved 7 basis points steeper to +42 basis points. In the very front end, the three-month Treasury bill declined 148 basis points to 0.06% while 3-month Libor contracted only 46 basis points to end the quarter at 1.45%.

Turning to the Agency sector, government-sponsored enterprise (GSE) debt spreads widened by 22 basis points to end the quarter at 27 basis points over comparable U.S. Treasuries while U.S. dollar-denominated Supranational, Sovereign and Agency (SSA) fixed-maturity securities' spreads were 60 basis points wider and finished the quarter at a spread of 90 basis points over comparable maturity Treasuries. For U.S. agencies, this move brought their spreads to their widest levels over Treasuries since early 2012 while SSA's are at spreads not witnessed since 2016.

During the quarter we maintained our relatively low overall allocations to the Agency sector. In terms of our outlook, we expect to see redemptions of seasoned agency callable bonds in conjunction with the sharp decline in rates. However, with the Fed committed to keeping rates at the zero lower bound until "the economy has weathered recent events", the call option risk on newly issued callable agency bonds has declined across all structures. With volatility likely to remain high, we will selectively look to add to the Agency sector and would use major SSA issuers to target specific duration points across the yield curve as needed.

Performance Attribution: Negative

Our yield curve posture modestly added to performance but was offset by our allocation to TIPS as break-even yields declined. While our allocations to the various Agency subsectors detracted from performance, much of the underperformance came from a few names residing in the foreign agency space that are tied to the oil sector.

ABS

Spreads on short-tenor asset-backed securities moved dramatically wider late in the first quarter as the financial markets seized up under the onslaught of the COVID-19 virus. Short-tenor AAA-rated ABS tranches saw waves of selling from levered investors, money managers forced to meet client redemptions and other market participants desperate to raise cash. With buyers having no interest in longer-tenor or lower-rated tranches, short AAA-rated ABS tranches became the most effective currency for liquidations and bore the brunt of the selling pressure. Eventually, crisis response actions from the Federal Reserve and the federal government brought some stability to the markets and ABS spreads saw some recovery. These actions included the re-enactment of the Term Asset-Backed Securities Loan Facility (TALF), a 2008 financial crisis program designed to provide non-recourse government funding to support the levered purchase of certain new issue ABS securities. At the end of the quarter, spreads on two-year AAA-rated prime auto, subprime auto and credit card tranches were marked 129, 193, and 108 basis points wider than at the start of the year. At those levels, spreads were 150-200 basis points tighter than their wides of the year, observed mid-March during the height of the selling pressure.

The quarter saw a record number of over 8,200 market participants attend February's Structured Finance Industry Group (SFIG) ABS conference, about 150 more than last year. Compared to the relatively bullish tones from the recent past, this year's conference was more subdued with coronavirus concerns dampening investors' sentiment. In our view, the consensus of the conference was that consumer balance sheets were in good shape and ABS credit performance could remain firm although the impact of the coronavirus may create challenges for the economy. Libor transition concerns were a focus of investor attention, particularly in relation to legacy deals without Libor replacement fallback language in their underlying documents. There was also considerable conversation around Environmental, Social and Governance (ESG) investing and how that might be implemented and measured within structured products. With the benefit of hindsight, conference participants massively underestimated the impact of the coronavirus and its effects on consumers, the economy and financial markets.

In the wake of the market volatility, the ABS new issue market ground to a halt with the last new issue deal, a subprime auto transaction from Westlake, pricing on March 11th. For the quarter, $47 billion of ABS priced, much lower than the $58 billion seen in the first quarter of 2019. Compared to last year, this quarter saw a dramatic drop in credit card securitizations with just over $2 billion pricing, almost 75% lower than last year's $9 billion first-quarter volume. With credit card trust performance metrics not yet reflecting the impact of the COVID-19 virus on consumers and the economy, posted charge-offs and delinquencies remain near historic lows, while monthly payment rates, portfolio yields, and excess spread remain near historic highs. The quarter saw charge-offs on the Wells Fargo index increase 11 basis points to 2.33%, 60+-day delinquencies unchanged at 1.10% and excess spread decline 14 basis points to 14.11%. In our view, the low utilization rates for the big name, largest credit card trusts which have highly seasoned, higher quality borrowers explain why monthly payment rates remain elevated. We believe trust cardholders are likely using their cards for rewards or payment convenience rather than as a line of credit. However, with expected record unemployment in the wake of the COVID-19 virus, we anticipate that utilization rates will spike higher over the near term and other credit metrics will also show rapid deterioration. Nonetheless, given their robust levels of credit enhancement, we do not anticipate any material credit concerns for our short tenor, senior, AAA-rated credit card ABS tranches.

Auto performance metrics also do not yet reflect the impact of COVID-19, so reported collateral metrics remain generally healthy despite some expected seasonal weakness (as the first quarter is typically the peak loss season for auto deals). The 60+-day delinquency rate on the Fitch Auto ABS indices showed subprime delinquencies at 5.62% in February, an increase of 9 basis points since year-end and 8 basis points higher year-over-year. Prime 60+-day delinquencies were up 1 basis point since the start of the year to 0.30% but were lower year-over-year by 4 basis points. We expect considerable deterioration in these metrics going forward once the impact of the COVID-19 virus is reflected in the data. However, we believe that the AAA-rated tranches held in our portfolios have sufficient credit enhancement to weather the coming storm.

New vehicle sales numbers cratered in March, as the economy went into a virtual shutdown. After posting two months above 16.8 million SAAR (seasonally adjusted annual rate), the quarter closed with March volumes of 11.4 million SAAR. Auto Original Equipment Manufacturers (OEMs) have launched a slew of incentive programs to reignite sales volumes, but it is an open question as to how successful these will be in an environment defined by “social distancing”. We anticipate that ABS auto floorplan structures may experience disruption due to slower sales volumes at automobile dealerships. However, in addition to credit enhancement, these structures are designed with minimum payment triggers which will redirect cashflows to protect senior tranches. Should the crisis persist beyond a few months, we would expect these triggers to be activated, accelerating the payoff of our senior tranches. As dealer floorplan financing is an integral part of the automobile sales ecosystem, the automobile industry remains motivated to support their dealership ABS floorplan structures and we do not expect material credit concerns with any of the AAA-rated tranches held in our portfolios. Much like during the great financial crisis, we believe that ultimately the OEMs will be duty-bound to support their dealer network floorplan programs and that downgrades of AAA-rated bonds are unlikely. With the economy shutting down, we expect used car prices to follow new vehicle sales numbers lower and anticipate that the March release of the Manheim Used Vehicle Index will show used car prices dropping significantly.

Over the course of the quarter, we generally maintained our ABS exposure in our shorter strategies while modestly reducing ABS exposure in our longer portfolios via both paydowns and secondary market sales. Going forward, with spread product widening in response to macro pressures, we anticipate selling more liquid ABS tranches to fund purchases of more attractively priced alternatives across both ABS and other spread sectors.

Performance Attribution: Negative

With spreads significantly wider, our ABS holdings generated large negative excess returns after adjusting for duration and yield curve positioning. The weakness was broad-based with all subsectors posting negative excess returns. Our best performing positions were our fixed-rate credit card holdings, which saw some spread retracement in the wake of the Fed’s efforts to stabilize the markets.

CMBS

The disruption in the markets caused by the COVID-19 virus drove CMBS spreads dramatically wider late in the quarter. Non-agency tranches suffered the most as the Fed's agency MBS purchase program included agency CMBS tranches and mitigated weakness in that sector. Starting on March 27th, we estimate that the Fed purchased approximately $3 billion of agency CMBS in three operations targeting Fannie Mae "DUS" and Freddie Mac "K-bond" tranches. Ultimately, at the end of the quarter, compared to like-duration Treasuries, three-year and five-year AAA-rated conduit tranches ended at spreads of 190 and 197 basis points, approximately 130 basis points wider. Even with the Fed's support, agency CMBS were also weaker with front-end Freddie Mac K-bond tranches ending the quarter at spreads of 90 basis points, anywhere from 35 to 50 basis points wider depending on the point on the yield curve.

Apart from a few agency CMBS deals, the new issue market for CMBS was effectively shuttered by the COVID-19 virus. By quarter-end, $25.1 billion of private label and $31.4 billion of agency CMBS had come to market. This compares to $20.8 billion and $36.2 billion, respectively, in the first quarter of last year, representing a 20.7% increase for private label CMBS and a 13.3% decrease for agency CMBS. We attribute the decline in agency issuance simply to a pause in that market given the rapid growth in multifamily agency originations over the last few years. With the non-agency new issue market effectively sidelined by the coronavirus, we would anticipate agency issuance to lead going forward.

CMBS delinquency data, which does not yet reflect the impact of the COVID-19 virus, trended downward over the quarter but ticked up slightly at quarter-end. The Trepp 30+-day delinquency rate rose 3 basis points to 2.07% in March. Trepp noted that this was "a rare break" from the downward trend of the last three years and with most loans having payments due on the first of the month, this was before the market gained clarity on the magnitude of the COVID-19 virus' potential impact on the US economy. Trepp speculated that upcoming COVID-19-related delinquencies might represent a new inflection point for delinquencies and that the February post-crisis low of 2.04% might persist for some time to come. We share Trepp's outlook and anticipate that CMBS delinquencies will shoot much higher over the coming months with lodging and retail properties showing the greatest deterioration.

Market gauges of commercial real estate prices have also yet to capture the effect of the COVID-19 virus with the March's release of the RCA Commercial Property Price Index (RCA CPPI) National All-Property Composite Index reflecting February data. At that point, the index stood at 141.2, a record high, and up 6.7% year-over-year. We anticipate that commercial property prices will suffer significant price declines in the near term as the economic impact of the COVID-19 outbreak becomes fully reflected in the market. As we noted above, we believe retail and lodging properties will be particularly hard hit.

We generally maintained or modestly reduced our CMBS exposure across portfolios over the first quarter. We added slightly to some of our agency CMBS holdings as we sought to continue our shift to a more defensive posture. Going forward we do not anticipate materially increasing our CMBS exposure across most portfolios. At the present time,we generally prefer short-tenor non-agency conduit tranches over agency alternatives. In our view, the Fed's agency CMBS purchase program has pushed the spread advantage of non-agencies to levels that more than compensate for their worse liquidity. Three-year conduit tranches now stand at a spread of 190 basis points over Treasuries and three-year Freddie Mac "K-bond" tranches at a spread of 90 basis points over Treasuries. The 100-basis point spread differential stands in sharp contrast to the low single digit to high 20's basis point range we have seen over the last few years. Despite the spread divergence, we remain selective and would avoid adding conduit tranches with high levels of exposure to retail or lodging properties. In the current environment, we are reluctant to materially increase our SASB exposure other than in very well-diversified "single-borrower" pools that offer the benefits of geographic diversification relative to "single-asset" alternatives. We prefer the industrial and healthcare subsectors as we feel they will be less directly challenged by the COVID-19 virus than properties in the lodging and retail subsectors.

Performance Attribution: Negative

With benchmark spreads significantly wider across the board, our CMBS positions generated negative performance after adjusting for duration and yield curve exposure. All subsectors were negative with our agency CMBS positions representing the best performers. We attribute the relative outperformance of our agency positions to the Fed's purchase activities limiting benchmark spread widening in that sector relative to non-agencies. Our floating-rate SASB positions were generally our weakest performers.

RMBS

Residential mortgage-backed securities dramatically underperformed like-duration Treasuries in the first quarter due to the impact of the COVID-19 virus on the financial markets. In March, as both world leaders and common citizens began to recognize the full extent of the challenges of battling the virus, financial markets seized up and bond spreads blew out to levels not seen since the global financial crisis. Mortgages were not immune with forced sales from deleveraging REITs and asset managers buffeting the sector. In response, the Federal Reserve directed the New York Fed to begin an "unlimited" QE4 program, including the purchase of agency MBS. In addition to these open market operations, the Fed also expanded access to the discount window, broadened central bank swap lines and enacted (or re-enacted) a broad variety of emergency programs designed to stabilize the markets. The FHFA also directed Fannie Mae and Freddie Mac to roll out streamlined mortgage payment deferral plans to help borrowers experiencing job losses while the Trump administration and Congress negotiated the passage of the $2 trillion CARES Act rescue and stimulus bill. We estimate that the Fed purchased over $250 billion of agency MBS by the end of the month of March, which served to stabilize the mortgage markets, albeit at much wider spreads relative to the start of the quarter.

Bonds backed by 15-year and 30-year collateral ended the quarter at spreads of 193 basis points over five-year Treasuries (133 basis points wider) and 131 basis points over ten-year Treasuries (55 basis points wider), respectively. The dramatic underperformance of 15-year tranches relative to 30-year tranches saw higher current coupon yields on 15-year collateral (2.31%) than on 30-year collateral (2.00%) at the end of the quarter. In our view, this anomaly reflects the efforts of the Fed to support the mortgage market through large purchases of generic 30-year collateral. Short-tenor non-agency spreads also moved wider in March with prime jumbo front cashflow tranches ending the quarter at a spread of 333 basis points over Treasuries, 207 basis points wider since the start of the year.

In our view, before the coronavirus, home prices and housing sales metrics were supported by a strong jobs market, historically low interest rates, limited inventories and the start of the Spring buying season. With housing market data not yet reflecting the wind down of the economy related to the virus, the data points that follow will no doubt turn substantially weaker in our view. The latest release of the S&P CoreLogic Case-Shiller 20-City Home Price Index showed that year-over-year home price gains in the twenty cities tracked by the index rose for the fifth consecutive month through January to 3.1%, but below economist predictions of a 3.2% increase. On a national level, Case-Shiller showed housing prices increasing 3.9% year-over-year in January, the highest growth rate seen in a year, and up from a 3.7% growth rate in December. Home sales numbers were also strong with February existing home sales coming in at the fastest pace in 13 years at a 5.77 million annual rate, well ahead of estimates of a 5.51 million pace. New home sales were also close to a 13-year high, coming in at a 765,000-annualized pace, also ahead of the consensus estimate of 750,000. Notably, however, the March release of the National Association of Home Builders sentiment index showed the emergence of the negative impact of the coronavirus, slipping to 72 from 74 in February and below analyst predictions although still near a two-decade high. As noted above, mortgage rates have failed to follow the rally in Treasury rates, although they still remain at historically low levels. The Freddie Mac 30-year commitment rate fell 39 basis points to end the quarter at 3.33%, only slightly higher than the 3.29% level seen in early March, which was the lowest level seen in the gauge's almost 50-year history. With the Federal Reserve Treasury purchases pushing nominal interest rates to record lows, primary-secondary mortgage spreads expanded 48 basis points over the quarter as originators struggled with capacity constraints and neglected to pass the benefit of lower Treasury rates through to borrowers.

Over the course of the quarter we generally maintained or increased our RMBS exposure across portfolios. We added exposure predominantly in the agency sector in both seasoned specified pools and seasoned short tenor "PAC" and sequential CMOs. We sold the remaining balances of our hybrid-ARM positions and various floating-rate and low duration holdings as we looked to extend duration via purchases of both RMBS and other spread products. In notable trades, early in the quarter we added to our holdings in a security issued and guaranteed by the National Credit Union Administration which, as an agency of the United States, is backed by the full faith and credit of the U.S. government. In February, we purchased a collateralized Fannie Mae sequential CMO and we sold some seasoned agency pools to raise needed liquidity in a few client portfolios.

Going forward, with the economy facing the challenges of the COVID-19 virus, we believe that our defensive posture remains prudent. We do not anticipate materially increasing portfolio exposure to RMBS outside of isolated opportunistic purchases of agency pools and CMO tranches at wide spreads. With challenges on the horizon from heightened unemployment levels, mortgage payment forbearance actions and the unknown consequences of "social distancing", we like the proven liquidity profile of our agency RMBS positions.

Performance Attribution: Negative

After accounting for duration and yield curve exposure, our RMBS positions showed negative performance for the quarter as wider benchmark spreads punished the sector. Our agency pools and CMO holdings were generally our best performers and our non-agency holdings the worst performers.

Municipals

Municipal issuance slowed considerably in March, bringing the first-quarter total to $89 billion. While this number is still higher than the $79 billion issued in first-quarter 2019, the slowdown in issuance is highlighted by March's $18 billion, compared to the $40 billion issued in February. First-quarter taxable issuance closed out the month at $23 billion, but again, the issuance in March on the taxable side was much lower than either January or February. Demand for municipal bonds was strong in the first quarter until the second week of March, as municipal bond mutual funds began the year with over $29 billion of inflows but ended the quarter with over $30 billion in outflows. Both taxable and tax-exempt municipal bonds underperformed U.S. Treasuries across the maturity spectrum over the quarter, according to the ICE BofA indices, as spreads widened because fund managers were forced to sell into a challenging market to raise cash to meet outflows.

The volatility and uncertainty in the markets due to concerns about COVID-19 also found their way into the Municipal sector by quarter end. Spreads widened mid-March when fund managers were compelled to sell, and broker-dealers were reluctant or unable to support the markets with their balance sheets. Importantly, up to this point, any spread widening has been mainly due to technicals in the market. While we expect some of the municipal subsectors will be affected more negatively than others, the spread widening in March was not a direct result of credit deterioration across all issuers. The effects of the virus are expected to be mixed for tax-backed municipal bonds. Sales tax and payroll taxes tend to be the first tax revenues to be negatively affected during economic downturns, whereas property tax revenues tend to be more stable, with any revenue declines occurring later in the cycle. Many tax-backed issues are structured in a way that provides ample debt service coverage, allowing them to continue receiving timely debt service payments in the event of lower tax collections.

The transportation subsector has seen the brunt of the initial effects of COVID-19, as passenger flights have been cut drastically, events have been cancelled, and people have been encouraged, if not ordered, to shelter-in-place. By the end of March, TSA throughput volume at U.S. airports was down over 90% from the same period a year earlier. We expect air travel to be as much of a part of our society after the coronavirus pandemic is over as it was prior, but the revenue lost during the weeks or months of shutdown cannot be made up once the pandemic is over, and fixed costs represent a significant portion of airport expenses. Thankfully, generally airports operate with strong balance sheets and tend to average over 500 days' cash on hand. Additionally, the CARES Act provides $10 billion for airports, $7.4 billion of which can be used for any legal purposes including debt service. Toll roads are also negatively affected by a decrease in travel, but not all toll roads will be hurt equally. We favor large, established toll roads located on routes without good, non-toll alternatives, absent a prolonged, enforceable domestic ban on road travel. We are more cautious on managed lanes, toll roads located in areas where there are decent, non-toll alternative routes, and new toll roads that have not operated through various economic cycles. Most toll road systems have the flexibility to raise rates to cover expenses and debt service. Bondholders are further protected with internal liquidity, debt service reserves, and the ability to tap other pools of money to cover expenses during times of revenue decreases. We believe the transportation subsector is positioned to weather the pandemic and have taken the opportunity to add to our exposure to select names as spreads have widened.

On the front lines of this pandemic response are the brave men and women working in our healthcare system. Hospital metrics had been strong going into this crisis, but we expect to see financial pressures as the portfolio of services offered at hospitals shifts from high-margin commercial pay elective surgeries to delayed pay or Medicare-paid COVID-19 treatments, which could lead to lower operating cash flow for 2020 by 80% or more depending on the system. We believe our holdings are typically well capitalized with margins that range from mid-single digits to low double digit. A 500-basis point cut to margins would result in deferred capital expenditures and modest net operating cash flow usage, but many systems have hundreds of days cash and can sustain operations over the coming months. The recently passed CARES Act provides $100 billion in grant aid to the healthcare sector to help hospitals pay for uninsured COVID-19 patient care and some of the extraordinary costs of treating patients that might otherwise not be reimbursed. In addition, the Centers for Medicare & Medicaid Services increased the rate of Medicare reimbursement for treating COVID-19 patients by 20%, providing additional support to hospitals.

Institutions of higher education were some of the first organizations to adapt to our current social-distancing policies by sending students home and conducting classes online. While certain housing, food and other auxiliary student-generated revenues will take a hit, colleges can continue to charge tuition while they instruct online, as many colleges had already been taking steps to accommodate more online learning. To the extent that these shelter-in-place policies carry into the Fall, we could see financial pressure for some of the more poorly capitalized schools. We continue to favor selective, well-capitalized higher education issuers that we feel are better positioned to withstand this pandemic and emerge stronger on the other side.

We believe the utility subsector will likely feel the least amount of stress during and after the pandemic, as residential customers need to use electricity, water and sewer services whether they are working from home or in the office. As some non-essential manufacturing and industrial customers cease operations, we would expect a decrease in electricity use, but most issuers are able to adjust their output to meet demand. We continue to look to add to our utility exposure as preferred names widen in sympathy with the rest of the market.

We were active in the first quarter in both the primary and the secondary markets, both before and during the emergence of the COVID-19 pandemic. Many of the fixed-rate bonds we bought in January and February were in the higher education subsector, where we favor top-tier schools with selective admissions criteria and stronger financial profiles. We also bought bonds in the transportation and healthcare sectors. After markets became dislocated in mid-March and dealers were reluctant to use their balance sheets to provide liquidity, we were able to take advantage of the spike in Variable Rate Demand Note (VRDN) levels by adding to exposure after dealers reset their rates in excess of 5% on average. Not only do the interest rates on these VRDNs reset weekly, but also the holder has a put option whereby the notes can be tendered at par plus accrued interest in five business days. These pricing/liquidity dislocations may not last very long, but the depth and experience of our municipal team continues to allow us to react quickly when yields became attractive and bonds are available.

Overall, we will continue to look to add to our taxable municipal holdings but now more than ever, selectivity is the name of the game. We prefer higher rated essential service revenue bonds as well as certain transportation, higher education and healthcare bonds from issuers we feel possess the financial strength to weather the current storm.

Performance Attribution: Negative

Performance of our municipal holdings over the first quarter ranged from neutral to negative. On an excess return basis, almost all subsectors performed poorly as spreads widened. However, in some of our shorter duration strategies, our exposure to VRDNs performed well and bolstered sector performance.

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