SECOND QUARTER 2020
SGIA
FIXED INCOME COMMENTARY

A Watched Pot Never Boils

By Lorenzo Newsome, Jr., CFA, FRM, PRM
Chief Investment Officer

Click below to jump to your area of interest.

Fixed Income Commentary
Review & Outlook

Smith Graham
INVESTMENT ADVISORS

The main challenge that plagues investors, central governments and citizens today is having an excessive short-term focus. The situation we find ourselves in today is unparalleled in terms of the speed of recent asset price declines, the subsequent rapid rebound after government credit and job market monetary and fiscal support, and the expected forecast and impact of possible corporate defaults. The situation is brought on by increased leverage. Revenues are slashed because of the economic impact of the COVID-19 health crisis. These dynamics make the future extremely difficult to predict.

My proverbial newsletter title is a poetic way of saying that time seems to slow down when one is waiting impatiently for something to happen. The Federal Reserve and the U.S. Treasury have put together an alphabet soup list of programs and facilities in response to the economic threat of the coronavirus pandemic on the U.S. economy. The Fed's good intentions to restore investment market functionality could be encouraging bad behavior.

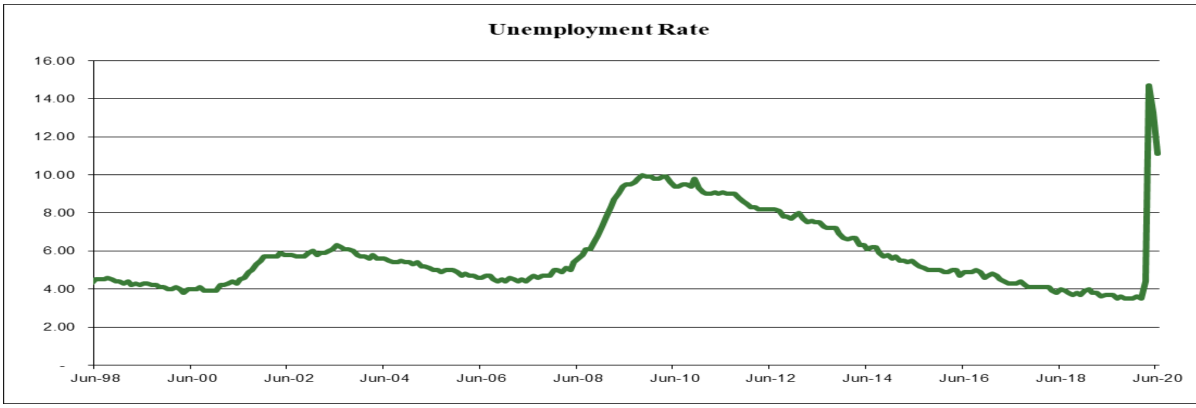
Given the widely used inflation targets the persistence of unconventional monetary policies is technically possible. Monetary policy crisis management based on tremendous expansionary monetary policy has, due to Goodhart's Law, no or a negative impact on consumer price inflation. Goodhart's Law states that when a measure becomes a target, it ceases to be a good measure. For example, the $200 billion worth of emergency facilities used to purchase various fixed income asset classes and provide loans increases financial leverage and amplifies the problem-as well as increases the risk. We may have a difficult time escaping the current debt trap as corporations and investors attempt to game the system.

"There is a psychological interplay between certainty, risk and expectations."

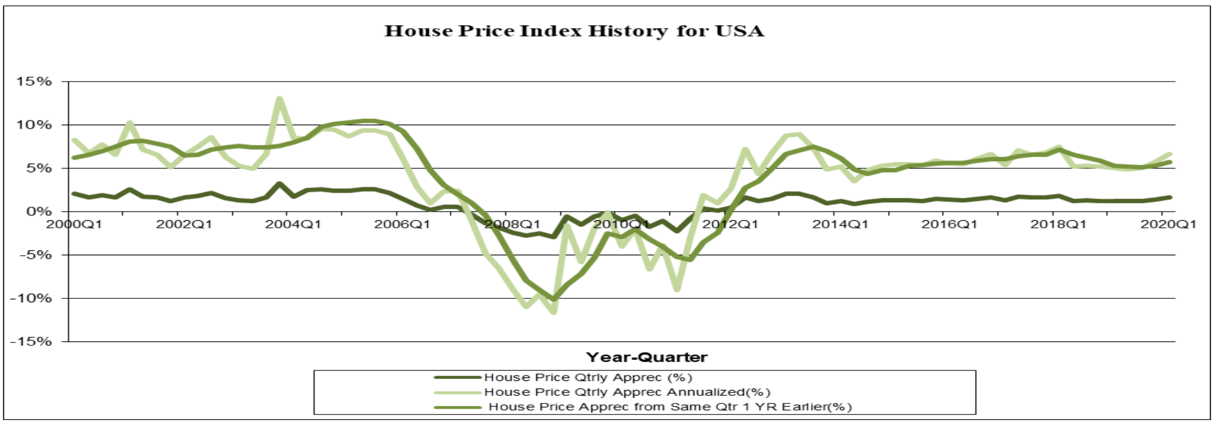
Not enough time has elapsed to see the actual economic impact of the Fed's emergency measures. Near-term investor confidence is not the most important measure of success for the Fed at this stage of the recovery. Stay in the kitchen, but don't continuously watch the pot. The bond market has stabilized, but investors have been very aggressively adding credit spread to portfolios. There is a psychological interplay between certainty, risk and expectations. Perhaps government policy caused false certainty and lowered asset price discovery. This leads to the misreading of risk, causing unrealistic expectations because of the Fed's "guarantee" backstop.

The COVID-19 crisis is moving at a slower pace and is extending longer than we would like. The pandemic will last longer than many investors think, and the economic damage will be deeper and potentially longer lasting than originally projected. We should not concern ourselves with a V, W, or U-shaped recovery. The financial markets now need a Crock Pot recovery to simmer these programs at a lower temperature than other cooking methods. The Instant Pot pressure cooker programs that the Fed has currently implemented may have overcooked the recovery.

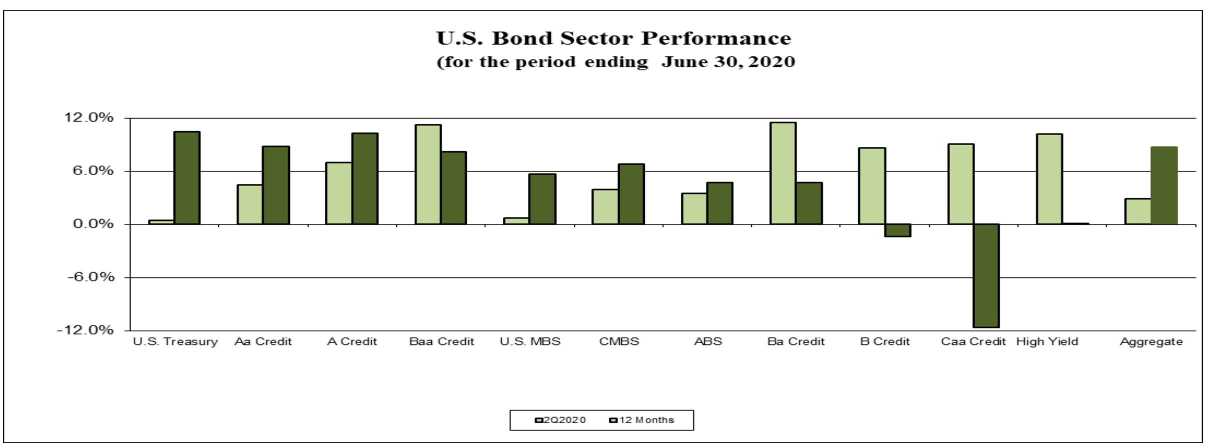
Please see "Boils" on page 4



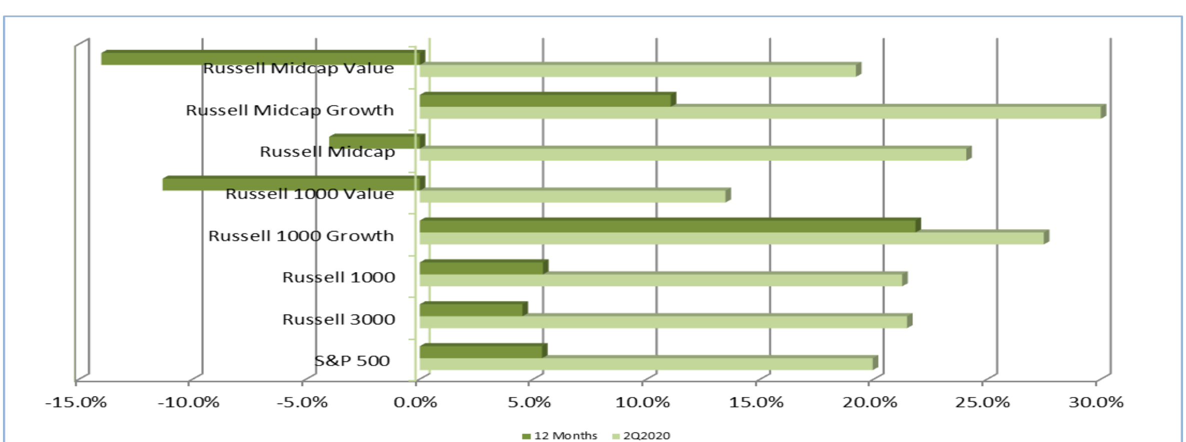
Source: Bureau of Labor Statistics



Source: FHFA



Source: Bloomberg Barclays Indices



Source: Bloomberg

REVIEW AND OUTLOOK

Given the massive sell-off in March and subsequent rally through June, the fixed income and equity markets have diverged in their view of the health of the U.S. economy. Technology, healthcare, and communications have been the drivers of leadership of the economy recently, not just the stock market. Looking forward, with expanding telecommuting and the increased focus on healthcare, technology could become an even bigger driver in the U.S. recovery.

The S&P 500 is up more than 18% for 2Q2020 and more than 37% from the lows of March 23rd. Investment grade credit OAS ended the quarter at 145 bps. OAS are only back about 70% of the low spread levels of the first two months of the year even with the help of the Fed's liquidity facilities. The bond market is being more cautious about this recovery than the top-heavy equity market.

All major domestic fixed income indices posted positive return numbers for 2Q2020, riding the risk on wave of liquidity injected by the Fed. The U.S. Aggregate index increased 2.90% during the quarter and is up 6.14% over the last 12 months. High yield and investment-grade debt produced decisive returns during the second quarter, according to Barclays Capital indices. The total returns from corporate high yield were 10.18% for the quarter. Investment-grade corporate debt produced total returns of 8.98%. High yield debt is rated below Baa3 by Moody's Investors Service and lower than BBB- by S&P.

The 2-year Treasury yield declined 10 basis points while the 10-year Treasury yield dropped 1 basis points during the quarter to yield 0.15% and 0.66% for the period, respectively. Corporates and Commercial Mortgage-Backed Securities were the best performing sectors within the U.S. Aggregate index. These two sectors returned 8.98% and 3.95%, respectively, for the quarter. Baa bonds were the best-performing investment-grade credit quality during the second quarter, posting a 11.23% gain. Energy, Consumer Cyclical and Basic Industry were the best performing industries within the high yield corporate sector.

The Bloomberg News monthly forecast of bond yields – which includes input from nearly 60 economists – forecasts that U.S. Treasury 10-year yields will increase to 0.80% in 3Q2020 and then rise to 0.90% in 4Q2020. All the yields are greater than the forecasted yields of the May survey.

More recently, longer Treasury yields have started to drift higher again, as optimism returned, but expectation at the short end of the curve is still that low rates are here to stay for a while. Fed support, wide spreads relative to yields, strong technical and expected supply should be much lower during the second half of 2020. The situation we find ourselves in today is unprecedented in terms of the speed of recent asset price declines, subsequent rapid rebound after government credit and job market supports. These flash cooking dynamics makes the future extremely difficult to predict.

"These flash cooking dynamics makes the future extremely difficult to predict."

I think that Fed Chairman Powell sums up the current condition and forecast very well with this part of his testimony he delivered, June 30th in an appearance before the House Financial Services Committee. Powell says "The path forward for the economy is extraordinarily uncertain and will depend in large part on our success in containing the virus. A full recovery is unlikely until people are confident that it is safe to reengage in a broad range of activities."

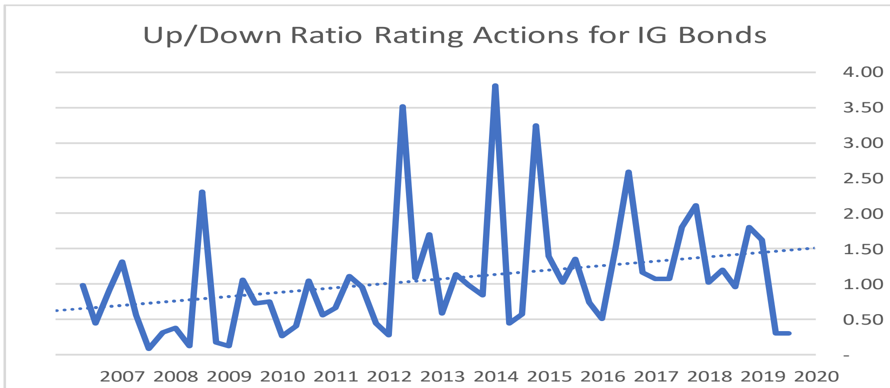
We will continue to manage portfolios that tend to exhibit less volatility than their relative index and strive to deliver attractive risk-adjusted returns. Our portfolios are designed to perform over a full market cycle with a focus on downside risk, a style we believe will succeed in the long term. We will focus on the trends and ranges, but always stay true to our investment principles.

"Boils" from page 1

The Moody's rating agency upgrade/downgrade ratio are believed to be able to analyze performance trends and length of historical ratings change cycles. Since the beginning of 2020, U.S. investment grade credits have seen 198 changes in ratings from Moody's rating agency. Out of that 198, 168 were downgrades. Rating agencies do not like corporations' poor balance sheet debt eating habits.

Chart 1 displays the rating action up/down ratio by quarter for the last fourteen years. The ratio is 0.18 for the first half of the year, substantially below the trend line. This highlights the negative trajectory of corporate issuers' credit metrics. The plummet of the up/down ratio is a result of the economic damage from the pandemic. I believe this trend is not likely to end soon.

Chart 1

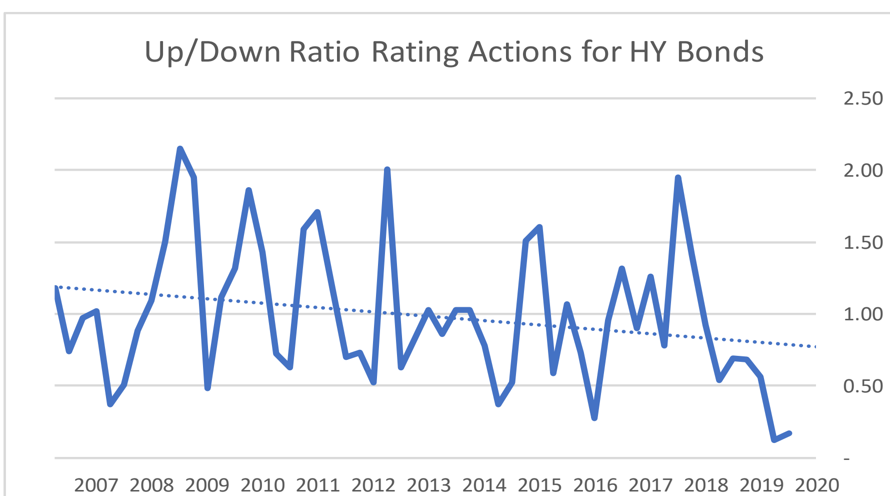


Source: Bloomberg Barclays Indices and SGIA

"The plummet of the up/down ratio is a result of the economic damage from the pandemic."

Chart 2 shows a high yield bond rating up/down ratio of 0.10 for the first half of the year. There were 84 high yield upgrades to 829 downgrades for the year. The changes in ratings of the two bond asset classes illustrate very different behaviors in the long-term, but similar behaviors in the near-term.

Chart 2



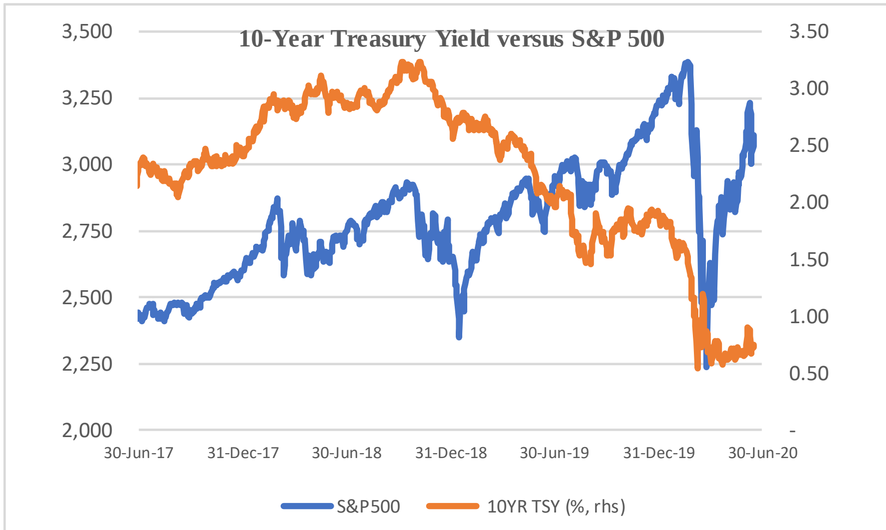
Source: Bloomberg Barclays Indices and SGIA

SGIA

We know that investors want to eat now, but a complete rebound in stocks in just over 2 months is surprising to us. The S&P 500 is at ~3100 and Bloomberg Barclays U.S. Credit Index is only 50 bps off year-end 2019 levels. I think we have been too conservative focusing on fundamentals instead of the extreme liquidity that the Fed has injected into the financial markets.

We are still in a stimulus driven market, rather than one guided by fundamentals. Let's look at some marketplace thermometers to gauge how our economic sustenance is coming along. Chart 3 shows that the relationship between these two series has changed over the last three years, with major divergence since March 2020.

Chart 3



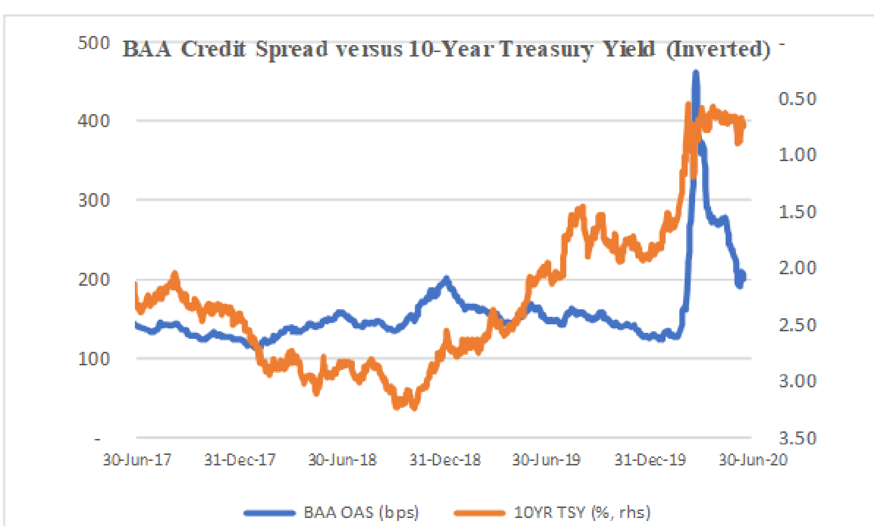
Source: Bloomberg and SGIA

"We are still in a stimulus driven market, rather than one guided by fundamentals."

Since late March, U.S. Treasury yields have moved mostly sideways, and increased only recently to around 0.90%, following a surprise rise in non-farm payrolls announced in the week ending June 5th. This indicates that bond investors seem considerably more cautious than their equity colleagues, not fully sharing the latter's optimism on a swift economic recovery once the pandemic is over.

Chart 4 examines daily BAA corporate bond index data from Bloomberg. It which covers the period from June 2017 to June 2020. The chart shows that interest rates and credit spreads are co-integrated and that the relation is negative.

Chart 4

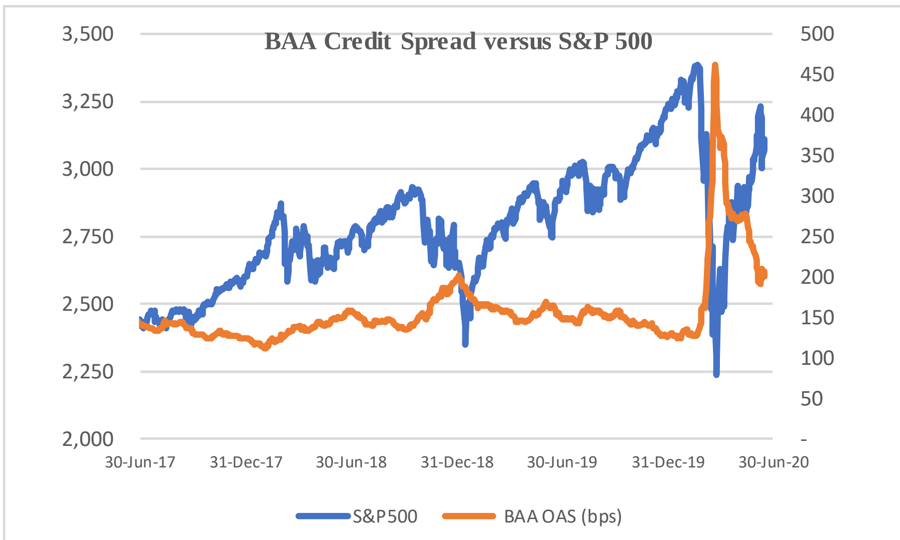


Source: Bloomberg Barclays Indices, Bloomberg and SGIA

Chart 5 shows the Bloomberg Barclays U.S. Credit Index overlaid against the S&P 500, plotted against the left-hand scale. We see how closely the two have moved together. It is worth noting, however, that this does not necessarily imply causality in either direction but could mean that both are driven by the reassurance of liquidity by the Fed. This relationship has a correlation of -0.96, -0.96 and -0.81 for the past 3-month, 6-month, and 12-month periods, respectively. As you can tell, the relationship between those two indicators intensified during the COVID-19 crisis.

The relationship between corporate-bond spreads and stock prices is one that has been stable and consistent throughout the entire crisis. The value of a company's stock will normally be a function of its projected future earnings. The size of its credit spread - as in the yield premium over a risk-free investment, such as a government bond or a swap - is more an indication of its ability to repay its debt.

Chart 5



Source: Bloomberg Barclays Indices and SGIA

"The relationship between corporate-bond spreads and stock prices is one that has been stable and consistent throughout the entire crisis."

The economy will have to create jobs very quickly or we will need to put more water in the pot (fiscal support). Try not to have a short attention span over the next 18 months. In my opinion, this recovery will take time. I believe this is going to be a Crock Pot economic recovery, not an Instant Pot financial recovery. Remember that a watched pot never boils.

Contact Us

For additional information please contact:

inquiries@smithgraham.com
713-227-1100
www.smithgraham.com

DISCLOSURE STATEMENTS

Additional Disclosure - A copy of Smith Graham & Co. Form ADV Part 2A, which describes our investment advisory services, fees and operations in more detail, is available upon request.

Investment Risk Disclosure - Fixed income securities are subject to the following investment risks:

- **Interest rate risk.** Interest rate risk is the risk that debt securities will decline in value because of changes in market interest rates. Generally, when market interest rates rise, the value of debt securities declines, and vice versa. An account's investment in such securities means that the value of the account will tend to decline in market interest rates rise. The prices of long-term debt obligations generally fluctuate more than prices of short-term debt obligations as interest rates change.
- **Credit risk.** Credit risk refers to an issuer's ability to make payments of principal and interest when they are due. Bond prices typically decline if the issuer's credit quality deteriorates. Lower grade securities may experience high default rates, which could mean that an account may lose some or all of its investments in such securities. If this occurs, the account's value would be adversely affected.
- **Investment grade bond risk.** Investment grade bonds are considered less risky than bonds whose ratings are below investment grade; however, ratings are no guarantee of quality. The credit quality of these bonds can decline which would normally cause the prices of these bonds to decline.
- **Below investment grade bond risk.** These bonds, commonly known as "junk bonds", involve a higher degree of credit risk. In the event of an unanticipated default, an account would experience a reduction in its income, a decline in the market value of the securities so affected and a decline in the account's value. During an economic downturn or period of rising interest rates, highly leveraged and other below investment grade issuers may experience financial stress that could adversely affect their ability to service principal and interest payment obligations, to meet projected business goals and to obtain additional financing. The market prices of below investment grade bonds are generally less sensitive to interest rate changes than higher-rated investments but are more sensitive to adverse economic or political changes or individual developments specific to the issuer. Periods of economic or political uncertainty and change can be expected to result in volatility of prices of these securities. NRSROs consider these bonds to be speculative in nature.
- **Mortgage-backed securities risk.** Mortgage-backed and securities are subject to prepayment risk. When interest rates decline, unscheduled prepayments can be expected to accelerate, and an account would have to reinvest the proceeds of the prepayments at the lower interest rates then available. Unscheduled prepayments would also limit the potential for capital appreciation on mortgage-backed securities. Conversely, when interest rates rise, the values of mortgage-backed securities generally fall. Since rising interest rates typically result in the decreased prepayments, this could lengthen the average lives of such securities, and cause their value to decline more than traditional fixed-income securities.

Performance Disclosure - Past performance is no guarantee of future results. Therefore, no prospective or existing client should assume that the future performance of any specific investment, investment strategy recommended and/or purchased by Smith Graham & Co. will be profitable or equal to corresponding indicated performance levels. Historical performance results do not reflect the deduction of transaction charges, investment advisory fees and/or other expenses, which, if included, would decrease the historical performance results. The collection of fees produces a compounding effect on the total rate of return net of management fees. As an example, the effect of investment management fees on the total value of a client's portfolio assuming (a) quarterly fee assessment, (b) $1,000,000 investment, (c) portfolio return of 8% a year, and (d) 1.00% annual investment advisory fee would be $10,416 in the first year, and cumulative effects of $59,816 over five years and $143,430 over ten years.

Index Comparison - Barclays Capital indices have been used as comparative benchmarks because the goals are to provide fixed income like returns. These indices are some the world's most recognized indices by investors and the investment industry for fixed income markets. These indices, however, are not managed portfolios and are not subject to advisory fees or trading costs. Investors cannot invest directly in these indices. These indices' returns also reflect the reinvestment of interest. Smith Graham & Co.is aware of the benchmark comparison guidelines set forward in the SEC Clover No-Action Letter (1986) and compares clients' performance results to a benchmark or a combination of benchmarks most closely resembling clients' actual portfolio holdings. However, investors should be aware that the referenced benchmark funds may have a different composition, volatility, risk, investment philosophy, holding times, and/or other investment-related factors that may affect the benchmark funds' ultimate performance results. Therefore, an investor's individual results may vary significantly from the benchmark's performance.

Forward Looking Statements

This newsletter may include forward-looking statements. All statements other than statements of historical fact are forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct.

Past Performance

Past performance is not indicative of any specific investment or future results. Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor.

Risk

Investment in securities, including fixed income instruments, involves the risk of loss.