THIRD QUARTER 2020

SGIA

FIXED INCOME COMMENTARY

The Ballot or the Bullet Bond

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Smith Graham
INVESTMENT ADVISORS

“Uncertainty and higher risk can mean higher returns, at least in the active sense.”

The foremost challenge that plagues investors, central governments and citizens today is uncertainty, in my opinion. Uncertainty surrounding the stalled next Washington stimulus program, the erratic U.S. COVID-19 infection curve, social unrest, and a contentious election cycle are the primary factors I believe are driving the current political climate. I don’t think there is a greater threat to U.S. economic competitiveness and social progress than our passive acceptance of a failing political system during this time of health and economic crises.

November 3rd, Election Day is just a few weeks away. There are prospects of a messy election season to add to the uncertainty of the financial markets that are being propped up (actually and impliedly) by the Federal Reserve. Uncertainty and higher risk can mean higher returns, at least in the active sense. But rising volatility in those factors’ money managers hope to help them beat the market must be watched closely.

Who will win the presidential election? I don’t know. Polls can be misleading, inaccurate and are not much use in the economic sphere. They are inadequate financial indicators. But it is a known fact that public policies, endorsed by elected officials, can have a dramatic impact on the U.S. economy. A key measure of this influence is the performance of the equity and bond markets.

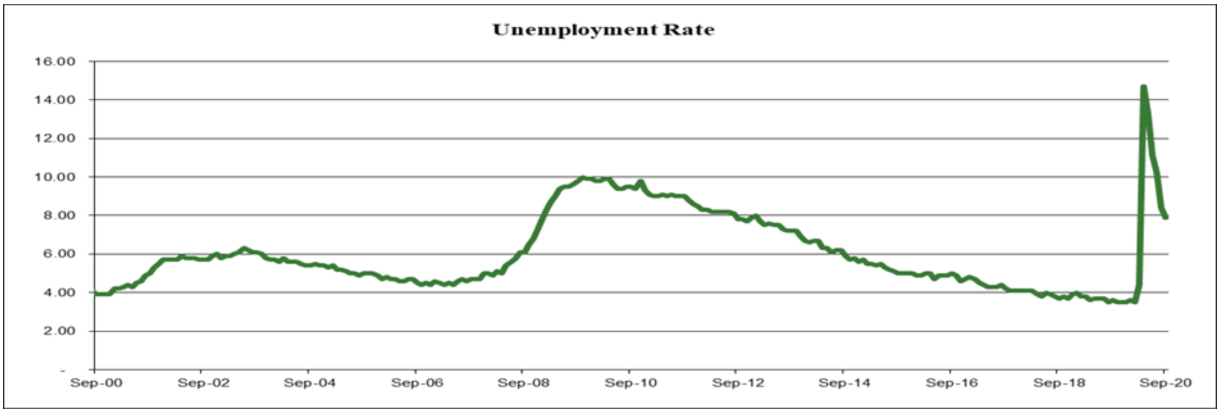
This quarter’s newsletter title is a play off one of the greatest speeches of the 20th century. Researchers at the University of Wisconsin-Madison and Baylor University compiled the list to reflect the opinions of 137 leading scholars of American public addresses. Number seven on the top 100 list is “*The Ballot or the Bullet*" by El-Hajj Malik El-Shabazz.[1]

The financial markets are generating divergent perceptions of the direction and financial health of the U.S. economy. There are several economic drivers, indicators and data that are providing mixed signals. The data become more difficult to interpret because of the market liquidity that is being provided by the Federal Reserve. This makes price discovery difficult for various securities and financial instruments. Our brains are filling in the uncertainties of these data with different prior experiences. We bring our life histories to these small perceptions, whether they are based on elections or the bond market.

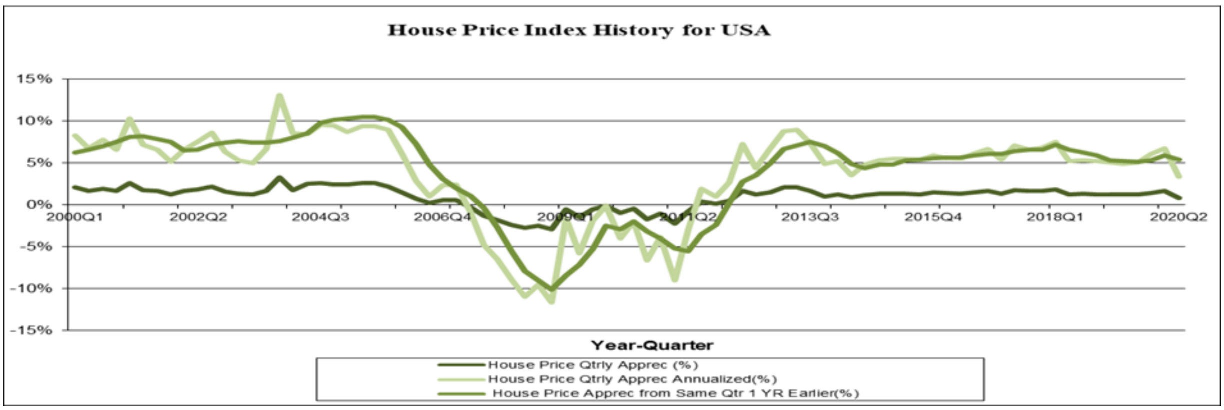
There are forked assumptions and disagreements with respect to national uncertainty about political, economic and health and human rights direction. This uncertainty can be called weapons of mass distractions. There are also forked assumptions and disagreements within the bond market concerning the direction of interest rates and credit spreads. The current economic and political environment provides a substantial amount of ambiguity. We address and objectively analyze the impact presidential elections have on the bond market: The Ballot or the Bullet Bond.

1. https://www.americanrhetoric.com/top100speechesall.html

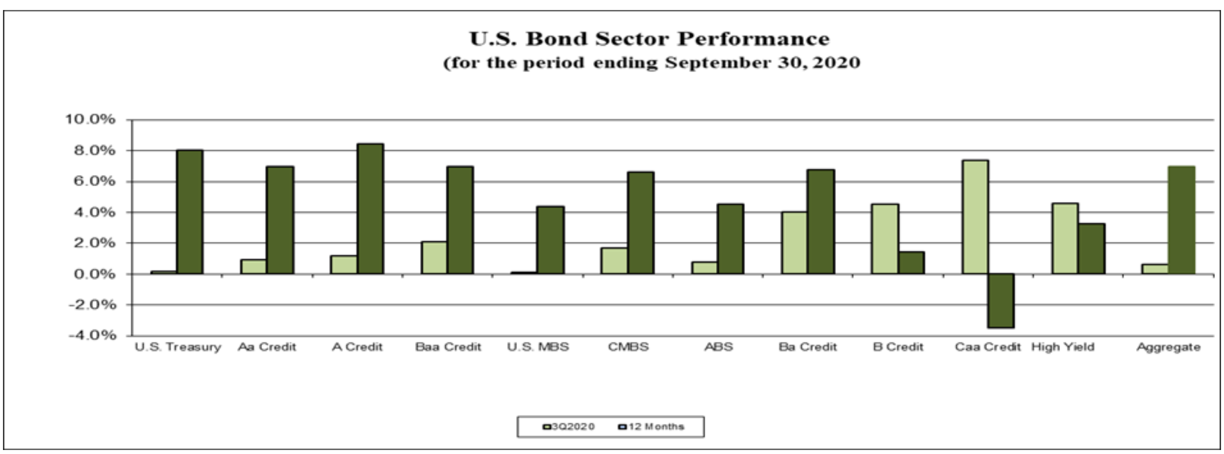
Please see “Uncertainty” on page 4



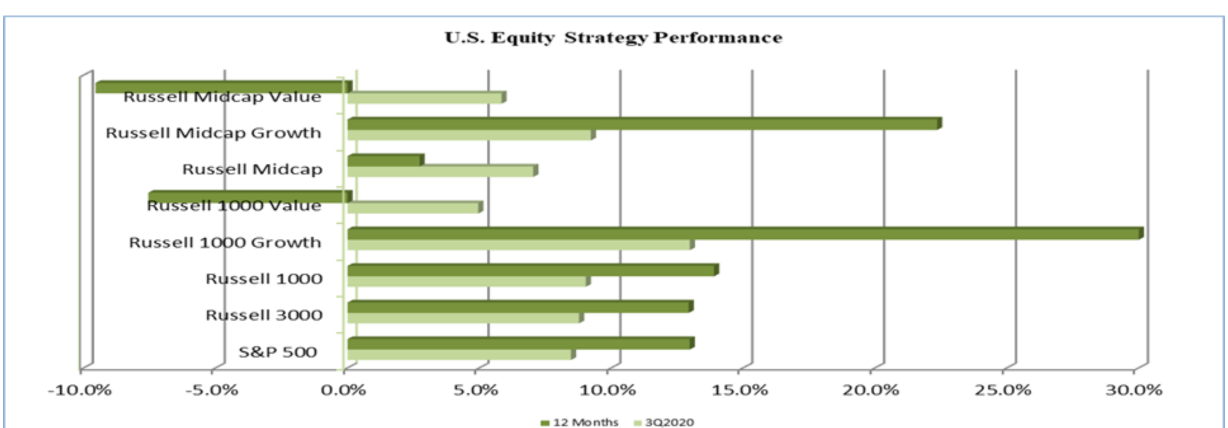
Source: Bureau of Labor Statistics



Source: FHFA



Source: Bloomberg Barclays Indices



Source: Bloomberg

REVIEW AND OUTLOOK

U.S. credit spreads have traded within an amazingly compressed range since the end of the second quarter. The series has operated in a 122-142 bps gamut during the period. The third quarter was downright calm relative to the 1st and 2nd quarter spread moves of -165 bps and 113 bps, respectively. The noteworthy focus in the bond market has been beta compression.

The S&P 500 is up more than 8% for 3Q2020 and more than 50% from the lows of March 23rd. Investment grade credit OAS ended the quarter at 128 bps. OAS are only back about 85% 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 spread tightening has slowed during the quarter as the country moves closer towards the presidential election.

All major domestic fixed income indices posted positive return numbers for 3Q2020, riding the risk-on wave of liquidity injected by the Fed. The U.S. Aggregate index increased 0.62% during the quarter and is up 6.98% over the last 12 months. High yield and investment-grade debt produced decisive returns during the third quarter, according to Barclays Capital indices. The total returns from corporate high yield were 4.60% for the quarter. Investment-grade corporate debt produced total returns of 2.12%. 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 2 basis points while the 10-year Treasury yield increased 3 basis points during the quarter to yield 0.13% and 0.68% for the period, respectively. Commercial Mortgage-Backed Securities and Corporates were the best performing sectors within the U.S. Aggregate index. These two sectors returned 1.71% and 1.54%, respectively, for the quarter. Baa bonds were the best-performing investment-grade credit quality during the third quarter, posting a 2.11% gain. Transportation, Consumer Cyclical and Capital Goods 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 0.75% in 4Q2020 and then rise to 0.85% in 1Q2021. All the yields are greater than the forecasted yields of the August survey.

"The end of the year is usually a challenging season for price risk and 2020 looks like it will not be an exception."

Investors may be overemphasizing the presidential election as a central or enduring principal of the financial market. Volatility in interest rates may stay subdued even if it increases in the equity market. The end of the year is usually a challenging season for price risk and 2020 looks like it will not be an exception. No matter how many businesses are allowed to reopen, typical economic life will not resume until consumers feel they are no longer at risk of contagion.

We still favor investment grade on a risk-adjusted basis considering the Federal Reserve support but are finding that multi-strategy and core plus funds are boosting their high yield allocations to capture yield that is non-existent in most fixed income asset classes. Even though we do not find BBs cheap anymore, we would be surprised if they sold off materially. Issuers are still more concerned with their cash liquidity over their increased balance sheet leverage. Security selection should be a key driver of outperformance with benchmark valuations likely to be in tight range for the remainder of the year.

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.

"Uncertainty" from page 1

Bullet bonds are standard bonds that make periodic interest payments and repayment of the principal amount at maturity of the bond and do not include any exotic features such as embedded call features, principal amortization or put features.

Presidential elections, politics and the political ecosystem can influence investors' portfolio choices, firms' policies, and financial market performance and volatility. Elections and the political environment influence the available information about government programs that have the potential to encourage the financial markets. This evidence can be viewed as signals for looming political policies, which will have implications for investors' and consumer confidence level.

Figure 1 displays the optimism level of the last ten U.S. presidential elections. The calendar year holding period performance after the presidential election years (1981-2017) shows that the equity markets have an aversion to uncertainty more than the bond market. A new president can create more worries: the potential for increased regulations, higher taxes, and other shifts the market perceives as anti-business can all affect mindset. The bond market provides consistent performance regardless of who was in office during the period.

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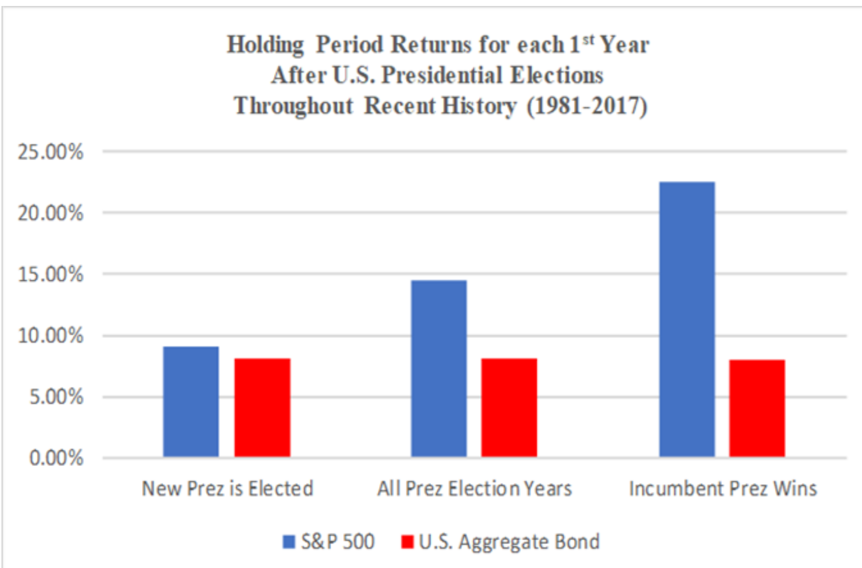
Figure 1



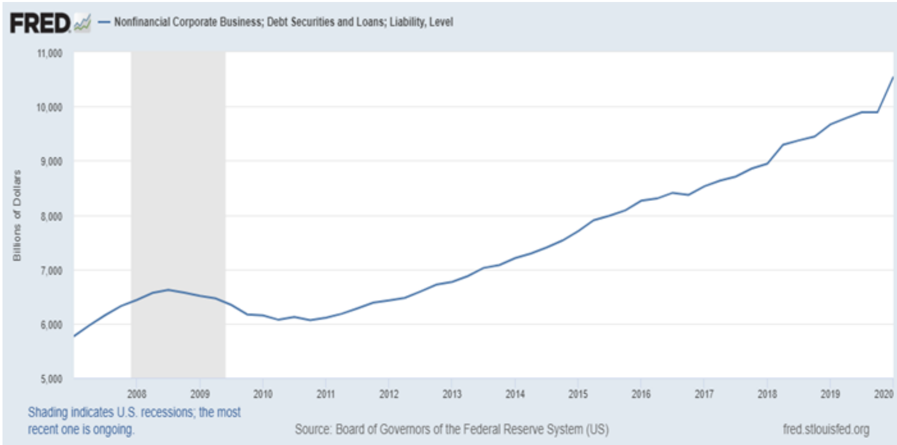
Source: Bloomberg Barclays Indices, Bloomberg and SGIA

Bets are on the expectation that the Federal Reserve, stimulus measures and an economic recovery will support equity and bond prices. Will that be enough to offset concerns linked to the U.S. election and the development of a successful coronavirus vaccine?

The continuing rise in debt levels leaves many corporations even more vulnerable to further economic shocks. This could be a major drag on new capital expenditure and investment while weighing on productivity and growth over the medium term. Calculating risk and risk premiums that are not distorted by the Federal Reserve liquidity efforts are an ever-increasing problem.

Corporate America has doubled the size of the debt on its balance sheet since the Great Recession, as shown in Figure 2. This increase in debt has contributed to increased economic volatility and has left companies in an exposed position to deal with shocks such as the current COVID-19 virus. The longer the economic problems continue, the more likely it is that defaults could begin to pick up, especially in the non-investment grade sector of the bond market.

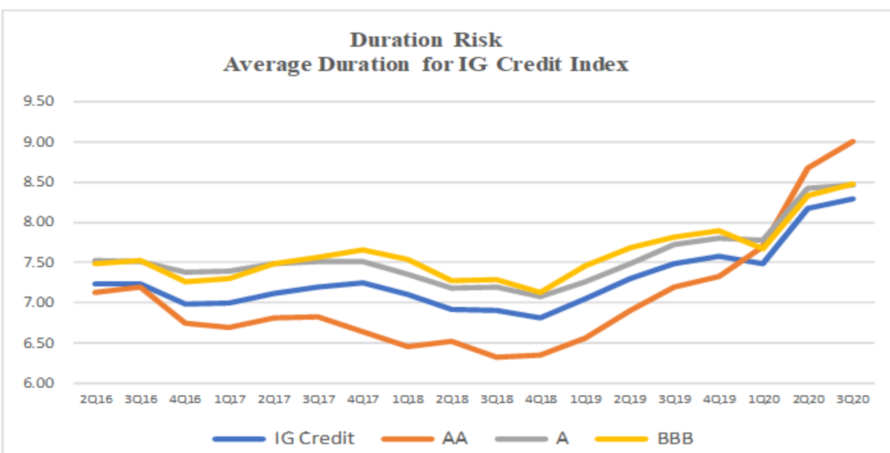
Figure 2 **Nonfinancial Corporate Debt and Loans**



"The risk for investment grade credit qualities has substantially increased because of duration extension."

Figure 3 shows that with lower interest rates, corporate bonds have also extended out on the maturity curve. This extension has increased the duration for investment grade debt. The risk for investment grade credit qualities has substantially increased because of duration extension. Duration is a measure of a bond's sensitivity to interest rate movements. Corporations are tucking away cash to attempt to head off potential cashflow/cash management uncertainties that could come up.

Figure 3



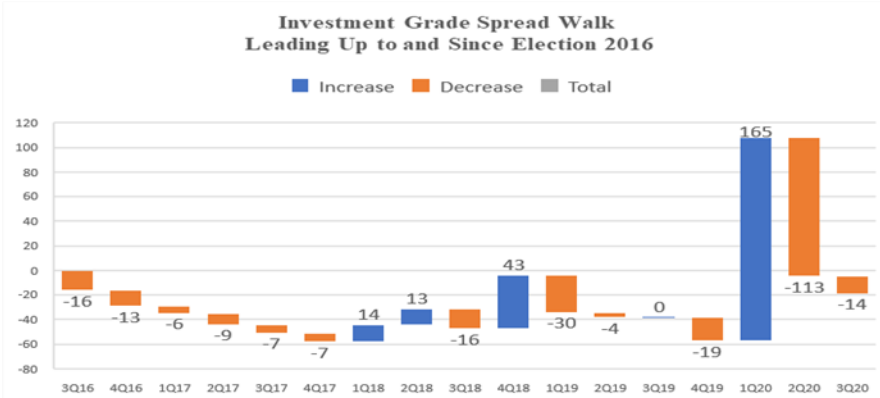
Source: Bloomberg Barclays Indices and SGIA

Additional deterioration of market conditions stemming from rising political uncertainty, elevated trade tensions, or a decline in consumer and market sentiment could have severe economic repercussions on a weakened labor market and depressed capital expenditures. Short-term turmoil around the election is an event that can cause dislocation in the treasury market more than the credit market. As the bond market contrasts the candidates' political agendas and variations around their economic plans, the bond market could become more unsettled.

“…the credit market has managed to be well behaved over the last four years.”

Figure 4 shows the quarterly change in investment grade credit spreads leading up to and since the 2016 election. Outside of market volatility involving the 4Q2018 oil hiccup, the Federal Reserve market miscommunication, and the 2Q2020 market meltdown because of the coronavirus, the credit market has managed to be well behaved over the last four years. Credit spreads are 14 basis points below levels from mid-2016.

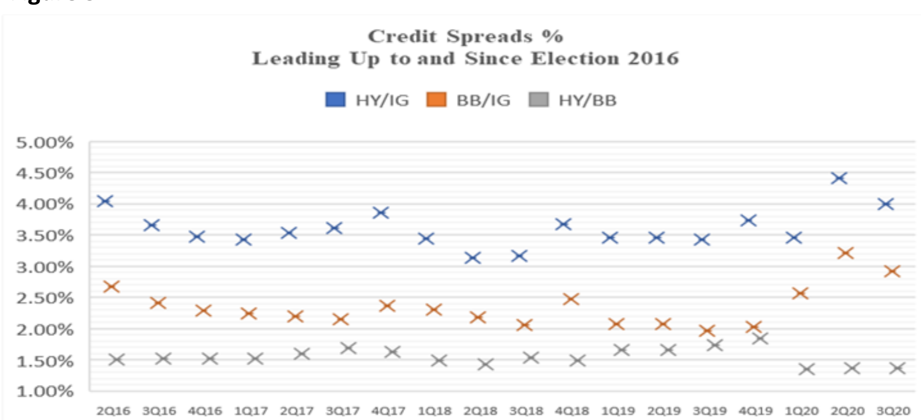
Figure 4



Source: Bloomberg Barclays Indices and SGIA

Figure 5 plots quarterly credit spreads as a percentage of another credit category, leading up to and since the 2016 election. Investment grade credit is currently trading wider relative to high yield and BB credit qualities. Investors reaching for additional yield are going down in credit quality. The HY/BB ratio of 1.32x has compressed below the four-year average of 1.55x. As investors continue to stretch for yield, opportunities are suggested to be more pronounce in the BB credit quality (excluding Energy) as they are substantially wider than their near-term average.

Figure 5



Source: Bloomberg Barclays Indices and SGIA

The speech, The Ballot or the Bullet provides so many useful parallels for the current day and time and the uncertainty surrounding a Biden or Trump presidency. All of us need to use the ballot in November, but the bullet bond is positioned to continue its positive historical performance in times of unpredictability.

“We may have democracy, or we may have wealth concentrated in the hands of a few, but we can't have both.”2 - SCOTUS Justice Louis Brandeis (Brandeis helped write the laws establishing and reforming the Federal Reserve System.)

2. As quoted by Raymond Lonergan in Mr. Justice Brandeis, Great American (1941), p. 42.

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- **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.
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Index Comparison – Bloomberg Barclays Capital indices have been used as comparative benchmarks because the goals are to provide fixed income like returns. These indices are some of 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 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.

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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.

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