FIRST QUARTER 2020
SGIA
FIXED INCOME COMMENTARY

Behind the Mask of Corporate Bonds

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Fixed Income Commentary
Review & Outlook

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With the downgrade of the Kraft Heinz Foods Company (KHC) in February 2020 by Fitch and S&P to below investment grade, investors are becoming concerned about how this and future downgrades will affect the high yield market. KHC was downgraded because of elevated leverage, declining earnings and contracting gross margins driven by higher logistics expenses, labor, and input cost inflation.

KHC was the 59th largest name in the investment grade credit index. KHC will now be the fifth largest high yield name with nearly $29 billion of debt, behind freshly downgraded Ford Motor (F) and Charter Communications (CHTR), Occidental Petroleum (OXY) and Sprint (S). With the downgrades, KHC, F and OXY move below the imaginary line of investment grade and have entered the land of below investment grade.

Issuers will bring several longer-dated bonds to the high yield space that will probably have a difficult time performing well because of limited natural buyers of long duration/maturity fallen angel bonds. This is because a significant number of ETFs are benchmarked to indices that don't include maturities of more than fifteen years. A fallen angel is a company that loses its investment-grade debt ratings due to the declining financial position of its issuer. The bond is downgraded by one or more of the big three rating services (Moody's, S&P and Fitch).

What is behind the mask (or curtain) of the high yield credit market? Is it like the curtain on a plane that separates the coach cabin from first class? To rewrite one of Renee Zellweger's (Dorothy) great lines in the film Jerry Maguire, she tells her son, "First class (investment grade bonds), that's what's wrong. It used to be a better meal (lower yield), now it's a better life (asset class)."

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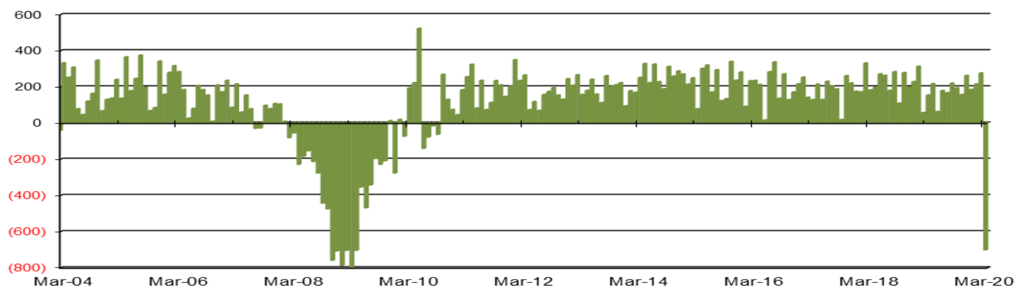
The COVID-19 health crisis has led to a dramatic repricing of credit markets that will take its toll on BBB issuers. The Federal Reserve began purchasing investment grade debt of both primary and secondary market corporate bonds and bond ETFs for businesses (BBB/Baa3 or above). The mid-sized business loan program in the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) should help the high yield market.

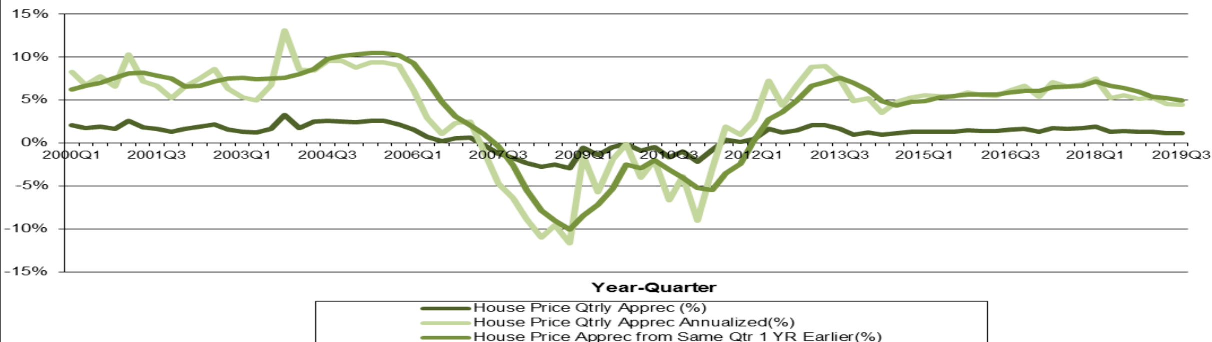
Over the years, airlines have been adding more debt to their balance sheets, squeezing more seats into the back of the plane and removing some extras like free checked bags and meals. Now all their attention is on getting government bailout money courtesy of the U.S. taxpayers. The volatility, lack of liquidity and conflicting information about the health crisis led to an increase in risk velocity. Risk velocity refers to the speed of an occurrence and the speed of an organization to react timely.

Is upside capped for a long time to come in the investment grade and high yield bond markets? We will analyze both asset classes and all credit qualities for opportunities in this time of financial dislocation.

Please see "Mask" on page 4



Source: Bureau of Labor Statistics



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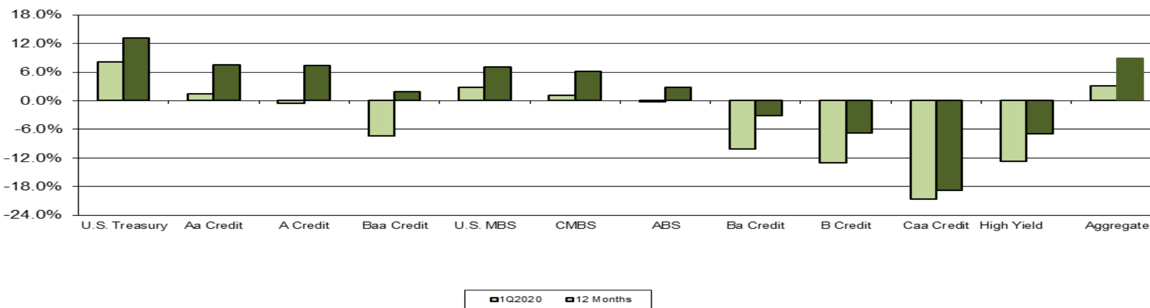
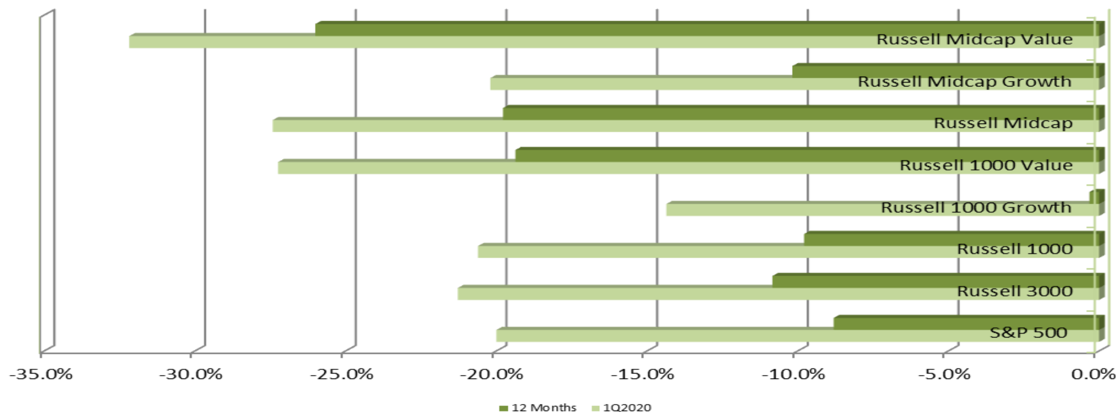


Source: Bloomberg Barclays Indices



Source: Bloomberg

REVIEW AND OUTLOOK

The first quarter can be summarized as follows: January – ordinary, February – interesting and March – bewildering. The Federal Reserve made two emergency interest rates cuts in two weeks, slashing the federal funds rate by 1.50 % to a range of 0.00-0.25%. The Fed is attempting to stay ahead of disruptions and economic slowdown caused by the rapidly spreading coronavirus. It was the largest emergency reduction in the Fed's more than 100-year history.

The Dow and S&P 500 had their worst first-quarter performances ever, losing 23.2% and 20.0%, respectively. The Dow also had its worst overall quarter since 1987 while the S&P 500 had its biggest quarterly loss since 2008. Concerns over the depth of problems presented by the coronavirus and full stock market valuations caused a major sell-off during the last week of the month. Risks are skewed to the downside with a slow and staggering recovery. The quarter closed with the Treasury curve steeping and the Treasury market producing massive returns. U.S. Credit closed out one of the most challenging periods on record, underperforming duration-matched Treasuries by 986 basis points for March and underperforming duration-matched Treasuries by 1272 basis points for the first three months of the year.

Most major domestic fixed income indices posted mixed return numbers for 1Q2020, despite the 125-basis points decrease in yield on the 10-year Treasury. The U.S. Aggregate index increased 3.15% during the quarter and is up 8.93% over the last 12 months. High yield and investment-grade debt produced negative returns during the first quarter, according to Barclays Capital indices. The total returns from corporate high yield were -12.68% for the quarter. Investment-grade corporate debt produced total returns of -3.14%. High yield debt is rated below Baa3 by Moody's Investors Service and lower than BBB- by S&P.

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The 2-year Treasury yield declined 132 basis points while the 10-year Treasury yield dropped 125 basis points during the quarter to yield 0.25% and 0.67% for the period, respectively. Treasury and Mortgage-Backed Securities were the best performing sectors within the U.S. Aggregate index. These two sectors returned 8.20% and 2.82%, respectively, for the quarter. U.S. Corporate bonds decreased -3.63% during the quarter. Aaa bonds were the best-performing investment-grade credit quality during the first quarter, posting a 3.96% gain. Utility, Technology and Consumer Non-Cyclical 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 decrease to 0.83% in 2Q2020 and then rise to 1.05% in 3Q2020. All the yields are less than the forecasted yields of the February survey.

The length of the quarantine required to contain the COVID-19 virus and the ultimate economic damage are the $2.2 trillion questions. Liquidity and price discovery will be at a premium with the Fed purchasing a plethora of security types. This is not your typical crisis or recession. This story should play out a lot differently. Everyone is desperate for liquidity. Some company managements will undergo structural changes to improve their credit positions, i.e., cut dividends, end share buybacks, reduce executive compensation and other expenses. This could play out to be a good environment for bondholders in the long run.

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.

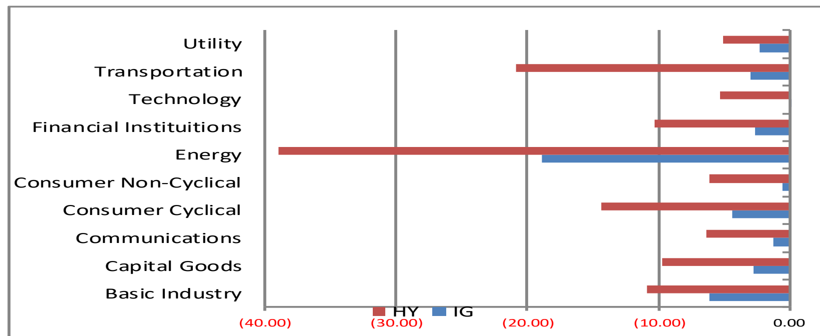
"Mask" from page 1

The COVID-19 virus has done a number on world health and world economics. Coronavirus fears, uncertainty and speculation continue to drive financial markets. Since there is no way to know at this point how widespread the epidemic will be, how long it will last or the magnitude of the economic damage, we are closely watching the economic and financial markets to preserve principal first, then to find opportunities to add value to client portfolios.

March 2020 was the worst sell-off in the investment grade corporate market since the financial crisis of 2008. Chart 1 shows that the worst performing sectors were energy, transportation, consumer cyclical and basic industry. Slowing global growth resulting in low oil demand and oversupply should weigh heavily on energy companies. Transportation demand will be impacted like no other downward spiral in modern history, in our opinion.

Chart 1

3 Month Total Return (as of March 2020)



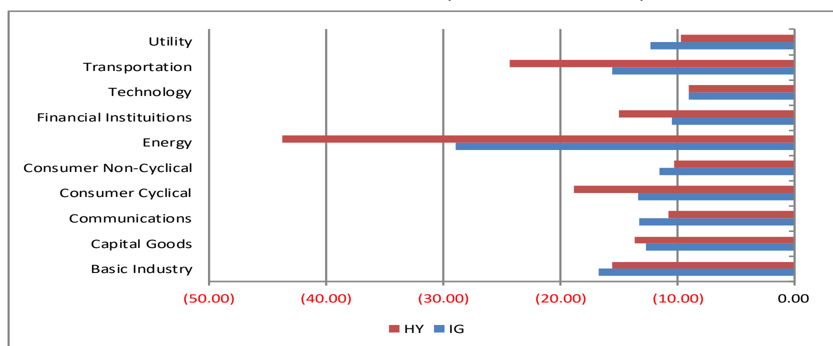
Source: Bloomberg Barclays Indices

"Coronavirus fears, uncertainty and speculation continue to drive financial markets."

Excess return in Chart 2 is identified by subtracting the return of one investment from the total return percentage achieved in the duration-matched treasury bond. Positive excess return shows that an investment outperformed its comparison. A negative difference in returns occurs when an investment underperforms.

Chart 2

3 Month Excess Return (as of March 2020)

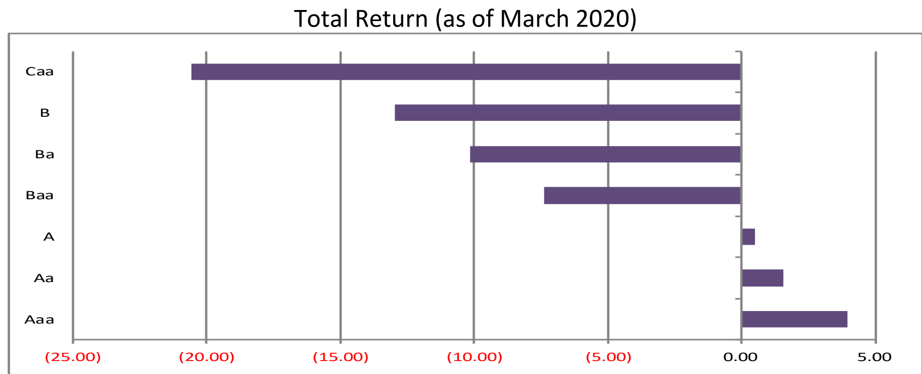


Source: Bloomberg Barclays Indices

Moody's Investors Service lowered its outlook on U.S. corporate debt from stable to negative, saying that a coronavirus recession will result in rising default rates. Government support will cushion the blow for some companies, but it is unlikely to prevent distress to businesses with less certain long-term viability. The situation is especially troubling as non-financial corporate debt totaled $6.6T at the end of 2019, a 78% increase since the Great Recession ended in mid-2009. We think fallen angel volumes will remain elevated as negative ratings action picks up, especially as the full corporate earnings impact has yet to be seen.

The pickup in spread by moving down in quality has generally increased across the curve. That move down in spread took a toll on the credit market in March. Segueing from looking at credit sectors we now will assess credit quality total returns in Chart 3.

Chart 3

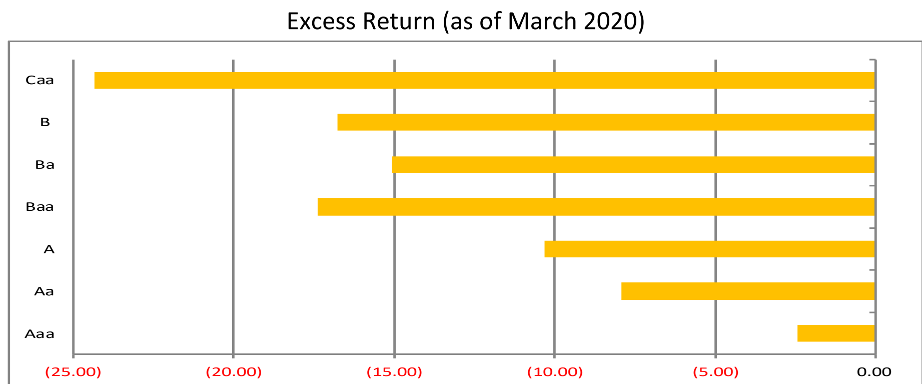


Source: Bloomberg Barclays Indices

While Ba debt has widened more than expected compared with higher-quality credit, the same holds true when compared with lower-rated credits. The shifting rates environment explains only a portion of the Ba widening, with the cohort meaningfully underperforming even when we take rate moves into account. Volatility is likely to remain elevated as investors wrestle with determining the economic effects of the coronavirus.

"Volatility is likely to remain elevated as investors wrestle with determining the economic effects of the coronavirus."

Chart 4



Source: Bloomberg Barclays Indices

The more than expected widening of Ba bonds seems to be overblown. On a relative basis, we view Ba debt as attractive given supportive upside/downside risk. Specifically, a risk-off environment should place greater pressure on lower-rated cohorts of the high yield market while a reversal of the recent sell-off should result in Ba compression relative to Baa.

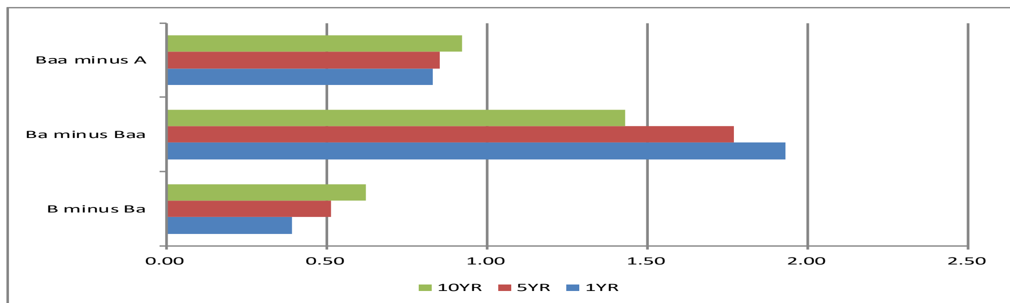
There's room for additional spread compression near-term as large fallen angels are digested in the high yield universe. Option-adjusted spreads (OAS) may still be poised to set new increases for the cycle as economic damage mounts from the coronavirus.

Chart 5 looks at corporate credit OAS numbers to determine if there is value in one credit quality rating versus another. The sample period covers 1Q2011 – 1Q2020, or 41 quarters. The credit qualities that are reviewed are the two lowest investment grade ratings by Moody's, (single-A and Baa) and the two highest credit ratings in the below investment grade category (Ba and single-B).

The current OAS for the credit qualities were subtracted from the one just above it on the credit scale. The difference or excess over historical averages is displayed in the chart. The chart suggests that current single-B yields have rallied through their recent levels. Baa yields have rallied through their 10 ½ year levels to a lesser degree than single-B names. Ba credit quality excess yields seem to provide the best value on a relative basis over the one, five and ten-year periods. We believe there is still upside opportunity in the Ba credit quality.

Chart 5

Corporate OAS - Credit Quality Excess
(Lowest Investment Grade and Highest Non-Investment Grade) (1Q2011 –1Q2020)



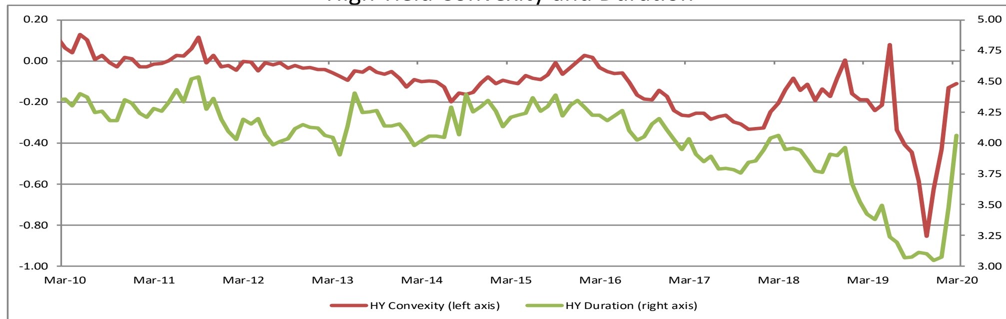
Source: Bloomberg Barclays Indices and SGIA

"Ba credit quality excess yields seem to provide the best value on a relative basis over the one, five and ten-year periods."

Over the past two decades, average durations have been increasing for investment-grade bonds and shortening for speculative-grade bonds. Duration is important because it reflects a bond fund's sensitivity to changes in interest rates. A higher duration reflects greater interest rate sensitivity. A 1% decrease in interest rates typically is consistent with a 1% increase equal to a bond's duration.

Chart 6

High Yield Convexity and Duration



Source: Bloomberg Barclays Indices and SGIA

The current market dislocation presents opportunity in the short duration high yield area. The outlook for high yield is positive over a three to five-year time horizon. Our portfolios may have to "shelter in place" until the landscape is safe enough to remove the mask.

I was struck by a quote after recently rereading parts of Nassim Taleb book, The Black Swan, "As we travel more on this planet, epidemics will be more acute-we will have a germ population dominated by a few numbers, and the successful killer will spread vastly more effectively."[1] The world will soon figure out the impact of the highly improbable.

1. The Black Swan: The Impact of the Highly Improbable, Nassim Taleb, 2007, p. 317.

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- **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.

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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.

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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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