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Fixed Income Strategy

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FOMO or FO-real

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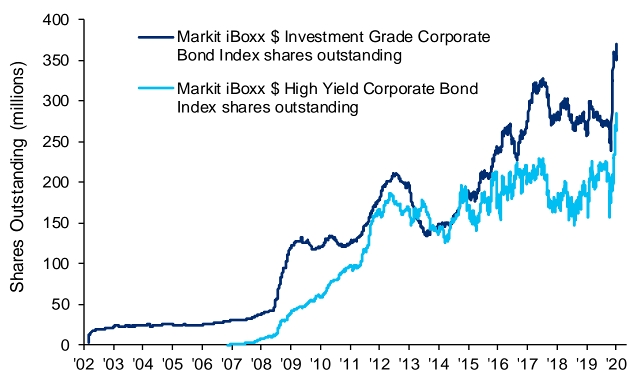
According to data published May 21, the Federal Reserve has now purchased $1.8 billion in corporate bond exchanged traded funds (ETFs). This is a part of the US central banks Secondary Market Corporate Credit Facility (SMCCF), which was put in place to support credit market conditions and corporations struggling from the Covid-19 pandemic. Actual purchases began on May 12.

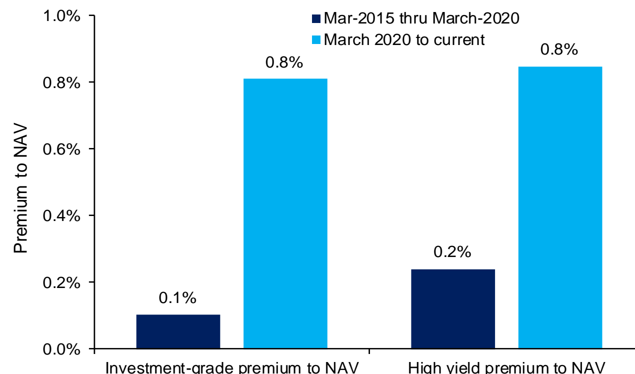
The Fed's weekly balance sheet data doesn't disclose which ETFs they bought. However, in the most heavily traded investment-grade (IG) and high yield (HY) corporate ETFs, shares outstanding have reached historical levels **(Fig. 1)**. Premiums to net asset value (NAV) have also moved meaningfully higher. In the case of IG, the average daily premium to NAV since March 23 is eight times higher than the average premium over the last five years. In HY, the average premium has jumped four times **(Fig. 2).** The central bank has stated their intention to disclose the names of borrowers participating in the program at least once a month.

Figure 1. Shares outstanding have reached record highs



Source: FactSet as of May 27, 2020.

Figure 2. Premiums to NAV have risen with the Fed



Source: Haver Analytics as of May 27, 2020.

Past performance is no guarantee of future results. Real results will vary. Indices are unmanaged. An investor cannot invest directly in an index

The Fed's ETF purchases accomplishes several things:

1) Through the ETF creation process, the Fed essentially becomes an indiscriminate buyer across a broad array of corporate sectors and maturities. Including financials and foreign corporates.
2) Buying ETFs removes the need for some corporates to "self-certify", which is required in order for an issuers individual bonds to be bought by the Fed directly. The potential stigma and/or association to taxpayer funds are reasons issuers could refrain from participating in SMCCF. Especially during the current politically sensitive environment.
3) Though it's likely that individual bond buying will be limited in both the primary and secondary credit facilities, the ETF purchases demonstrates to investors that Fed intensions are real and these policies aren't just for show.
4) As an active buyer of ETFs, the Fed removes some future liquidity concerns that created sharp price declines and wide discounts to net asset value during the March-April sell-off. Similarly, this should add additional liquidity to secondary corporate trading as well.

The Fed effect on performance

Since the Fed announced their support for IG and HY corporate bonds and ETFs, index spreads have tightened meaningfully. Since March 23, the Bloomberg Barclays US IG Corporate Index has narrowed 190bp to 185bp, for a gain of 14.4%. At the same time, the Bloomberg Barclays US HY Corporate Index has narrowed 420bp to 680b, for a 16.7% gain.

INVESTMENT PRODUCTS: NOT FDIC INSURED • NOT CDIC INSURED • NOT GOVERNMENT INSURED • NO BANK GUARANTEE • MAY LOSE VALUE

The Fed effect on yield

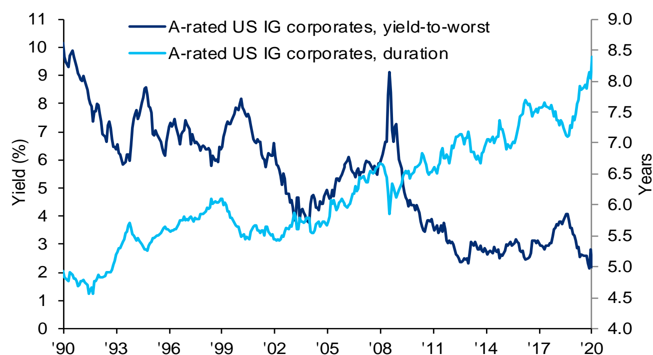
However, to see the full Fed effect, one must look below the top line when analyzing benchmarks. Despite above average spreads, absolute yields on high quality IG corporates have tracked US Treasuries (UST) lower. For example, the 2.0% average yield found on A-rated US corporates is 120bp *lower* over the last 12 months. At the same time, the record amount of longer-dated corporate supply has pushed the average index duration to a historical high of 8.4 **(Fig. 3)**. In other words, US IG benchmark yields are much lower and the inherent interest rate risk has moved significantly higher.

The Fed effect on curves

Credit curves have also shifted over the last several weeks. After briefly reaching its flattest level in over ten years, IG corporate yield curves have followed UST curves steeper. Currently, the yield difference between 2-year and 10-year IG corporates is 120bp, its steepest since November 2017. Moreover, higher quality issuers have steeper yield curves than lower quality IG.

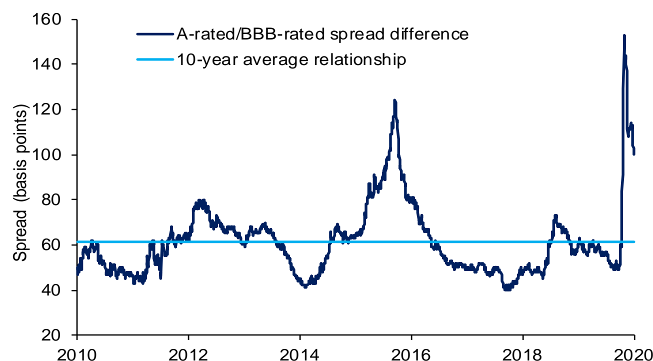
Simultaneously, the rally in risk assets has been more pronounced in shorter-dated bonds, steepening spread curves. Getting a bit more granular, BBB-rated spreads have *not* rallied as much as higher quality corporates. This has left BBB spreads 100bp wider than A-rated bonds, or about 40bp above its 10-year relationship **(Fig. 4)**. Downgrade risks remain prominent in BBBs, though Fed policy to support "fallen angels" should provide some stability in spreads. Altogether, we believe the best risk/reward proposition can be found in 5-year, BBB-rated IG bonds.

Figure 3. IG index duration at an all-time high



Source: Bloomberg Barclays Indices as of May 27, 2020.

Figure 4. BBBs spreads are historically wide to Single-A



Source: Bloomberg Barclays Indices as of May 27, 2020.

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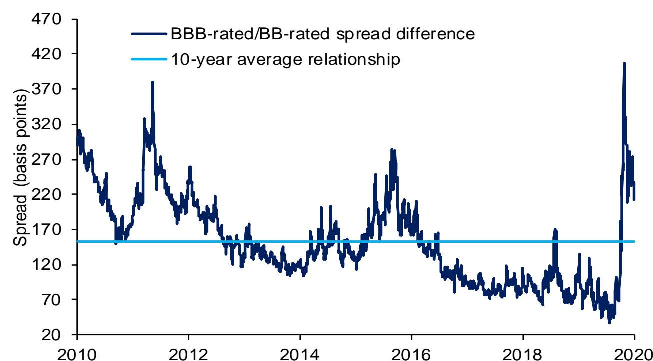
As we argued in the [April Quadrant] and our [May Bond Market Monthly], we preferred a high quality near-term bias, but reflected on the longer-term opportunity in lower quality fixed income assets. In CPB's Global Investment Committee Level 1 (fixed-income only) tactical asset allocation, we express this view with overweight's to both global IG and HY bonds.

Despite the improvement in markets, lingering uncertainties over the economic impact of Covd-19 has left some parts of the market behind. Indeed, valuation outliers become more pronounced as you move lower in credit quality. For example, BB-rated high yield bond yields of 5.4% are 210bp higher than the yields on BBB-rated IG. This is roughly 75bp higher than its long-term average **(Fig. 5)**. In addition, BB-rated HY has about half the duration risk then the BBB-rated index.

The bifurcation of value in high quality/low quality can also be found in the US municipal bond market. Following an extraordinary two-month rally (munis outperformed UST by 700bp since March 23), yield ratios have nearly fully recovered. Today, yields on AAA-rated munis are back down to (or through) historical low levels. 2-year AAA-rated muni yields are a measly 12bp.

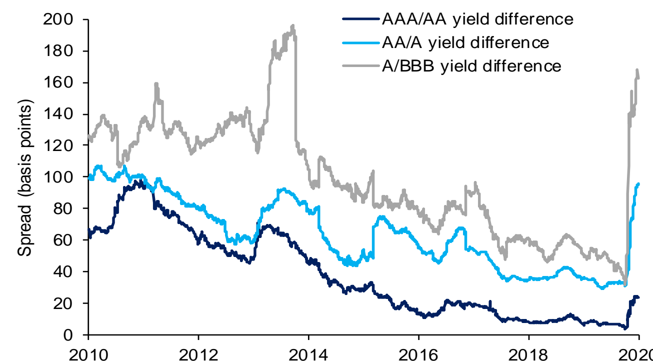
On the other hand, when dropping from AAA-rated to A-rated munis, investors can pick up 160bp in yield. Further, moving down to BBB-rated can fetch investors another 125bp. This is the largest yield-pick up across these ratings buckets since 2013 **(Fig. 6)**.

Figure 5. BBs are historically wide to BBBs



Source: Bloomberg Barclays Indices as of May 27, 2020.

Figure 6. Lower rated IG munis offer selective value



Source: Bloomberg Barclays Indices as of May 27, 2020.

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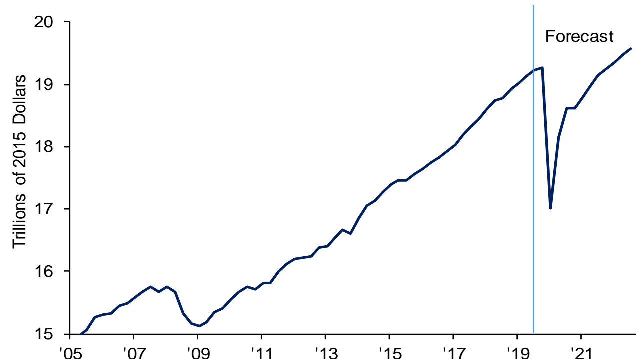
Don't paint by numbers

Similar to HY bonds, you can't paint all lower quality municipal issuers with the same brush. The further down you go, the more selective you need to be. Nevertheless, value can be found in both taxable and tax-exempt bonds. For example, particular short-term municipals where the underlying issuer is considered "high quality" by Moody's can offer tax-free yields above 4.0%. For US investors, this implies a taxable equivalent yield near 7.0%, or higher depending on any state tax exemptions. Even for taxable investors, these yields can be compelling.

That said, we are aware that markets have rallied on Fed liquidity measures, not on fundamentals. As we know, the economic downturn from Covid-19 will be epic **(Fig. 7)**. Defaults in HY markets are rising, and likely to continue to do so **(Fig. 8)**. It is possible we could see HY default rates rise to 10% later this year. US state revenues are also expected to suffer, even with many parts of the country beginning to open up. This can have significant impacts on local municipalities, resulting in ratings downgrades. Of course, any reinfection of Covid-19 later in the year, and the subsequent public reaction, is a risk we still consider.

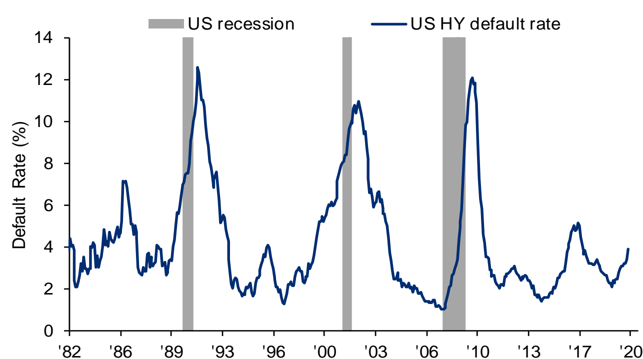
To us, this implies taking an active approach when investing in lower quality markets. Utilizing the expertise of portfolio managers and product specialists will be require to navigate many of these markets. In some instances, "buy and hold" should not be the primary investment objective. Nonetheless, the dramatic shift in value over the last two months, alongside massive Fed and government policy support, has positively augmented our risk appetite.

Figure 7. We expect a 40% annualized drop in 2Q GDP



Source: Citi Private Bank OCIS Team as of May 27, 2020.

Figure 8. Defaults in HY bonds are likely to rise



Source: Bloomberg Barclays Indices as of May 27, 2020.

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