BOND MARKET UPDATE

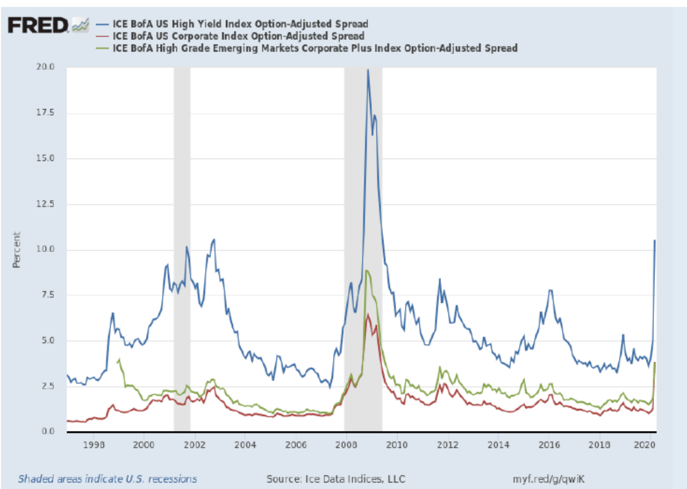
MARCH 27, 2020

CARY STREET PARTNERS
A LUXON FINANCIAL COMPANY

WHAT HAS HAPPENED

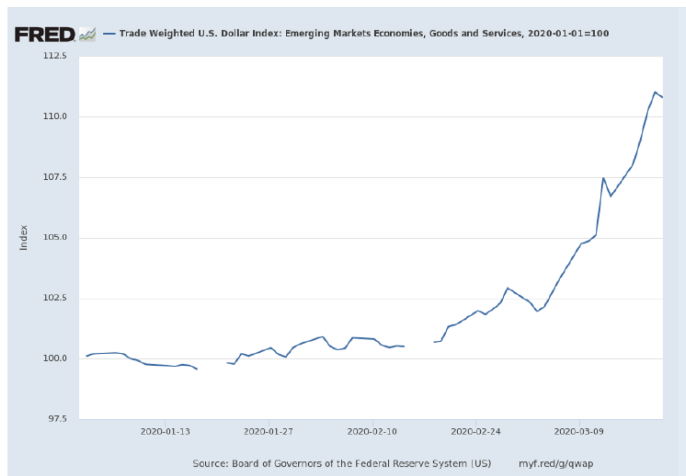
- As COVID-19 has traveled across the globe, it has caused extreme panic and volatility in global equity markets that has crossed into global fixed income markets.
- Fixed income spreads, the yield differential between corporate and treasury debt, have widened substantially as seen in Figure 1 as investors have tried to gauge the economic damage that is being done as a result of the virus. Spread widening such as this indicates a flight to safety.
- As seen in Figure 2, bond markets have priced investment-grade corporate bonds at prices that imply that 10% of these high-quality bonds will default over the next 5 years as of March 10th (by March 17th, a week later, implied defaults jumped to over 17%[1]). At the height of the Great Depression, the actual five-year default rate on investment-grade corporate bonds reached approximately 5%.
- Mutual fund redemptions have resulted in a liquidity panic that has compounded the problem and led to large bid/ask spreads across the fixed income market, including T-bills and other normally safe short-term, cash-like instruments. The bid and ask indicates the sell and buy side of a transaction, a widening of these prices indicates a lack of liquidity.
- The same flight-to-safety has driven the U.S. dollar up in value approximately 10% since the beginning of March versus other major currencies. This further locks up global fixed income markets and acts as a headwind to international bond investors when they translate returns back into dollars. (Figure 3)

FIGURE 1: FIXED INCOME YIELD SPREADS



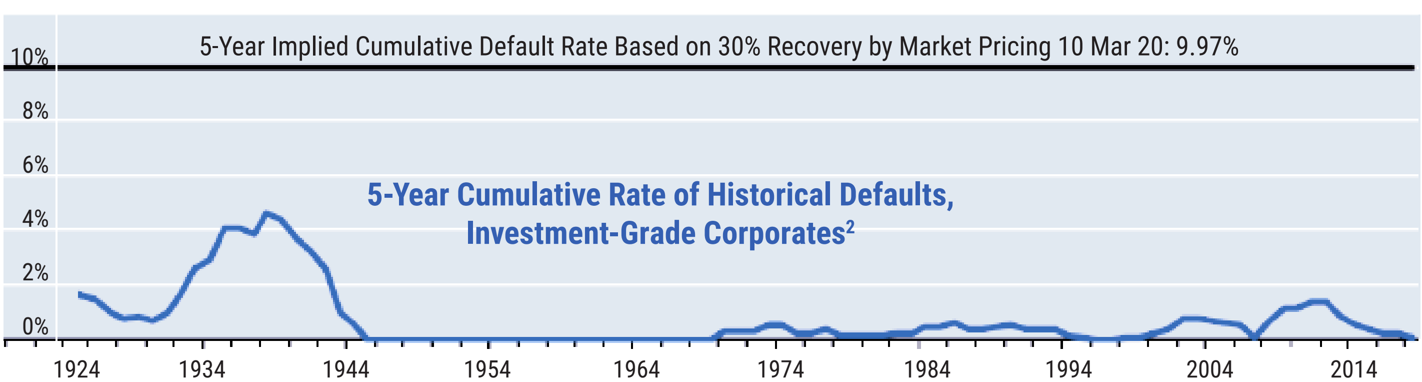
Source: The Federal Reserve

FIGURE 3: TRADE WEIGHTED U.S. DOLLAR INDEX: EMERGING MARKET ECONOMIES, GOODS AND SERVCIES, 2020-01-01=100



Source: The Federal Reserve

FIGURE 2: DEFAULT RATES, INVESTMENT-GRADE CORPORATES



Source: Moody's, Bloomberg Barclays, Bloomberg. As of 10 Mar 20. [1]Calculation assumes 25 bps liquidity premium. [2]As of 31 Dec 18.

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WHAT IS BEING DONE

- The Federal Reserve has been very responsive in creating ample amounts of monetary liquidity to keep markets functioning and provide economic support:
  - > Central Bankers have cut the Fed Funds rate to zero, providing daily overnight liquidity operations, quantitative easing in Treasuries, Agency MBS and CMBS, set up additional liquidity for foreign central banks, and set up lending facilities for credit dealers and money market funds.
  - > The Federal Reserve has also announced elimination of reserve requirements, commercial paper purchases, purchases of some investment grade bonds, an asset-backed loan program and a program to lend directly to small businesses.

- Congress has passed or is working on bills to provide significant relief:
  - > Emergency funds, waive student loan interest, funds for virus research, IRS delay of tax payments for individuals and corporations, benefits for paid sick leave, enhance unemployment benefits, food aid, medical funds.
  - > An additional $2 Trillion for direct cash payments, loans and guarantees for struggling economic sectors as well as several other plans as needed.

WHAT TO DO FROM HERE

EXCESS RETURNS DURING PERIODS OF CREDIT SPREAD EXTREMES	2002	2003	2008	2009	2011	2012	2015	2016
High-Yield Bond[2]	-13.5%	25.9%	-40.4%	61.2%	-5.4%	13.4%	-5.5%	16.3%
Investment Grade Corporate Bond[3]	-1.4%	6.1%	-20.8%	23.5%	-2.3%	8.2%	-1.5%	4.8%
Emerging Market Bond[4]	-1.1%	31.4%	-32.5%	43.0%	-3.9%	21.3%	8.3%	14.9%

- In the short run, we strongly recommend that investors be patient and do nothing that will permanently impair their fixed income assets. History has shown that once the Federal Reserve steps in to ease the more temporal panic-related dislocations in the fixed income market, the bid/ask spreads should come back down allowing investors to recapture their non-economic losses. At that point, investors can make decisions based on longer-term conditions.

- In the short to intermediate term it is important to consider what we have learned from the past. Extreme increases in credit spreads do not last forever. Over the last 20 years, investors that have withstood the pain of extreme markets have recouped their losses and, in many cases, have earned substantial excess return the following year.

- For those clients that need to adjust their bond allocations, they should consider leaning into those sectors that are being directly supported by the Central Bank. These may include agency and non-agency mortgages and municipals. We continue to recommend limiting exposure to the investment grade sector, as BBB paper can easily slip into junk status with credit downgrades.

[1] Source: Moody's, Bloomberg Barclays, Bloomberg

[2] ICE BofA US High Yield Index (USD Unhedged)

[3] ICE BofA US Corporate

[4] ICE BofA US Emerging Markets Sovereign & Credit

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