Investment Insights

Active Management: Fixed Income Through the Crisis

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Highlights

- Bonds continue to serve an important role in portfolios, helping to protect capital in difficult times.
- Given steps that state and local issuers took to strengthen their financial positions leading up to the crisis, the overall municipal bond asset class is well positioned to weather through stress.
- The investment grade bond market is active and functioning well, bolstered by the quick and unprecedented actions taken by the Federal Reserve.
- We do not expect an acceleration in inflation in the near term due to the demand shock created by COVID-19; we believe the Fed is unlikely to adopt a negative interest rate policy.
- A higher quality/lower risk approach in taxable portfolios has been additive during this latest market stress; in municipal bonds, we continue to focus intensely on individual credits.

Chief Portfolio Strategist Peter Langas recently hosted a roundtable discussion with senior Bessemer investment professionals to discuss our fixed income portfolios in the wake of the COVID-19 pandemic. Similar to our recent roundtables with internal equity portfolio managers and colleagues who oversee external managers (see "Active Equity Management Amid Turbulence" and "Active Management: The View From External Managers"), Peter posed a number of questions to them, including views on the safety of municipal bonds given government budget shortfalls, current dynamics within different sectors of the bond market, and how teams are navigating the current environment. This *Investment Insights* provides a summary of their conversation. For further information, we encourage interested readers to peruse "Debt Dynamics and Modern Monetary Theory in a Post COVID-19 World," which provides an in-depth analysis of our views on elevated global government debt levels, their inflation implications, and an alternative theory of government deficit spending.

We continue to offer our deepest sympathies to everyone affected by the virus.

Peter Langas, Chief Portfolio Strategist (PL): Let's begin our discussion with the backdrop of what was happening in March in the bond markets as the pandemic escalated. What were you seeing in your respective areas of fixed income, and how did portfolios perform in the midst of the volatility?

David Rossmiller, Head of Fixed Income

The environment was difficult; equities dropped more than bonds, but the bond markets are much more complicated. Treasuries in this environment rallied to a point, but then liquidity started to dry up and bid-offer spreads widened out, even in the Treasury market, which tends to be the most liquid and deepest market in a crisis. Credit spreads widened, and dealers were under funding stress and started stepping away from markets. They weren't making liquid markets in bonds or taking on inventory, and traders at this point had just moved offsite — so they were struggling to make markets as well. Leveraged funds aggressively sold bonds, exacerbating the problem; meanwhile, mutual funds had redemptions and were forced sellers. Liquidity and funding markets were pretty stressed for a while. The Fed then stepped in with their alphabet soup of solutions, and things finally started to settle down.

Betty Cuervo, Head of Taxable Fixed Income

In the beginning of March, trading conditions in the credit markets were pretty weak. This was the case for bonds of just about any maturity or quality. Small issues were especially difficult to trade. There was little rhyme or reason for the bids we saw; there was a high degree in variability of bond prices even intraday. This environment lasted for about 10 days.

Kevin Akinskas, Head of Municipal Bonds

The story in municipal bonds was a little different. From about March 9 to March 23, the asset class lost about 11% of its value due to forced selling and the knock-on effects associated with that. This was obviously very extreme for the asset class. The primary market froze, so there were no new issues coming out, and secondary market liquidity dried up. However, this was not without precedent — if you look back over the past decade, we've had similar episodes of heightened volatility in 2016, 2013, 2011, and 2008 (which was remarkably similar in magnitude and duration to this pullback).

David Rossmiller, Head of Fixed Income

In terms of performance, the high quality bond portfolios have performed well. Taxable portfolios were up to nearly 80% Treasury and agency exposure, which helped in the downturn. A higher-quality/lower-risk approach in taxable portfolios has generally paid off during this latest market stress. We've had a number of questions as to whether clients are better off holding cash or bonds, and the outperformance of bonds over cash through this crisis has clearly demonstrated the benefits that bonds can provide in portfolios.

PL: Let's talk more about municipal bonds. Kevin, the lockdown has created huge budget shortfalls, and state and local governments are going to come under severe pressure. What concerns do we have about municipal defaults and the overall safety of the municipal market?

Kevin Akinskas, Head of Municipal Bonds

Broadly speaking, we are not terribly concerned about the municipal market. Taking a step back and considering the nature of the market, it is a $3.8 trillion market that consists of over 70,000 distinct issuers. While we understand the overall concern, it's important to appreciate how the market functions. This market is just about as idiosyncratic as it gets. Each issuer has its own set of risks. Yes, headwinds are forthcoming, and they're certainly significant and noteworthy — but when you analyze the numbers behind it, this perspective helps.

In terms of default studies, if you look at the period from 1970 to now, and analyze municipal defaults on a rolling 10-year basis, the municipal default rate is 0.16%. Comparing this to other types of bonds, corporate defaults are well in excess of 10%, and sovereigns are over 7%. The point is, with munis, you really have to understand exactly what you want in the portfolio because no two general obligation bonds are exactly the same. No two revenue bonds are exactly the same. It's a highly differentiated sector of the fixed income market.

When we think about the stresses that are forthcoming, thinking back over the past decade, many state and local issuers have taken really important steps. They've taken rainy day funds up to record levels. They've worked to strengthen their balance sheets. By and large, they actually entered this downturn on much stronger footing than heading into the 2008 financial crisis. The headlines tend to focus on the perennial bad actors in the asset class — like the State of Illinois, for example. But overall, we believe the asset class is fundamentally sound, and it's well positioned to get through the stress, even without the amount of federal aid that's coming forth.

PL: With incredibly high unemployment — at levels we haven't seen since the Great Depression — what if people stop paying bills like water and sewage? In the past, essential service revenue bonds seemed to be very safe. Are these possibly in jeopardy now? Will their quality suffer?

Kevin Akinskas, Head of Municipal Bonds

We don't think so. Again, there might be certain entities that face that kind of stress. But water and sewer systems generally maintain very solid cash positions. In addition, these systems have more autonomy than issuers of general obligation (GO) bonds. If they come under budgetary stress, they can simply raise their rates to help offset that, or they can delay projects. There are various levers they can pull. Toll roads are another classic example. Most toll roads have strong balance sheets, again, with very strong liquidity — and they have a certain degree of rate-setting autonomy.

PL: Turning now to the credit markets — before the downturn, there were concerns about the growth in the triple-B market, and the risks that could come if those were downgraded to high yield. What is happening now? Is that risk playing out?

Betty Cuervo, Head of Taxable Fixed Income

To a certain extent, some of those concerns have come to fruition, and some have not. Year-to-date, we've seen approximately $200 billion of investment grade bonds downgraded to high yield, and we expect more. Estimates are for 10% to 12% of triple-Bs to be downgraded over the next 12 to 18 months; there is certainly a downgrade cycle happening. On the other hand, the big concern wasn't that there would be downgrades — there are always downgrades in a recession. The bigger concern was that this huge amount of investment grade debt moving into high yield would overwhelm the significantly smaller high yield market, causing spreads to blow out and the market to freeze up.

For the most part, however, as credits have been downgraded to high yield, they have been absorbed relatively easily. A big reason for this is the Fed's quick and unprecedented action in lowering rates immediately, and its corporate bond buying program, which includes high yield and support for fallen angels. Spreads in the high yield market have snapped back — they've retraced about 40% of the spread widening. The market is functioning and active.

PL: How would you characterize the availability of credit right now? Are there certain areas that are under stress where companies are having a problem accessing the markets?

Betty Cuervo, Head of Taxable Fixed Income

For investment grade bonds, the market is wide open, and it has been very active. In the last two weeks of March and into April, we saw record issuance, and May was active as well. Transactions are getting done. The asset-backed securities market is active as well. If there's any part of the market where there is some stress, it's the leveraged loan market, which was considered the riskiest part of the market prior to the virus. And even there, some deals are getting done, and banks are working with issuers.

PL: As you mentioned, in March, spreads blew out widely, then they retraced most of that — but where are they today, and what are they saying about fundamentals?

Betty Cuervo, Head of Taxable Fixed Income

I think the market has done a reasonable job of pricing risk after the initial liquidity crisis, which was not driven by fundamentals. Right now, the highest quality companies that are least impacted by the virus are trading at, or very close to, levels where they traded prior to the crisis. Credits that are at risk of falling into high yield are trading like high yield names. Everything else is trading somewhere in between, with differentiation for sector, credit quality, liquidity — all the things you would expect. Right now, the investment grade and high yield markets are trading a little tighter to where they normally would be at the beginning of a recession. The Fed's bond buying programs are driving this dynamic.

PL: With an uncertain economic environment going forward, help us understand the massive amounts of issuance taking place. Has the environment actually gotten riskier, and we're actually leveraging the system, creating more risk?

Betty Cuervo, Head of Taxable Fixed Income

Unlike issuance of the past few years, where companies were levering up their balance sheets to make potentially risky acquisitions or buy back stock, a lot of the issuance now is being done to shore up the balance sheet, to pay down credit lines, or just to have extra cash on the balance sheet. The issuance itself is not what makes the environment more risky. The real risk is how will earnings perform through the recession? As earnings decline, leverage obviously increases, and that's what may fuel further downgrades. We had the initial hit in downgrades to sectors that were obviously impacted by the virus. The energy sector was certainly impacted with the plunge in energy prices. But now we have to evaluate how companies will operate through the recessionary environment, and in an environment where consumer behavior will change.

PL: Going back to municipals bonds, Kevin, could you walk us through how your process works to safely navigate through the treacherous environment we have right now, and how our portfolios are positioned from a credit standpoint?

Kevin Akinskas, Head of Municipal Bonds

The process begins with first identifying, through both the primary and secondary markets, the individual bonds that would best fit client portfolios, and then performing a robust credit analysis. This analysis involves a deep dive on the issuer, reviewing the offering statement, credit agency reports, and the like. We also have a significant, detailed review process where we monitor, on an ongoing basis, issuers held in client accounts and the funds. If we identify any potential stress, we evaluate further and may ultimately put that bond up for sale in order to get in front of any sort of financial distress. An example of our credit analysis is a State of Colorado issue; one of the sections in the offering statement noted a legal challenge to the validity of the statute authorizing the bonds. It wasn't widely disclosed or even widely noted in the agency reports, but we caught it, and chose not to buy the bond. Catching little nuances like this is incredibly important and can help us avoid problems down the road.

PL: Could you talk about our positioning right now, and any changes you have made to take advantage of dislocations in the markets?

Kevin Akinskas, Head of Municipal Bonds

We have trimmed some GO bonds exposure, and we increased exposure to the water and sewer sector, as it's a way to own the beta of the market without the policy risk associated with GO bonds. At some point, we're probably going to begin to take up the revenue sectors again, like transportation and healthcare, where spreads have reached pretty extreme levels but seem to have plateaued. With the essential nature of many of those systems — like large multistate healthcare systems, tollways, and airports — many have very robust fundamentals. We think that will be a trade for the near future, but we're not quite there yet.

PL: Specifically related to the New York portfolio, can you share thoughts on bonds that might have significant COVID related exposure, like the MTA?

Kevin Akinskas, Head of Municipal Bonds

We see the MTA as an essential system for New York City and the entire New York Metro area — including suburban counties and parts of Connecticut. Anyone coming in and out of New York City most likely utilizes the MTA in one form or another. There was an important litmus test for the MTA earlier this month, where they brought forth a $700 million deal to test market access and secure longer term financing — and it was wildly oversubscribed. Investor demand is there at the right price. And very recently, they queried the state about tapping the Fed's Muni Liquidity Facility for shorter term financing. While the headlines about ridership and everything else are certainly unnerving, we believe the MTA is an absolutely essential regional asset that will continue to garner strong governmental support — on both the state and local level.

PL: Turning to positioning taxable bond portfolios from a credit standpoint, how is the team navigating through this from a research standpoint? Are you considering looking to lower-quality credits to find opportunities there?

Betty Cuervo, Head of Taxable Fixed Income

Our process is also very credit driven. Every position within the portfolios is reviewed by our credit team, which does a full financial review as well as a market and fundamental qualitative review of companies. Our portfolio management team participates in credit decisions. We monitor our holdings daily, we look at what we hold, and we consider where the bonds are trading — are there any concerns? We spend a lot of time also looking at valuations. Where are bonds trading relative to their fundamental credit profile?

In terms of our positioning, we have some exposure to triple-Bs; the vast majority of these are in the high- to mid-triple-B range. We think this sector provides attractive yield and return potential. That said, I don't really see us going substantially higher with our exposure. We are committed to maintaining high quality portfolios, and we think that we can add some carefully selected triple-Bs, but we don't want to overextend there.

I don't see a scenario where we would be actively investing in anything below triple-B-minus; the goal is to maintain an overall high credit quality. I do see potential to increase our exposure to corporate credit relative to Treasuries. We began doing that as we entered the crisis and spreads widened. We've continued to incrementally add credit.

PL: Let's move on to interest rates. David, before we tackle the question of whether we may see negative interest rates in the U.S., could you explain how negative interest rates actually come about and why any investor would want to buy a negative-yielding bond?

David Rossmiller, Head of Fixed Income

Negative interest rates can come about in two ways. One is if the central bank sets its policy rates below zero, the way Japan and the European Central Bank have, among other central banks. The other way is markets could simply buy enough bonds to drive longer term yields negative. Policy rates below zero is not something the Fed wants at this point. The goal of low rates and especially negative rates is for the central bank to push investors into higher risk, more productive assets, creating a wealth effect. The reality is that negative rates hurt the elderly and savers, and also hurt banks' profitability — leading to lower and lower credit creation over time. I think this is why the Fed is resistant.

Why would people want to invest their money in something that gives a negative interest rate? Well, risk aversion is one answer — there's a balance between risk and reward and safety. Risk averse investors may be okay with slightly negative yields in order to avoid putting money into equities or other risky assets. Safety comes at a high price in this environment, and some people are willing to pay that price.

PL: How do you reconcile the dynamic that the markets seem to be expecting negative rates, but the Fed has reiterated they won't happen?

David Rossmiller, Head of Fixed Income

Looking at fed funds rate futures, in the middle of 2021, it shows this rate dipping to minus one basis point. We would take this with a grain of salt; it's pretty close to zero. That said, the market may be implicitly trying to get the Fed to comment on this. But the Fed has been clear that it doesn't want negative rates. If the Fed does change its mind, it will resist, and then all of a sudden we'll have a negative rate policy. I certainly don't think that's going to happen anytime soon. It's not our base case, and the markets are being very timid so far about forecasting negative rates.

PL: Can you talk about our expectations for interest rates going forward and how that is affecting our duration positioning?

David Rossmiller, Head of Fixed Income

Our inflation expectations are pretty low right now. We have a Fed that's very active and buying a lot of securities. They've got short term rates at roughly a zero yield and keep buying longer term bonds. So, we expect a positively sloped yield curve, but one that has the potential to flatten further. As a result, in the portfolios, duration is higher than the benchmark. We're invested in bonds further out the yield curve to try to take advantage of that positive slope and the higher yields that we can get in longer maturities. We do have the possibility of higher capital gains if equities sell off again and bond yields go lower. In that scenario, we'll earn the yield plus capital gains.

PL: With bond yields so low, there is not a lot of potential for capital appreciation. Why, then, invest in bonds right now? Why not just hold cash?

David Rossmiller, Head of Fixed Income

There are three reasons to invest in bonds. One is income. Another is the potential for capital gains. And the third is overall portfolio protection in the context of a portfolio that includes multiple asset classes. The income component right now is pretty low, so that isn't a huge motivator. People look at very low yields and have doubts about capital gain potential — for example, going from only 50 basis points to a zero yield — at which point there are no more gains to be had. This is not entirely true, because yields can go down and still provide reasonable capital gains, as we've seen in the last six months. Longer term yields can even go negative if things get really challenging.

Overall portfolio protection is the strongest reason to hold high grade bonds right now in my view. There's a lot of volatility out there. It has come down, but there's still a lot of potential volatility in equity markets and other risky assets and bonds. High grade bonds are the one asset class that really does give some level of protection. These types of bonds, as we've seen in year-to-date performance, tend to go up in value when everything else goes down.

PL: Kevin and Betty, could you both talk about your views on investing in taxable municipal bonds?

Kevin Akinskas, Head of Municipal Bonds

First, I would note that the relative value proposition has declined from the March extremes for tax-exempt bonds, but it's still there. Despite the rebound, there's still room to run, and that's even before you factor in the value of the exemption. We continue to like tax exempts, especially for payers in higher tax states. To your question, we think the taxable muni trade is actually really interesting right now, too; they obviously have the same fundamental credit characteristics as their exempt counterparts, but they tend to offer enhanced spread and appeal to a wider investor audience (corporations, property and casualty insurers, life insurers, and overseas investors). That said, liquidity tends to be lower than their corporate bond counterparts.

Betty Cuervo, Head of Taxable Fixed Income

Taxable munis do offer a spread premium to corporates. A large part of that spread premium reflects the liquidity risk, but even looking through that, we have found some compelling situations. We have participated in a few deals and may do more. While the spread premium is nice, it is not so large that it negates the liquidity risk there, so we are staying away from smaller lots where liquidity is more of an issue.

PL: Thanks to each of you for your very thoughtful perspectives. We see our fixed income portfolios as a very important component of our clients' portfolios — the part that should always be there, especially in times of stress.

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