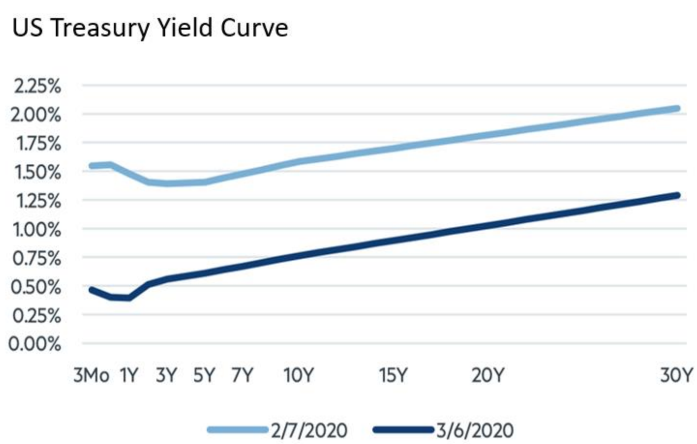
Fixed Income Commentary – March 14, 2020

From our February Comment:

> *In our 2019 year-end commentary we reiterated that "economies rarely stop growing because of old age but, as the cycle extends, they become more vulnerable to external shocks and/or policy errors." Flash forward two months and now we have an external shock (Coronavirus) and Central Banks around world with little wiggle room to respond.*
>
> *We have maintained defensive equity postures for some time because our valuation work has pointed us in that direction. In fixed income markets, if there is an economic slowdown it would probably impact corporate credits around the world rapidly. Our fixed income portfolios are strongly tilted toward higher rated credits and we will be watching credit spreads carefully, but they are extremely low and a long way from attractive.*

In less than two weeks since that Comment we have witnessed dramatic volatility with major global equity indices down about 20% from all-time high levels achieved in mid-February.



The above graph shows the change in US Treasury yields over the last month.

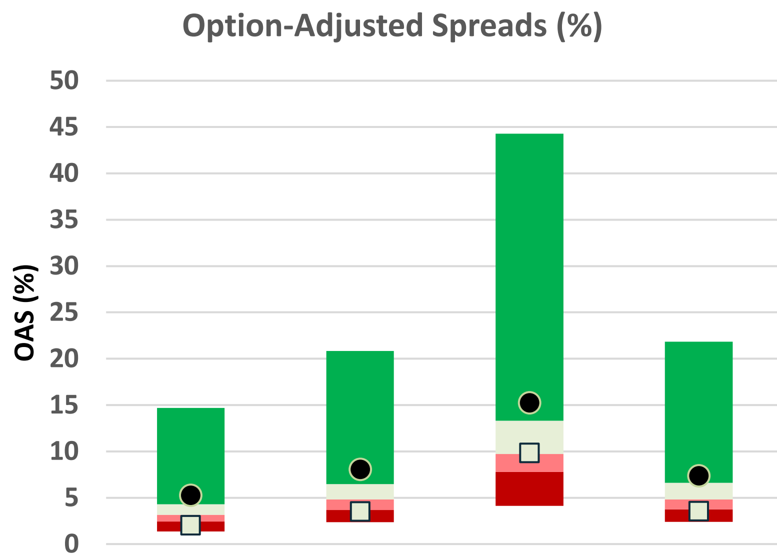
Source: Bloomberg

Meanwhile, fixed income markets rallied strongly following the 0.50% Fed rate cut on March 3. Interest rates across the entire yield curve fell quickly and the benchmark 10 Year Treasury yield fell at one point to 0.35% on an intraday basis but has since rebounded to 0.95%.

This level of volatility is highly unusual and has been accompanied by equally dramatic increases in corporate bond yields relative to Treasuries - something we have expected.

The yield on lower quality credit bonds (BB, B, C and HY) has improved dramatically in just the past three weeks and now trade at or above their historical yield relationship to Treasuries. The HY is a composite of BB, B and C rated credit bonds.

Dark Green is top quartile (top 25%).



Date	*BB*	*B*	*C*	*HY Index*
2/19/2020	**2.04**	**3.52**	**9.84**	**3.57**
3/12/2020	**5.3**	**8.08**	**15.26**	**7.42**
Increase	**159.8%**	**129.5%**	**55.1%**	**107.8%**

This sudden move can be attributed to:

1/ Coronavirus concerns and negative consequences on the economy, earnings and credit deterioration worldwide.

2/ Impact of the Saudi dispute with Russia resulting in dramatic declines in energy pricing, potentially leading to large increases in energy company bankruptcies.

3/ High fixed income valuations due to investors chasing yield in a low yield environment, which caused those investors to ignore credit concerns.

4/ Very long duration economic expansion that many strategists believe could quickly end.

5/ Election cycle uncertainty.

6/ Bond dealers have been restricted in trading by the Fed's banking laws requiring stronger balance sheets. This has been an important reason for the recent bond market volatility because when buyers turn into sellers there is no-one to take up the slack.

To summarize, we are suddenly looking at fixed income markets through a more opportunistic lens. Our Investment Strategy Group is evaluating several discrete strategies and vehicles to take advantage of these credit dislocations, especially if they continue/accelerate. We want to be opportunistic but methodical.

Thanks for your trusts and confident in us.

Don Callaghan
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