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Fixed Income COVID-19 Update

March 19, 2020

Market volatility

This ride has gotten "bumpy" and "the fasten seat belts light" is likely to remain lit for some time.

Clearly, as we write this note, financial markets, our communities and the underlying freedoms that underpin our lives are extremely fluid and dynamic. The global response to stop or slow the spread of COVID-19 (Coronavirus) is frightening, stunning and surreal at the same time. The speed at which financial markets have processed the realization that the pain of this virus will be felt far beyond the homes and hospitals of those infected is unprecedented. **As of March 18, investment grade corporate option-adjusted spread (OAS) stood at 285 basis points, a 10-year high; that spread was +99 on February 21. Equity markets have also repriced in stunning fashion with the S&P 500® down over 29% from its all-time high level reached on February 19.** Yields have collapsed as investors have reached for the safety of U.S. Treasuries and have been propelled by the Federal Reserve that cut its benchmark rate by 125 basis points in a matter of weeks, to 0 – 0.25%. It took over ten years for the Federal Reserve to raise its benchmark rate from 0-0.25% to 2.25%-2.50%. It has taken less than nine months to reverse course back.

So, what does this all mean for the portfolios that we manage and how we are navigating this environment? First, we entered 2020 positioned for a spread widening backdrop and repricing of risk environment. We did feel that 2019 was a period of extreme exuberance in markets and investors compensation for the risks they faced was poor. As a team, we felt that the risks faced by the market in its record eleventh year of expansion were numerous even if they were difficult to identify and quantify. For us, the surprise was the eye-popping pace at which the market, fueled by the impact of the coronavirus, has revalued risk. Secondly, we have underemphasized and continue to dislike corporate sectors that we feel will be most impacted by the inevitable global slowdown that is upon us. Basic materials, capital goods, retail and leisure travel are examples of these.

The areas in our portfolios that are most sensitive to the current climate are the energy and airline industry. Yet, we feel our holdings in these areas remain prudent. Within energy, we continue to favor volumetric-driven areas like midstream/pipelines and de-emphasize price-driven areas like exploration & production and services. In the airline industry, we have no exposure to unsecured debt offerings by the airline industry and our holdings are in the form of Enhanced Equipment Trust Certificates (EETCs), which are secured by aircraft. In a situation where travel stress may be prolonged, but still temporary, this may cause solvency concerns for airline operators; however, we feel even through a stressed situation the value of the aircraft and strength of these structures is unlikely to be materially impacted. This rationale is further supported by the lack of new supply that is available to the airline industry as the result of production concerns. Lastly, although the volatility we have seen in interest rates is extreme, we seek to take minimal deviations relative to our benchmarks in duration exposures. In our opinion, this foundational core belief has proven valuable as interest rate forecasts are extraordinarily difficult.

With that being said, we are not immune from the current environment and finding attractive risk-adjusted returns in a market dominated by risk-aversion is humbling. The overall widening in credit spreads has been a detractor in relative performance so far in 2020. Also, the rapid reduction in yields has led to increased prepayment expectations in mortgage markets, associated turmoil to the consumer with virus related work stoppages has negatively impacted structured credit and the overall lack of liquidity in the fixed income market has made for a difficult dynamic. We do feel that the situation will remain challenging; however, we continue to analyze the fixed income market for opportunities with a heightened sensitivity to downside risk. The repricing of credit has allowed us the potential to find opportunities that make more economic sense than they did to start the year.

In closing, we truly appreciate the long-term nature of our relationship in good times and challenging ones. We look forward to normalcy returning to everyone's life and a time when we can meet face-to-face and shake hands again. Unfortunately, we are not expecting that this will happen quickly, and we want you to know that we are only a phone call, email or video chat away. This ride has gotten "bumpy" and "the fasten seat belts light" is likely to remain lit for some time. However, we want to keep the lines of communication open as we navigate this dynamic. We are aware that in your portfolio the pain of your fixed income allocation might pale in comparison to equity and more esoteric allocations; yet, we understand our role and will continue to drive competitive total returns, income and be focused on protecting the assets you already have.

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