SEIX INVESTMENT ADVISORS LLC®
A VIRTUS INVESTMENT PARTNER

Investment Grade Taxable and Tax-Exempt Fixed Income:

Record Liquidity and Leverage as Pandemic Election Nears

> With the economy still recovering from pandemic lockdowns and uneven mitigation efforts, the Federal Reserve (Fed) does not see any reason to remove its emergency programs and is committed to letting the economy run hot, keeping rates near zero for a very long time given high levels of unemployment and more deflationary pressures than inflationary pressures.

> Entering 2020 the gross leverage ratio for the investment grade non-financial sector was already near record highs, and post the COVID-19 issuance wave it is now heading toward a record high approaching four times. Rating agencies are putting more emphasis on liquidity and less emphasis on leverage, which probably buys the corporate sector additional forbearance for some time.

> On the tax exempt side, the start of the third quarter of 2020 witnessed the continued strength of retail. Performance for July was aided by the final wave of money being returned to investors, through coupon payments and maturities, outpacing supply. The Bloomberg Barclays Municipal Index, a broad measure of the municipal market, returned 1.23% for the quarter.

> Lesser quality paper performed well as investors resumed reaching for yield regardless of the credit risks or credit pressures in the municipal market, which we think are going to be quite evident over the next six months. However, on a year-to-date basis higher quality has still performed extraordinarily well with AAA gaining 4.24%, AA advancing 3.71%, single A up 2.83% and Baa up 0.99%.

INVESTMENT GRADE—TAXABLE

Corporates Set Pace on a Nominal Basis

Longer term interest rates were range-bound with little change across the yield curve as bond market volatility plumbed record lows. Investment grade corporates set the pace on a nominal return basis, led by BBB's. And high yield was led by CCC's, which is interesting when energy was the third worst performing sector in the high yield market.

Hooked on easy money, corporations set another monthly new issuance record for September for both investment grade and high yield borrowers. Investment grade issuance was first to eclipse its prior annual issuance record back in August, but a robust issuance month in September allowed the high yield market to also set a new annual issuance record, all before the fourth quarter even begins! Needless to say, all of this additional borrowing reflects a considerable jump in leverage. While the investment grade leverage ratio started the year at about 2.9 times, pro-forma projections (which are probably on the conservative side) suggest the gross leverage ratio for the investment grade non-financial sector is going to be about 3.9 times, which would be a record high.

Cause for concern? Sure, but the rating agencies are providing forbearance in the sense that they're putting more emphasis on liquidity and less emphasis on leverage. That more likely buys the corporate sector additional forbearance for some time. Credits that normally would get downgraded are probably just going to be put on negative outlook and stay there for a while, unless something idiosyncratic occurs with their company.

In any case, many Fed officials, including Chair Powell, have stated that the Fed does not see any reason to remove the Fed's emergency programs in place, which is interesting because some are scheduled to end at the end of the year and some next March. Suffice it to say, the Fed will do whatever it has to do to support the financial markets and the stock market in particular. Among the options available to the Fed are further extensions to its emergency programs; additional quantitative easing; another Operation Twist (buying longer term and selling shorter term government bonds in an effort to provide additional monetary easing); and/or more powerful forward guidance. Should bond yields rise to the point where they negatively impact the stock market, the Fed could deploy yield caps or shift to a yield curve control strategy.

Rate Volatility Disappears

Rate volatility really disappeared over the third quarter with the front end of the yield curve anchored by the Fed's intentions to not do anything with rates for at least three years. For the full quarter, the low to high range for two and five-year Treasury yields was five and 13 basis points (bps) respectively. On the longer end of the yield curve, 10- and 30-year treasury yields, the same range was modestly higher at 24 and 32 bps, respectively. After an early August rally that marked the low in Treasury yields for the quarter, these ranges were even tighter, with the two-year and five-year Treasury yield ranges going down to three and seven bps, respectively.

Given the low rate volatility and little overall change in prevailing benchmark rates, nominal returns were relatively muted. But in terms of excess returns, it was another solid quarter for most spread sectors. Within the investment grade market, commercial mortgage backed securities (CMBS) and corporates led the way, producing 148 bps and 140 bps of excess return, respectively. Specific to the corporate sector, the long end outperformed the intermediate maturity range with 187 bps of excess return versus the intermediate's 111 bps. The industrial sector offered the best excess at 150 bps, while utilities and financials delivered 128 and 124 bps, respectively. BBB's again outperformed with 186 bps of excess return compared to about 100 bps for A-rated corporate credit. The only exception to positive excess in the third quarter was the residential mortgage backed securities market, which was essentially flat during the quarter, as it remains in the throes of a pre-payment wave. Asset backed securities had about 65 bps of excess, and the government related sector produced another solid quarter with about 90 bps of excess.

The "plus" sectors offered another robust quarter of excess return, albeit well below the heady returns seen over the prior quarter. The high yield market delivered 437 bps of excess return, accounting for most of the 4.60% total return on the quarter. Lower quality CCCs were the outperformer again, earning 713 bps of excess, well ahead of the 399 bps of excess the higher quality Ba/B sleeve garnered for Q3. Even the leveraged loan market nearly matched that high yield total return, earning 4.13% in total return terms. Emerging market debt earned a solid, but more subdued 226 bps of excess return.

While Fed Chair Jay Powell, in a recent press conference, gave a three-year commitment to not raising policy rates (zero interest rate policy or ZIRP), forward guidance that he repeatedly characterized as "strong and powerful", some investors still expressed disappointment the Fed didn't offer more. Given that the multi-year commitment to ZIRP was well telegraphed at this year's Jackson Hole conference in late August, where Powell outlined the Fed's new average inflation targeting regime, many market participants were hoping for a longer and more detailed commitment regarding the Fed's ongoing quantitative easing efforts. The Fed is currently purchasing about $120 billion a month in Treasuries and RMBS via a schedule the Fed updates bi-monthly. There was speculation that the Fed may offer a more formal, long term asset purchase plan that was conditional on the achievement of some unemployment or inflation objective. While there was modest disappointment immediately following the FOMC meeting in mid-September, the market was able to rebound. The pattern is all too familiar, as the market consistently looks for "more" from the Fed, but these one-off disappointments are soon forgotten because history shows the Fed inevitably delivers "more" accommodation.

Amidst the continued rebound in risk markets, in tandem with hopes for more fiscal stimulus and an inevitable vaccine, the consensus still expects long term Treasury rates to head higher. According to the Bloomberg survey (Oct 9th), the median expectation for the 10-year Treasury is 1.14% for the fourth quarter of 2021, as opposed to 75 bps today. The two-year Treasury was expected to rise by less, given the Fed's commitment to ZIRP until inflation "moderately" overshoots the 2% objective for "some" time.

If long term yields were to follow this anticipated path higher and start to negatively impact the stock market, we would expect the Fed would strategically intervene to support asset prices. As mentioned earlier, an easy first step would be to alter its asset purchases and target only longer term Treasuries, similar to its past "Operation Twist" efforts to contain long term yields. Similarly, the Fed could also put a yield cap on long-term rates or invoke a yield curve control strategy, as has been done by the Bank of Japan recently. The Fed will not stand idly by and allow higher long term rates to negatively impact asset prices.

Can the Fed Reflate the Economy?

The economy globally and in the United States is decelerating. A recent study by Bloomberg Economics based on the Fed's latest projections suggests the output gap will not close until at least 2024 and as such would imply there will be no rate hike until at least 2025. (The Congressional Budget Office estimates that the output gap will not close until 2030.)

No wonder the Fed formally announced its average inflation targeting regime framework where the Fed will give precedence to employment rather than inflation, which means the Fed is going to let the economy run hot. We think it will keep rates near zero for a very long time.

How (and whether) the Fed can achieve an inflation overshoot is another matter. After all, there are more deflationary pressures than inflationary pressures currently, and cyclically, inflation numbers are likely to weaken into the first quarter of next year, after which inflation could pick up. Given the dramatic price declines witnessed last spring during the pandemic lockdown, just through base effects y-o-y inflation will rise next spring and likely exceed 2% for a brief spell. How the market and the Fed handle this dynamic will be key to market performance in 2021.

For further insight into where inflation is headed, consider the whole concept of "break-evens," a term that refers to the market view of inflation expectations. In the most recent quarter there was another expansion in break-evens as measured by the difference between nominal Treasuries and Treasury Inflation-Protected Securities (TIPS). (Note: the principal of TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index.) The 10-year break-even rate expanded by almost 30 bps in Q3, signaling a market expectation of about 1.6% inflation over the next decade—quite a rebound from the late Q1 and early Q2 period that saw the 10-year break-even rate sink below 1%.

This market based inflation "expectation" is important to the Fed, as it believes that inflation expectations play a critical role in future inflation outcomes. Also worth noting is the Fed has more than doubled its ownership of the overall TIPS market, from 10% at the start of the year to around 22% (see chart). In that environment, when you have a huge non-economic buyer, it shouldn't be a surprise that you get wider break-evens. The Fed seems to be engineering its own narrative of rising inflation expectations lest the winds of deflation or disinflation become a bigger concern. Perhaps this is comforting to the Fed, but the

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market remains far more skeptical about the Fed's ability to generate any sustainable inflationary response, given its inability to do so over the entire recovery following the global financial crisis. The market's message to the Fed seems to be, "So what you're telling us is, with the same tools, you're going to produce this time what you failed to produce in the prior cycle? I'm not buying it."

Will reflation efforts lead to a weaker dollar that discourages foreign investment as some market participants anticipate? Don't count on it. At current exchange rates, Japanese insurance companies inured to negative interest rates in a lot of developed markets are still comfortable buying 10-year and 30-year Treasuries. That should continue to support the market for U.S. Treasuries. As the old adage goes, money goes where it's treated best, and it's still treated best in the United States.

FED OWNERSHIP OF TIPS MARKET HAS SOARED
12/2/2015 to 9/30/2020

Source: Bloomberg

Outlook

The fourth quarter could be very volatile. Aside from the uncertainty of additional fiscal support, there's the risk of a hung election, and the confluence of COVID-19 and seasonal flu season could exacerbate confusion.

National polls, particularly ones calling for a Democratic blue wave, may be interesting, but they're not predictive since there are really have 51 separate elections, and as we learned in 2016, there are inevitable sampling errors in all polls.

Polls sampling "registered voters" are better than "all adults", but less reliable than "likely voters". Recent history shows that only slightly more than 50% of eligible voters actually vote. The last five presidential elections have produced an average turnout of just under 55%. We try to pay attention to polls of likely voters, because they tend to be the most accurate. They're also the most expensive, because you need to ask more questions to determine whether somebody is a likely voter or not. And then you've got to decide what percentage of Democrats, Republicans, and Independents do you poll.

Considering the vagaries of polling methodology, we believe the election is too close to call at this point—a lot closer than the national polls and media surveys would indicate.

Due to the pandemic, there will be massive amounts of mail-in ballots (as opposed to absentee ballots where there's almost always a chain of custody involved). There will no doubt be voter integrity issues. There will be delays in counting the mail-in ballots. As always, turnout will be important, albeit less so given the ability to vote by mail.

Imagine this realistic scenario given the unprecedented levels of mail-in ballots this cycle: election night results point to a decisive electoral college victory for Trump, but when the mail-in ballots (which may take quite a long time to count) are counted, it points to a decisive Biden victory. From a financial markets perspective, the ensuing uncertainty, legal wrangling, and confusion could spark unprecedented volatility.

Wall Street may be warming up to Biden, but remember how long the markets demonstrated that they favor Trump's policies of lower taxes, less regulation, and more focus on small business, as opposed to Biden's pledge of higher taxes, more regulation, and industrial policy. No matter who wins, a large fiscal spending package next year appears to be inevitable. The difference will be the amounts and type of spending.

Should the election drag out for weeks (or even months), neither side is going to be content. Our concern is how much civil unrest ensues given year-to-date disturbances.

INVESTMENT GRADE TAX-EXEMPT

Lesser Quality Performed Well Despite Growing Credit Risk

The start of the third quarter of 2020 witnessed the continued strength of retail. Performance for July was aided by the final wave of money being returned to investors, through coupon payments and maturities, outpacing supply. Strong economic numbers, a Federal Reserve (Fed) emphasizing lower short rates for longer, and uncertainty around additional stimulus packages all weighed on the market as September ended. The net result was relatively little yield change 10 years and longer, where yields moved lower by one to three basis points (bps) during the quarter, while the front end of the market (9 years or less) moved six to 18 bps lower in yield. The Bloomberg Barclays Municipal Index, a broad measure of the municipal market, returned 1.23% for the quarter.

Lesser quality paper performed well as investors resumed reaching for yield regardless of the credit risks or credit pressures in the municipal market, which we think are going to be quite evident over the next six months. Returns over the last three months by credit quality, as reported by the Bloomberg Barclays Indices were: AAA +0.80%, AA +0.96%, single A +1.45%, and Baa +3.11%. However, on a year-to-date basis higher quality has still performed extraordinarily well with AAA gaining 4.24%, AA advancing 3.71%, single A up 2.83% and Baa up 0.99%.

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Intermediates Set the Pace

With a growing pandemic reaching the highest levels of government in a weak economy and election year, municipal bond investors remained cautious in 3Q20. Despite the unknowns and uncertainty, within the Bloomberg Barclays Muni Index, the seven-year performed very well with a 1.47% return, while the five-year gained 1.28% and the 10-year advanced 1.27%. The long bond performed a little better, up 1.41% for the quarter, but year to date, intermediate munis set the pace for total return with the seven-year up 3.79%, the 10-year up 3.77%, and the long bond up 3.14%. We think the intermediate area has more upside potential, especially as we near the end of the year.

Barbell to Bullet Strategy

Against that backdrop, we have changed from our barbell strategy of last year to a more bulleted emphasis in the 10- to 15-year area. We believe retail investors will continue to reach a little further out on the yield curve, due to the extraordinarily low rates that are available in the one to five-year area.

We remain more invested in 15-year maturities and shorter and look to remain that way for the rest of the year. Issuance appears to be picking up in October as many issuers enticed by the current level of short-term rates are looking to get deals into the market before the election given uncertainty about what might happen afterwards.

Outlook

Our biggest concern right now is that the spread premium on some lesser quality paper has narrowed very quickly and in some cases is not far from levels seen earlier this year. For one thing, there could be significant fiscal pressures throughout the country resulting from the pandemic shutdown and reduced mobility. For another, we currently do not have a Fed backstop for municipal bonds like the one that was implemented for taxable corporate markets. (Note: The Municipal Liquidity Facility, established by the Fed, drew interest from only two credits: Illinois and the Metropolitan Transportation Authority in New York; other issuers were put off by high costs. This program may be discontinued.)

In our opinion, there are very big credit concerns with investment grade paper. We do not think we will see an increase in the default rate, but we could see meaningfully more downgrades than upgrades. And there is the potential for some super downgrades where a credit might fall several notches, depending on the severity of fiscal disclosures. That is one reason why we are primarily invested in larger issuers so we can get timely updates, thus allowing us to monitor the credit's trends through a conservative and somewhat defensive lens. Our portfolios remain very, very high quality. We intend to stay that way, as we expect to see quality spreads widen out this month or early November given growing fiscal pressures on municipalities.

Issuance appears poised to reach as much as $430 billion for the full year. Particularly noteworthy on supply this year is the remarkable increase in taxable municipal issuance. So far about one third of all issuance has been taxable munis, a direct result of interest rates remaining low, and in some cases moving lower. Some issuers are now able to refund tax-exempt municipal issues with taxable municipals (with fewer restrictions) and still have a savings. With tax exempt issuance declining and taxable issuance increasing, we expect the municipal market will shrink slightly over the year, and in a lower for longer rates environment, we think this trend could continue for a while.

We are still optimistic on municipal bonds, notwithstanding the need for more caution on credit and the likelihood of volatility increasing in the fourth quarter. Outflows might continue through October or until the election is finally decided, but after that, we expect individuals will seek municipals. It is still an easily accessible tax advantaged investment for them. It is a conservative part of the typical portfolio, and we believe the asset class will continue to perform very well over the next few years.

Downgrade, Default, and Climate Risks

When Moody's Investors Service lowered the credit ratings of New York City and New York State in late September (for the first time in about three decades), the market remained resilient. Moody's dropped both the city and state by one notch to Aa2, the third-highest investment grade rating, and warned of a long return to normal as the region tries to rebound from the pandemic. Nevertheless, highly taxed New York residents are still buying tax exempt munis—higher quality paper, perhaps—but the national default rate has not changed, and we do not expect that to change much, except for the most fiscally strapped sectors.

Clearly, Illinois and New Jersey are under pressure, but other states like Georgia are strong, and they will be able to manage through forthcoming challenges. Federal assistance or another fiscal relief package from Congress could help the credits of the most beleaguered states and the municipalities, but it is possible it still will not be enough. It will be nearly impossible for the hardest hit states and municipalities to avoid cutbacks in services and employment.

One final thought, although it may not get as much press attention in the municipal space, climate risk (and its long-term implications) are also taken into consideration—more so today than, say, a few years ago. In California, the worsening onslaught of wildfires is a major expenditure, but that is a tremendous economy. How individual communities with limited resources absorb the costs of natural disasters is another factor in our credit and fundamental analysis.

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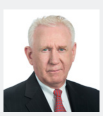
Authored by:

Investment Grade – Taxable



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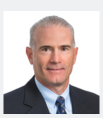

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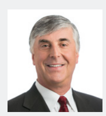
Investment Grade – Tax-Exempt



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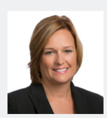

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Seix Investment Advisors is an investment management boutique focused exclusively on managing fixed income securities since 1992. Seix seeks to generate competitive absolute and relative risk-adjusted returns over the full market cycle through a bottom-up focused, top-down aware process. Seix employs multi-dimensional approaches based on strict portfolio construction methodology, sell disciplines, and trading strategies with prudent risk management as a cornerstone.

The **Citigroup Economic Surprise Indices** are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises (actual releases vs Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance [been] beating consensus. The indices are calculated daily in a rolling three-month window. The weights of economic indicators are derived from relative high-frequency spot FX impacts of 1 standard deviation data surprises. The indices also employ a time decay function to replicate the limited memory of markets. **Bloomberg Barclays Long U.S. Treasury Index** includes all publicly issued, U.S. Treasury securities that have a remaining maturity of 10 or more years, are rated investment grade, and have $250 million or more of outstanding face value. **Bloomberg Barclays U.S. Corporate Investment Grade Bond Index** measures performance of investment grade corporate bond funds. The index is calculated on a total return basis. **Bloomberg Barclays U.S. Corporate High Yield Bond Index** measures fixed rate non-investment grade debt securities of U.S. corporations, calculated on a total return basis. **Bloomberg Barclays Municipal Bond Index** is a capitalization weighted bond index created by Bloomberg Barclays intended to be representative of major municipal bonds of all quality ratings.

A **Basis Point (bp)** is equal to 0.01%.

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