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Investment Grade Taxable and Tax-Exempt Fixed Income:

Will Fiscal and Monetary Policies Make America Reflate Again?

> For all the uncertainty about the pandemic, elections, and fiscal support from Washington, the fourth quarter of 2020 saw a liquidity driven rally led by the lowest quality, highest beta parts of the investment grade taxable market. According to Deutsche Bank, 38 of the 39 asset classes it follows were up in the quarter, very much like 4Q19. Long Treasuries lagged as rates gradually moved higher after the election and vaccine efficacy announcements. Corporates led investment grade, with BBB-rated issues posting the best performance. On the high yield side, CCC's led the way.

> In the municipal bond market, the keywords for the quarter were strong demand and not enough supply as investors continued reaching for yield and quality spreads narrowed. State and local governments reaped the benefits of low rates at the moment they needed money most. The Bloomberg Barclays Municipal Index returned 1.82% for the quarter. AAA paper was + 1.22%, setting up a full-year total return of 5.51%.

INVESTMENT GRADE—TAXABLE

Liquidity Driven Rally, Steeper Yield Curve, and Reflation Bets

Talk about ending a turbulent year strong. After pandemic lockdowns and massive unemployment prompted aggressive and unprecedented monetary and fiscal responses in the spring, 4Q20 continued a liquidity driven rally led by the lowest quality, highest beta parts of the market. Long Treasuries lagged as rates gradually moved higher after the election and vaccine announcements. Yields on 10-year and 30-year benchmark Treasuries rose by 23 and 19 basis points (bps), respectively. Corporates led investment grade, with BBB-rated issues posting the best performance. On the high yield side, CCC's led the way in Q4.

According to Deutsche Bank, 38 of the 39 asset classes it follows were up in the quarter, very much like 4Q19. However, the returns for 2020 were once again a testament to the power of the Federal Reserve's (Fed) extensive and expanded toolbox that harkened back to the global financial crisis (GFC). This time around, even Fed Chair Powell said the Fed crossed many red lines to support the credit markets in coordination with the Treasury Department. Both the size and speed of the Fed and Treasury's efforts dwarfed that GFC response back in 2008/2009, thereby spurring a 2020 risk reversal of epic proportions. Looking at capital market returns, it is difficult to reconcile an economy that by June was 10.1% below its peak in real GDP at the end of 2019, a peak-to-trough decline only outdone by the Great Depression. Even after the miraculous rebound in Q3, real GDP remains 3.4% below its prior peak. For perspective, the peak-to-trough decline during the GFC was 4%.

Similar to 2019, for the full year 2020, both haven and risk assets benefitted alike. Long Treasuries gained about 17.7% (14.8% in 2019), Corporates delivered 9.9% (14.5% in 2019) and High Yield gained 7.1% (14.3% in 2019). The major difference for the spread sectors in 2020 was the need to re-trace the dramatic spread widening of Q1, hence excess returns were well below what the spread sectors delivered in 2019. Additionally, gold was up 25%, and silver jumped 47.9%—quite a contrast to the S&P 500®, which advanced 18.4% on a cap-weighted basis, but only 12.8% on an equal weighted basis. The NASDAQ, on the other hand, rose 45%, easily eclipsed by the NYSE FANG+ index, which leapt a little over 103%. But the Russell 2000's 31% gain in Q4 versus the S&P 500's 12.1% advance suggested that market leadership may have finally shifted from growth to value.

Entering 2021, the market narrative is clearly expressing the belief that reflation will lead to inflation. The inflation-linked market had another solid quarter as 10-year break-evens were about 35 bps wider to end the year at a two-year high of 1.99%. As a result, real yields flirted with record lows, and by the end of the year the Fed had more than doubled its ownership of the TIPS markets from 10% to 23%. The Fed's dominance in the TIPS market clearly assisted/drove the inflation narrative throughout the course of the year.

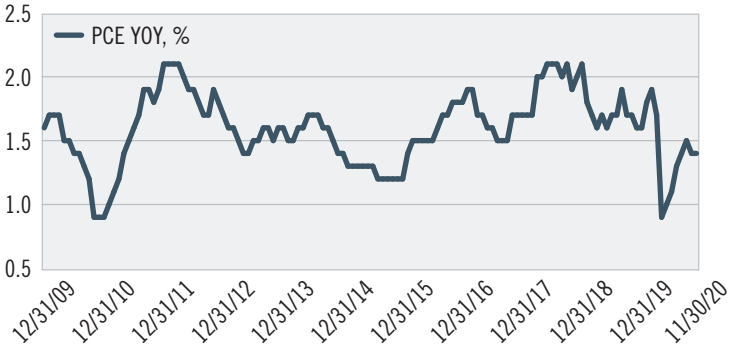
Current indicators suggest that inflation as represented by year-over-year CPI, (currently at 1.2%) will easily exceed 2% by early spring. Some forecasts suggest this inflation proxy could peak in a range between 2.5% and 3.0% by May, however, it should be noted that this is largely due the base effects of the very low inflation experienced during the economic lockdown last spring. How the market and the Fed react to these well-known base effects will have a very strong impact on the Treasury market and by extension, risk markets in general.

Consensus estimates for growth suggest the first half of 2021 is going to be weaker than the second half, largely because of the myriad of COVID mitigation efforts that will likely persist as the vaccine rollout proceeds across our nation. Despite a somewhat remarkable recovery already, there are still 9.8 million fewer jobs than there were in March, and the COVID crisis has resulted in a slew of behavioral changes that could have profound long-term effects.

Can cyclical economic responses overwhelm structural forces? There is still a large output gap that's bigger this cycle than it was at the trough of the GFC, and small businesses remain in an extremely precarious position due to the ongoing lockdown mandates.

Small businesses represent about $9 trillion of the U.S. economy, or 45% of GDP. They're responsible for about 60% of jobs, but more importantly, small businesses have been the job creation engine of the U.S. economy. While some are being forced to close temporarily, more and more small businesses are closing permanently—hardly a good omen for the economy.

CORE PCE STILL SHORT OF THE 2% FED TARGET OVER THE PAST DECADE DESPITE MASSIVE INTERVENTION

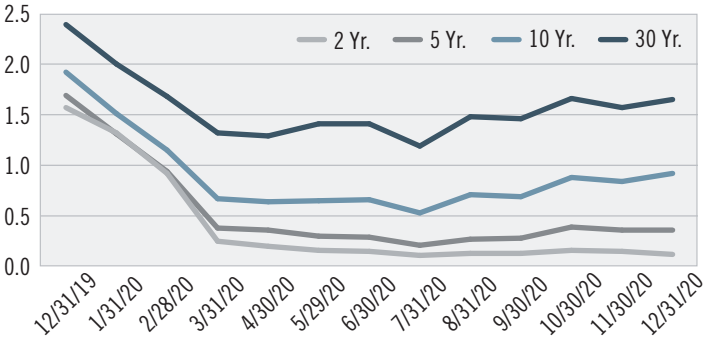


Note: While the Consumer Price Index (CPI) released by the U.S. Bureau of Labor Statistics probably gets more press, the Fed states its goal for inflation in terms of the Personal Consumption Expenditures price index (PCE) issued by the Bureau of Economic Analysis. CPI tends to report somewhat higher inflation.
Source: Bloomberg

How Rates and Excess Returns Evolved

Q4 saw long rates rise modestly after being little changed over both Q2 and Q3 after the initial COVID shock. In October, market sentiment reflected the prospect of Democrats winning the White House and both houses of Congress, ushering in much more stimulus, and therefore more Treasury supply. In November, enthusiasm focused on approved COVID vaccines and the potential for strong recovery in 2H21, notwithstanding the chances of another decline in GDP in the first quarter of the year. By December, however, as the political landscape seemed to become clearer, the focus returned to increased federal spending, better growth, and more supply, prompting concerns about duration risk and how high rates would go in the new year. For the quarter, longer term Treasuries rose while the front end was relatively unchanged given the Fed's commitment to a zero interest rate policy stance. Despite this modest reversal in Q4, 2020 saw another year of lower Treasury yields across the board, with each benchmark yield having made a new record low at some point. The following exhibit shows the dramatic move lower in Q1, the range trade of Q2/Q3, and the upward drift of longer term Treasury yields in Q4.

BENCHMARK TREASURY YIELDS



Source: Bloomberg

As it relates to excess returns for the spread sectors, Q4 saw a return to solid outperformance led by the lower quality segments, a dynamic the investment grade market grew accustomed to in 2019. Corporates generated 411 bps of excess return in the fourth quarter, the second best of the year after Q2 following the Fed's massive "red line crossing" intervention in the market. That brought corporate excess return for the full year into positive territory, albeit only 49 bps, but a pretty remarkable recovery, given all the turmoil the market experienced.

Long corporates generated 739 bps of excess return. Intermediates showed a more modest 208 bps. For the full year, long corporates still underperformed, as the sector was hard pressed to recover what it suffered through in the first quarter, when its excess return was on the order of negative 22%. But amazingly enough, it bounced back to only being down 133 bps for the year. Intermediate corporates delivered 117 bps of positive excess for the full year.

In terms of ratings, BBB's outperformed in Q4 with just over 500 bps of excess compared to 326 bps of excess return for the single-A category. For the year, AA corporates had 37 bps of excess; single-A had 68 bps, and BBB's had 47 bps, so all in not much differentiation over the full year.

In the securitized sectors, commercial mortgage-backed securities (CMBS) had a good quarter with 150 bps of excess return, which also brought them back to positive for the year at 51 bps. Residential mortgage-backed securities (RMBS) only had 34 bps of excess over the quarter and finished the year modestly negative. From a valuation standpoint, RMBS remains ridiculously rich amid a massive prepayment wave given how low rates have fallen, in addition to the Fed's ongoing QE effort through which the Fed is adding approximately $40 billion of net RMBS exposure monthly to the balance sheet. Similar to TIPS, there is nothing like a large non-economic buyer to push valuations to somewhat extreme levels.

The government-related sector continued to recover, gaining 155 bps of excess return in Q4, but still finished the year with negative 165 bps of excess, unable to regain the losses suffered in the first quarter.

continued

Outlook

How long can the liquidity fueled rally continue given the elevated and stretched valuations? While an above-average risk of a financial sell-off based on fundamentals seems plausible, the Fed is no doubt going to keep rates pegged at zero for several years and the backstop support it offered credit markets in 2020 further fuels a seemingly perpetual "risk-on, the Fed has my back" mentality. As we've said before, the Fed has become the guardian of the stock market, but it's difficult to imagine it doing much more with corporate spreads at these levels. The Fed's reaction function would change, however, if there was a material blowout in spreads to the point where corporations were unable to refinance their maturities. In that scenario the Fed could respond with more emergency lending programs to support bank and nonbank companies. Similarly, should the Treasury market find itself under duress, causing interest rates to rise too fast and threaten the stock market, the Fed would likely alter its QE program and target long-term Treasuries and implicitly cap long term yields.

Against that backdrop, continued fiscal support in the United States should provide underlying support to the economy. The lame duck session in Congress surprised with an additional fiscal package on the order of $900 billion. The recent return of the "blue wave" given the Democratic sweep of both run-off elections in Georgia has consequently upped the ante for even more stimulus from the incoming Biden administration in 2021. Market participants have embraced this backdrop and are discounting only more upside for the second half of 2021, thereby ignoring any risks along the way, particularly as it relates to the ongoing pandemic, the challenges of the vaccination rollout, and the ultimate arrival of herd immunity and a return to "normal", whatever that may look like in a post-COVID economy/society.

The future is far more challenged and nuanced than capital markets currently discount. Given the degree of slack in the labor market, with almost 10 million more people needing to find employment in an economy that is only partially open, the fiscal support is really just backfilling all the lost income that results from a COVID induced economic lockdown. The savings rate is elevated as a result, but this only offers a bridge to the other side, when the economy opens more fully and hopefully with more opportunity for gainful employment. In that sense, the fiscal support is a way to pay the bills amidst the current turmoil. Much analysis seems to conclude there is a pent-up demand boom coming as a result of the stimulus as if this is a garden variety economic slowdown.

Meanwhile, many small businesses are disappearing on a daily basis, increasing the chance for more permanent economic scarring that many market participants and pundits seem to dismiss out of hand. Our economy is very dynamic, but the breadth of this economic crisis clearly dwarfs the scope of anything witnessed historically, such that any predicted outcome from an econometric model should be viewed through a very skeptical lens.

The lifeblood of our economy/labor market has always been small businesses. The damage done over the course of the COVID lockdowns, which continue to this day, leave this critical segment of our economy facing unprecedented challenges that monetary and fiscal policy can't adequately address given the fact that businesses need to be open to generate cash flow and revenue to employ people. This is more important to the small business sector than either monetary or fiscal support. Capital markets are too quick to dismiss those challenges when policy responses are unprecedented in speed or size. This creates a rather large disconnect between asset valuations and the underlying economic fundamentals going forward. The 2021 consensus that sees only upside is likely to be disappointed as the year evolves, unless small businesses are allowed to reopen and prosper—the sooner the better.

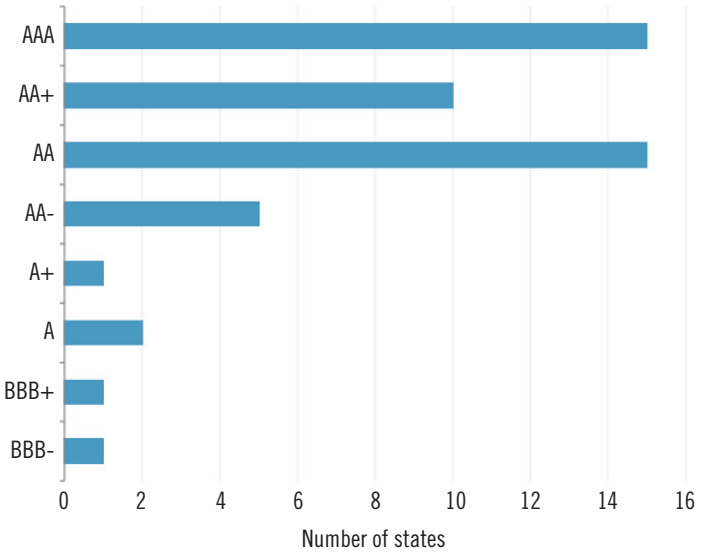
INVESTMENT GRADE TAX-EXEMPT

Strong Demand, Not Enough Supply

For all the uncertainty about the pandemic, elections, and fiscal support from Washington, the fourth quarter of 2020 capped one of the strongest years ever for municipal bonds as investors continued reaching for yield and quality spreads narrowed. State and local governments reaped the benefits of low rates at the moment they needed money most.

The Bloomberg Barclays Municipal Index, a broad measure of the municipal market, returned 1.82% for the quarter. In terms of ratings, AAA increased 1.22%, AA gained 1.47%, single-A rose 2.37%, and Baa was up 3.53%. For the full year, AAA paper had a total return of 5.51%, AA was up 5.24%, single-A advanced 5.27%, and Baa gained 4.55%.

STATE RATINGS DISTRIBUTION as of 12/11/20



Source: Standard & Poor's Financial Services

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Record Issuance, but Taxable Issues Declined

While the full year 2020 experienced a record amount of issuance—approximately $496 billion, $180 billion of that was taxable munis, a significant increase over 2019. The tax exempt portion in 2020 actually fell below 2019 levels.

For 2021, we anticipate total issuance could be somewhere between $450 billion and $550 billion, probably in the higher end of that range. One question, though, is whether issuers will take advantage of low interest rates in the first half or quarter of the year. Another is whether they will continue to refund their tax exempt paper with taxable municipals. We expect the answer to both questions is yes. The refunding part is basically an advantage for issuers to add savings of four to 10%, thanks to record low absolute interest rates.

We believe those trends will continue, especially given the likelihood of more federal assistance to fiscally strapped states, municipalities, and infrastructure entities like New York's Metropolitan Transportation Authority. As COVID vaccinations ramp up, we also expect a fairly strong economic rebound in the second half.

While the Treasury market appears to be anticipating additional stimulus that should fuel stronger growth, we think interest rates will rise gradually, but not in a way that would spook retail investors who dominate the municipal market.

Expensive Ratios Have Presented Selling Opportunities

Don't forget the seasonality of the municipal market; in January and February, there's much more money coming to investors (given coupon payments, call dates, and maturities) than there is supply. Come the March and April period, supply/demand dynamics typically shift the other way (more supply less demand).

As a result of this imbalance, we have seen Treasury yields rise, whereas municipal bond yields have gone up just very slightly. That's because retail investors don't look at Municipal/Treasury ratios or quality spreads. Once they get their muni bond proceeds, they want to put it to work, either in quality or higher yield issues.

Either way, ratios have become very expensive, and we see that as a selling opportunity in the municipal market. In normal years, the yield on a five year, AAA-rated municipal bond as a percentage of an equivalent Treasury has been around 82%. Lately, however, the ratio for a five-year muni has been 51% that of equivalent Treasuries; the seven-year ratio has been 58%, and the 10-year ratio has been 70%, rather rich by historical standards, but still a potential opportunity to sell into robust retail demand.

Staying Nimble Since the Pandemic Sell-off

When the municipal market panicked last March and April, the bonds of toll roads, hospitals, airports, hotels and convention centers were particularly hard hit. The challenge was determining which credits had the most resilience and longest runway to recovery.

Rigorous research and credit analysis identified certain toll roads and airports in major hubs that were extraordinarily cheap, but likely to rebound early. On the other hand, many investors avoided secondary hubs for fear that some airlines would leave them as passenger volume plummeted.

Among other attractively priced credits were larger multi-hospital complexes that were diversified throughout the country with the size, efficiency, market dominance, and wherewithal to withstand pain, as opposed to more vulnerable single-site hospitals.

A number of such issues have rebounded well, but with current spreads and rates expected to move higher, some investors have grown cautious.

Outlook

There should be no question that 2021 will be another challenging year, and downgrades could well outnumber upgrades again. According to the National League of Cities (NLC), nearly 70% of cities are experiencing negative financial health as a direct cause of COVID. Of those negatively impacted by COVID, 90% have experienced a revenue decrease; 76% have experienced an expenditure increase, which includes the cost of personal protective equipment and paying essential workers for overtime. As a result, many municipalities have been cutting expenditures and laying off employees.

Despite extraordinary credit pressures, we expect lesser quality paper will outperform this year. (It underperformed last year.) Active management, security selection, spreads, and timing, will be key, of course.

Volatility, as usual, should create attractive potential buying opportunities and attractive potential selling opportunities. Liquidity will be another matter. Since dealers are not buyers anymore for inventory, strong retail demand may lead them to buy in the secondary market, sometimes at very tight spreads.

We're going to be remain conservative and pretty much duration neutral. We are still focusing on very high quality issues, but have added some exposure in the A-rated category and are open to BBB credits in a favorable market environment.

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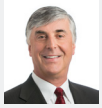
Authored by:

Investment Grade – Taxable

James F. Keegan
Chief Investment Officer and Chairman,
Senior Portfolio Manager
Seix Investment Advisors

Perry Troisi
Managing Director, Senior Portfolio Manager
Seix Investment Advisors

Investment Grade – Tax-Exempt



Ronald H. Schwartz, CFA
Managing Director, Senior Portfolio Manager
Seix Investment Advisors

Dusty Self
Managing Director, Senior Portfolio Manager
Seix Investment Advisors

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The **Municipal/Treasury Ratio**, M/T ratio or muni-Treasury ratio, as it is more commonly known, is a comparison of the current yield of municipal bonds to U.S. Treasuries. It aims to ascertain whether or not municipal bonds are an attractive buy in comparison. The ratio uses indices from the Thomson-Reuters Municipal Market Data (MMD) series.

S&P 500® Index is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **CBOE Volatility Index**, known by its ticker symbol VIX, is a popular measure of the stock market's expectation of volatility implied by S&P 500 index options. **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%. **Average Coupon** is the weighted average coupon (annual rate of interest on the bond's face value that the issuer agrees to pay the holder until maturity) of all the securities in a fund.

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