SEIX INVESTMENT ADVISORS LLC®
A VIRTUS INVESTMENT PARTNER

Investment Grade Taxable and Tax-Exempt Fixed Income:

Greater Liquidity, Lower Volatility, and an Insatiable Reach for Yield

> The fourth quarter capped a banner year thanks to continued dovishness and stimulus from the Federal Reserve. Risk assets and haven assets all performed well, which was quite unusual. Complacency has replaced risk aversion.

> We continue to favor Treasuries. In the corporate sector, spreads per unit of leverage are at an all-time tight right now. From that perspective, we are concerned that investors are not being paid for the risk that they're assuming, hence we remain very underweight the sector.

> In the tax-exempt market, some investors are not being adequately compensated for credit risks we are seeing in the market. Case in point: the general obligation (GO) bonds of Illinois and New Jersey, which each returned more than 11%.

> We are still bullish on the municipal asset class. If supply decreases and demand is strong, ratios can get much stronger. We've already seen signs of such strength at the beginning of this year as investors poured new money into a market with limited supply.

INVESTMENT GRADE—TAXABLE

Heady Performance

Euphoria proliferated as 2019 came to an end, thanks to an expansion in the Federal Reserve's balance sheet as well as a commitment for further expansion over the first half of 2020. To the extent risk markets were supported by the Fed's early 2019 pivot and subsequent three interest rate cuts, a fourth-quarter return to balance sheet expansion (insisting it's not quantitative easing) in tandem with an apparent thaw in U.S.-China trade relations provided an additional tailwind to risk taking as the end of the year came into focus.

According to Deutsche Bank, the 38 non-currency asset classes it tracks were all up in 2019—quite a contrast to 2018 when 31 of the 38 asset classes had a negative return. The S&P 500® had its best year since 2013 and over 90% of the constituents within the S&P 500® were positive, but investing shouldn't be that easy. The NASDAQ had its best year since 2009. Gold had its best year since 2010. Treasuries had their best year since 2011, and the Bloomberg Barclays Aggregate Index had its best year since 2002. To say it was unusual that haven assets like Treasuries and gold did as well as they did at the same time that risk assets performed as well as they did would be an understatement.

In corporate credit, BBB-rated companies led the way again in the investment grade sector during Q4, up 242 basis points (bps) in excess return terms, while CCC's total return topped the high yield sector over the quarter with a gain of 3.74% vs. 2.61% for the full high yield index, thanks to a strong December performance. Q4 was the only quarter of the year that the lower rated tier of the high yield market outperformed other tiers. For the full-year 2019, long corporates (as represented by the Bloomberg Barclays Long U.S. Corporate Investment Grade Bond Index) led the way, delivering 23.89% in total return terms. Delineating between the rating tiers, BBB's were up 16.44%, while single-A's were up 12.99%, in total return terms. Within high yield, full year total return for BB's led the way earning 15.5%, easily eclipsing the lower rated CCC sector's 9.5% performance.

With respect to excess returns, nearly everything was positive in Q4. The corporate index generated 242 bps of excess return, bringing the full-year tally for corporates to 676 bps of excess return—all in all, a banner year. Residential mortgage backed securities (RMBS) were up 62 bps in Q4 (and 61 bps for the year) as the cheapening we saw in earlier quarters brought some buyers in to the sector. Commercial mortgage backed securities, on the other hand, eked out only six bps of excess return in Q4, but a still respectable 181 bps for the full year. Asset backed securities were the lone exception in Q4 with negative three bps of excess return, but the sector still gained 71 bps for the full year.

Complacency Replaces Risk Aversion

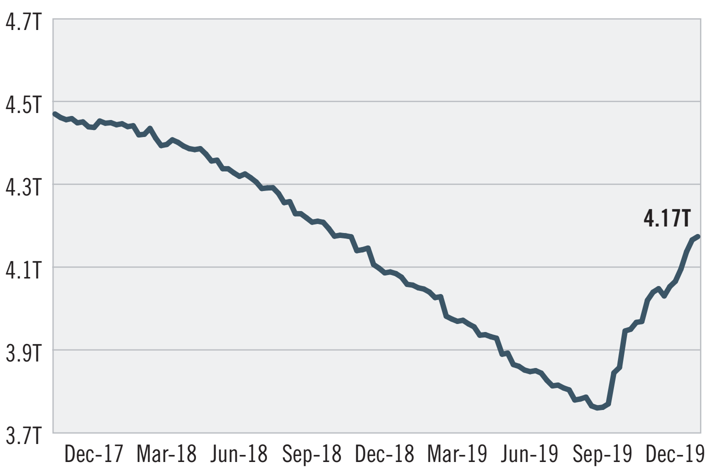
Now, you may ask yourself how we got to this point when corporate earnings contracted during the first three quarters of 2019, according to FactSet, and negative earnings growth is expected to continue in the fourth quarter. (In 2018, earnings per share were up about 24+% as corporate tax relief fell directly to the bottom line, and yet the S&P fell about 4.5% as the Fed raised rates 100 bps and contracted its balance sheet by $373 billion.)

Enter the 2019 Fed pivot. Now that it is once again expanding its balance sheet, complacency has replaced risk aversion. The CBOE Volatility Index (or "VIX") ended 2019 just below 14 versus more than 36 in December 2018. The S&P 500's forward multiple expanded by four points in 2019. The CNN Fear and Greed Index, which measures two of the primary emotions that influence how much investors are willing to pay for stocks, was at 93 at year end versus 10 at the end of 2018. And according to Investors Intelligence, there were three times as many bulls as bears, unlike the end of 2018 when it was about even bulls and bears.

Exhibit 1 below illustrates the growth in the Fed's balance sheet after the Fed pivoted from quantitative tightening (QT) over the first seven months of 2019 to a new round of balance sheet expansion in the fourth quarter. By virtue of their latest asset purchases being in the Treasury bill market, in addition to the repurchase funding they are offering to the money market at very low rates, the Fed claims this asset purchase program is not quantitative easing (QE), but the impact on the balance sheet and liquidity conditions filters through to easing overall financial conditions like every prior iteration of quantitative easing. Over the course of the entire post-crisis period there has been a very strong correlation between risk asset performance and changes in the Fed's balance sheet; the most recent quarter's returns were consistent with this history.

EXHIBIT 1 – FEDERAL RESERVE BALANCE SHEET

QT Pivots to "Not-QE" QE



Source: Bloomberg. For illustrative purposes only. Data as of 1/13/20.

Fourth-Quarter Points

Interest rates moved up modestly over the quarter, led by the long end with 10- and 30-year Treasury yields up the most (+25 and 28 bps, respectively), while the two-year point actually fell five bps. As a result, the yield curve steepened 31 bps to a positive 35 bps, the highest closing level of the year.

October 11th was the pivotal date. That's when a Presidential tweet signaled a breakthrough on U.S.-China trade tensions that would ultimately lead to what's being called a "Phase One" deal. Little else in the way of concrete details have been released, but a mid-January "signing" is scheduled after which the market should eventually learn more about the parameters within the "Phase One" agreement.

More important, though, was the Fed's announcement that it would start purchasing $60 billion a month in Treasury bills beginning on October 15, continuing into the second quarter of 2020. This was in addition to the Fed's intervention in the money market, which saw it commit to conducting overnight and term repo operations at least through January of 2020 to ease funding conditions over the usual calendar year-end period that can produce significant volatility. The volatility in the funding markets in mid-September was the catalyst for this specific intervention, and by year end the Fed was providing just under $260 billion in repo funding in addition to having purchased just under $160 billion of Treasury Bills during the fourth quarter.

Adding all these factors up, the Fed's balance sheet has grown by over $400 billion to $4.17 trillion, which suggests that it could approach its prior peak of $4.5 trillion by the summer of 2020.

OUTLOOK

Fed Chair Jerome Powell and other officials have made it very clear that there's a very high bar to raising rates. That bar is related to inflation, which must persistently print above their 2% target (for the y-o-y core PCE deflator) for a sustained period of time before the Fed even considers hiking rates again. On the other hand, the bar is much lower for the Fed to again reduce rates in our view.

The Fed has gone from being a hostage of the stock market to the guardian of the stock market, injecting liquidity as needed to keep financial conditions easy in terms of sustaining the economic expansion. So, in 2020 as it relates to Federal Reserve policy, the bias favors the Fed cutting rates again rather than raising rates.

Granted, the Fed is positioning itself on hold in an election year like 2020 and it does not want to be perceived as capitulating to President Trump. But if the economy disappoints and/or the risk markets sell off and financial conditions tighten, we have no doubt that the Fed would cut rates further and expand its balance sheet—for insurance, or reassurance.

With respect to long rates, our long-term forecast is still that the 10-year Treasury trades below 1%. Regular readers may recall our expectation that the 30-year would trade below 2%, albeit it in the next recession, but the 30-year actually crossed that threshold in 2019. For the short to intermediate term, the 10-year will probably trade in the well-worn 1.5-2.0% range, but there is a greater risk that it breaks below 1.5% rather than breaking much above 2.0%.

Growth is expected to slow in 2020. The economic consensus for 2020 GDP, per Bloomberg's January survey of over 80 economists, is for a 1.8% growth rate. That would represent a drop from 2.3% for 2019, assuming the fourth quarter growth prints around 2%, which is where several GDP tracking models currently have Q4 GDP growth.

While the Fed's 2020 central tendency GDP forecast may be somewhat higher at approximately 2.1%, the key will be the labor markets. Given that the manufacturing/industrial economy

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is already exhibiting characteristics that imply recession-like conditions, the critical question is whether there is spill over to the household and consumer sector. We'll be watching changes in the labor markets and consumer confidence metrics closely.

After all, the risk markets are discounting more favorable outcomes for 2020: no recession; an earnings recovery; a weaker dollar; a smooth Brexit; a continuing trade truce with China (although the European Union and United States could soon find themselves in a trade spat); a Trump reelection; and further balance sheet expansion by the Fed.

Many investors are anticipating that reflation replaces the recession concern of 2019, with GDP coming in about 2%, plus or minus, led by consumption. That scenario would have the manufacturing/industrial recession bottoming (or already having bottomed) with no spill over to the household and consumer sector. Global fiscal policy is expected to move to center stage at some point in 2020 (our view sees 2021 as more likely), taking the baton from global monetary policymakers. Here the lead may come from Europe, given the emphasis the new European Central Bank President Christine Lagarde has expressed over the first few months of her tenure.

Against that backdrop, we continue to favor Treasuries. In the corporate sector, spreads per unit of leverage are at an all-time tight right now. From that perspective, we are concerned that investors are not being paid for the risk that they're assuming, hence we remain very underweight the sector. Given the macro backdrop, the Fed's balance sheet expansion and its desire to keep financial conditions loose, as well as the low level of interest rates globally, investors' need for high quality income producing assets will likely continue to benefit the Treasury market in 2020. Exhibit 2 below illustrates how low 10-year developed market sovereign yields are globally; the U.S. remains the high yielder.

EXHIBIT 2 – DEVELOPED MARKET SOVEREIGN YIELDS

Region	Security	Yield
Japan	JGB 0.1 12/20/29	-0.01
Switzerland	SWISS 0 1/2 05/27/30	-0.470
Denmark	DGB 0 1/2 11/15/29	-0.165
Germany	DBR 0 02/15/30	-0.159
Netherlands	NETHER 0 1/4 07/15/29	-0.077
Austria	RAGB 0 1/2 02/20/29	0.013
Finland	RFGB 0 1/2 09/15/29	0.025
Belgium	BGB 0.9 06/22/29	0.067
France	FRTR 0 11/25/29	0.090
Ireland	IRISH 1.1 05/15/29	0.102
Sweden	SGB 0 3/4 11/12/29	0.188
Portugal	PGB 1.95 06/15/29	0.430
Spain	SPGB 0.6 10/31/29	0.479
United Kingdom	UKT 0 7/8 10/22/29	0.750
Israel	ILGOV 1 03/31/30	0.886
Australia	ACGB 2 3/4 11/21/29	1.216
Italy	BTPS 1.35 04/01/30	1.376
Greece	GGB 3 7/8 03/12/29	1.391
Norway	NGB 1 3/4 09/06/29	1.455
New Zealand	NZGB 3 04/20/29	1.501
Canada	CAN 2 1/4 06/01/29	1.611
Hong Kong	HKGB 2.24 08/27/29	1.642
Singapore	SIGB 2 7/8 07/01/29	1.745
United States	T 1 3/4 11/15/29	1.842
Iceland	ICEGB 6 1/2 01/24/31	3.370

Source: Bloomberg. Data as of 1/13/20.

INVESTMENT GRADE TAX-EXEMPT

Tax Reform Continues to Transform the Muni Market

For all of the uncertainty at the end of 2018, we remained enthusiastic about the municipal bond market's prospects in 2019, but the ensuing supply/demand dynamics and performance truly exceeded our expectations.

While the broad Bloomberg Barclays Municipal Bond Index returned 0.74% for the quarter, the AAA index had a total return of 0.72%, the AA index and the A index both gained 0.71%, and the Baa index moved 1.02% higher for the quarter. For the full year, the AAA index was up 6.73% the AA index was up 7.12%; the A index returned 8.10% and the Baa index advanced 9.94%

Being long was the best place to be for the year. The further you went on the yield curve, the stronger the returns. The yield on the five-year AAA-rated bond was down 85 bps; the 10-year was down 84 bps, and the long bond was down 93 bps. The five-year return, on the other hand, was 5.45%, the 10-year, 6.74%, and the long bond delivered 10.26%.

Historic Supply and Demand Dynamics

On the supply side, total volume for 2019 was approximately $410-420 billion, considerably higher than estimates. Three interest rate cuts by the Fed in the second half certainly helped. But the primary driver was a sharp increase in the volume of taxable munis being issued, thanks to the Tax Cuts and Jobs Act of 2017, which eliminated tax-free refunding of issues.

Rates have come down so much that tax-free bond issuers can now refund their bonds with taxable munis and realize a significant savings in the process, and those tax-free bonds, by and large, are not being replaced.

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We expect this trend toward taxable munis will continue in 2020 if rates stay low, which is to say, a 10-year Treasury below 2.25%. So, if 2020 muni issuance amounts to $420-440 billion as anticipated, we would expect tax-exempt issuance of $315 billion, down 11% versus 2019, while taxable munis rise to about $110-115 billion. Such an upsurge would be nearly one and a half times the amount of taxable munis issued in 2019.

Phenomenal demand also surprised the market. Inflows into municipal mutual funds for the full year of 2019 totaled a record $93.6 billion. That beat the previous record of $78.6 billion, which was in 2009.

OUTLOOK

We believe the tax-free supply in 2020 is going to be less than 2019. There's just not enough tax exempt bonds. Whether vigorous demand continues is another matter. With riskier asset classes facing a number of challenges, we believe retail investors will still want to be invested in tax-free bonds as an alternative to the equity market, which will be hard pressed to match the outsized gains of 2019. Once again the strongest demand should come from areas with high state income taxes—California, New York, New Jersey, Illinois, and Connecticut, for instance, where investors are clamoring for income from in-state munis free of state and local taxes.

Our number-one concern, however, is a scenario in which the combination of strong demand and a dovish Fed sends the absolute rate so low that retail investors simply choose to move into the money market or short-term fund to mitigate price volatility. After all, the yield on a 10-year AAA-rated bond as of January 7th was at 1.36%.

Our other concern is quality credit spreads are at historically tight levels. Lesser quality paper may have outperformed during the rally of 2019 as investors reached for yield, but we don't think that's going to be repeated in 2020, given the risk of increased volatility, which we've already seen at the beginning of this year.

While our barbell strategy was advantageous throughout 2019, we have since eliminated some of our positions in the longer end, somewhat concerned that the curve could steepen.

We believe higher quality paper is the place to be in 2020, especially if Baa-rated paper underperforms.

In terms of sectors, hospitals will likely remain under pressure, but larger, diversified (if not, dominant) systems should remain attractive. So should airports within major hubs and selective revenue bonds, and water and sewer issues.

Credit analysis will be crucial. So will relative value trading, as in taking advantage of the inefficiencies of the market.

Some investors are not being adequately compensated for credit risks we're seeing in the market. Case in point: the general obligation (GO) bonds of Illinois and New Jersey, the two weakest states in the country, budget-wise returned more than 11%, respectively.

The bottom line: we're still bullish on the municipal asset class. If supply decreases and demand is strong, ratios can get much stronger. We've already seen signs of such strength at the beginning of this year as investors poured new money into a market with limited supply.

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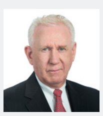
Authored by:

Investment Grade – Taxable



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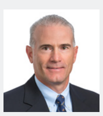

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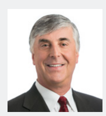
Investment Grade – Tax-Exempt



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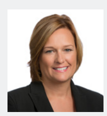

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Seix Investment Advisors is an investment management boutique focused exclusively on managing fixed income securities since 1992. Seix seeks to generate competitive absolute and relative risk-adjusted returns over the full market cycle through a bottom-up 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.

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. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

The **CNN Fear and Greed Index** examines seven different factors to establish how much fear and greed there is in the market: stock price momentum, stock price strength, stock price breadth; put and call options; junk bond demand; market volatility, and safe haven demand (i.e., the difference in returns for stocks versus Treasuries.

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.

Credit Ratings noted herein are calculated based on S&P, Moody's and Fitch ratings. Generally, ratings range from AAA, the highest quality rating, to D, the lowest, with BBB and above being called investment grade securities. BB and below are considered below investment grade securities. If the ratings from all three agencies are available, securities will be assigned the median rating based on the numerical equivalents. If the ratings are available from only two of the agencies, the more conservative of the ratings will be assigned to the security. If the rating is available from only one agency, then that rating will be used. Ratings do not apply to a fund or to a fund's shares. Ratings are subject to change.