SEIX INVESTMENT ADVISORS LLC®
A VIRTUS INVESTMENT PARTNER

Investment Grade Taxable and Tax-Exempt Fixed Income:

Volatility, Liquidity, Stability, Uncertainty, and Quality

> As pandemic mitigation swept the country, fiscal stimulus and liquidity provided some welcome relief in the deepest contraction since the Great Depression.

> Yet, the confluence of very good performance by risk assets (thanks to the Federal Reserve) and haven assets signaled ongoing deep-seated problems with the economy.

> After a very volatile March and April, municipal bond investors resumed reaching for yield despite constrained supply and looming credit issues.

> We maintain our focus on quality and longer maturities as states and municipalities hardest hit by COVID-19 mitigation face unprecedented challenges. We expect major fiscal pressures will lead to more downgrades than upgrades.

INVESTMENT GRADE—TAXABLE

Liquidity Rocks as the Fed Crosses the Rubicon

The second quarter of 2020 got off to a rocky start as pandemic mitigation swept the country, but unprecedented fiscal and monetary responses from both a size and speed perspective provided some welcome relief in the deepest contraction since the Great Depression.

Talk about strong cross-currents: The Dow Jones Industrial Index had its best quarter since 1Q87. The S&P 500® had its best quarter since 1998. The Nasdaq saw its best quarter since 2001. The Russell 1000 Growth Index had its best quarter ever. Oil saw its best quarter since 3Q90 as West Texas Intermediate prices rallied by almost 92% after a brief stay in negative territory. Gold had its best quarter since 1Q16 and year-to-date has gained 17.4%. As haven asset performance goes, only long Treasuries outperformed gold. Silver also had its best quarter since 4Q10.

Yet, the confluence of very good performance by risk assets (thanks to the Federal Reserve) and haven assets signaled ongoing deep-seated problems with the economy.

The recession, it turns out, actually started in February 2020, according to the National Bureau of Economic Research (NBER), which may be the fastest the NBER has ever declared a recession relative to its start. No surprise, given the millions of workers who joined the unemployment rolls each week.

Then, on April 9, a date financial historians will long remember, the Federal Reserve wheeled out what amounted to a money cannon (forget "bazookas") by announcing that it would purchase fallen angel corporate bonds and ETFs, including high yield ETFs. Fast forward three months: the Fed is already one of the largest holders of several large ETFs in the corporate space.

It bears repeating why such intervention was so important. Remember that before the pandemic, there was about $2.1 trillion in non-financial, BBB-rated corporate debt. And according to the rating agencies, about $700 billion of that amount were credits with leverage statistics more akin to non-investment grade. So what the rating agencies were doing was providing ratings forbearance that would continue until there was an economic slowdown/recession that would inevitably force their hand and the downgrades would surely follow.

The Fed knew it had to step in. Some 37% of that $2.1 trillion in BBB, non-financial corporate debt was either under review for downgrade, or had a negative ratings outlook, raising dire implications for the high yield market, which at approximately $1.3 trillion in market value, was now facing the potential for several hundred billion dollars in fallen angel supply. This pending flood of additional downgrades would have occurred at the same time that high yield mutual funds and ETFs were likely experiencing significant outflows, thereby further pressuring the high yield market and by extension the stock market.

That was really a critical data point for both the credit markets and the equity markets. As massive fiscal stimulus and liquidity injections took effect, there was a lot of excitement building over the second half of the quarter about the re-opening of the economy, prompting significant gains in risk assets. Now, however, 60% of the states are either reconsidering relaxed restrictions or locking down parts of their economies again. We'll be paying close attention to the implications of that about-face.

The Hole Truth

For all the positive economic surprises, particularly on employment and retail sales, it is more important to assess the data in the context of the level of the change, relative to the pre-pandemic lockdown, as opposed to the rate of change given the depth of the hole that was dug in the economy. Sure, there has been improvement, but we still have double-digit unemployment (with some federal benefits slated to run out soon, if not extended), many consumers are in limbo, a number of sectors remain distressed, and corporate defaults and bankruptcies are on the rise.

Against that backdrop, we would caution that the Fed can solve liquidity problems, but it's not in a position to address solvency problems, which we think remain a significant risk within the credit markets and particularly within the non-investment grade sectors of the corporate bond market. All Fed liquidity does is buy time; it doesn't create revenues or cash flow, and we've got to pay close attention as that story plays out. The reckoning we anticipate may not occur in the third quarter, or even the fourth quarter, for that matter, but underestimating the challenges ahead would be a mistake for all investors. That said, the Fed will be there should the economy or the financial markets require more support.

While the economy should snap back in the third quarter, we believe the shape of any recovery is likely to resemble a reverse square root symbol (see Exhibit 1), as opposed to the V- or U-shaped recoveries seen by optimistic prognosticators. Our second recovery scenario would look more like a W, or maybe a series of W's.

EXHIBIT 1. INITIAL SHOCK TO THE ECONOMY MAY BE BEHIND US, BUT RECOVERY PATH REMAINS VERY UNCERTAIN 7/31/14 - 5/31/20

Source: The Conference Board Leading Economic Index®, Bloomberg

Performance

In the second quarter there wasn't much change in rates or the yield curve. Treasury rates really didn't move. Two-year and five-year Treasuries declined by about 10 basis points (bps). The 10-year was pretty much unchanged on the quarter. And the 30-year was up about nine bps. Ranges over the second quarter for Treasuries were very muted relative to the first quarter, especially compared to what we experienced in March, when flows were overpowering in both directions. Q2 was more about risk asset performance and, in particular, corporate credit, both investment grade and high yield.

On the investment grade side, the corporate bond sector delivered 847 bps of excess return, accounting for most of the sector's 8.98% total return. IG corporate credit was led by the lower quality sector, the BBB's, which outperformed A's by 429 bps. For the plus sector, high yield corporate credit generated 966 bps of excess; similarly, this was the bulk of the 10.18% total return. In high yield however, higher quality BB's outperformed B's by 286 bps and CCC's by 236 bps, respectively. Those excess returns explained most of the total return on the quarter due to the aforementioned muted move in Treasury rates after the Fed's actions of late March and early April.

Energy was the best performing sector in both the investment grade corporate market and the high yield market. The investment grade energy sector was up a little over 19%, and high yield energy was up 40%. With crude oil having advanced 92% over the quarter, this outcome was not particularly surprising.

Moving away from credit, the securitized asset classes were pretty subdued. With the Fed still actively buying residential mortgage-backed securities (RMBS, the largest sector of the securitized market) RMBS produced only 38 bps of excess return.

Commercial mortgage-backed securities and asset-backed securities generated 323 and 326 bps of excess return, respectively, which was good, but certainly not what we saw in credit. That's largely because the commercial mortgage market faces a long term re-evaluation given how much the pandemic has disrupted behavior at both the corporate and individual level. Employers will begin to analyze their office space needs going forward while at the same time employees will question the need to live in urban centers. Should the work from home model become a more permanent part of many industries, the implications for urban center office space and multi-family housing will take time to sort out.

Outlook

On its present course, the Fed is going to take its balance sheet from around $7 trillion now to $10 trillion by the end of the year— just under 50% of GDP—and it's very clear that it will do more if it needs to, but what some investors may not realize is that there's an inverse relationship between the Fed's balance sheet and economic growth. The more aggressive the Fed is with its balance sheet, the more we're convinced that the economy will weaken, not strengthen, while the risk of deflation rises, not shrinks. In other words, the Fed's zero interest rate policy and balance sheet expansion are not stimulative to the economy, but they sure do drive risk assets.

On the fiscal side, following the Senate's swift rejection of the House's $3.5 trillion stimulus plan, Senate Majority Leader Mitch McConnell said that he would like to see an alternative by the end of July. The Trump administration said they want something by the first week of August, albeit on the order of $1 trillion or less. In the face of such political headwinds, we believe the larger infrastructure stimulus is more likely in 2021 than in 2020.

Small business may be left in the lurch. Consider the pessimism gleaned by a recent Census Bureau survey that asked small businesses through the end of June when they expect things to return to normal: 41% said "longer than six months," but 9.3% said "never." Adding that up reveals 50% of the small businesses surveyed think we're at least six months away from returning to "normal," whatever that may be.

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Also worth noting: a COVID household survey done by the University of Chicago in which 25% of those surveyed remain concerned about having enough food, and 65% said they had no plans to use a credit card. That's a dramatic change from what we've seen up to this point. As for the elusive concept of returning to normal, 75% of those surveyed said they are avoiding large crowds and public places, 72% are avoiding restaurants, and 38% feel "hopeless about the future."

China Tensions

Clearly, there is a new cold war between the United States and China. So the question is, how does that manifest itself? While the State Department under Secretary Mike Pompeo is becoming very hawkish on China, we doubt the Trump administration is going to do anything to upset the financial markets between now and the election. If Trump is reelected, the cold war will likely accelerate. If former Vice President Joe Biden is elected, policy may turn dovish, although members of the current House of Representatives are closer to Trump than they are to Biden as it relates to China.

The implications for emerging markets really relate to global trade, which continues to be very weak. The best proxy for global trade, in our view, is South Korean export data, which remains down around 11% y-o-y even after a bounce back in June. Since the end of 2018, y-o-y export data from South Korea has only seen one month of positive growth.

The other issue for emerging markets is the U.S. dollar, which weakened in the second quarter, but is still well within a trading range. So we would watch the dollar very closely. If the dollar breaks lower that's going to be good for emerging markets, and if the dollar strengthens that's bearish for emerging markets. When you combine weak global trade and a weak recovery that favors a stronger dollar, that suggests emerging markets will remain under pressure.

The combination of a weakening global economy, weak global trade, a shortage of dollars, and a formidable amount of dollar denominated debt, particularly within the emerging market corporate sector, bodes well for the dollar. That's an out-of-consensus view right now, but it's a relative world. While the Fed was first to ramp up aggressive monetary policies, the European Central Bank was right behind it, along with the Bank of Japan and the Bank of England. Given that sequencing, all we saw was a minor dollar correction as the Fed was out of the gate the fastest.

INVESTMENT GRADE TAX-EXEMPT

Continued Focus on Quality and Longer Maturities

After a major sell-off in March and April, the municipal bond market rallied in May and showed signs of greater stability in June, albeit with wrenching volatility as municipalities wrestled with potential revenue shortfalls in the wake of pandemic mitigation efforts. For the second quarter of 2020, municipal bonds (as represented by the Bloomberg Barclays Municipal Bond Index) gained 2.72%, pulling the year-to-date return positive at 2.08%.

We expect volatility to continue, perhaps not to the same degree witnessed in the first six months, but the municipal bond market is trading very thin as dealers are less willing to hold inventory and demand eclipses supply. Summer months are favorable for the municipal bond market as more money is coming due to investors during June, July, and August than bonds being issued.

Demand has already been pretty strong, especially in the one- through 10-year maturities. Mutual fund flows were steady as nearly $13 billion came into municipal funds over 14 weeks as reported by the Investment Company Institute. The quick return of retail investors to the municipal market helped boost total return during the second quarter as the seven- and five- year areas of the curve returned the best performance. The Bloomberg Barclays 7-year Municipal Bond Index return was 3.31% and the Bloomberg Barclays 5-year Municipal Bond Index returned 3.26% for the same period.

Quality Reigns, but Greater Risk Looms as Investors Reach for Yield

Quality continued to be a big factor in the first six months of 2020. The Bloomberg Barclays AAA Index posted a 3.42% return for the first six months of 2020; the AA Index gained 2.73%; the A Index was up 1.36%; and the Baa Index slipped -2.05%. As investors found their footing in June, many resumed their quest for yield. As a result, the AAA Index eked out a paltry 0.03% return for the month; the AA Index was up a mere 0.38%; the A Index gained 1.49%; and the Baa Index advanced a surprising 3.28%.

We believe there are still significant credit issues ahead as states and municipalities contend with dramatic revenue shortfalls. Many state budgets include payments they anticipate receiving from the federal government; the timing and size of such help remains uncertain given Congress's summer recess schedule. There is ongoing speculation that Congress may try to pass one more stimulus package with more direct aid to state and local governments before the November election.

In the meantime, we expect major fiscal pressures will lead to more downgrades than upgrades. In the investment grade category, we do not anticipate an increase in defaults. However, below investment grade and speculative project financing will come under pressure. After all, revenues are down dramatically for many projects, and many states and municipalities now have gaping holes in their budgets given their dependence on tourism and retail sales. Imagine Florida, where 70% of the state's revenue is based on sales tax, and the spread of COVID-19 has worsened.

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As the virus has spread across the country, it is clear that the hardest hit municipal bond issuers are facing unprecedented budget challenges. (See Exhibits 2 and 3.) Credit spreads will probably continue to improve this summer because of a supply and demand imbalance, but we expect increased supply during September, October, and November could lead to quality spreads widening out.

EXHIBIT 2. ESTIMATES OF LOST STATE GOVERNMENT REVENUE UNDER ALTERNATE SCENARIOS Seven Major States

	Revenue Lost ($B)			
	FY20	FY21		
		V-Shaped	Slow	Second Wave
California	11.6	5.8	17.4	31.9
New York	0.0	9.4	9.4	20.5
Texas	9.3	0.0	4.6	15.5
Florida	4.6	2.3	6.9	12.6
Illinois	3.7	1.9	5.6	10.3
New Jersey	3.3	1.7	5.0	9.2
Pennsylvania	3.9	2.0	5.9	10.8

Sources: Stephen D. Whitaker, "How Much Help Do State and Local Governments Need? Updated Estimates of Revenue Losses from Pandemic Mitigation," Federal Reserve Bank of Cleveland, June 29, 2020; Census of Governments, Occupational Employment Statistics, National Association of State Budget Officers, National Income and Product Accounts, Bureau of Labor Statistics Current Employment Statistics, Energy Information Administration, and Whitaker's calculations. The views in Whitaker's study are those of the author and are not necessarily those of the Federal Reserve Bank of Cleveland or the Board of Governors of the Federal Reserve System.

EXHIBIT 3. ESTIMATED DECLINES OF STATE AND LOCAL REVENUE Top Revenue Sources, Nationwide

Revenue Type	FY20 Revenue Lost ($B)
Total General Sales Tax	39.6
Hospital Charges	17.8
Individual Income Tax	11.9
Corporation Net Income Tax	10.5
Air Transportation Charges	7.6
Motor Fuel Sales Tax	7.5
Misc. General Revenue	6.8
Tolls	3.8

Source: Stephen D. Whitaker, "How Much Help Do State and Local Governments Need? Updated Estimates of Revenue Losses from Pandemic Mitigation," Federal Reserve Bank of Cleveland, June 29, 2020. The views in Whitaker's study are those of the author and are not necessarily those of the Federal Reserve Bank of Cleveland or the Board of Governors of the Federal Reserve System.

Outlook

We maintain our favorable outlook on municipals, but are cautious, given concerns about credits that are temporarily being ignored. We expect to see a lot of pressure on credits in the third and fourth quarter. While Congress may pass one more stimulus package this year, we also expect states and municipalities are going to be disappointed in the amount of assistance they receive. That is when they will finally have to consider massive budget cuts.

Stephan D. Whitaker, policy economist with the Cleveland Fed, estimates that state and local governments have lost $141 billion of revenue from all sources in fiscal year 2020 due to the COVID-19 mitigation shutdowns. Under three scenarios of increasing severity, Whitaker estimates that state and local governments will need to cut expenditures by between $59 billion and $350 billion in fiscal year 2021 to offset impending loses of revenue. Some of the revenue losses can be offset by the rainy day funds that state and local governments have set aside during the expansion, but jurisdictions that lack a fiscal buffer may face painfully deep service cuts, said Whitaker in a June 29 report.

At the same time, the bonds of all sorts of revenue projects (e.g., toll roads, stadiums, airports, convention centers, hotels, etc.) are under pressure, with the essentiality of projects themselves and how they have performed during the current recession coming into question. Lower revenues will no doubt lead to layoffs. Less affected may be utilities and water and sewer bonds.

General obligation bonds are more based on property taxes, and property values have held up fairly well so far, thanks to considerable government support. Nonetheless, millions remain unemployed so the question becomes whether we will see an increase in foreclosures and a decline in property values.

In any case, we do not foresee a V-shaped economic recovery. We believe it will be a very slow and challenging recovery in which a number of municipalities have yet to make hard decisions about their day-to-day finances, let alone long-term issues like unfunded pension obligations. States like Illinois and New Jersey could be in for a very difficult time.

All of which underscores our concern that the credit rebound we have seen will be followed by a second round of pain highlighting the importance of quality security selection and rigorous risk management.

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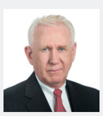
Authored by:

Investment Grade – Taxable



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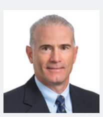

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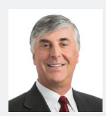
Investment Grade – Tax-Exempt



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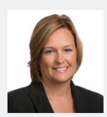

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S&P 500® Index is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **CBOE Volatility Index**, known by its ticker symbol VIX, is a 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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