SEIX INVESTMENT ADVISORS LLC®
A VIRTUS INVESTMENT PARTNER

Investment Grade Taxable and Tax-Exempt Fixed Income:

Trade Slows, Economy Cools, Credit Soars, Repos Spike, and Munis Rock

> Economic jitters increased in Q3, prompting two Federal Reserve rate cuts as the effects of a global slowdown moved beyond manufacturing, setting the stage for one or two more rate cuts by the end of the year, depending on the data flow between now and December.

> A continued slowdown in China, which has been responsible for about a third of global growth directly and more than half indirectly since the great financial crisis, could dampen growth in the rest of the world. Against that backdrop, increased leverage has led to a considerable deterioration in the overall quality of the investment grade corporate bond universe.

> Municipal bond funds continued to enjoy extraordinary demand during the summer as investors sought attractive yields from a limited supply of tax-exempt bonds in a declining rate environment.

> After the Federal Reserve cut rates twice in the quarter, quality spreads continued to tighten as a lot of money flowed into high yield muni funds, which have been very popular.

INVESTMENT GRADE—TAXABLE

Are Investors Being Adequately Compensated for Risk?

The third quarter of 2019 offered two months (July/Sept) of modest "risk on" performance surrounded by a very unsettling "risk off" August. Corporates (as represented by the Bloomberg Barclays U.S. Corporate Investment Grade Bond Index) returned 3.05%, as rates continued to decline and the corporate sector benefitted from having the longest duration of the IG spread sectors. Residential mortgage backed securities (RMBS), with much shorter duration, were up 1.37%, and commercial mortgage backed securities (CMBS) earned 1.89%. Asset backed securities (ABS), the shortest duration IG spread sector, returned only 0.92% over the quarter.

The aforementioned interest rate shift saw yields on the 10-year and 30-year Treasuries decline by 34 and 42 bps, respectively over the quarter. At the front end of the curve, yields on the two-year and five-year notes were down 13 bps and about 22 bps, respectively. The year-to-date yield changes are impressive, with the five and ten-year points on the curve declining by about 100 bps. It goes without saying that this decline in rates does not normally coincide with the rally is risk assets seen in 2019, which is best illustrated by the S&P 500's 20.55% year-to date total return (trailing one-year total return is 4.25%).

Excess returns in these primary spread sectors—corporates, RMBS, CMBS and ABS—were quite muted. Focusing on the largest sectors, Corporates, for instance, produced only four bps of excess return, and RMBS had six bps of excess. From a quality perspective, lower quality risk modestly outperformed again in Q3, with BBB credit risk now having earned 515 bps of excess return year-to-date versus single A credit risk earning 317 bps of excess.

For the plus sectors, the Bloomberg Barclays High Yield Index produced 1.33% of total return and only 19 bps of excess return; the total return differential versus IG credit was primarily from high yield's lower duration. In contrast to the IG market's lower quality outperformance, the high yield market has seen the higher quality segments outperform in 2019. Over the first three quarters of the year the high quality Ba/B sector has returned 11.86% (661 bps of excess) while the CCC sector has returned 5.73% (95 bps of excess).

Emerging markets (EM) is the only place in that core plus space where we saw some underperformance. EM produced negative 93 bps of excess, which is not uncommon when the dollar strengthens as it did in the third quarter.

While the Federal Reserve characterized its rate cuts as insurance or mid cycle adjustments, we view the performance dichotomy in credit as a potential "canary in the coal mine". Juxtaposing an IG credit performance that was led by BBB's against CCC high yield risk with a negative return in the same period—down 1.76%, offers an illustration of investor behavior that could presage a slowdown or recession and an inevitable repricing of risk.

Macro Concerns

U.S. aggregate employment data remained near record highs, but weakness in the manufacturing sector looked like it is starting to spill over into the service sector, as evidenced by the most recent ISM non-manufacturing survey. However difficult to discern the impact of the trade war, the slowdown in China appears to be secular, not cyclical. This is a considerable headwind to global growth, given China's massive contribution since the financial crisis. Germany looks like it is headed into recession, if it's not there already, which threatens to drag down the rest of Europe.

The September meeting saw the European Central Bank (ECB) announce its intent to restart quantitative easing in November, when former International Monetary Fund Chair Christine Lagarde succeeds ECB President Mario Draghi. With the ECB policy rate currently at a negative 50 bps, Lagarde is likely to encounter a split between easy money advocates and monetary hawks, a very divided committee on par with the Federal Open Market Committee in the United States.

Credit Binge May Leave a Hangover

It's highly likely that the U.S. growth rate, inflation, interest rates, and risk asset prices all peaked in 2018. Since the recovery began following the global financial crisis, a credit binge has led to a considerable deterioration in the overall quality of the investment grade corporate bond universe. As a result, investors are not being compensated for the risk being assumed at this late stage of the cycle.

Ratings agency forbearance has allowed many companies to retain an investment grade rating despite having leverage metrics that historically would have been assigned a non-investment grade rating. Approximately one third of the BBB universe had non-investment grade leverage metrics, and there is a high risk that a considerable amount of that BBB exposure could become "fallen angels" in the next recession.[1] This is a risk not only to the investment grade market but the high yield market as well, considering how large that fallen angel cohort could be this cycle.

Compounding this balance sheet deterioration is the fact that a significant portion of the leverage was used for shareholder friendly dividends, M&A, and stock buybacks.

Concurrent with this leverage cycle, a seemingly insatiable quest for yield has pushed many investors to take risk they have historically avoided. This is a dynamic exaggerated not only by low nominal yields globally, but also by demographics as waves of baby boomer retirees shift more exposure into income producing assets.

Even more alarming, a significant amount of this yield chase has been done through passive investment vehicles. Given the backdrop of unattractive valuations and a 10-year debt expansion cycle, investors now more than ever need active management to navigate the inevitable end of cycle dynamics that will see the corporate credit sector undergo significant volatility and re-pricing.

Can the Fed Orchestrate a Soft Landing?

The most recent soft landing occurred in 2016, but we think that that's a low probability event this time around, since the Fed and other major central banks are running out of ammunition with monetary policy. Given that China has been the locomotive of the global economy and considering all the countries that supply China with its raw materials and various imports, China is probably directly and indirectly responsible for 50-60% of global growth. The United States has been responsible for just under 15% of global growth since the end of the financial crisis. If China's economy continues to slow, so will the world economy. The rates market seems to be embracing that view, but risk markets have really not yet begun to signal such concern.

Wild Cards

What could stop or reverse the global slowdown? The most likely catalyst, in our view, would be a U.S.-China trade deal, but we doubt it will be the comprehensive package that President Trump has argued for. If an agreement is reached, it will probably be what we call a "soybean deal", whereby China agrees to buy more products led by agriculture. In that scenario, three major issues would be left unresolved: intellectual property theft, technology transfers, and China's subsidization of state owned enterprises as they climb up the value chain in the technology space. While a partial deal of this nature might be attractive to President Trump for political reasons only, the likelihood of ongoing negotiations for these more critical, unresolved issues will continue to cast a pall over longer-term strategic decision making. In short, the oft referenced uncertainty that is a headwind today is likely to persist in 2020.

Repo Volatility at the New York Fed

The other focus that the market had as Q3 ended was volatility in the short-term lending markets via repurchase agreements ("repos"). While a confluence of events in mid-September created a real funding crisis, the idea that the New York Fed was caught by surprise when it hit is perplexing to say the least. The primary events were on many investors radar long before the mid-September fire drill. The combination of a corporate tax payment deadline, a relatively large settlement of Treasury auctions, and Treasury's ongoing replenishment of its cash buffer following the recent debt ceiling suspension were all well known by the investor community and the Federal Reserve. All these events remove reserves from the system. Concurrent with these events, the forthcoming quarter end created a backdrop where primary dealers, who normally serve as intermediaries in the repo market, began to withdraw from the repo market. The regulatory requirements—and consequent capital charges/liquidity regulations—that accompany normal quarterly reporting for dealers leaves very little balance sheet space for "low return" repo transactions. It was this sparse balance sheet capacity in tandem with the other reserve draining factors that lead to the spike in short term funding.

The New York Fed's reaction to this chain of events was slow and very concerning, in our view. Market participants recognized the potential for such a cash crunch, but the New York Fed, under new leadership, appeared very surprised when it actually was happening. In fact, when the New York Fed rolled out the first emergency open market operation, it failed. It took the New York Fed about an hour before they were able to come back and complete the operation and suppress the funding stress. Since that fateful mid-September day, overnight and term open market operations have been executed to maintain order in the repo market, and repo rates have since returned to more normal levels as a result.

[1]A fallen angel is a bond that was previously investment grade (> BBB- / Baa3) but has since been reduced to speculative grade (< BB+ / Ba1).

continued

One possible explanation for that operational snafu was the recent departure of two veteran New York Fed employees who were responsible for open market operations; apparently they had considerable differences with John Williams, the New York Fed's President since June 2018 and as a result were unceremoniously pushed out of their roles this past June. Williams succeeded Bill Dudley, the Goldman Sachs alumni who ran the Fed's New York region from 2009 through mid-2018. William's is an Economics Ph.D. whose background was primarily in research at the San Francisco Fed. Given the critical role the New York Fed plays as the executor of the Federal Reserve's monetary policy through its open market desk, the selection of someone with very little direct market experience made the selection questionable, and recent market events have validated such concerns to many market participants, ourselves included. Longer term solutions are pending from the Federal Open Market Committee to address the functioning of the repo market, details that should be forthcoming in the fourth quarter. Stay tuned.

INVESTMENT GRADE TAX-EXEMPT

Quality Spreads Continued to Tighten

Municipal bond funds continued to enjoy extraordinary demand during the summer as investors sought attractive yields from a limited supply of tax-exempt bonds in a declining rate environment. One big factor was investors' abiding desire to cushion the effects of tax reform, particularly diminished deductibility of state and local taxes. Another driver was the confluence of coupon payments, maturities, or bonds being called from investors' portfolios.

While the broad Bloomberg Barclays Municipal Bond Index returned 1.58% for the quarter, the AAA index had a total return of 1.35%; the AA index rose 1.49%, the A index gained 1.73%, and the Baa index moved 2.05% higher for the quarter. For the first three quarters, the AAA index was up 5.97%; the AA index was up 6.36%; the A index returned 7.34%, and the Baa index advanced 8.82%.

After the Fed cut rates twice in the quarter, quality spreads continued to tighten as a lot of money flowed into high yield muni funds, which have been very popular. The two-year muni rate was down three bps from Q2; the five-year was down eight bps; the 10-year was down 21 bps, and the 30-year was down 30 bps. But the longer bonds still performed the best.

September, however, was somewhat turbulent. Treasuries backed off a little bit, as did the aforementioned supply/demand imbalance. Yields rallied quite a bit: the two-year index went up 21 bps when Treasuries went up 10 bps; the five-year AAA index advanced 20 bps when Treasuries went up 15 bps; the 10-year index gained 20 bps, while the 10-year Treasury was up 16 bps; and the 30-year index moved 17 bps vs. 15 bps for the Treasuries.

OUTLOOK

Continuing to focus on very high quality (i.e., no leverage, no derivatives), we expect to be well positioned when quality spreads widen out, which they will at some point. We have since reduced our barbell approach, and have also capitalized on trading on inefficiencies in the market during illiquid periods.

Remember: the muni market is not a very liquid market, even in a bull market. When it turns (and high yield muni funds have to sell), the key questions will be: who they're going to sell to, who will be the liquidity provider, and what will the spreads be like? We assume spreads in that scenario will widen significantly and quickly, especially if outflows eclipse inflows.

For the time being, however, municipal bonds continue to attract strong interest, with more than a billion dollars a week coming into mutual funds as Treasury rates have fallen, according to the Investment Company Institute.

With robust demand likely to continue, we remain very bullish as equity investors grow more cautious. After all, some of those investors are in the 50% tax bracket (including federal and state), and there should be plenty of opportunity to satiate their appetite for real tax-free income, particularly in higher tax, fiscally challenged states like California, New York, New Jersey, and Connecticut, where municipals have performed quite well in 2019.

Looking at 2020, there are indications that municipal bond supply may rise to $400 billion, from around $360 billion. Interestingly enough, some tax-free bond issuers lately have gotten around refunding restrictions via taxable munis, since rates have come down so much. Should that trend continue, $300 billion of the expected $400 billion in muni issuance next year may be tax free, and $100 billion may be taxable.

continued

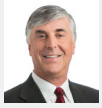
Authored by:

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

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.

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. **Bloomberg Barclays U.S. Corporate High Yield Bond Index** is an unmanaged market value-weighted index that covers the universe of fixed rate, non-investment grade debt. The **Bloomberg Barclays Municipal Bond Index** is a market capitalization-weighted index that measures the long-term tax-exempt bond market. The index is calculated on a total return basis. The indexes are unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment.

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.

Effective Duration is the change in the value of a fixed income security that will result from a 1% change in interest rates while taking into account the way changes in rates will affect the expected cash flows of any bond with an embedded option such as call or prepayment option. This measure assigns a probability to the exercise of a call option, where applicable, based on specified shifts in the yield curve. Duration is expressed as a number of years, and generally, the larger the duration, the greater the interest rate risk or reward for a portfolio's underlying bond prices.

VIRTUS INVESTMENT PARTNERS

www.virtus.com • 1-800-243-4361