SEIX INVESTMENT ADVISORS LLC®
A VIRTUS INVESTMENT PARTNER

Investment Grade Taxable and Tax-Exempt Fixed Income:

Bursting Bubbles, Economic Shutdowns, Fed Bazookas, and Historic Changes

> The COVID-19 pandemic wasn't the cause of the global meltdown; it was a catalyst, given how many asset classes were priced for perfection. The price of investor complacency will be steep, but after waves of forced (or indiscriminate) selling, potential opportunities for active managers should grow.

> Following rate cuts, quantitative easing (QE), repo activity, and other monetary programs, the Federal Reserve is prepared to enlarge its record balance sheet further to boost liquidity as the likelihood of a deep recession increases.

> Nearly all sectors of the municipal market will be impacted at some level. While supply in the primary and the competitive markets was non-existent as of April 2, we anticipate longer term investors will eventually find buying opportunities in high grade quality bonds. Other bonds are going to have a very difficult time, especially expensive malls backed by tax free bonds or ambitious rail projects.

> It will be difficult to predict when relatively normal liquidity will return to the muni market. A lot will depend on when investors feel more confident, but we believe demand for high grade municipals could resume this summer as demand should overwhelm supply.

INVESTMENT GRADE—TAXABLE

March Mayhem Triggers Phenomenal Response

From our perspective, the COVID-19 pandemic wasn't the cause of unprecedented sell-offs that roiled markets in 1Q20; it was the catalyst. Before governments started pumping the health emergency brakes on economic activity, risk in the financial world was priced for perfection, and investor complacency abounded. Now that much of the United States is in lockdown, what started out as a supply shock when China went into a lockdown due to the virus has morphed into a demand shock with most of America focused on the essentials while under "stay at home" directives. Concurrently, oil prices plunged nearly 67%, mostly in March, after a price war between Saudi Arabia and Russia erupted, adding to the turmoil. In addition to shocks in supply, demand and oil, we can add U.S. dollar and wealth/balance sheet shocks to the mix. The VIX came into 2020 below 15, but by the end of February it was up to 40 before ultimately spiking to 82 in mid-March as the stock market sell-off accelerated due to the deleveraging of rules based strategies (risk parity) and forced liquidations related to margin calls. The modest recovery in stocks over the last week of the quarter saw the VIX settle back down to around 53.

Enter the Federal Reserve, which cut rates 150 basis points (bps) in about two weeks—a return to ZIRP—and instituted a quantitative easing program that started at $700 billion and quickly became unlimited (Exhibit 1). They rolled out trillion-dollar-plus-a-day repo facilities and the alphabet soup from their 2008 playbook plus a few new ones. The Commercial Paper Funding Facility (CPFF), Primary Dealer Credit Facility (PDCF), and the Money Market Mutual Fund Liquidity Facility (MMLF) target the money market and broader funding markets to keep the plumbing of the capital markets flowing. Two new programs, the Primary Market Corporate Credit Facility (PMCCF) and Secondary Market Corporate Credit Facility (SMCCF) target corporate bonds and ETFs. The Fed will actually buy corporate bond issues in both the primary market as well as the secondary market. Additionally, foreign exchange swap lines that date back to 2008 were expanded to include more foreign central banks with more attractive pricing and longer terms, essentially fulfilling the role of central banker to the world.

The Fed engineered all these interventions under section 13-3 of the Federal Reserve Act that allows for lending to any entity in "unusual and exigent circumstances." Technically, the Fed isn't a buyer of any assets, but a lender, and the capital required—call it a first loss provision—is provided by Treasury. Through Treasury's participation the Fed is protected from any loss and this is important because the Federal Reserve Act also stipulates that such lending should be effectively riskless. The Treasury had limited resources remaining in an Exchange Stabilization Fund (ESF) that it has historically used for these guarantee efforts with the Fed. Given the magnitude of this round of intervention, more capital was going to be needed; that's where Congress comes in.

Congress passed a fiscal spending bill to the tune of $2.2 trillion. This package included $454 billion for Treasury to use in conjunction with the Fed to lend via its multitude of emergency programs. Another $46 billion in loans and loan guarantees were specified for airlines and businesses crucial for national security (Boeing). The magic behind these loan programs is leverage. Ultimately, the level of loss protection needed will depend on the type of credit risk taken, and most market analysts have settled on leverage of up to 10-1, implying overall lending of $4 to $4.5 trillion.

Additional stimulus is likely to follow, but what concerns us is that only about $900 billion of that $2.2 trillion is going to households and small businesses. After all, $1.35 trillion is slated to go to the Fed by topping off the aforementioned ESF, and then to industries and big businesses, even though small businesses represent about 70% of employment and about $9.5 trillion of America's $21 trillion in GDP.

We doubt that $349 billion in small business lending facilities—even if they're forgiven—is really going to plug the hole, as this amount represents less than one month's revenue of the small business sector's revenue. As a result, a lot of small businesses unfortunately may go out of business.

EXHIBIT 1 – THE FED EXPANDS BALANCE SHEET TO $6.08 TRILLION TO CUSHION DEBT MARKETS as of April 8, 2020

Source: Federal Reserve and Bloomberg

In Fed We Trust

What the Fed did in March was amazing and unprecedented, even in the context of the 2007-08 global financial crisis (GFC). On March 3rd the Fed conducted its first intermeeting rate cut since the GFC. A G-7 finance minister meeting the day before offered no concrete plan of action, essentially leaving the Fed action as plan B to stem the decline being seen across risk markets globally. Despite this "preemptive" 50 bps rate cut, the capital markets continued to sell off.

On Sunday, March 15th, the Fed cut rates another 100 bps (to a zero-to-25 bp target), returning to a zero interest rate policy stance the Fed inflicted on savers and retirees for seven years in the aftermath of the GFC. They also announced a return to a massive amount of QE: $500 billion for Treasuries and $200 billion for mortgages, and those numbers were quickly increased after they started doing it. They increased their repo operations on the 15th, with some days seeing up to $1.5 trillion of repo on offer. They lowered the rate on discount window borrowings, which historically has been the last place member banks would go to get a loan, albeit at a slightly penal rate, but this time the Fed was encouraging banks to use it. They also cut reserve requirements to zero.

After that came the alphabet soup of liquidity/bailout programs mentioned above, some of them new, some previously used in the GFC.

The critical distinction for this cycle is that the Fed is moving both faster and further out the risk spectrum by buying corporate credit—something they never did in the GFC. They also reintroduced and expanded their FX swap lines with various foreign counterparties as the massive flight to quality against the backdrop of a global recession and resulting contraction in global trade created a global shortage of dollars.

Performance

As hordes of investors moved toward quality, Treasuries led the performance rankings. Long Treasuries were up almost 21% in the first quarter while in total return terms investment grade corporate bonds were -3.15%, high yield -12.68%, leveraged loans -13.19%, and emerging markets debt -8.67%.

At the front end of the yield curve, two- and five-year maturities outperformed modestly versus 10's, but rates came down to levels that we haven't seen for a long time. By the end of the quarter, the two-year Treasury was at 0.25%, five-year was at 0.38%, 10-year was at 0.67%, and the 30-year was at 1.32%.

Credit dramatically underperformed in Q1, and that was led by the lowest quality, highest beta sectors of the market. On the investment grade side, BBB's were hammered, and within high yield, CCC's turned in the worst performance.

Investment grade corporate spreads were 179 bps wider, ending the quarter with an option adjusted spread (OAS) of +272 bps. High yield corporate spreads were 543 bps wider to end the quarter with an OAS of +880 bps.

Excess Returns

Given much wider spreads across the board, excess returns for all the spread sectors took a beating. Across the primary investment grade sectors, corporate credit suffered the most, with excess returns of -13.5%. That was the worst calendar quarter ever. For perspective, at the height of the GFC in the third quarter of 2008, that excess return was -10.27%. Just a note, most quarterly recaps talk about excess returns in bps, as the outcome is typically less than 1% (100 bps). In fact, since 2000, the median quarterly excess return for investment grade corporate bonds is 0.38% (38 bps). That should offer some perspective on this quarter's excess – MINUS 1350 bps!

The long corporate credit sector was the clear underperformer with -21.95% in excess return over the quarter—far worse than 2008, when the worst quarter was a -13.28%. The intermediate sector delivered 892 bps of negative excess return. Lower quality underperformed a fair amount as BBB's delivered excess return of -16.92%, again worse than 2008, when its worst quarter was -13.52%. Higher quality AA's only saw -8% of excess while single A's saw -10.5%.

In terms of sectors, both industrials and utilities suffered their worst quarters ever by a pretty fair amount. Industrials delivered -14.84% in excess terms versus -8.63% in Q4 '08. Utilities endured -15.4% of excess versus -11.36% in Q4 '08.

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Financials, which as you will recall were the epicenter of the global financial crisis, were the "outperformer" this time with -10.46%, not as bad as Q3 '08 when it was -16.16%.

In the securitized sectors, residential mortgage backed securities (RMBS) experienced a fairly muted -83 bps of excess, helped in large part by massive Fed purchases over the second half of March. Commercial mortgage backed securities (CMBS), on the other hand, had negative excess of -5.86%; a painful quarter for sure, but also not as bad as the GFC. Unwinding of CMBS positions this time around was more concentrated in the front of the curve, in tandem with a good amount of selling in asset backed securities (ABS), largely to meet margin calls.

In non-investment grade corporate credit, all the numbers were also horrible, but did not match what happened in the GFC. High yield's excess return was -17.03%; the higher quality Ba/B sleeve was -15.81%, but CCC's were -24.35%. In Q4 2008, high yield's excess return was -24.9%.

OUTLOOK

Recession Certain – Very Deep, Very Broad; Duration and Shape Will be Key

Clearly, the Trump administration faces a difficult balancing act as the global economy enters recession territory. The questions are: how deep, how broad, and how long a recession? We think it's fair to say it will be a very deep recession.

Some analysts estimate the second quarter could contract at a 30-50% annualized rate. Our own analysis suggests that it very easily could be a 50% contraction in Q2, and a very broad one at that. It's hitting virtually all industries in all geographies both here and abroad.

How Long a Recession?

It's pretty obvious to us that it will not be a V-shaped recovery, given the amount of demand destruction, especially among small businesses, and probably not a U-shaped recovery. If it's an L-shaped recovery, the question is: how long do we stay along the bottom? Much depends on whether there will be changes in behavior—both on the part of consumers and corporations. We believe there will be fairly significant changes that will depart from the historical patterns of the American consumer. We're likely to see less consumption and more savings.

Sea Changes Ahead?

De-globalization, which has already started, may well accelerate as global supply chains shift and many countries and companies realize that they can't rely on a single source, especially when that source is China.

As it relates to the financial markets, while the largest buyer of shares in the previous cycle was corporations buying back their own shares, we expect to see fewer share buybacks and greater emphasis on stakeholders (customers, employees, and communities) after the crisis subsides. A singular focus on the shareholder will become a thing of the past.

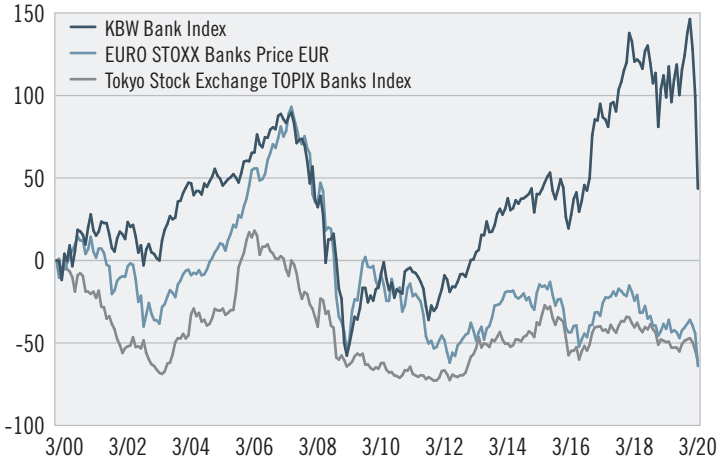
How big could the Fed's balance sheet get?

The short answer is: as big as they want it to because there's practically no limit at this point. To put that into perspective, the European Central Bank's balance sheet is 40% of European GDP. Japan's is 102% of GDP. The Fed's is about 28-29% of U.S. GDP, but note that the Fed balance sheet went from $4.16 trillion at the end of February to $6.08 trillion on April 8, according to Bloomberg. Emulating the Japanese balance sheet, while not desirable, cannot be ruled out as the Fed takes a page from former ECB President Mario Draghi's "whatever it takes" strategy.

Negative Rates

Our outlook on negative rates has not changed. While policy rates are unlikely to go negative, intermediate and long term rates on the other hand could go negative. We've seen that happen in Europe on both policy rates and longer term rates. However, in this case, we are still going to take the Fed at face value when they profess that negative rates do not work. Remember unlike many other countries, the shareholders of the Fed are not the government or the taxpayer, but the banks, and as shareholders of the Fed, they've seen what negative rates have done to Japanese banks and European banks (Exhibit 2). U.S. banks will not want to go there.

EXHIBIT 2 – U.S. BANK INDEX VS. EURO AND JAPAN BANK INDEX PERFORMANCE 12/31/1999 - 3/31/2020



Source: Bloomberg

Deflation

Amid widespread declines in the prices of various assets, deflation is a real risk, especially when it comes to commercial real estate. While it may be hard to gauge the long-term behavioral impact of the current crisis on office demand, there's no question in our minds that corporations will completely reassess not only their

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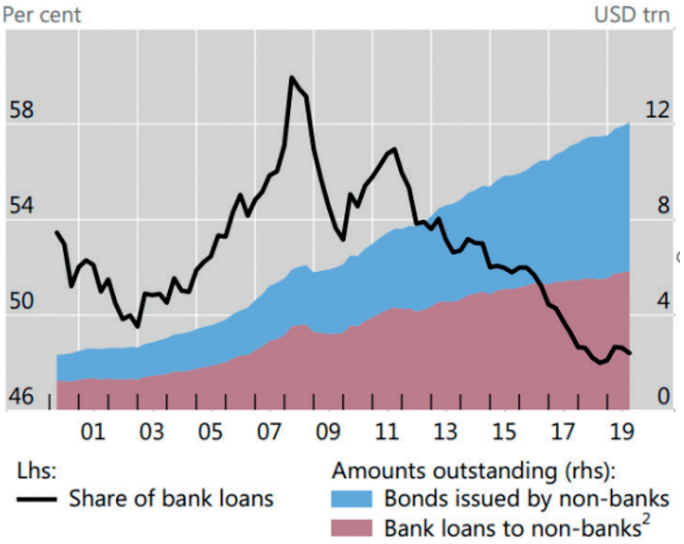
daily needs, but also their emergency needs like off-site operational facilities and back-up data centers. We will be spending a lot of time analyzing this sector and anticipate there will be potential opportunities to capitalize on as the current crisis plays out.

Emerging Markets

Emerging markets are in a really difficult spot here, partly because they have too much dollar-denominated debt, primarily in the corporate sector (see Exhibit 3), and partly because of a significant shortage of U.S. dollars, which is why the Fed has been doing everything they can do to boost liquidity. They started with the dollar swap lines to their traditional developed counterparty central banks and then they extended it to some of the bigger emerging market central banks. Subsequently, the Fed then created a specific repo facility (FIMA – Foreign and International Monetary Authorities) targeting an even broader subset of central banks that own Treasuries and need dollars. Rather than sell Treasuries, these entities can instead enter into a repurchase agreement with the Fed and get the dollars they need. China alone needs about $250 billion a year to just buy commodities that are priced in dollars, and there are not enough dollars in the world right now to satisfy China and everyone else's demand for U.S. dollars. Indeed, China is not generating enough dollars right now because its current account surplus has gone from about 10% of GDP to around 1% of GDP.

EXHIBIT 3 – ALARMING TRAJECTORY OF EX-USA DOLLAR-DENOMINATED DEBTS



Source: Bank for International Settlements, data as of 3/31/20.

INVESTMENT GRADE TAX-EXEMPT

March Mayhem: Leverage, Panic, Illiquidity, and Massive Outflows

Historically, March has never been a friendly time for the municipal bond market, but it remained very strong until a tsunami of bad news spurred investors to sell en masse. Credit spreads widened and ETFs, which had not been tested in a deeply weakening market, exacerbated the downswing as investors saw their NAVs getting crushed and ran for cover. As of March 25th, ICI data reflected outflows of $-42 billion for the month, creating a squeeze on liquidity and a repricing of risk at the same time.

To call the ensuing market upheaval unique would be an understatement. Normally considered low-risk, municipals disconnected from Treasuries as concerns about fiscal and economic conditions of state and local governments overwhelmed investors. Yields on daily reset variable rate demand notes rose as high as 8%. Municipal short-term yields and yields on pre-refunded bonds rose to 3% even as 10-year Treasuries remained under 1%. Municipal-to-Treasury ratios cheapened significantly across the curve with 5-year, 10-year, and 30-year ratios ending the month at 291%, 191%, and 147%, respectively.

Amid harrowing illiquidity, leveraged municipal bond funds were especially hard hit. Short-term rates rose dramatically, forcing the collapse of some tender option bond (TOB) programs. TOBs create leverage by borrowing from money market funds to invest in high quality longer dated municipal bonds. The expectation is that the purchased long term bonds will yield more than the borrowing rate paid on short-term floating rate securities. Early in March, short rates skyrocketed and forced the unwinding of TOBs (selling the long maturity securities), adding more pressure to an already strained municipal market.

The lesson here: You get what you pay for. If the yield on a municipal fund looks too good, there is a reason for that, and unfortunately many investors in leveraged high yield funds have learned the hard way. Some high yield funds own bonds that they may not be able to get a bid for, let alone a bid they find reasonable, for quite some time as issuers' credit ratings worsen.

Performance

By late March, as volatility and illiquidity hit an inflection point, non-U.S. and corporate based investors returned to the muni market, prompting a dramatic rally. The speed with which the municipal yield curve moved higher was matched only in the speed and depth with which it returned to lower yields. In three trading days (3/17 – 3/20) the Municipal Market Data (MMD) 10-year yield moved higher by 95 bps from 1.69% to 2.79%. By March 30th, the MMD 10-year was yielding 1.24%.

Looking at the entire quarter, high grade municipal bonds (as represented by the Bloomberg Barclays Municipal Index) performed well in 1Q20, returning -0.63%, but underperforming the Bloomberg Barclays US Treasury Index, which returned 8.20% for the same period. Year-to-date gross issuance was $90 billion, nearly 18% higher than the same period last year.

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Historic Volatility

The municipal market has never experienced this level of volatility, not even during the GFC. Municipal/Treasury ratios peaked on March 23rd at levels never before seen. The 2-year ratio was 857%, the 10-year ratio was 369%, and the 30-year was 251%. Ratio analysis became irrelevant and will probably not return to any historic norms until we witness a more stable market and Treasuries, more likely than not, at higher rates.

The mismatch between buyers and sellers was most evident in secondary market clearing level of bonds, especially lesser quality new issues. For example, the highly sought after Buckeye OH Tobacco Settlement 4.00% Due 6/1/2048 (CUSIP: 118217CX4) rated BBB+ by Standard & Poor's priced at an initial offering of 2.60% ($112.513) on 2/26/20 and traded as low as 2.15% ($116.922) on the same day. By 3/24 those bonds were trading at 4.60% ($90.571) and ended the month at 3.16% ($107.278) (All data reported by the Municipal Securities Rulemaking Board).

We do not expect to see that sort of volatility on highly rated credits as we continue to focus on maintaining at least AA average rating in our portfolios and look for relative opportunities with the potential to add performance. Increased market volatility is increased potential opportunity when it comes to security selection. It is this market environment we really like, when there is panic selling, when high quality paper is just being dumped because the owners have to sell believing that is the best way to get the most realistic bid.

Default Risks

Huge deficits are being forecast from virus related shutdowns. We recognize that defaults in the municipal market are bound to happen. Our focus is to what degree and how exposed is the investment grade category, and that depends on how long the current crisis lasts. If restrictions lift by the beginning of June, millions of people returning to work would no doubt boost the economy. If it is a slow recovery, a lot of investment grade paper, especially A-rated and higher, should perform accordingly. Bonds rated BBB and lower would be very questionable in that scenario.

Nearly all sectors of the municipal market will be impacted at some level. Below are a few of our current thoughts and concerns:

> **Hospital Bonds**, which had been very strong performers over the past few years, are now under incredible pressure compounded by the lack of sufficient help.

> **Senior Living Facilities**, given the risk of community spread in some geographies.

> **University Dormitories**, a category replete with issuance of BBB bonds backed by dormitory facilities at major colleges before the crisis. When those dorms were occupied, the cash flows were good; now they're unoccupied. How long will they stay unoccupied, and how long can such facilities last being empty?

> **State and Local GOs** are in stronger positions, but states that were fiscally challenged before the crisis may face incredible pressure. Could one or more states lose their investment grade ratings? That is hard to project. We'll have to see how long the crisis lasts.

> **Transportation, including Toll Roads.** Bonds that were solid like toll roads are now questionable and more illiquid. In evaluating such credits, analysts typically factor in revenue projections over different time periods and assume they might deviate by a small percentage. Now there are practically no revenues from these toll roads.

What will happen to such credits? A lot depends on the financial strength of issuer, its management, and how long revenues are severely impacted. The same goes for fiscally strapped states. While unfunded pension liabilities will remain a long-term issue, the immediate concern is whether potential shortfalls in tax revenues will jeopardize current obligations.

Take the State of New York, for example, historically a very strong credit and rated AA+. But now that it is on a wartime footing, it is very much under pressure. Standard & Poor's recently put it on negative watch. That just means the state might be downgraded to AA, given the likely interruption in tax revenues while costs are going up. Other municipalities may come under similar pressure. Smaller ones could go bankrupt.

OUTLOOK

While supply in the primary and the competitive markets was non-existent as of April 2, we anticipate longer term investors will eventually find potential buying opportunities in high grade quality bonds.

Our analysts are reviewing our positions every day. Any positions with yellow flags have been eliminated in order to maintain our longstanding emphasis on high quality. Credit spreads on some bonds are still not wide enough and on other bonds are very wide, given continued uncertainty about how long the medical and financial crisis is going to last.

Other bonds are going to have a very difficult time, especially expensive malls backed by tax free bonds (i.e., American Dream in New Jersey-now closed), or ambitious rail projects (i.e., Virgin Trains' plans for a Miami-to-Orlando train line, which has no ridership, throwing credit analysis into a quandary).

The illiquidity we are seeing right now is probably more of a potential buying opportunity than anything else, especially for a high quality portfolio. It will be difficult to predict when relatively normal liquidity will return to the muni market. A lot will depend on when investors feel more confident. However, we believe demand for high grade municipals could resume this summer as demand should overwhelm supply.

Looking ahead, we believe municipal bonds will remain an attractive investment class. Quality will be king, and if volatility subsides by summer, rates on municipals should move lower.

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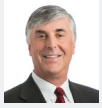
Investment Grade – Tax-Exempt



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