Breckinridge CAPITAL ADVISORS

PERSPECTIVES

COMPARING 2020 COVID-19 MARKET TURMOIL TO 2008

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By Peter Coffin

Breckinridge President Peter Coffin shares thoughts on the turmoil affecting municipal and corporate bonds as the markets and the economy endure effects related to COVID-19.

Q. HOW DOES THIS DOWNTURN COMPARE TO 2008?

A. It is worse in many respects. Declines in stock prices along with spikes in bond spreads and Municipal/Treasury ratios are more dramatic and sudden this time. Yields climbed on municipal and corporate bonds even as Treasury yields fell.

Higher yields reflect both illiquidity and credit concerns. We see evidence that the drastic shifts are mostly due to illiquidity—especially in the municipal market. The fact that prices of high quality pre-refunded or AAA state obligations fell so significantly is clearly due to liquidity, we believe, because credit risk remains low for these bonds. Even Treasury bonds, considered the safest investment, suffered significant ongoing illiquidity, despite the Fed's best efforts.

The fact that prices reversed so dramatically this week confirms for us our view about recent volatility being due more to technical imbalances than underlying fundamentals. If sentiment reverses again, a resumption of accelerated fund redemptions could create imbalances like we saw earlier. This potential is a caution for investors to avoid reactions to day-to-day pricing changes in any asset class that is being overwhelmed by technical factors.

Q. WHY IS LIQUIDITY WORSE?

A. More forced selling, mostly from bond funds. Bond funds grew bigger following the Great Financial Crisis (GFC). Much of the inflows likely came from money market funds with investors seeking better yields by extending maturities. Now bond funds are experiencing outflows. Investors are stampeding back to money market funds.

As the pace of mutual fund outflows surpasses the GFC, they have a snowballing effect. There is heavy selling due to liquidations from leveraged and programmatic strategies also.

Dealers cannot cope with all this selling. Following the GFC, tighter regulations reduced risk tolerance and the amount of capital dealers commit to support liquidity. Dealers are struggling to hedge and manage exposure to U.S. Treasuries, further complicating liquidity.

Q. BUT CREDIT RISK IS DRIVING SPREADS WIDER TOO, CORRECT?

A. Yes, a huge and rapid economic shock like this one pressures municipal and corporate credit quality. From our perspective, mitigating this circumstance is an up-in-quality bias that Breckinridge maintains. We seek to avoid investing in marginal investment grade bonds that we believed are expensive. We seek to invest in industry-leading companies and essential and financially solid municipal issuers that we believe will prove resilient. The high-quality corporate and municipal bonds we seek to invest in should be better able to absorb an economic shock than lower quality bonds, in our view.

Credit rating downgrades are likely if the current downturn persists. Despite the economic dislocation, we have high confidence that our holdings' credit fundamentals, including our view that their ability to meet debt obligations in a timely manner will stay intact. As written, the federal government fiscal stimulus passed by the Senate yesterday (March 25) can provide meaningful support for companies and municipalities.

Q. IN ADDITION TO MAINTAINING YOUR UP-IN-QUALITY APPROACH, WHAT ELSE IS BRECKINRIDGE DOING?

A. We are staying true to our philosophy. In times like these, fixed income performance can help to counterbalance equity risk. Right now, we are:

- *Continuing our in-depth credit quality reviews for bonds that we own.* We are examining their capacity to endure a changed economic environment in the near, intermediate and longer term.

- *Being opportunistic.* When the herd flees, good corporate and municipal bonds may come under pressure. With our disciplined and risk-aware approach, we look to add value by investing in securities that others sell but which we believe still have value relative to other bonds.

- *Staying out of the stampede.* An investor in a separate account bond portfolio can step aside from the herd. Separate account investors own the bonds in their account, whereas mutual fund investors are commingled with other shareowners. As direct owner, the separate account investor can avoid the stampede, earn cash flow from coupons and maturities, and wait out the storm. We believe a separate account can be a haven from market dislocation for many investors.

- *Staying faithful to our mandate.* We seek to build portfolios that are positioned to endure turmoil, sustain a reliable source of income, and preserve capital.