Breckinridge CAPITAL ADVISORS

COMMENTARY

We acknowledge that market conditions have changed since the publication of this commentary. It is intended to be a review of the month of February. For our most recent thoughts on the current state of the market please contact CR@breckinridge.com.

FEBRUARY 2020 MARKET COMMENTARY

SUMMARY

- **U.S. Treasury Curve:** Treasury yields were stable to slightly higher during the first half of the month before falling precipitously during the last two weeks on widening coronavirus (COVID-19) concerns. The 10-year Treasury closed at 1.15 percent, an all-time low.
- **Tax-Exempt Municipal/Treasury (M/T) Ratios:** After following a path lower for most of the period, M/T ratios increased at the end of the month. The 10-year and 30-year spots closed at 82 percent and 92 percent, respectively.
- **Municipal Market Technicals:** New issue supply exceeded $36 billion, per The Bond Buyer, an impressive 38 percent year-over-year increase.
- **Corporate Market Technicals:** Index-eligible IG corporate fixed-rate supply was $97 billion, off 8 percent from the same period last year and a 44 percent decline from the prior month.
- **Securitized Trends:** Spreads for mortgage-backed securities (MBS) ended the month the widest in four years. Agency commercial mortgage-backed securities (Agency CMBS) was the best performer within securitized bond markets.

MARKET REVIEW

February was a difficult month for investors. U.S. equity indexes touched all-time high levels by mid-month before declining 11 percent, which wiped out stock market gains year-to-date. While economic data was generally in line with expectations, relentlessly unsettling news about efforts to contain the spread of COVID-19 shook investor confidence. Two business days into March, the Federal Open Market Committee cut the Federal Funds rate by a half percentage point (0.5 basis points (bps)) explaining, "The committee is closely monitoring developments and their implications for the economic outlook and will use its tools and act as appropriate to support the economy."

Treasury yields drifted a little higher during the first two weeks of the month, then fell sharply and prices rallied, as COVID-19 concerns caused downward revisions to global growth estimates. Investors sought the relative haven that bonds historically offer in times of economic uncertainty, as reflected in asset flows to bond mutual funds, based on to ICI/Lipper data.

The 10-year Treasury bond yield ended February at an all-time low of 1.15 percent, the 30-year at an all-time low of 1.68 percent and stocks were 13 percent off all-time highs reached just days before (See Figure 1 showing Treasury yields at three points in time during the month).

MUNICIPAL MARKET REVIEW

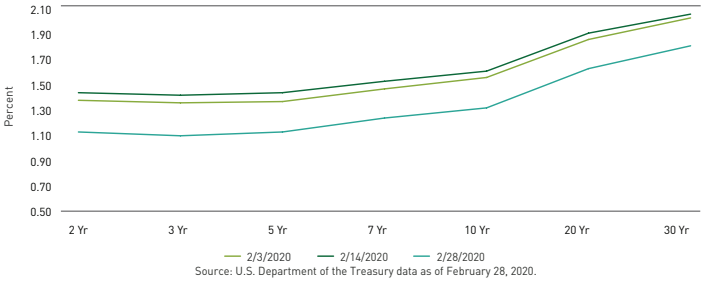
Municipal yields followed Treasury yields during the month, reaching all-time lows per MMD data. Yields for the 10-year and 30-year bonds closed the month at 0.93 percent and 1.52 percent.

Municipal/Treasury (M/T) ratios benefited. After spending much of the month showing very low relative value, municipal bonds underperformed Treasuries by a wide margin during the last two trading days of the month, and ratios rebounded sharply, per Barclays. Compared with the end of January, the 5-year M/T ratio improved to 80 percent, representing a remarkable 17-ratio increase. The 10-year and 30-year spots closed at 82 percent and 92 percent, respectively, also up from the prior month end, although not as dramatically as the 5-year, Barclays data showed.

A positive technical environment prevailed as mutual

fund flows into tax-exempt funds continued. For February, weekly flows averaged nearly $2.3 billion, per data from ICI/Lipper. Tax-exempt bond issuance was just over $26 billion for the month, per The Bond Buyer, 15 percent higher than issuance in January 2020, and 38% higher than February 2019. Taxable municipal bond issuance remained strong at 26% of the total municipal bonds issued for the month.

FIGURE 1: TREASURY BOND YIELDS DECLINED MORE SIGNIFICANTLY DURING THE SECOND HALF OF FEBRUARY



Source: U.S. Department of the Treasury data as of February 28, 2020.

Municipal bonds posted positive returns for the month, but underperformed Treasuries on a total return basis across the curve. The BBG Municipal Bond Index returned 1.29 percent and the BBG Municipal 1-10 Year Blend Index gained 0.71 percent. Like last month, maturities 5 years and longer had the strongest returns while bonds rated BBB outperformed other rating categories, Bloomberg data showed.

On the credit front, Puerto Rico struck a tentative deal with bond holders that would reduce its debt load by $24 billion. In most circumstances, a development such as this could have reassured if not encouraged investors, but the potentially positive development was overwhelmed by uncertainty about the global path of COVID-19 and implications for economic upheaval across regions. We published an article considering some of the risks that could influence the market (*See Considerations for the Municipal Bond Market and COVID-19*) and continue to monitor the market and portfolio holdings.

We continue to be defensively positioned across strategies given COVID-19 and late-cycle dynamics. During the month, we shortened the target durations for our intermediate- and long/intermediate-maturity strategies by .05 years due to historically low yields and a flattened yield curve. The allocation to the six-year and longer portion of the curve was reduced in favor of the 1- to 5-year range. Treasury bond positions established in January and February due to the relative expensiveness of tax-exempt munis will be reversed now that tax-exempt munis are trading at relatively more attractive ratios (See *Surge in Taxable Issuance Creates Opportunities in the Municipal Bond Market* and *Low Yields Elevate Value of M/T Ratios, Crossover Trades*).

CORPORATE MARKET REVIEW

During the final week of the month, the corporate bond market caught up with the equity market sell-off, and spreads widened meaningfully. As the tone turned more negative for corporate bonds, there was no new corporate bond issuance during the last week of the month for the first time since February 2018 during a non-holiday week. In February, the Bloomberg Barclays U.S. Corporate Bond index was 20bps wider to 122bps. Corporate bonds underperformed similar-duration Treasuries by 176bps for the month, as measured by the BBG U.S. Corporate Index and the BBG Treasury Index.

The best-performing sectors and industries were supranational, Foreign local government, office real estate investment trusts (REITs), healthcare REITs, and construction machinery. The worst-performing sectors were independent energy, oil field services, food & beverage, midstream oil and gas and cable satellite. Across the investment grade quality spectrum, higher-rated bonds outperformed lower-rated bonds. Specifically, bonds rated Aa+ generated negative 70bps of excess returns compared to negative 220bps for BBB-rated bonds, according to Barclays.

A positive technical backdrop was characterized by a drop in supply and solid fund flows. Investment grade fund flows were a healthy $27 billion, according to Wells Fargo. Fixed-rate, gross investment grade supply for February was about $97 billion in February, according to Barclays data, off 8 percent from the same period last year. Noteworthy also, February 2020 issuance was nearly 44 percent lower than the $172 billion in January, illustrating the dramatic cooling of new issuance during the month.

We continue to be defensively positioned across strategies given COVID-19 and late-cycle dynamics. In terms of credit, corporate profit growth may slow as the coronavirus spreads globally. We published an article considering some of the risks that could influence the corporate bond analysis (See *Monitoring the Coronavirus for Risks to Bond Strategies*) and continue to monitor the market and portfolio holdings. Spreads widened 29bps through February, creating opportunities in select high grade issuers, per Barclays.

SECURITIZED MARKET REVIEW

During the month, mortgage-related securities traded directionally with Treasury yield changes: outperforming

when rates increased or were stable, which was the story for the first half of the month, only to underperform significantly when rates declined and mortgage prepayment projections increased during the second half of the month. Duration for the mortgage-backed security (MBS) index declined sharply and spreads to Treasury bonds widened, ending the month their widest in four years, according to Barclays data.

Agency CMBS was the best performing segment of the securitized markets with total return of 2.29 percent, according to Barclays data. Agency mortgage-backed securities (agency MBS), as represented by the BBG MBS Index, earned a total return of 104bps, trailing Treasuries of similar duration.

MBS spreads continue to look attractive relative to other IG sectors. Asset-Backed Securities and Agency CMBS, given the structural prepayment projections built into the bonds, should continue to perform well in risk-off environments, in our view.

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