Breckinridge CAPITAL ADVISORS

COMMENTARY

JULY 2020 MARKET COMMENTARY

SUMMARY

- **U.S. Treasury Curve:** Treasury yields continued to grind lower across the curve. The curve flattened during July, as long-term yields fell more quickly than shorter-term yields. The two-year bond yield fell 4 basis point (bps) while the 10-year yield was lower by 13bps and the 30-year yield by 22bps.

- **Tax-Exempt Municipal/Treasury (M/T) Ratios:** Municipal bonds outperformed Treasuries, sending M/T ratios lower. The 2-year ratio compressed more than 60 ratios. The 5-year ratio fell 35 ratios. Ratio changes further out the curve were muted.

- **Municipal Market Technicals:** July new issuance was more than $44 billion, per Barclays, less than June and 46 percent more than the same month last year. Taxable issuance continued to increase at a breakneck pace, up more than 500 percent from June, per The Bond Buyer.

- **Corporate Market Technicals:** Investment grade (IG) fixed-rate corporate bond supply slowed in July from the torrid pace of the first half of the year to $56 billion. The Fed's buying activity in the bond market continues to provide significant technical support.

- **Securitized Trends:** Nominal Mortgage-Backed Securities (MBS) current coupon spreads ground tighter. Persistent Fed buying of 2-2.5 percent coupons continued to provide direct support to the sector. Other securitized asset sectors benefited from the Fed and its Term Asset-Backed Securities Loan Facility (TALF).

MARKET REVIEW

The influence of conditions related to the spread of COVID-19 remained during July, as many states experienced increases in cases, hospitalizations and deaths. As states relaxed social and business restrictions, economic indicators—industrial production, retail sales and existing and new home sales, for example—rebounded above initial estimates. Stock and bond prices increased. For bond investors, the persistent grinding of yields lower and spreads narrower challenged the search for income.

Investors appeared to look past declining gross domestic product (GDP) measure (a seasonally adjusted negative 32.9 annual rate) and unemployment claims (1.43 million in the week ended July 25). Their enthusiasm may be buoyed by expectations for improved economic and business conditions in 2021. As the month closed, the U.S. dollar trended weaker against other major global currencies which could impact demand for U.S. dollar-denominated IG fixed income.

In our view, the path to recovery will be slow and uneven with the risk still present of a second wave this fall. Government intervention remains an overwhelming market technical, overriding fundamentals. After the Federal Open Market Committee meeting, Fed Chairman Jerome Powell said, "The path forward for the economy is extraordinary uncertain and will depend in large part on our success in keeping the virus in check." He said Congress and the central bank would need to do more in the months ahead. Entering August, additional fiscal stimulus was stalled in House/Senate/White House negotiations.

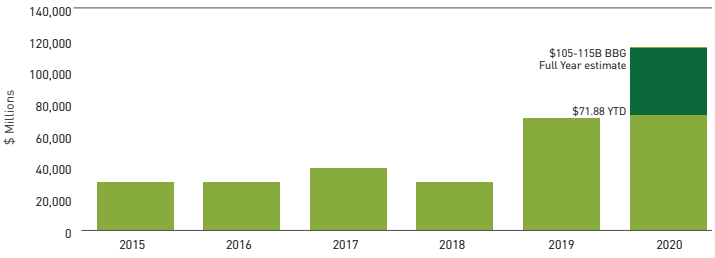
MUNICIPAL MARKET REVIEW

Municipal bond yields broke out of a tight trading range mid-month, reaching new record low levels in several tenors. During July, AAA general obligation bond yields fell 14 to 18bps in the 2- to 5-year range, 22 to 25bps up to 10 years and 25 and 26bps from 10 to 30 years. Yields below 1 percent stretched across the curve to 17 years.

Year-to-date, yields have declined 90bps in the front end, between 80bps and 90bps in the belly of the curve and more than 70bps out longer. The muni curve flattened modestly over the month, with 2s10s and 2s30s curves sitting at 52bps and 124bps, respectively.

Municipal bonds outperformed Treasuries in July. The BBG Municipal Bond Index posted a total return of 1.68 percent, while the BBG U.S. Treasury Index earned 1.14 percent. Ratios were lower with the 2-year falling nearly 60 ratios and 5-year dropping 35 ratios. Among municipal bonds, longer maturities outperformed shorter maturities and lower quality bonds outperformed higher quality, per Barclays.

FIGURE 1: BARCLAYS ESTIMATES TAXABLE MUNICIPAL BOND ISSUANCE TO EXCEED $105 BILLION IN 2020



Source: The Bond Buyer: Full year totals 2015-2019 and YTD 2020
Barclays: Estimate for full year 2020, as of July 31, 2020.

Muni issuance in July totaled roughly $43 billion, per The Bond Buyer, down 15 percent month-over-month but up 41 percent year-over-year. Year-to-date gross issuance stands at $248 billion.

Municipal issuers continued the year's accelerated pace of taxable muni deals, accounting for $16 billion in issuance during July, pushing year-to-date taxable supply to $69 billion, per The Bond Buyer. The low interest rate environment and provisions limiting state and local tax deductions contained in the Tax Cuts and Jobs Act of 2017 continued to support taxable muni bond issuance. Barclays estimates that taxable bond issuance could exceed $105 billion in 2020, which would be a 50 percent increase over notably high level issued in 2019. While healthy taxable supply has provided some crossover opportunities for tax-exempt strategies, spreads tightened over the month, particularly in the front-end. The yield pickup waned somewhat in the low-yield environment, although valuations relative to corporate bonds continued to look compelling.

Muni fund flows were positive in July, per J.P. Morgan, finishing the month with $1.8 billion inflows for an eleventh consecutive week pushing the year-to-date inflows to $3.1 billion.

Credit fundamentals remained challenged, in our view, particularly in sectors reliant on rebounding consumer activity and increasing mobility. On a more positive note, robust fund inflows and strong demand for bonds due to heavy projected seasonal reinvestment should support the positive technical environment in August.

CORPORATE MARKET REVIEW

IG corporate spreads tightened by 17bps in July, ending the month at 133bps. Spreads on long corporate bond fell 19bps, driving higher relative performance compared to intermediate corporate maturities, where spreads tightened 16bps. Corporate credits rated BBB outperformed single-A-rated credits.

The BBG Corporate Bond Index gained 3.25 percent for the month and 8.44 percent year-to-date through July. According to Barclays, the best-performing sectors were independent energy, transportation, metals and mining, life insurance and natural gas. The worst performing sectors were supranationals, airlines, foreign agencies, foreign local government and banking.

Corporate bond prices also found support in market technicals. First, companies generally paused new bond issuance while second quarter earnings reports were underway, and only $56 billion of IG corporate fixed-rate bonds priced, per Barclays. Although July was down from $159 billion in June, IG corporate fixed-rate supply hit $1.2 trillion at month end on a year-to-date basis and was up by 88% year-over-year. Second, the Fed's IG corporate bond purchasing program, which began in June, continued, with holdings reaching over $12 billion. Third, fund inflows remained elevated, with IG funds reporting about $37 billion of net new flows in July, per EPFR, slightly below June's $47 billion inflow.

Credit fundamentals have weakened with the recessionary conditions spurred by COVID-19: high unemployment, repressed consumer demand and stifled business activity, have negatively impacted revenues and earnings. However, after a majority of Q2 earnings reports, according to S&P, companies are generally beating very low expectations.

Corporate actions since the onset of the pandemic indicate that IG companies are preserving liquidity by reducing discretionary share buybacks, and boosting financial flexibility through refinancing higher-cost, near-term debt with longer-term bonds bearing lower coupons. Rating agency credit downgrades slowed after a flurry of activity in April and May. Still, downgrades are expected to outpace upgrades.

Volumes of fallen angels, company ratings slipping from IG to high yield categories, are likely to remain elevated.

SECURITIZED MARKET REVIEW

While nominal current coupon MBS spreads ground to their tightest level since mid-February, persistent Fed buying of lower coupons has driven relative value and performance within the sector. Lower coupons outperformed higher coupons again. Other sectors in securitized products continue to benefit from TALF/Fed support. According to the Barclays Bloomberg indices, asset-backed securities had another strong month, generating 26bps of excess returns with autos outperforming credit cards. Agency Commercial MBS (CMBS) generated modest positive excess returns but lagged non-agency CMBS.

We consider MBS spreads to be attractive relative to Treasuries due to strong technicals in MBS attributable to the Fed's unlimited quantitative easing. We expect carry rather than spread tightening to contribute to mortgage total return performance going forward. ABS and ACMBS spreads approached year-end 2019 levels, but should still outperform in a risk-off environment, in our view. As government stimulus tapers off, its likely more loans will become delinquent and/or default given weak labor market conditions.