Breckinridge CAPITAL ADVISORS

COMMENTARY

MAY 2020 MARKET COMMENTARY

SUMMARY

- **U.S. Treasury Curve:** The Treasury yield curve steepened, trading in a tight range. Yields in the 2- to 7-year segment declined. The 10-year yield increased by a basis point (bp) and the 30-year yield gained 14 bps. Market function improved due to ongoing Fed support through continued purchases of Treasuries. Early in May, the Treasury Department launched sales of a 20-year bond.

- **Tax-Exempt Municipal/Treasury (M/T) Ratios:** Municipals substantially outperformed Treasuries. Muni bond yields moved lower, reaching new historic lows in the 2- to 5-year range by month end. The muni yield curve steepened. M/T ratios plummeted, falling to near 100 percent in 2 years, 127 percent at 5 years and 116 percent at 30 years. (See Figure 1.)

- **Municipal Market Technicals:** Issuance ticked up over the month but marked the lowest May volume since 2014. Taxable issuance continues to be a meaningful share of new issuance, representing $36 billion or 24 percent of the total year to date, per The Bond Buyer.

- **Corporate Market Technicals:** Investment grade (IG) supply was elevated. About $241 billion was priced in May, according to Bank of America. Year-to-date IG supply eclipsed $1 trillion, an astounding 96 percent increase over 2019. Fed purchases of corporate bond exchange traded funds (ETFs), added to its corporate bond buying program, was market positive.

- **Securitized Trends:** Securitized market conditions were favorable. Mortgage-backed securities (MBS) were rangebound due to the Fed's continued support in the sector. The agency commercial mortgage-backed securities (ACMBS), non-agency CMBS and asset-backed securities (ABS) sectors generally delivered robust positive total and excess returns for the month.

MARKET REVIEW

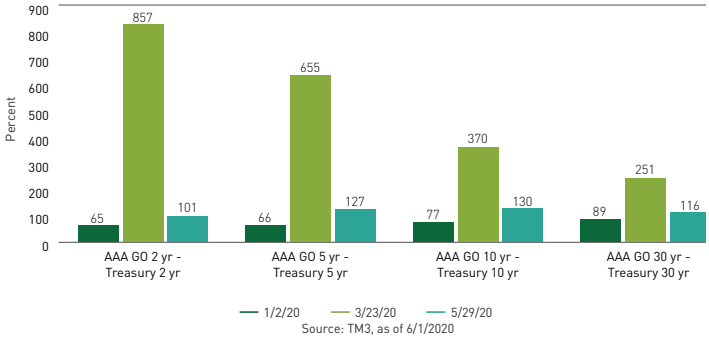
During May, many states increased economic activities that were restrained by lockdowns related to COVID-19. While economic activity is a long way from pre-COVID-19 levels, investors appeared to feel a sense of relief and markets rallied. Stocks gained. Municipal and corporate bond spreads narrowed, and prices increased. Markets continued their positive performance even as violence wracked many American cities at the end of the month, when protests of the deaths of black men and women intensified and turned destructive.

The Fed continued its intervention in markets and backstops for risk asset values. It seemed that investors might be looking through the deteriorating near term fundamentals in 2020 to the potential of more favorable economic conditions in 2021. For example, S&P Index corporate earnings reported for Q1 were lower by 15 percent compared with the same period last year, per FactSet, but spreads on IG corporate bonds moved 200 bps tighter from March wides. Similarly, municipal bond spreads tightened substantially off March wides, despite headline-driven credit risk concerns due to anticipated revenue falloffs for states and municipalities. Persistent increases in new unemployment claims were not enough to keep prime, AAA-rated ABS spreads from approaching their tightest range of the year.

MUNICIPAL MARKET REVIEW

The municipal bond market had its rally cap on for the entire month, bolstered by investor confidence in asset market and economic backstops provided by Congress and the Fed. Absolute yields hit historic lows across shorter maturities, setting new low marks in the 2- to 5-year ranges, and matched the record low in the 1-year maturity. M/T ratios fell across the curve (See Figure 1). The curve steepened in the 2s10s segment and 2s30s segment, finishing at the widest levels year-to-date and in more than a year.

FIGURE 1: M/T RATIOS REFLECT DIMENSIONS OF MUNI MARKET CHANGES DURING 2020, ESPECIALLY SHORTER MATURITIES



Source: TM3, as of 6/1/2020

The BBG Municipal Bond Index was up 3.18 percent. Per Bloomberg, longer duration led the way. The long bond (22 plus years) earned 4.16 percent versus 3.27 percent in 10-year tenor. The water and sewer sector was the best performing sector over the month and to-date this year.

Higher quality remains in demand and continued to outperform lower quality, according to Bloomberg. It is worth noting a rebound in performance of lower-quality bonds during May. Moving forward, persistently low yields and strong technicals could continue to benefit the performance of low-quality bonds. The BBG Muni High Yield Index was up 4.08 percent on the month. The index's year-to-date total return remained at a loss 6.35 percent. Bonds rated BBB added 3.09 percent, modestly lagging AAA-rated bond gains of 3.22 percent.

Issuance of nearly $28 billion was the lowest May total since 2014 comprised of $22 billion tax-exempt and $5 billion taxable. Year-to-date issuance at the end of May totaled $150 billion, a 10 percent increase over the same period in 2019, per The Bond Buyer. Taxable municipal bond supply reached a substantive $36 billion or 24 percent of total issuance marking a 160 percent increase year over year. Taxable municipal bond valuations remain compelling with spreads near year-to-date wides. Municipal fund inflows continued, with Lipper reporting combined weekly and monthly inflows of $1.1 billion for the one-week period ended May 27. May inflows reduced year-to-date outflows to less than $19 billion.

Historically low yields did not deter demand, as summer reinvestment commenced. The appetite for municipal bonds supported improved market access for relatively weaker names. Sizable and relatively more financially challenged issuers, including the New York Metropolitan Transit Authority, and general obligation issues of the states of Illinois and Connecticut cleared the market in May.

The market's reception for these issues could portend positive conditions for tax-exempt muni bonds, in our view. If future budgets are strained on a cash-flow basis, new borrowing for infrastructure improvements and new construction could remain low, limiting supply. Tax-exempt supply could be further restrained by a potential revival of the Build America Bond program, as proposed earlier this year by House Democrats as part of a $760 billion infrastructure program.[1] Demand could increase should tax rates increase to address deepening fiscal deficits. Munis remain one of the few tax-advantaged options. In addition, yields on competing options such as Treasuries and cash remain low to zero.

CORPORATE MARKET REVIEW

IG corporate bond spreads continued to grind tighter, ending May at 174 bps. Spreads are well off their wides of 373 bps in March. Bonds rated BBB outperformed other rating categories and were 36 bps tighter, while A-rated bond spreads were 21 bps tighter.

The BBG Corporate Bond Index gained 1.56 percent for the month and 3.00 percent year-to-date through May. According to Barclays, the best-performing sectors were oil field services, independent energy, refining, midstream, and sovereigns. The worst performing were financial companies, supranationals, electric utility, retail REITs and natural gas.

Credit fundamentals are weak with the coronavirus-induced recession negatively impacting corporate cash flows and high new bond issuance increasing debt. S&P 500 Index earnings declined approximately 15 percent in Q1, year-over-year. Analysts' expectations are for further declines of potentially as much as 25 percent in Q2.

Rating agency activity remains high, with downgrades dwarfing upgrades at levels not seen since 2009, particularly among high yield bonds. Volume for fallen angels—IG bonds falling to high yield categories—are likely to remain elevated given high leverage prior to COVID-19.

A silver-lining is that IG companies are raising record amounts of needed cash, reducing near term debt rollover and liquidity risks (See *Corporate Bond Market Outlook Q1 2020*). Furthermore, a broad reduction underway in shareholder rewards like stock buybacks and stock dividends preserves free cash flow and financial flexibility.[2]

Technicals remain favorable due to IG fund inflows and Fed buying of corporate bonds and ETFs. Approximately $241 billion of IG supply priced in May, in addition to the $545 billion issued in March and April.

IG supply eclipsed $1 trillion at the end of May, the fastest start to a year ever. Fund inflows remain solid, with IG funds reporting about $32 billion in May, per Informa PLC/ EPFR Global, up from April's $23 billion. Notably, IG dealer inventories declined to $4.5 billion in May from about $8 billion in April, per Credit Suisse, as buying activity in the primary market remains elevated.

The Fed purchased nearly $3 billion of IG corporate ETFs as of May 27th. The current pace may undershoot the Secondary Market Corporate Credit Facility's $50 billion of capacity by September, giving it room to accelerate activity, if needed.

SECURITIZED MARKET REVIEW

MBS performance was rangebound in May due to the stability that the Fed's continued support provided to the sector. As measured by the BBG U.S. MBS Index, the sector earned a total return of 12 bps for the month, leaving year-to-date excess returns at negative 31 bps. After $700 billion in net purchases in three months by the Fed, spreads have flatlined at 110 bps, which still affords the sector attractive relative value in a quantitative easing (QE) environment with the Fed's unlimited support providing a strong technical to the sector.

ACMBS had a strong month returning 65 bps, per Barclays. Non-agency CMBS benefited from the risk-on backdrop provided by the Fed's support and resurging investor confidence to generate a total return of 1.35 percent.

ABS posted a 1.09 percent total return, based on Barclays data. AAA-rated, prime ABS spreads are back to pre-crisis levels due to strong demand for high-quality sectors, particularly in the front end. New issue supply is down 40 percent year-over-year, a technical condition that supported performance during the month.

FOOTNOTES:

1. "House Democrats propose $494 billion surface transportation bill," The Bond Buyer, June 3, 2020.
2. S&P Global Ratings, Credit Trends, as of July 18, 2018.