Breckinridge CAPITAL ADVISORS

COMMENTARY

OCTOBER 2019 MARKET COMMENTARY

SUMMARY

- **U.S. Treasury Curve:** The Treasury yield curve steepened during the month of October as the Fed delivered its third 25 basis point (bp) rate cut this year. The two-year Treasury yield fell 10 basis points (bps) during the month while the 20-year and 30-year yields drifted higher by 6 and 7bps, respectively.

- **Tax-Exempt Municipal/Treasury Ratios:** Similar trends were evident in municipal market data as shorter yields trended lower during the month while yields on 20- and 30-year bonds moved higher. Municipal ratios fell across the curve: in the low- to mid-70s for two and five years and 3 ratios higher for 10 years.

- **Municipal Market Technicals:** New-issue supply continues at an elevated pace with $52 billion coming to market.[1] Taxable issuance made up a big portion again—about 25 percent of total issuance—with over $13 billion. The elevated taxable issuance over the last two months has eased the pressure on the tax-exempt side and municipal performance has held in well.

- **Corporate Market Technicals:** The corporate yield curve flattened with longer maturities outperforming. Investment grade (IG) corporate fixed supply was flat year-over-year at $71 billion, down from $135 billion in during the prior month.[2]

- **Securitized Trends:** Tight nominal spreads on asset-backed securities (ABS) saw investors rotate into higher-beta sectors such as agency commercial mortgage-backed securities (agency CMBS) which matched agency MBS at 9bps of excess returns relative to duration-matched Treasuries.

MARKET REVIEW

The Treasury yield curve steepened on the third federal funds rate cut during 2019. The two- year Treasury yield fell 10 basis points (bps) during the month while the 20-year and 30-year yields drifted higher by 6bps and 7bps, respectively. At the month ended, macroeconomic influences supported a rally in risk asset investments as investors grew less risk averse due to a federal funds rate cut of 25 bps, an in-line gross domestic product report pegging annualized growth at a rate of 1.9 percent for the third quarter (compared with 2.0 percent at the end of the second quarter) and a jobs report that surprised to the upside. Indications of progress toward a phase-one trade accommodation between the U.S. and China and the potential for a resolution to the Brexit issue also contributed to the risk-on sentiment.

Economic growth is slowing in the U.S., but it is outpacing the eurozone. Some inflation measures are trending higher. Consumer sentiment remains positive while weaker manufacturing readings appeared to discourage business investment. Our outlook was realized by the Fed's late month fed funds cut and accompanying statement that the current policy stance is "likely to remain appropriate."[3] We do not anticipate any further cuts this year or during 2020 based on current conditions.

MUNICIPAL MARKET REVIEW

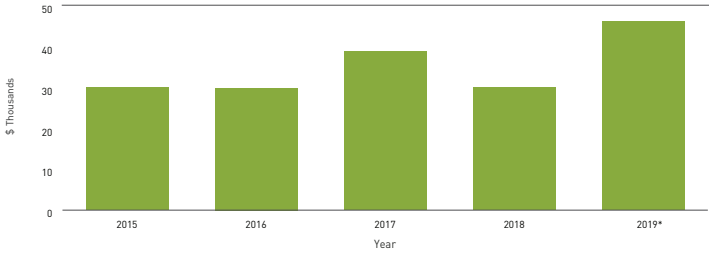
Municipal bond yield curve changes reflected trends in the Treasury curve. Municipal bond yields fell from five years and shorter and rose from eight years and longer as the municipal curve steepened, reversing the inversion in the short-end of the curve. Yields fell for the 2- and 5-year maturities by 11 and 8bps, respectively. The largest increase in yields was in the 10- and 30-year ranges, where they rose 7 and 5bps, respectively. Municipals outperformed

Treasuries in the front end of the curve (5 years and shorter), with ratios falling by 2 and 3 ratios in 2 and 5 years. The ratio for the 10-year maturity was higher by 3 ratios.

New-issue supply continues at an elevated pace with $52 billion coming to market. Supply year-to-date now stands at $330 billion, 13% higher than the pace through the same period in 2018.

Taxable issuance was approximately 25 percent of total issuance. *The Bond Buyer* reported, "The issuance of taxable municipal securities has leapt to record levels in 2019 against a post-advance refunding backdrop of historically low rates and heighted interest from an expanding pool of international investors."[4] Elevated taxable issuance during 2019, particularly during the last two months, eased the pressure on the tax-exempt side and municipal performance held in well.

FIGURE 1: TAXABLE BOND ISSUANCE SURGED YEAR-TO-DATE IN 2019



*Year to date through October 31, 2019
Source: The Bond Buyer as of October 31, 2019.

The last week of October marked 43 consecutive weeks of bond fund inflows, with YTD inflows to municipal bond funds running at a record pace for 38 consecutive weeks.[5] Generally, municipal market fundamentals remain stable, as taxes are beating estimates and home price growth remains positive. Demand for tax-exempt income has remained strong enough to absorb new issuance.

CORPORATE MARKET REVIEW

IG corporate bond spreads compressed 5bps primarily due to better-than-expected third-quarter earnings announcements, positive equity market performance and supportive supply and demand factors. As the corporate credit curve flattened, longer maturities outperformed. The best-performing corporate bond market sectors during October according to the *Barclays October 2019 U.S. Investment Grade Corporate Update* were Refining, Life Insurance, Wireless, Building Materials and Cable Satellite. The worst-performing sectors were Supranationals, Independent Energy, Midstream Energy, Foreign Local Government and Construction Machinery. Bonds rated BBB performed best relative to the other quality sectors, while bonds in the Aa+ quality sector underperformed the other sectors.

IG corporate fixed supply was $71 billion, flat year-over-year and a notable decline from $135 billion in September. Demand remained solid with long-term IG bond mutual funds reporting $17 billion of inflows over the last month, per the Investment Company Institute, bringing year-to-date inflows to $108 billion.[6] Foreign investors also continued to buy U.S. IG corporate bonds, which is supportive of valuations.

IG corporate-debt leverage, while still notably high in an historical context, has begun to moderate as more issuers are responding to rating agency and investor concerns.

SECURITIZED MARKET REVIEW[7]

MBS net supply is on track to end the year around $285 billion, one of the highest levels since the crisis.[8] New and existing home sales started to show strength, reflecting lower rates and better affordability. A steeper yield curve projects higher forward rates which then projects slower prepayments which extends MBS durations, particularly lower coupons. Agency MBS produced 9bps of excess return relative to duration-match Treasuries. Range-bound Treasuries trading led to lower volatility and multi-year wides in nominal spreads, which brought buyers in off the sidelines. Asset-backed securities underperformed Treasuries in a rare off month for the sector. Tight nominal spreads saw investors rotate into other higher-beta sectors such as agency CMBS, which matched agency MBS at 9bps of excess returns. Longer maturities outperformed shorter parts of the curve.

FOOTNOTES:

1. *The Bond Buyer*, as of October 31, 2019.
2. Bloomberg Barclays, *U.S. Investment Grade Corporate Update*, as of November 1, 2019.
3. Reuters, "Big central banks move to wait-and-see mode," *https://www.reuters.com/article/us-global-economy/big-central-banks-move-to-wait-and-see-mode-idUSKBN1XD09V*. November 3, 2019.
4. *The Bond Buyer*, "Why the explosive growth of taxable munis could be sustainable," *https://www.bondbuyer.com/news/why-explosive-growth-of-taxable-municipals-could-be-sustainable?brief=00000159-f607-d46a-ab79-fe27f2be0000*. November 6, 2019.
5. *Lipper fund flow data*, as of November 1, 2019.
6. Bloomberg Barclays, *U.S. Investment Grade Corporate Update*, as of November 1, 2019.
7. Securitized performance is represented by Bloomberg Barclays Index data.
8. Bank of America Merrill Lynch, *Securitized Product Weekly*, as of November 1, 2019.