Breckinridge CAPITAL ADVISORS

COMMENTARY

SEPTEMBER 2019 MARKET COMMENTARY

SUMMARY

- **U.S. Treasury Curve:** The 2s10s portion of the curve steepened slightly after the FOMC cut the Federal Funds Rate. The 10-year Treasury traded in a wide range, from a low of 1.45 percent to a high of 1.90 percent.
- **Tax-Exempt Municipal/Treasury Ratios:** Municipal yields moved more than 20 basis points (bps) higher from historic lows from 10 years and longer in mid-September. Municipals lagged Treasuries, causing municipal/Treasury ratios to cheapen substantially.
- **Municipal Market Technicals:** September supply was just over $35 billion, marking two consecutive months of elevated supply. By the end of the month, year-to-date (YTD) total supply was 9 percent above last year's pace.
- **Corporate Market Technicals:** Investment grade (IG) corporate fixed-rate supply was $135 billion, one of the largest totals ever for the month of September, per Barclays. A record 130 IG issuers tapped the market. Maturities of $82 billion served to mute net supply at about $53 billion.
- **Securitized Trends:** Prepayment fears within the mortgage-backed securities (MBS) sector moderated on modestly higher rates and low volatility month-over-month. A flight to quality in the asset-backed securities (ABS) sector remained the main driver of price action.

MARKET REVIEW

Markets recovered in September after the risk-off tone in August as trade rhetoric softened and economic data bounced back. Over the month, Treasury yields rose, and IG credit spreads tightened. As widely predicted, the FOMC cut its benchmark rate by 25 basis points (bps) for the second time in the third quarter, citing "the implications of global developments for the economic outlook as well as muted inflation pressures" as the primary drivers. The meeting had three dissents, the most since the December 2014 meeting, with two members arguing for no change to the Fed Funds Rate and one member calling for a 50bps cut. Even with the dissenting views, the median expectation is for no additional cuts this year or in 2020, while the market is expecting one more cut this year and an additional cut in 2020.

The U.S. economy continues to hold up well despite ongoing trade tensions. Most recessionary signals are not flashing red; retail sales, consumer confidence, and wage growth data all are near recent highs.

Interest rates remained volatile. Over the month, yields on the 10-year Treasury traded in a wide range, recovering from the low levels of August to reach as high as 1.90 percent. After inverting during August, the 2s10s portion of the yield curve steepened by 5bps following the rate cut. The 2s30s curve steepened by 3bps.

On September 17, the cost of borrowing in the repurchase market jumped to as high as 10 percent overnight.[1] In the weeks that followed, the Fed pumped nearly $400 billion into the overnight financing market to steady its operation. On October 8, Fed Chairman Jay Powell acknowledged while speaking at the National Association for Business Economics that "an important channel in the transmission process—wholesale funding markets—exhibited unexpectedly intense volatility." Subsequently, the Fed said it would increase its purchases of short-term Treasury securities to avoid a recurrence of the unexpected strains in the money markets.

MUNICIPAL MARKET REVIEW

Municipal yields rose over the month, with the 2-year, 5-year, 10-year and 30-year closing the month at 1.22 percent, 1.23 percent, 1.42 percent and 2.01 percent, respectively. After hitting historic lows during August, yields spiked in mid-September resulting in the worst week for municipal bond performance in three years. September marked the first negative monthly returns for the year. Through September 30, 2019, the one-month return for the Bloomberg Municipal Index was -0.81, while the Bloomberg Barclays 1-10 Year Index return was -0.76 percent. Year-to-date (YTD) through September 30, the indexes returned 6.75 percent and 4.73 percent, respectively. The 10-year and 15-year segments showed the worst returns. September returns were strongest for shorter maturity bonds.

Municipals ratios were in the mid-70 percent range in 2-3 years segments, high-70 percent range for 5 years, and 85 percent and 95 percent for 10 and 30 years, respectively. The 1s6s portion of the municipal bond yield curve remained inverted.

September supply was just over $35 billion. It was the second consecutive month of elevated supply. At month end, year-to-date supply was $275 billion, 9 percent ahead of last year's pace, per *The Bond Buyer*. Demand remained on a record-breaking pace with 38 weeks of positive mutual fund flows, the largest inflow since 2009.[2]

Credit conditions remained generally good. Taxes are outperforming budget targets in the three largest states: California, New York, and Texas. Weaknesses include an uptick in impairments in the non-rated and high yield segments. A large default in the Virgin Islands appeared more likely.

CORPORATE MARKET REVIEW

IG corporate spreads compressed in September by 5bps on stronger equity markets, a temporary reprieve in the U.S./China tariff war, and favorable technical factors. The Bloomberg Barclays U.S. Investment Grade Corporate Index generated 38bps of excess returns. The best-performing sectors during September were Oil Field Services, Diversified Manufacturing and Supermarkets. On the other side, the worst-performing sectors were Transportation, Health Insurance and Banking. From a ratings perspective, lower-quality bonds outperformed higher-rated bonds, with BBB-rated corporates generating 58bps of excess returns compared 23bps for A-rated credits.

Technicals remained solid. IG supply for September was $134.7 billion, per Barclays, bringing the YTD total to $815.3 billion. September was the busiest month of 2019 and the third largest month on record in terms of gross supply.[3] A record 130 IG issuers tapped the market.[4] Maturities of $82 billion resulted in a more muted net supply total of $53 billion. BBB-rated bond issuance has dominated with 42% of IG corporate fixed supply coming in the BBB-rated quality segment. Issuers are beginning to shift issuance away from releveraging activities to refinancing high-cost debt and extending maturities. Long-term IG mutual funds reported $18 billion of inflows over the last month, per the Investment Company Institute, bringing year-to-date inflows to $97 billion. Healthy foreign demand should support valuations.

SECURITIZED MARKET REVIEW

Prepayment fears, which have dominated the MBS sector for most of the year, moderated on modestly higher rates and low volatility month-over-month. Spreads remain wide and we believe they present an attractive entry point considering the level of convexity in the market.

Within the ABS sector, a flight-to-quality remained the main driver of price action. Persistently negative front-end swap spreads continue to keep a lid on valuations.

Structural features inherent in the agency commercial mortgage-backed securities sector provided a buffer against prepayment fears stemming from the month's sharp rate rally, which has helped bolster strong performance.

FOOTNOTES:

1. "Fed Injects More Into Money Markets After Banks Bid Heavily for Funds," *Wall Street Journal*, September 18, 2019.
2. Lipper and JP Morgan as of September 30, 2019.
3. Bank of America as of October 1, 2019.
4. Barclays Credit Research as of October 4, 2019.