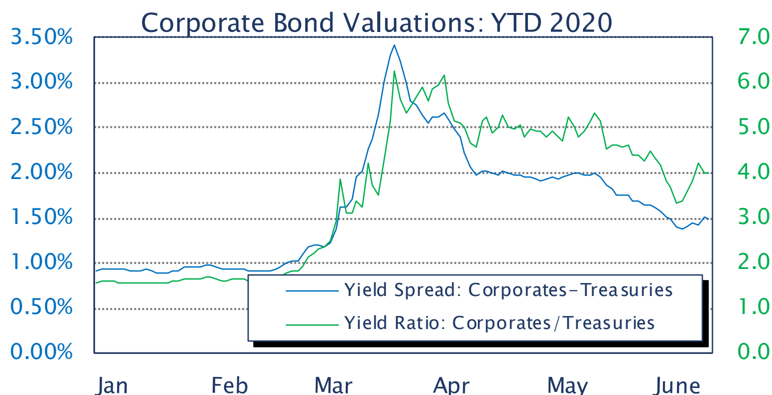
JUNE 2020

# INVESTMENT UPDATE

This month, we want to quickly cover a couple of important things that are going on in the corporate bond sector, where there has been a lot of excitement—both good and bad—over the past three months.

As the chart on this page shows, the yield spread that corporate bonds offered over and above those of like-maturity Treasury bonds (the blue line in this chart) began the year at historically tight levels, offering less than 100 basis points (1.00%) of incremental yield. To put that in perspective, that was very nearly the tightest margin in more than a dozen years, going back before the beginning of the financial crisis. We've also plotted an alternative measure, the average corporate bond yield divided by the average yield for Treasuries—in other words, the yield ratio of corporates to Treasuries measured over time. The results are largely the same; any way you slice it, corporate bonds didn't offer a lot of value for investors at the start of the year. But that changed dramatically in March.




As the reality of the breadth of the coronavirus became known in early March, investors began running for cover, selling risky assets to either hide out in cash or in safer government-backed securities. The result for bond investors was a rapid widening in the yield differential between corporates and Treasuries. Between the third week of February and third week of March, the average yield spread of high grade corporates rose from approximately 95 basis points (BP) to more than 340 basis points. Seeing the market in disarray, the Fed rolled out a number of emergency liquidity measures which quickly served to calm the markets; as shown in the chart, corporate yield spreads moved back to 255 BP at the end of March and further narrowed to approximately 200 BP, staying at roughly that level throughout April. Using our "percent more income" measure, the ratio of corporate yield to Treasuries reached a peak of 6.3X in late March, the highest ratio ever recorded for investment-grade bonds. That ratio stabilized in the neighborhood of 5X through April—yet that was still above the highest level seen during the financial crisis.

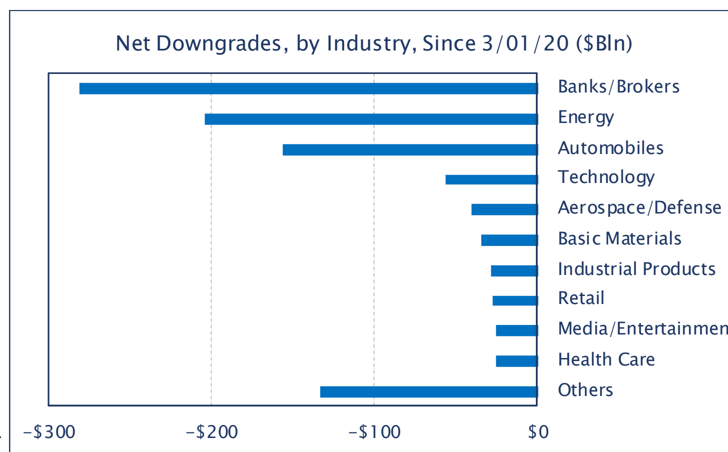
The period of yield spread (and yield ratio) widening in the first quarter of 2020 produced the worst relative returns for high grade corporate bonds ever reported for a calendar quarter, as Treasury returns beat those of corporate credits by nearly 13% on a duration-neutral basis. The price of the average Treasury security rose by more than 7 ½ points in the quarter, while corporates fell on average by more than 4 points. Value investors dream of these kind of market dislocations, when emotions rule the day and investment fundamentals go out the window. The case for "buying whatever's getting hammered" is bolstered to the point of dogma when an entity with the clout of the Federal Reserve announces (as it did on March 23rd) that it is "committed to using its full range of tools" to support the credit markets. Add in the coronavirus-related fiscal stimulus that's been extended over the past three months to households and businesses, and you've got a lot of money backstopping the US economy.

It should therefore come as no surprise that yield differentials have continued to shrink over the past few weeks, as the worst economic impacts of the virus—for the broad economy as well as corporate profitability—appear to be fading. The US is slowly emerging from our virus-afflicted hibernation, and with it, retail sales and corporate investment are expected to follow. As sudden as the sell-off was for risky assets early in the year, their recovery has been no less surprising, especially for the US stock market, which is now essentially flat, year-to-date. There's a lot of good news reflected in the price of stocks right now, pointing to a quick recovery with few lingering aftereffects. Meanwhile, the high grade credit markets still have a decent margin of safety priced in; but that's a bond market hallmark—we're perpetually worried (if not downright pessimistic) about what the future may hold. We're not ready to declare victory yet, and yield differentials remain historically elevated as a result.

Switching gears slightly, one reason why the credit markets haven't recovered to the same extent as equities is the fear of downgrades from the ratings agencies. Despite the many programs in place to assist workers and organizations, the coro-

navirus has had a broad and dramatic impact on corporate earnings. Some industries (airlines, hotels) have been directly impacted by a drying up of revenues, while others (energy, retailers) have been more indirectly hit by a general slowing of economic activity. In any case, the COVID outbreak has been, to put it simply, bad for business. For many organizations the recovery phase of this outbreak could be a long and difficult process, putting future earnings under pressure for an extended period. And when businesses experience lower profitability and impaired cash flow, their ability to make guaranteed payments to bondholders can become problematic.

The major ratings agencies (Moody's, S&P, and, more recently, Fitch) are responsible for analyzing the prospects of corporations that issue bonds, and assigning a rating based on the financial strength of those issuers. Over the years, the agencies have come under criticism for doing a poor job of accurately rating companies, most notably during the "corporate malfeasance" era in the early 2000s (hello, Enron!) and during the financial crisis (hi, Lehman!). In their defense, it's no easy matter to examine a company that falsifies its financial statements and lies to examiners and auditors, as Enron did, and despite Lehman Brothers' surprising collapse, the ratings agencies did a reasonable job in rating corporate bonds leading up to and during the financial crisis (better not to mention the abysmal work they did analyzing CMOs and other structured residential mortgage products, however).




Whether they do a good job or not, we nevertheless operate at the mercy of the ratings agencies. No, we don't depend on their analysis of companies (although they can be useful as another source of information); we perform our own credit research in-house, with an experienced team that has consistently added value in our clients' portfolios. Rather, we are at their mercy because of the rule-based nature of modern bond portfolio management. One of the somewhat unique characteristics of the credit markets—especially the high grade corporate sector—is that most total return bond managers (like Agincourt) must comply with client guidelines regarding credit ratings. If one of your bond holdings was issued by a company that gets downgraded, you could be forced to sell it.

Typically, if a company is downgraded it occurs at a time when the company is struggling, and that would also imply that the price of its bonds are under pressure as well. To make matters worse, particularly when the downgrade means that the credit moves below a rating of "BBB," the price of the bond may fall dramatically, as portfolio managers could be forced to sell the bond, in accordance with client guidelines or fund rules (e.g., "no holdings rated below investment grade are allowed"). Further, the convention for the Bloomberg Barclays Indexes is that an issuer's bonds exit the investment grade universe the month the downgrade takes place, just when the selling pressure is at its height, and price pressures are at their worst. In other words, holders of downgraded bonds can be forced out, by rule, at the exact time you do not want to be selling.

The ratings agencies are keen to prove their worth this time around, and have already downgraded more than $1 trillion in investment-grade corporate bonds since March 1st (see chart, data courtesy BofA Securities). There is currently another $600 billion of mid- to low-BBB rated corporates earmarked for possible downgrade in the near future (compared to roughly $3 trillion in BBB-rated corporate credits in the index). This is particularly concerning for corporate investors, as downgrades of these bonds will in many cases mean falling out of the investment grade universe. For especially weak credits—many of whom have had multiple downgrades over recent months—the slide down the ratings ladder will continue, and culminate in default. Among high-yield energy companies (admittedly a very weak sector) the rolling 12-month default rate has spiked to 11%, from less than 3% a year ago.

To be clear: Our credit team has done an excellent job over the past few cycles, and has lived up to their reputation this time around as well. We had zero exposure to the biggest, most damaging downgrades of the past few months (including Occidental Petroleum, Ford, and Macys), and there are no bonds in our portfolio currently that we expect to be forced to sell in the coming months. Nevertheless, in this environment, we are watching developments and news flow very closely, as the outlook can change, which could impact our holdings. As always, active management, and staying one step ahead of the ratings agencies, is essential to maximizing returns and controlling risk in our clients' portfolios.

In short, from a relative value perspective, high grade corporate bonds remain our top pick for the sector most likely to outperform in the coming months. But with the macro environment as yet unsettled, and ratings trends still pointing downwards, navigating this market will continue to be a challenge.