

Coronavirus and Fixed-Income Markets
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We've just closed the books on a pretty dramatic first quarter in the fixed income markets. There was really nowhere to hide, aside from government bonds. US Treasuries were up 8 percent while global governments were up 3 percent in US dollar terms. But nearly all credit sectors sold off. We saw a lot of dispersion. High yield sold off between 12 and 15 percent, and emerging market debt was down, too. On average, high-yield dollar denominated emerging market bonds were down more than 22 percent, with the biggest drawdowns coming from the oil exporting countries. Global investment grade corporates also sold off, down a more modest 4 percent.

But the biggest market sell-off was in securitized sector, where credit risk transfer securities, which had historically been much less volatile than corporate high yield, sold off dramatically as levered investors were forced to sell their positions, creating a somewhat vicious pricing cycle that left the securities down, in some cases, more than 20 percent.

The commercial mortgage-backed securities (CMBS) market also came under pressure as worries about a further drop in mall traffic and hotels sent bond prices down. In particular, CMBX, the credit default swap that references 25 CMBS from a 2012 vintage, sold off with the A-rated tranche down more than 10 percent and the BBB- tranche down 17 percent.

The sell-off pushed spreads on credit sectors to the widest levels that we've seen since the global financial crisis. For example, US high yield spreads reached 1100 basis points mid-month. By quarter end, markets had come down a bit, with high yield retracing to just inside 900 basis points, but remain elevated.

What's been unprecedented is the speed of the sell-off. As investors sold indiscriminately from electronically traded funds and mutual funds, spreads widened quickly. In a matter of a couple weeks during March, they moved to levels that took more than 300 days to achieve in 2008. That resulted in the dramatic sell off in a very short period. And one of the reasons for that sharp decline in prices and widening in spreads was the liquidity crunch in the markets. You had investors all wanting to go one way, selling. And no one was there to take the other side, as dealer balance sheets have been much reduced and closed to risk-taking.

As a result, we saw big price drops as sellers tried to find someone to take the other side of the trade, and large spikes in bid-ask spreads reflected this poor liquidity. The potential for this sort of liquidity crunch is something that we've been focused on since the 2008 global financial crisis, but we did not expect it to be quite this intense. Now, looking ahead, we're certainly not calling the bottom here, but we would expect a rebound in the performance of credit sectors as liquidity improves and market sentiment improves.

The selloff in spreads amid this liquidity crunch has made select credit positions very attractive with significant future return potential. For example, with spreads at these levels, investment-grade corporates have much better upside than downside from here. If nothing happens, investors will earn just shy of 3 percent return over treasury bonds. But if they rally back, say 100 basis points from here, you're looking at nearly 10 percent potential excess return. Whereas if they widen 100 basis points from here, you'll lose only about 4 percent. Now that's a pretty attractive asymmetry of return.

The high-yield market offers another compelling return opportunity. Spreads are now more than eight hundred basis points and historically, whenever you've been here in the subsequent 24 months, you've never had a negative return. And the average return has been around 22 percent.

In the securitized space, investors have been concerned about a deterioration in fundamentals as the economy comes to a temporary standstill and consumers face job losses. But we think the sell off, in both residential and commercial mortgage related instruments, exceeds what's warranted by fundamentals. It's been exacerbated by that lack of trading liquidity. We continue to see compelling opportunity in this space. There are many parallels to 2008, in that amid this dramatic liquidity driven selloff, attractive opportunities emerge. We're taking a slow and steady approach, as we know volatility could persist in the near-term, but we're looking to selectively provide liquidity amid these attractive valuations.

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