Wow!

At the beginning of the first quarter, the coronavirus had yet to hit the radar screen of U.S. economists as a risk they were watching. It seemed to be little more than a flu-like virus spreading from a "wet market" in the city of Wuhan, China. The first confirmed case in the U.S. occurred on January 20, and the President was still minimizing the danger as late as March 9, comparing the 546 confirmed U.S. cases to the thousands of annual flu deaths. But within a week, the coronavirus had become a national emergency. The President suspended travel from Europe on March 11, the NCAA basketball tournament was canceled on March 13, and by the week of March 15 governments across the country were issuing shelter-in-place orders, closing schools and non-essential businesses. The S&P 500 lost 34% of its value between February 19 and March 23 and corporate credit spreads widened in concert. Stock values and credit spreads recovered some by the end of the quarter in response to extraordinary government support, but remain a long way from their pre-COVID-19 peak.

To say the first quarter was "volatile" would be an understatement. But in markets like these, experience matters. We want our clients to know we put our 25+ years of experience and professional judgement to work in a big way over the last 60 days on your behalf. The current crisis bears some similarities to past ones, but has also brought unprecedented challenges of its own. Be assured though that your team at OIM has our hands on the wheel of your portfolios.

Our commentary will focus on fixed income market performance, the extraordinary actions of the Federal Reserve and the U.S. government, and a revised 2020 forecast, albeit tentative, for the U.S. economy.

First Quarter Fixed Income Recap

2020 began with 2-year treasuries and 10-year treasuries yielding 1.57% and 1.92%, respectively. Things changed quickly, however, as the Fed cut rates aggressively to address the coronavirus pandemic and its effect on the economy. Two's and ten's ended the first quarter yielding 0.23% and 0.67%, respectively. The flight to safety resulted in a treasury rally while credit products suffered from spread widening and lack of liquidity. Below are highlights on fixed income performance in the first quarter.

- Long government bonds were the top performing sector, returning 21.5% in the quarter, due to the effect of duration on interest rate declines. Bond prices rise as yields fall. The longer the bond, the greater the price increases. The short-end of the curve benefited from rate cuts as well. The Bloomberg Barclays U.S. Treasury index ended the quarter with a return of 8.1%.
- Investment grade and high yield credit sold off as spreads widened significantly during the quarter. The Bloomberg Barclays U.S. Credit index returned -3.1% while the U.S. Corporate High Yield Credit index returned -12.7%. Investment grade spreads widened 165bps to 255bps. High yield was the worst performing fixed income segment as spreads widened from 336 basis points at the beginning of the quarter to 880 basis points at the end of the quarter. Investment grade and high yield spreads ended the quarter significantly above their long term averages (124 bps and 511 bps, respectively).
- Leveraged loans/floating rate was the next worst performing segment as the S&P/LSTA U.S. Leveraged Loan 100 index returned -9.9%. Loans in the energy sector experienced a double-whammy in the quarter due to the coronavirus outbreak and a war for market share between Russia and Saudi Arabia which drove a 66% decline in Brent crude in the quarter.
- Municipal bonds experienced historically high volatility in March with $28 billion in outflows resulting in a large sell-off before rallying back. The Bloomberg Barclays Municipal Bond index posted -0.6% return for the quarter. High yield municipal bonds, however, continued to sell off with return of -6.9%.
- Non-U.S. local currency global bonds were hurt as the U.S. Dollar appreciated during the quarter. Emerging market debt, both dollar and non-dollar, experienced spread widening. Just about all major developed and emerging market currencies declined relative to the U.S. Dollar with the exception of the Japanese Yen. Japanese government bonds were the sole global bond segment to post modest positive returns for the quarter.

The Fed Takes Action

While politics and bureaucracy seemingly exacerbated the COVID-19 crisis, the Federal Reserve acted with speed and force to stabilize the financial system and ensure orderly banking and securities markets. Below is a summary of the extraordinary measures implemented by the Fed beginning in March and continuing post quarter-end:

- Two rounds of rate cuts, 50bps on March 3 and 100bps on March 15, reducing the Fed Funds target rate to the lower bound, 0% to 0.25%.
- $700 billion in quantitative easing ($500 billion in treasuries, $200 billion in mortgage backed securities) on March 15. This program was later expanded to an "as needed" (i.e. "unlimited") amount to support the smooth functioning of credit markets and effective transmission of monetary policy.
- Implementing multiple measures to ensure adequate liquidity in the banking system, including overnight and term funding for primary dealers and dollar swap lines for global central banks.
- Establishing the Commercial Paper Funding Facility, providing a liquidity backstop to issuers of high rated commercial paper.
- Establishing the Money Market Mutual Fund Liquidity Facility, ensuring adequate liquidity to meet demands for redemptions by households and other investors.
- Establishing the Term Asset-Backed Securities Loan Facility to support asset-backed securities markets which include student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration.
- Establishing the Primary Market Corporate Credit Facility and the Secondary Market Corporate Credit Facility to provide $850 billion in liquidity to corporate debt markets by purchasing new and existing corporate debt issues, including those of "fallen angels" (firms losing investment grade ratings due to the pandemic) and high yield exchanged traded funds. Forget moral hazard, the Fed is purchasing high yield bonds.
- Establishing of the Main Street Lending Program, offering $600mm in loans to small and mid-sized businesses (less than 10,000 employees and $2.5 billion in revenues). This program is in addition to the Small Business Administration's Paycheck Protection Program offering forgivable loans to small businesses (less than 500 employees).
- Establishing of the Municipal Liquidity Facility, offering up to $500 billion in lending to states and municipalities.

These measures have provided essential support to financial markets at a time of increasing economic uncertainty and financial strain. The Fed has promised to use its "full range of tools" to ensure financial stability and minimize unemployment resulting from the crisis – which in "Fedspeak" means "whatever it takes." OIM estimates the Fed's balance sheet could expand by up to $2.6 trillion as a result of the aforementioned measures.

Congress Provides Fiscal Stimulus

In addition to the heroic efforts off the Federal Reserve to keep financial markets functioning through monetary stimulus, the Federal Government has also passed three pieces of legislation to help offset the impact of coronavirus from a fiscal perspective. The first two bills increased funding for public health and coronavirus research and expanded paid sick leave for workers and families impacted by quarantines. But the biggest fiscal impact comes from the CARES Act, a $2 trillion spending bill consisting of the following provisions:

- $532 billion in loans and other aid to corporations, states and municipalities (including $61 billion for airlines and other businesses critical to national security such as Boeing). Part of these funds will provide an equity backstop for credit losses resulting from the various lending facilities established by the Federal Reserve.
- $377 billion for the Small Business Administration to implement a Paycheck Protection Program. These loans are intended for firms with less than 500 employees (or entities within larger corporations) and will be forgiven if workers are retained for eight weeks. Up to 25% of the loans can be used for non-payroll expenses such as mortgage and rent payments.
- $290 billion in direct payments to households based on an income test (individuals and households earning more than $99k and $198k, respectively, are ineligible).
- $260 billion for expanded unemployment insurance. Benefits were expanded to cover more categories of workers, pay out for a longer period of time (39 weeks vs. 26 weeks) and increase by $600 weekly for the first four months.
- $290 billion in tax cuts, deferrals, and other benefits for businesses to improve near term cash flow.
- $150 billion in direct aid to states
- $385 billion to aid to hospitals, veterans' care, FEMA and others

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The size and scope of the CARES Act will help offset the effects of the pandemic and potentially aid the speed an eventual economic recovery. The Wall Street Journal, based on a study by Moody's Analytics, estimates 29% of the economy has suddenly gone idle in the last month. Assuming nominal gross domestic product of approximately $1.8 trillion monthly, Moody's estimate would equate to approximately $525mm in lost economic activity for every month the economy is shut down. The size of the stimulus, should it be implemented quickly, is sufficient to offset a little over three months of activity lost to shutdowns. These back-of-the-envelope calculations do not consider demand destruction from job losses, ongoing public health restrictions such as social distancing beyond the lockdown period, or a second wave of infections. As a result, it should not be a surprise that the government is already in discussions regarding a 4th stimulus package.

Our Revised 2020 Economic and Fixed Income Outlook

In our fourth quarter economic commentary, we forecasted a continuation in the economic recovery, with modest improvement in economic growth over 2019 due to Fed rate cuts, the alleviation of uncertainty resulting from the Phase One trade agreement with China, and the acceleration of wage growth from record low unemployment. Only the pandemic matters now and our previous 2020 forecast has quickly become obsolete. Below are our revised estimates, albeit very tentative ones, for the metrics that matter most at the moment: GDP, unemployment, and interest rates.

Gross Domestic Product:

While the duration of government shelter-in-place orders remains uncertain at this point, OIM believes the economy will re-open sometime in Q2. However, absent a breakthrough in treatment of COVID-19 in the near term, we do not believe it will be "business as usual." Governments will likely need to maintain some restrictions for the good of public health, including limitations on travel and public gatherings and mass testing, contact tracing and quarantines to contain the spread of the virus and limit strain on the healthcare system. Furthermore, we expect job losses, business closures, and lower business investment to constrain growth for the remainder of 2020. Because of this, OIM estimates a slower recovery as opposed to quick recovery. OIM estimates GDP growth to decline at an annualized rate of approximately -30% in the second quarter, flattening out in the third quarter as some people return to work and consumer spending begins to normalize, and returning to positive growth in the fourth quarter.

Unemployment:

The early read on employment data released in recent weeks has been outright scary. Approximately 16.7 million people have filed claims for unemployment insurance the last three weeks through April 4. Adding these people to the 5.8 million who were unemployed in February, and assuming a civilian workforce of 164.5 million people, the unemployment rate has blown out from 3.5% to 13.7%. For perspective, the unemployment rate topped out at 10% in the Great Recession. Most job losses thus far have occurred in the retail and hospitality sectors that are currently closed due to government shelter-in-place restrictions. Given the backlog in unemployment claims processing, we expect these numbers to remain exceptionally high in the next few weeks.

So how high will unemployment go? Based on a study of workers in vulnerable industries, the St. Louis Fed estimates unemployment could exceed 30%; however, we believe unemployment will top out around 20% for a few reasons. First, not all workers in vulnerable industries will be laid off. Second, many businesses may continue to pay employees in order to retain them for a re-opening of the recovery or to qualify for government support. Second, industries are adapting to the current social distancing environment. Modern technology has allowed many people to work from home and retailers and restaurants, for example, are processing orders online and offering curbside services. Finally, many workers have been furloughed and not laid off, allowing employers in some industries to bring them back quickly when the economy reopens.

Interest Rates:

As previously mentioned, the 10-year treasury yield declined 125 basis points in the first quarter to 0.67%. Similar sized moves were seen across the yield curve, and the shape of the curve remained largely intact and upward sloping. We expect interest rates to remain low due to the resumption of bond purchases by the Fed and a recessionary economic environment. Inflation (as measured by CORE PCE) ticked up modestly to begin 2020, increasing from 1.6% YoY in December to 1.7% and 1.8% in January and February, respectively. We do not expect potential product shortages from factory shutdowns or supply chain disruptions to result in permanent price inflation for consumer goods. Rather, low oil prices and job losses are likely to keep consumer prices and wage growth low. The economy is more likely to fight disinflation in the near term than inflation. However, we believe the Fed's "whatever it takes" posture will prevent outright deflation over the long run.

Investment Grade and High Yield Bond Outlook moving forward: As we discussed in detail above, COVID-19 took a toll on all risk assets in March. Corporate spreads widened as much as 224 basis points in investment grade and 600 basis points in High Yield in March alone. Corporate total return in March was the worst since back to back months of September and October of 2008.

However, there were positive developments towards the end of the month. Markets did rebound following all the many stimulus actions from the Fed and Congress. In addition, the investment grade primary market reopened to record new issuance supply, $262 billion, in March with High Yield new issuance also beginning to develop at month's end.

We expect pressure on markets to remain in the near future and the negative news on the COVID-19 front will continue. We will be patient and diligent and positioned in quality companies that can weather this storm. We believe many bonds are trading far below value at this time. We will continue to monitor the situation and the companies we are invested in very closely. If we believe there is a cause for action, we will act but we have built all of our portfolios to withstand environments like we are currently in.

Fundamental Research and Our Disciplined Investment Process

As you are aware, financial market conditions have been extremely challenging, however we continue to believe that significant intrinsic value exists beyond the prices reflected in the quarter-end marks for our corporate securities. At quarter end, net credit spreads (credit spreads less expected defaults) are near historical contraction. Liquidity is returning to the credit markets and trading with depth of bids and offers as returned after two rugged weeks in mid-March. There have been many new corporate issues as mentioned previously and most corporate sectors have tightened significantly which bode well for the credit markets. We believe that the high quality companies with strong balance sheets and stable liquidity sources that form the traditional core holdings of our portfolios will survive and recover, but the road to recovery will be slow and bumpy. We continue to believe that our bottom-up, fundamental analysis and portfolio diversification will position us to continue avoiding major individual security losses and take advantage of opportunities.

Should you have any questions on strategy, performance or business development, please do not hesitate to contact us. Most importantly, please be safe and have comfort in knowing we are here working hard every day on your behalf.

Thank you,

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