Logan Fixed Income

LOGAN FIXED INCOME MARKET COMMENTARY
Q1 | 2020 REVIEW

FEDERAL RESERVE

At year-end, investors were expecting the FOMC to be on hold for the duration of 2020, with a small chance of one rate cut in the second half of the year. At the time, the Fed expressed satisfaction with the level of rates as low inflation and low unemployment meant they were meeting their targets.

Just a few months later and the whole conversation has changed. We have witnessed 150 bps of cuts during the quarter, and yet no one is shocked. Investors are not showing disagreement with the decision. The only questions we hear are, "What is the Federal Reserve going to do next?"

CORPORATES

A decade of low interest rates has encouraged record amounts of issuance, which has been used for share buybacks to support equity prices. This position has left record amounts of debt on balance sheets. These higher levels of debt leave some companies in more difficult positions to service their debt. The general thinking at the end of 2019, was investors would penalize these weaker credits over the medium term.

More recently, corporations are maxing out their credit lines. The idea is to raise cash before it is needed in case the lines are later reduced or pulled. Although the Fed has already instructed banks not to stress about liquidity and capital buffers that were put into place following the recession of 2009, the impact is causing spreads to widen significantly, especially in BBB-rated airlines and energy debt. Overleveraged firms may find it more difficult or significantly more expensive to rollover their upcoming maturities.

MBS AND RESIDENTIAL MORTGAGES

Initially, record low rates in the Treasury market (which mortgage rates are based off) raised expectations for a wave of refinance activity.

U.S. TREASURY YIELDS	12/31/2019	3/31/2020	YTD Change
2 Yr.	1.569%	0.246%	1.323%
3 Yr.	1.609%	0.293%	1.316%
5 Yr.	1.691%	0.380%	1.311%
7 Yr.	1.831%	0.541%	1.290%
10 Yr.	1.917%	0.669%	1.248%
30 Yr.	2.390%	1.321%	1.069%
10s minus 2s	34.8 bps	42.3 bps	

Source: Bloomberg

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We have witnessed loan originators increase the spread between their costs and the rates charged in order to marginally slow the applications.

From the perspective of an investor, we have observed speeds increase leaving few options to reinvest the proceeds. Financial institutions are seeing a build-up of cash with few options for a reasonable return.

MUNICIPAL

As most state and local governments started the year in a strong financial position, we do not expect the decline in revenues to have a long-term impact on their credit worthiness. We anticipate seeing some credit downgrades as reserves are used to maintain day-to-day operations, but do not expect to see widespread defaults emanating from this severe slowdown in the economy. The quarter ended with immense technical pressures arising from the selling in municipal mutual funds and ETFs, which has cheapened the entire sector as compared to Treasuries. The immediate need of these commingled funds to meet cash redemptions lead to an abrupt change in direction for municipal yields. This reverses the flight-to-safety move through most of the period as investors sought out safe havens.

While revenue from property tax is not expected to decline significantly, revenue from sales tax will be meaningfully decreased well into the summer moving directionally with GDP as the economy comes back online.

Where we could, we added to exposure in the 3-5-year maturity range and in up-in-quality credits to take advantage of the temporary dislocation before munis trade closer to their historical relationship to Treasuries. We will be watching the net cash flows of municipal mutual funds and its impact on the relative value on the sector.

OIL

The OPEC+ alliance has failed as Russia balked at Saudi Arabia's aggressive push for additional output cuts, and walked away from the alliance, sacrificing oil price support in exchange for high market share while punishing U.S. shale producers. WTI has dropped from a high of $62.23 on January 6 to end the period at $20.09.

This supply shock is on top of the demand shock as the bulk of the country is in stay-at-home mode. Typically, at this time of year, summer vacations are being planned. We expect roughly flat to slightly negative demand growth on the year, the weakest since the financial crisis. The gas gauge in my car has hardly moved in the last 2 weeks.

LOOKING FORWARD

While each global event is different, the best we can do to see what the immediate future will bring is the experience of China. Chinese businesses were eager to reopen, even as the number of COVID-19 cases crested. It was a struggle to get workers in place, but most companies are back to work. The key difference is that industry makes up a greater part of the economy in China as compared to the U.S. After the backlog in orders was fulfilled, orders collapsed as demand was understandably weak in Europe and the U.S. Even Chinese domestic demand has fallen. The next step was factory layoffs. While each major economy is different around the globe, there tends to be enough overlap that we can measure where we are along the path and tweak our responses to improve outcomes.

The tremendous easing by the Federal Reserve as well as the multitude of programs being rerolled out, in addition to the CARES Act (Coronavirus Aid, Relief, and Economic Security) being implemented by the Federal Government, has set the stage for the economy to recover at a quicker pace. While not preventing a recession, the assistance will most likely be felt in the future as the damage without these programs would be worse.

We look forward to future commentaries commenting more on sectors and economic fundamentals.

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