Logan Fixed Income

Q2 | 2020

LOGAN FIXED INCOME MARKET COMMENTARY
Q2 | 2020 REVIEW

SQUINTING INTO THE FUTURE

The quarter actually progressed towards normalcy:

- Large, direct Fed market purchases ended in April.
- Bond traders had a clear picture of Treasury funding plans, including the new 20-yr.
- Investment grade corporate issuance slowed, meeting supply demands rather than emergency funding needs by corporations.
- Equities explored relative value rather than an exclusive focus on fear and greed. Volatility dropped and remains low.
- The dollar rebalanced against global currencies, no longer enjoying an exclusive premium.

Furthermore, bond issuance was so strong in late March and April that the three-month average hit a record high, while mortgage applications for both refinancing and home purchase have rebounded strongly in recent weeks. In short, the corporate bond and residential mortgage markets don't appear to need any additional support from QE – borrowing costs are already low and credit is freely available.

While the economy is now on the road to recovery, that road is likely to have many twists and turns along the way.

While news about possible vaccines remain promising, there are still a number of unknowns regarding the virus and the economic outlook. On an optimistic note, nothing was broken in the U.S. economy prior to the COVID-19 outbreak. Moreover, unusually quick and well-targeted policy moves by the Fed, Congress and the Trump administration appear to have prevented the health care crisis from becoming a financial crisis or systemic economic crisis. That said, there is still a great deal of uncertainty about whether the U.S., Asia and Europe will see a second wave of the virus.

U.S. TREASURY YIELDS	12/31/2019	3/31/2020	6/30/2020	YTD Change
2 Yr.	1.569%	0.246%	0.149%	1.420%
3 Yr.	1.609%	0.293%	0.173%	1.436%
5 Yr.	1.691%	0.380%	0.288%	1.403%
7 Yr.	1.831%	0.541%	0.491%	1.340%
10 Yr.	1.917%	0.669%	0.656%	1.261%
20 Yr.	N/A	N/A	1.174%	N/A
30 Yr.	2.390%	1.321%	1.411%	0.979%
10s minus 2s	34.8 bps	42.3 bps	50.7 bps	

Source: Bloomberg

Trade relationships have also been disrupted and COVID-19 has spread disturbingly to the developing world, particularly Brazil and India, presenting a continuing threat to supply chains.

CURRENCIES

Bloomberg News reports on the findings of an HSBC study that should shock no one, but is well worth repeating nonetheless: Negative interest rates in Europe have undermined the euro's use as a reserve currency. In other words, given a choice between holding euro-denominated sovereign debt at a negative rate and US Treasuries at a positive rate, central banks around the world are choosing Treasuries. Also not surprising, HSBC predicts the euro will gain in reserve currency status if interest rates are positive again. We expect the FOMC not to use this tool to help the U.S. economy to increase GDP and assist the speed the economy to a strong position.

CORPORATES

May and early June have allowed firms to issue massive amounts of new debt at attractive levels (attractive to the issuer, not the investor). With the assistance from the Fed, the corporate bond market has shown its operating efficiently. Since the second quarter started from such a weak point (relatively wide spreads), performance for the sector has been quite strong.

MBS AND RESIDENTIAL MORTGAGES

We see a large portion of the real estate market in a freeze, with listings down nationwide and borrowers struggling to meet debt payments. The Federal Housing Finance Agency says extension of foreclosure and eviction moratoriums, which were set to expire at the end of June, will help keep borrowers and renters in their homes during the current coronavirus pandemic.

MUNICIPAL

State and local governments employ 12.5% of the workforce . (Source: First Horizon Financial) Their tax revenues have plunged and their budgets are stretched. Even as the private sector started rehiring workers in May, the public sector cut almost 600,000 jobs. More state and local job cuts are coming, even as state and local tax increases bite into paychecks. Yields blew out to start the quarter as municipal mutual funds saw redemption requests for the first time in over a year. Yields ratcheted in as the FOMC included the sector in its purchase program. As of the end of the quarter, we observed yields at +200-350% of comparable Treasuries, much improved from the 700-800% we witnessed at the beginning of April.

OIL

Coming into the pandemic, OPEC+ faced a dilemma. Most of its members, including Saudi Arabia, aren't built for oil prices below $60 a barrel. Yet $60-plus oil had encouraged more output from non-members, especially U.S. shale producers. Deploying the weapon of lower priced oil in 2014 certainly hurt shale producers, but an infusion of new capital enabled shale to weather the storm. Meanwhile, the economic fallout of less revenue hurt OPEC members to the point where they not only abandoned that strategy, they acknowledged defeat by joining with Russia and a few others to form OPEC+. Since then, OPEC has been trading away market share for higher, but still inadequate, oil prices, which was one reason why Russia bridled at further cuts in March of this year. One thing that is helping OPEC+ this time around is that shale's own track record of dismal returns means a bailout in the U.S. from the stock market or bondholders isn't forthcoming this time. The fracking industry is cutting output swiftly and must consolidate, meaning future production growth is likely to be subdued compared to the pre-crash pace.

Yet the basic contours of the OPEC+ dilemma are intact. Its members remain dependent on oil and need prices far higher than today's levels to fund themselves. They must withhold supply to drain the glut of inventory that had built up. Yet with higher prices, the temptation of countries such as Iraq or Nigeria to
brake through targets to shore up financial stability will be irresistible. Meanwhile, shale producers will emerge from this rationalization less exuberant than they once were but still more than able to take advantage of an oil rally.

In response, OPEC+ would have to resort to the same method of discipline it has before: flooding the market until everyone, its own members included, struggle to cover costs. One added complication: the President's impaired electoral prospects mean he is likely to threaten security consequences for Saudi Arabia if it does anything to hurt shale producers in red states this summer. Oil (WTI) ends the quarter priced at approximately $39.27, hitting its low for the period of $21.17 on April 28. (Source: Bloomberg)

LOOKING FORWARD- INFLATION

Some disinflation is more likely in the next couple of years than inflation. Although there are some factors that will push up costs and thus inflation — broken supply chains, spot shortages, and the costs of making workplaces and transportation safer, for example — these will be overwhelmed by the disinflationary effects of cautious consumer and business spending, a weak global economy and low commodity prices.

ECONOMIC RECOVERY

Our economy will almost certainly experience the biggest one-quarter GDP drop ever recorded this period. And yet, households will be in better financial shape after the recession than when it began thanks to the various Federal programs implemented in March and April. There's no precedent for this, but it bodes well for a stronger recovery.

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