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INCOME RESEARCH + MANAGEMENT

IR+M UPDATE
Diverging Roads

April 22, 2020

The global spread of the coronavirus created economic uncertainty and extreme market weakness. Within the US Investment Grade bond market, the most significant spread widening in over ten years was driven mostly by market technicals as liquidity evaporated - in a scramble for cash, investors sold what they could.

We believe that the market has since somewhat normalized as government programs have helped support liquidity with direct purchases and numerous backstop facilities. Spreads have tightened and we feel investors can now focus on the fundamental picture, sorting through each industry to determine which may persevere, which may struggle to revert to normal, and which may have longer-term issues. Below, our Analysts have provided some color on the risks and opportunities across sectors, and the potential for fundamental industry changes going forward.

Checking the Rearview Mirror

- Spreads entered the year near all-time lows, then widened as investors rushed to raise funds and liquidity was challenged. Since the Federal Reserve intervened, spreads have become more differentiated across sectors and credit quality.
- As fundamentals deteriorated, analysts were challenged to update models and reduce earnings estimates given the difficulty in predicting the scale and duration of the impact.
  - Over $90 billion of debt was downgraded to below investment grade in March, and could potentially top $500 billion by year-end, which would increase the high yield universe by 25-50%.
- While funds from the largest stimulus bill in history are beginning to reach those in need, the speed and shape of recovery will be driven by the virus timeline and reopening the economy, not the stimulus.

Quite the Trip for Bond Spreads

	12/31/2019 (bps)	4/21/2020 (bps)	YTD Wides	Date of YTD Wides
IG Corporate	93	214	373	3/23/2020
Financials	80	215	378	3/23/2020
Industrials	99	217	383	3/23/2020
Utilities	97	185	298	3/24/2020
AAA	52	106	210	3/20/2020
AA	48	136	250	3/23/2020
A	70	165	309	3/23/2020
BBB	120	275	457	3/23/2020
Short	43	167	390	3/23/2020
Long	136	240	359	3/23/2020
Securitized	42	79	135	3/19/2020
MBS	39	70	132	3/19/2020
ABS	44	174	325	3/26/2020
CMBS	72	174	260	3/25/2020
Taxable Munis	116	225	262	3/25/2020
HY Corporate	336	768	1100	3/23/2020

- As we assess the uncertainty surrounding business disruption and unemployment, we expect some industries to be impacted more than others; recovery will not be uniform. Differentiating between industries and specific companies that can adapt and recover over the medium-term, and those that may suffer longer-term damage, can be the key to successful investing going forward. We believe active management and security selection will be crucial to navigating this environment.

Avoiding the Potholes

- The impact on the consumer weighs heavily on many industries, such as Energy, Autos, and Transportation.
- The downstream impact of unemployment trends has a long timeline. As a result, we are cautious in our investments and rely on our bottom-up analysis to evaluate risk and potential opportunities.

Energy	Autos	Transportation
Energy prices and demand remain low, even as OPEC announced a 23-nation agreement to cut oil production. The industry is bracing for significant job loss and we see a large potential for rating downgrades to high yield. Low oil prices may turn the bearish tide for natural gas which has far reaching implications for gas producers, chemical manufacturers, and utilities.	The Auto industry has already experienced a significant drop in sales and the outlook for 2021 is uncertain. While auto manufacturers began the year with healthy balance sheets, the industry will be challenged and we have already begun to see downgrades. There is potential for consolidation in the industry with this challenging period serving as the catalyst for mergers.	Airlines have seen an extreme decline in air traffic, down over 90% year-over-year and the timeline for the return of non-essential travel is uncertain. The standard business model focused on seat density in a world of “social distancing” may delay recovery. A smaller and more concentrated industry may emerge in a post-crisis environment.

Sources: Bloomberg Barclays as of 4/21/20. The views contained in this report are those of IR+M and are based on information obtained by IR+M from sources that are believed to be reliable. This report is for informational purposes only and is not intended to provide specific advice, recommendations for, or projected returns of any particular IR+M product. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission from Income Research & Management.

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Some Bumps In the Road

- Industries like Financials, Healthcare, and Pharmaceuticals have not escaped the impact of the economic downturn, and we feel confident that they are well-positioned to withstand the bumps in the road.
- CMBS and ABS have excellent structural protections, but issuance will be lower and methods of financing may change. Work-from-home may impact office demand longer term.

Financials	Healthcare / Pharmaceuticals	CMBS / ABS
Banks and Insurance Companies entered the downturn in a position of relative strength with stable balance sheets. Banks are imperative to the overall financial system and are conduits to extend the government's monetary and fiscal policy programs. The economic situation remains fluid and the outlook will depend on the length and severity of the downturn.	Hospitals and device makers will suffer from deferred elective surgeries and increased supply and labor costs. Healthcare REITs, including labs, medical office buildings, and hospitals should remain stable, while senior housing has experienced weakness that COVID19 will only exacerbate. Pharmaceuticals generally have low leverage but face pricing headwinds. The search for a vaccine highlights their essentiality.	We expect delinquencies to increase and payment forbearance to affect most securitized structures. CMBS backed by hotel or retail properties, and ABS bonds backed by consumer payments like auto leases, will be stressed. However, we believe that senior bonds, which offer structural protections, will hold up fundamentally in the long term.

Open Road Ahead

- Technology/Telecom/Cable and some Consumer sub-sectors have been less negatively impacted by the current lockdown, and have a more favorable degree of balance sheet flexibility.
- Agency MBS are implicitly backed by the Government, are supported by the Federal Reserve purchases, and provide important structural protections against forbearance, since the Agencies pay principal and interest on a timely basis.

Technology/Telecom/Cable	Consumer	MBS
Connectivity is important with many working from home and isolated from family and friends. Many technology companies have seen a boost in sales to enhance home offices; however, larger ticket hardware sales will most likely be delayed given the economic uncertainty. Software companies, cloud providers, and virtual work environment companies are likely to see stable and even growing demand for their services.	Consumer sub-sectors, such as food and beverage, large discount retailers, supermarkets, and home improvement, benefit from consumers staying at home. Many have strong e-commerce capabilities, which have been key during lockdowns. Sales have risen rapidly in recent weeks as shoppers have stockpiled necessities and prepare for a prolonged stretch at home.	Social distancing measures and income disruption will lead to lower housing activities, such as new home sales and refinancing activities. Tighter underwriting standards and stress at the servicers should lead to slower prepayments and reduced mortgage origination; this a positive technical for MBS securities. The Federal Reserve's unlimited MBS purchasing program has also provided significant relief to the market.

Today's extraordinary health crisis has led to significant unemployment and business disruption. While the government has provided massive programs aimed at supporting the broad economy, we expect ongoing market volatility and economic weakness until the virus subsides and more normal activity resumes.

Against this backdrop, we believe that certain sectors will be impacted more than others. To navigate these winding roads ahead, we remain steadfast in our disciplined approach of bottom-up credit analysis and risk evaluation. As always, we will continue to closely monitor our holdings, evaluate evolving risks and seek opportunities resulting from market dislocations.

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