

Bond Markets: The Other Half of a Diversified Portfolio in Tough Times

March 2020

SEI New ways.
New answers.®

- Much of the world's focus has been on equities, but fixed-income and commodities markets have been just as volatile in the year-to-date through mid-March.
- While volatile in bond-market terms, fixed-income losses have been much milder than equity losses, reinforcing the importance of prudent portfolio diversification.
- High-yield and emerging-market debt have held up fairly well outside of energy-related sectors.

Global financial markets are moving quickly. While much of the world's focus has been on equities, fixed-income and commodities markets have been just as volatile in 2020. As always, we caution investors to not put too much credence in short-term market gyrations. Focusing on long-term goals is often the best way to avoid rash decisions that can turn out poorly in the end.

US Treasuries Hit All-Time Low Yields

On 9 March, the entire US Treasury yield curve fell below 1.0%—all the way out to 30 years—as investors piled into Treasuries (yields and prices move inversely)¹. This represented all-time lows for yields on all but the shortest maturities. The move was largely driven by investor risk reduction as it corresponded to the worst day for US equities at that point since the most acute phase of the global financial crisis in October 2008².

Moves like this are a mixed bag for investors and consumers. First, much milder bond-market losses have helped soften equity losses in investment strategies that are diversified across asset classes, reinforcing SEI's mantra of prudent portfolio diversification (compare, for example, year-to-date performance through mid-March on the Bloomberg Barclays Global Aggregate Index to the MSCI ACWI Index).

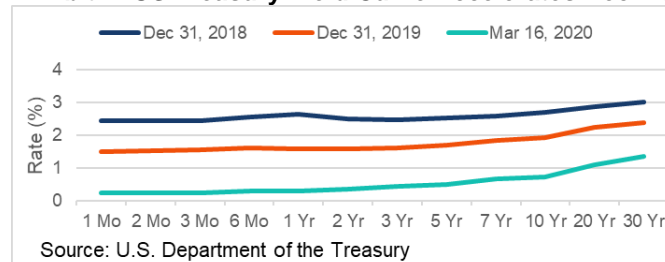
Lower yields can also result in falling consumer lending rates on everything from revolving credit to auto loans and mortgages. But the fly in the ointment is that lower yields also tend to signal a muted inflation outlook.

Our base case is for a period of weak inflation pressures rather than a deflationary spiral. The Treasury Inflation-Protected Securities (TIPS) market reflects this view as the 10-year implied inflation rate tumbled to 0.9% on March 13, well below the Federal Reserve's (Fed) preferred 2% inflation target³.

¹ "Bond market breakdown sees historic spread between buyers and sellers." 9 March 2020. CNBC.

² "UK and US stock markets suffer worst day since 2008 – as it happened." 9 March 2020. The Guardian.

Exhibit 1: US Treasury Yield Curve Accelerates Decline



Central Banks

Central bank activity has been led by the Fed, which executed two surprise rate cuts—on 2 March and again on 15 March—lowering the fed funds rate to near zero. The Fed also formally restarted quantitative easing (QE), with a plan to purchase \$700 billion in Treasuries and mortgage-backed securities, as well as a range of other measures to ensure short-term funding markets remained stable.

The Bank of Canada immediately followed the Fed's first off-cycle cut with similar action at the conclusion of its meeting, also on 2 March. The Royal Bank of Australia enacted a 0.25% cut on 3 March and the Bank of England did a surprise 0.50% cut on 11 March. The European Central Bank refrained from cutting rates further into negative territory at its scheduled monetary policy meeting on 12 March, but unveiled a program to extend low-cost loans to banks and announced plans to recommence purchasing eurozone bonds in another QE program. We expect an ongoing coordinated response from central banks moving forward.

Rate cuts may potentially be helpful longer term to alleviate disinflationary pressure, but they are unlikely to provide meaningful market support in the short term as they don't immediately alleviate demand destruction, supply chain disruptions, or eliminate COVID-19.

³ The Fed's preferred measure of inflation is the price index for personal consumption expenditures (PCE).

Investment-Grade Credit

Credit spreads versus Treasuries have widened, but this is more a result of the “risk off” buying frenzy in the Treasury markets than widespread degradation of investment-grade credits. Markets have been challenged, but somewhat orderly, and we are not seeing much forced or panic selling. Still, essentially all non-Treasury spread sectors have underperformed, and these are areas where active managers like ourselves have been traditionally overweight.

The potential for downgrades, as opposed to outright defaults, appears to be more of a concern for investment-grade credit. Downgrade risk is certainly higher in some segments than others, namely BBB rated issuers and particularly within energy.

In our view, however, this has not translated into opportunities. There was no new issuance in the investment-grade corporate market during the second week of March. We are generally comfortable with the issues we hold and we do not believe we have seen complete capitulation in credit, which would represent a buying opportunity to potentially add risk. To the extent that performance has lagged, it has generally been a case of a modest underweight to duration when yields fell dramatically.

In the UK, our credit exposure has been brought down in line with the benchmark. An overweight to banking has been a headwind, albeit offset by an underweight to transportation. Duration was underweight heading into this period of heightened volatility and has risen closer to neutral.

High-Yield

By most measures, high-yield bonds had held up fairly well, only falling about 2% year-to-date through 6 March (according to the ICE BofA High Yield Constrained Index). But as was the case for essentially all risk assets, losses in high-yield bonds accelerated dramatically on 9 March.

Liquidity—which is generally lower for high yield than investment grade—has deteriorated, but not to the point where it has caused real issues. There has been no new issuance this month and quotes are wide. Many high-yield funds, SEI’s included, appear to have cash to cover rising outflows. Exchange-traded funds (ETFs) and credit default swaps (CDX) have also been a source of funding for outflows, limiting the need to sell actual bonds. While these are all signs of stress, high-yield markets are still orderly and manageable. Outflows

would really have to ramp up for SEI or our sub-advisors to become forced sellers.

High-yield market performance has varied widely by sector, with energy suffering from reduced oil demand and a fierce battle for market share between Saudi Arabia and Russia, at the expense of prices. Unsurprisingly, leisure has also fared poorly in a world of COVID-19-related quarantines and travel bans.

Conversely, telecommunications and healthcare (which are two larger high-yield sectors) along with bank loans (which are above bonds in the capital structure, and typically BB rated floating-rate instruments) have fared much better. This dynamic may persist for a bit.

High-yield spreads over comparable US Treasuries have moved considerably wider this year, some of which is deserved—particularly in the case of energy, where default risk has certainly risen. In other sectors, the spread widening has been more a case of “guilt by association.” We continue to cautiously look for opportunities, keeping in mind the lower levels of liquidity in high-yield markets and the potential for significant outflows if investors begin to panic.

There may be more “fallen angel” opportunities than usual if we see a number of downgrades of BBB rated securities; this occurs when bonds issued with investment-grade credit ratings are re-assessed with below-investment-grade ratings. Our managers have indicated that they are looking to add risk, particularly in beaten up areas, when it makes sense. Overall, we have not made any significant positioning changes to our high-yield portfolios.

Emerging-Markets Debt

The debt markets in developing regions have not been functioning as well as US debt markets; still, losses have been fairly manageable. We’ve seen minimal issuance in primary markets and light trading in secondary markets with wide bid-offers. Energy has become of ever-increasing importance as approximately 40% of sovereign emerging-market issues are from net-oil exporting nations⁴.

Performance has been somewhat challenged in the selloff as we had a market beta of approximately 1.1. We remain underweight US dollar-denominated assets, although at levels much closer to neutral than before, which detracted. Positions correlated to oil prices were relatively mixed. Although we’ve avoided major positioning changes, we have leaned into high-quality local interest-rate duration while reducing currency beta.

⁴ “Oil Price Impact on Global Credit.” 9 March 2020. Morgan Stanley: Global Credit Strategy.

Commodities

Most commodities are highly correlated with economic growth, so it's no surprise they have slumped as COVID-19 threatened global growth prospects. Oil prices have declined by more than most commodities as Saudi Arabia and Russia have engaged in a battle for market share. Crude-oil prices plunged dramatically from March 6 to March 9 and having seemingly settled in the high-\$20's-to-low-\$30's range per barrel for now.

In our view, this level is unsustainable. We believe Saudi Arabia and Russia need prices around \$70 and \$50, respectively, to break even in fiscal terms. Meanwhile, higher-cost US shale producers will probably not be able to sustain themselves for a prolonged period with prices this low.

While none of the major oil producers can really live with this price level long term, they can continue to pump over the short term. With the increasing importance of the energy sector across fixed-income markets, low oil prices could remain an issue for a while.

SEI's View

Fast-moving developments in global financial markets tend to be dominated by a focus on equities. We think the moves in fixed-income and commodities markets this year have been just as worthy of attention as the stock-market selloff.

While certainly not a cure-all, lower rates should help companies and consumers navigate the economic rough patch that will follow the widespread COVID-19 containment measures that have started to be implemented.

Two important points stand out: we urge investors, even in a market environment as turbulent as this, to keep a fixed focus on long-term goals and the plans developed to achieve them. Additionally, the different performance pattern produced by bonds at a time when stocks and commodities have tumbled should be taken as a sign that thoughtful portfolio diversification truly functions precisely as intended when investors need it work.

Glossary

Beta: Quantitative measure of the Fund's volatility relative to the benchmark used. A beta above 1 indicates the Fund is more volatile than the overall market, while a beta below 1 indicates a Fund is less volatile.

Duration: Duration is a measure of a security's price sensitivity to changes in interest rates. Specifically, duration measures the potential change in value of a bond that would result from a 1% change in interest rates. The shorter the duration of a bond, the less its price will potentially change as interest rates go up or down; conversely, the longer the duration of a bond, the more its price will potentially change.

Index Definitions

The Bloomberg Barclays Global Aggregate Index is an unmanaged market-capitalization-weighted benchmark, tracks the performance of investment-grade fixed-income securities denominated in 13 currencies. The Index reflects reinvestment of all distributions and changes in market prices.

The ICE BofA US High Yield Constrained Index tracks the performance of below-investment-grade, US dollar-denominated corporate bonds publicly issued in the US domestic market, capping exposure to individual issuers at 2%.

The MSCI ACWI Index is a market-capitalization-weighted index composed of over 2,000 companies, representing the market structure of 48 developed- and emerging-market countries in North and South America, Europe, Africa and the Pacific Rim. The Index is calculated with net dividends reinvested in US dollars.

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