# SEI is Staying Calm
# COVID-19 Crisis: Fixed Income Review
April 2020

SEI New ways. New answers.®

- The COVID-19 crisis provided a massive exogenous shock to global capital markets.
- Almost nothing worked from an active management standpoint, as most credit sectors underperformed government bonds. As such, the benefits of thoughtfully diversified fixed-income portfolios remained hard to see.
- During this volatile and historically challenging time, we remain focused on a long-term view and continue to have confidence in our investment process and current positioning.

---

**Fixed-Income Markets in Depth**

Fixed-income markets had a turbulent quarter as fears of rapidly spreading COVID-19 triggered a powerful flight to safety that drove Treasury yields lower by over 100 basis points. In response, the Federal Reserve (Fed) reestablished its zero interest policy which was last employed in the aftermath of the Great Financial Crisis. While Treasury bonds enjoyed a powerful rally, other sectors experienced dramatic selloffs as investors withdrew record amounts from corporate, mortgage and municipal bond mutual funds and Exchange-Traded Funds (ETFs). Businesses fearing the immediate loss of revenue and individuals fearing the loss of employment income looked to raise cash reserves through the liquidation of their investment portfolios. These large fund redemptions were sold into an extremely illiquid market that saw Wall Street dealers providing minimal capital to the market-making function. Yield spreads widened in all non-government sectors due not only to deteriorating credit fundamentals, but also the exceedingly illiquid markets. The following data points capture the magnitude of the yield spread changes.

- Investment-grade corporate bond spreads widened from 95 basis points above Treasurys in mid-January to 373 on March 23.
- High-yield bond spreads widened from 315 basis points in mid-January to 1,099 on March 23.
- Agency mortgage-backed security (MBS) spreads widened from 38 basis points in mid-January to 132 on March 19.
- Yield ratios on 10 year AAA-rated municipal bonds to Treasuries rose from 73% in mid-January to an unprecedented 330% on March 20.

ETFs that track corporate and municipal bonds traded at discounts of up to 8% to their net asset values (NAV's) amid heavy redemptions. Even Treasury securities experienced several days of poor liquidity as their yields rose on days that experienced large equity selloffs—a rare occurrence.

This historic market dislocation was followed by a flurry of policy measures from the Fed targeted at restoring liquidity to the bond market. The Fed launched programs that specifically provided capital to the corporate commercial paper market, the municipal variable rate demand note market, the investment-grade corporate bond market, the municipal bond market and the asset-backed securities (ABS) market. Additionally, the Fed reinstated a Quantitative Easing program last employed during the Global Financial Crisis that initially allocated $700 billion for the purchase of Treasurys and Agency MBS, but was later raised to "whatever is necessary" to restore the liquidity to these markets. This aggressive and rapid reaction reflects the importance of a properly functioning fixed-income market to avoid an economic catastrophe. The magnitude of these measures is ultimately what gives us optimism about the opportunities that currently prevail in the fixed-income market.

**Fixed Income Active Positioning**

Coming in to 2020, SEI had the following views about market conditions and economic prospects:

- Global economic growth would be gathering modest momentum, while the U.S., in the later stages of its growth cycle, would exhibit growth but at moderating levels. Inflation would continue to be benign despite the Fed's efforts to achieve its 2% target. Developed government bond yields appeared too low given the prospects for growth and central bank policies targeted at raising the inflation dynamic.
- Corporate credit fundamentals were healthy, but bond valuations appeared expensive given recent trends toward increasing corporate leverage.
- MBS and ABS of consumer receivables were trading at modest valuations, but were supported by strong credit fundamentals due to a strong labour market, rising wage growth, and a rising savings rate.

 

Accordingly there were a number of themes that were expressed across our portfolios, including:

- Against the backdrop of steady to improving global economic growth and very low interest rates, developed market government bonds appeared expensive. Accordingly, many of our investment-grade portfolios moved to short duration positions relative to their benchmarks. This was in contrast to 2019 when long duration strategies were the prevailing position. This was most pronounced in our global bond strategies that were short negative yielding European government bonds.
- Most investment-grade portfolios had reduced corporate credit risk throughout 2019 and maintained allocations roughly neutral or slightly overweight relative to benchmarks. Rich valuations and corporate leveraging trends also justified this positioning.
- Most portfolios were overweight structured products including agency MBS, credit card and auto ABS, commercial mortgage-backed Securities (CMBS) and collateralised loan obligations (CLOs) where permitted (mostly high yield). Many of these sectors (CLO's the exception) are high-quality instruments that provide a defensive characteristic to the portfolios. This was appealing relative to the more expensively valued corporate sector.
- Our global and emerging-market debt portfolios were overweight higher yielding emerging-market government bonds, particularly in Latin America, most notably, Mexico.

**Fixed-Income Performance Review**

Given portfolio positioning that was reflective of continued steady economic growth, the abrupt halt to economic activity amid an environment of social distancing had a notably negative impact on our relative returns.

- The short duration position detracted from results in our global and U.S. Core Fixed Income Funds. The underlying investment managers in our portfolios responded by covering this position in the U.S. core funds and to a lesser extent in global fixed-income portfolios.
- Overweights to structured products detracted from return in virtually all of our funds. While there is value in this sector, new purchases have been limited due to a preference for additional exposure in corporates.
- The de-risking that occurred in our portfolios in the corporate sector during 2019 minimised the impact from the underperformance in this sector. Several portfolios have begun to incrementally add to corporate exposure by buying higher quality, less cyclical issues. A highly active new-issue calendar that began in late March offered the opportunity to do so.
- Our high-yield portfolios have an underweight to the energy sector which helped relative returns. Our non-U.S. registered high-yield portfolios performed roughly in-line with their benchmarks.
- In emerging-markets debt portfolios, overweights to local currency bonds, specifically Mexico and Russia, detracted from returns as these positions underperformed with the fall in oil prices. Additionally, an overweight to dollar-denominated corporate bonds also detracted from return. Portfolios reduced the local currency overweight by about 5% to roughly 2%. Liquidity was particularly hampered in the asset class and for investors who are able to buy and hold, hence providing current liquidity, we see opportunities in the recovery.

**Fixed Income: Looking Ahead**

Active managers generally suffered during the quarter as reflected by the strong performance of the Bloomberg Barclays U.S. Aggregate Index, which placed in the 17$^{th}$ percentile in its Lipper peer group. This is often the case during strong flights to quality. As previously noted, SEI's Fixed Income portfolios, with some exceptions, also suffered in our relative performance versus our benchmarks. The dislocations in the market during the first quarter, however, are now providing us with an opportunity to recover that underperformance, and in the case of high-yield and emerging-markets debt to potentially generate attractive absolute returns.

The economic contraction that is accompanying the spread of COVID-19 will certainly create some areas of distress in the fixed-income markets, including energy, airlines, lodging and retail. But the widening of yield spreads in the non-government sectors has also effected many high-quality, less cyclical issuers that we believe offer excellent value. Additionally, the large liquidity premiums that now exist in these sectors are offering active managers excellent opportunities for investment. The Fed's portfolio of programs are being specifically targeted to improve market liquidity, providing an opportunity for skilled investors to potentially capitalise on some extraordinary inefficiencies.

The market environment has many similarities to the 2008-2009 period. In that sense, we have been here before. Like that earlier period, we are optimistic about the prospects for market normalisation and quite confident that our current positioning will capture the unique opportunities that now prevail in the market.

**Glossary of Terms:**

**Index Definitions**

**Bloomberg Barclays U.S. Aggregate Bond Index (USD Hedged**): The Bloomberg Barclays U.S. Aggregate Bond Index is a benchmark index composed of U.S. securities in Treasury, government-related, corporate and securitised sectors. It includes securities that are of investment-grade quality or better, have at least one year to maturity and have an outstanding par value of at least $250 million.

**Important Information**

The opinions and views in this commentary are of SEI only and are subject to change. They should not be construed as investment advice.

Investments in SEI Funds are generally medium- to long-term investments. The value of an investment and any income from it can go down as well as up. Investors may get back less than the original amount invested. Returns may increase or decrease as a result of currency fluctuations. Past performance is not a reliable indicator of future results. Additionally, this investment may not be suitable for everyone. If you should have any doubt whether it is suitable for you, you should obtain expert advice.

The SEI Global Assets Fund Plc, SEI Global Investments Fund Plc, and SEI Global Master Fund Plc (the "SEI Funds") are structured as open-ended collective investment schemes and are authorised in Ireland by the Central Bank as a UCITS pursuant to the UCITS Regulations. The SEI Funds are managed by SEI Investments, Global Ltd ("SIGL"). SIGL has appointed SEI Investments (Europe) Ltd ("SIEL"), an affiliate of SIGL, (together "SEI") to provide general distribution services in relation to the SEI Funds either directly or through the appointment of other sub-distributors. The SEI Funds may not be marketed to the general public except in jurisdictions where the funds have been registered by the relevant regulator. The matrix of the SEI fund registrations can be found here seic.com/GlobalFundRegistrations.

No offer of any security is made hereby. Recipients of this information who intend to apply for shares in any SEI Fund are reminded that any such application may be made solely on the basis of the information contained in the Prospectus. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding the funds or any stock in particular, nor should it be construed as a recommendation to purchase or sell a security, including futures contracts.

In addition to the normal risks associated with equity investing, international investments may involve risk of capital loss from unfavourable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Bonds and bond funds are subject to interest rate risk and will decline in value as interest rates rise. High yield bonds involve greater risks of default or downgrade and are more volatile than investment grade securities, due to the speculative nature of their investments. Narrowly focused investments and smaller companies typically exhibit higher volatility. SEI Funds may use derivative instruments such as futures, forwards, options, swaps, contracts for differences, credit derivatives, caps, floors and currency forward contracts. These instruments may be used for hedging purposes and/or investment purposes.

While considerable care has been taken to ensure the information contained within this document is accurate and up-to-date, no warranty is given as to the accuracy or completeness of any information and no liability is accepted for any errors or omissions in such information or any action taken on the basis of this information.

This information is issued by SEI Investments (Europe) Limited, 1st Floor, Alphabeta, 14-18 Finsbury Square, London EC2A 1BR which is authorised and regulated by the Financial Conduct Authority. Please refer to our latest Full Prospectus (which includes information in relation to the use of derivatives and the risks associated with the use of derivative instruments), Key Investor Information Documents and latest Annual or Semi-Annual Reports for more information on our funds. This information can be obtained by contacting your Financial Adviser or using the contact details shown above. SEI sources data directly from FactSet, Lipper, and BlackRock, unless otherwise stated.