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# Fixed Income Alert:
## *Market Illiquidity vs. Credit Defaults*

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# Fixed Income Alert

Global financial markets are experiencing massive disruptions and price volatility as governments take drastic measures to combat the COVID-19 virus. One clear disruption is the disappearance of liquidity in all fixed income markets, from Treasuries to corporate and municipal bonds to asset-backed securities. This temporary market-wide liquidity crunch is leading to price drops across asset classes and must be analyzed separately from individual issuers' credit events.

While the volatility is significant, we emphasize that portfolios which are structured to hold most positions to their natural maturities – which is how we design client fixed income portfolios – are well positioned to weather this storm. Read on for our thoughts.

# Extreme Volatility

The foundation of all US credit markets rests upon the 'on-the-run' Treasury curve. Treasury yields are referred to as the 'risk-free' rate, because when push comes to shove you can always rely on the US Treasury to pay its debt when due – it therefore has no 'default risk'. With nearly $17 trillion in outstanding tradeable debt, it's also the deepest and most heavily-traded single-issuer market in the world, and Treasury holders know they can always find a buyer at or near the then-current reference price. This means Treasuries have very little 'liquidity risk.'

All other bonds carry varying degrees of incremental default and liquidity risk compared to Treasuries and are priced on top of it; for example, when we're quoted a corporate bond offering at +200 basis points ("bps"), we know its yield is 2 percentage points above the comparable maturity Treasury yield.

We're stating the obvious to emphasize the widespread impact of the recent major moves in the bond markets. Since the beginning of the year, most short-term Treasury yields have nose-dived to nearly 0%, with most of the drop occurring just this month.

**Treasury Yields**

| Maturity | As of 12/31/2019 | As of 1/31/2020 | As of 2/28/2020 | As of 3/19/2020 | YTD Change |
|---|---|---|---|---|---|
| **3 Month** | 1.55% | 1.55% | 1.28% | 0.02% | -1.53% |
| **6 Month** | 1.59% | 1.53% | 1.16% | 0.03% | -1.55% |
| **1 Year** | 1.58% | 1.44% | 1.02% | 0.16% | -1.42% |
| **2 Year** | 1.57% | 1.32% | 0.92% | 0.46% | -1.12% |
| **3 Year** | 1.61% | 1.30% | 0.90% | 0.56% | -1.05% |
| **5 Year** | 1.69% | 1.31% | 0.94% | 0.69% | -1.00% |
| **10 Year** | 1.92% | 1.51% | 1.15% | 1.14% | -0.78% |

*Source: Bloomberg*

# Chaos on March 17, 2020

But while Treasury yields have generally declined (and their prices increased) on a year-to-date basis, a dramatic burst of illiquidity and resulting price declines hit the Treasury market on Tuesday, 3/17. In fact, the Treasury market experienced one of its most volatile days in recorded history, as the 10 Year yield surged +35 bps from 0.73% to 1.08%, a nearly 50% increase. Not to be outdone, over the past 11 business days the 10 Year TIPS (Treasury Inflation Protected Securities) yield posted a jaw-dropping 157 bps trading range and rose +40 bps on March 17th alone - its largest ever daily move.

These are benchmark securities in the biggest single-issuer market in the world; of all the asset classes, Treasuries are the undisputed financial fortress. Swings this rapid and intense are essentially unprecedented. If the global bastion of stability is being shaken, the logical implication is that this earthquake will radiate into other markets as well.

That's precisely what's happened. The Treasury market's gyrations are greatly amplified in the much shallower and less liquid ABS/MBS, corporate, and municipal bond markets. The sharp volatility increased the impulse to sell while decreasing other investors' appetite to buy. For example, in the first 2 months of 2020, A3/A rated Caterpillar 2.9% senior corporate bonds due 03/15/21 changed hands in a narrow +5 to +25 bp range. On March 19th, it traded at nearly +200 bps. It's just one of many victims of the vicious market-wide cycle of downward-spiraling prices, one which is further accelerated by the mark-to-model pricing services used to price bonds on client account statements. While COVID-19 will impact economic conditions and Caterpillar's fundamental business prospects, its claims-paying ability hasn't deteriorated in proportion with this precipitous move. This is instead primarily the result of a market-wide liquidity crunch.

## CAT 2.9% 3/15/21s Spread to Reference Treasury (Ask Side)

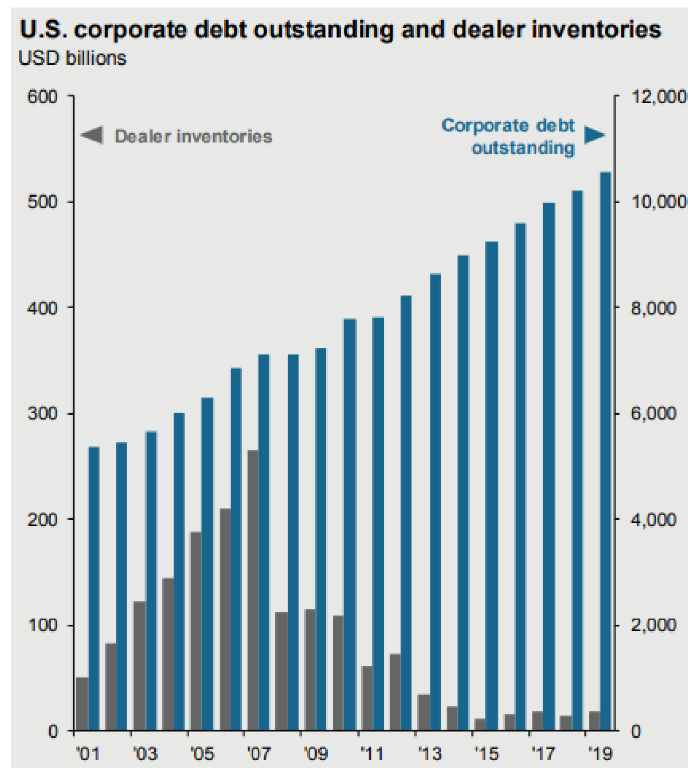
*Source: Bloomberg (CUSIP 14913Q2G3)*

# Why Is This Happening?

In our nearly 40 years of navigating the fixed income markets, we've witnessed periodic bouts of market illiquidity during past dislocations. While the circumstances are never quite the same, many followed the same general script:

1) As a tail-risk event unfolds, investors seek to raise cash for various reasons, at first just amounting to a cumulative trickle that's easily absorbed by markets.
2) As the event grows in magnitude, dealers grow risk averse, buyers became scarce, and the market is unable to transact at rational prices that sellers would normally expect.
3) The supply-demand mismatch leads to plunging prices as the desperate "must-sell" portion of holders are forced to accept any bid, further dragging down prices and reinforcing a negative-feedback loop that quickly spreads to other assets.

This is exactly what occurred last week, with the impact magnified by the current environment. Recall we've repeatedly pointed out that the major central banks' long-running zero/negative rate policies ushered in a wave of excessive borrowing by companies and sovereign governments. At the same time as companies levered up, bond dealer balance sheets noticeably contracted (partially due to regulatory pressure), widening the mismatch between the amount of outstanding corporate debt and the ability of dealers to support the quote-driven fixed income market. In volatile times, the dealer community's balance sheet often shrivels up further, exacerbating the illiquidity.




*Source: JP Morgan Guide to the Markets (as of 9/30/19)*

In a stressed marketplace, it's not just the marginal credits that get hit. Although liquidity crunches tend to start first with lower-grade issues, as it gains steam it spreads to medium and high-grade issuers. Illiquidity in the current Treasury market has quickly radiated throughout the entire corporate and municipal bond markets.

# Current Market Observations

Energy sector borrowers are under extreme pressure from sharply lower oil prices brought on by the twin shocks of reduced global demand and a collapsed production-quota agreement between OPEC and Russia. Given its reputation for stable and repeatable cash flows, this sector typically trades with narrow credit spreads, but today it's trading as if the world's energy consumption has permanently dried up. Normally we'd expect ongoing liquidity in non-financials (such as industrials and consumer products) but these sectors are also proving illiquid. Ironically, financial sector bonds, which normally are the first to see spreads widen, have shown a degree of liquidity from the dealer community.

*Basically, every sector is suffering to at least some degree regardless of COVID-19's actual economic impact on fundamentals. It's not a question of individual credits, but rather the entire marketplace.*

# How Does This End?

The negative-feedback liquidity spirals tend to be broken by some combination of these factors:

- Market Shakeout: Over time, as asset holders realize that markets are illiquid and the price of transacting is high, investors turn to other sources of liquidity, reducing the selling pressure.
- Corporate Events. Large, well-capitalized companies step in to issue multiple tranches of debt in the primary market. If successful, this can establish a market bottom with highly-visible referential benchmark levels. Over the past couple of days, several large companies have sold new benchmark debt – Exxon Mobil, McDonald's, UPS, Disney, Coca-Cola, and Intel.
- Fed Action. The Fed can take a targeted approach by directly buying some critical portion of a destabilized market. It's already announced some interventions: additional purchases of Treasuries and MBS, plus new secured lending facilities meant to backstop money market mutual funds, the commercial paper market, and certain short-term municipal securities.
- Federal Government Action. Bailouts, direct guarantees, and other supportive fiscal actions can be implemented to aid ailing industries.

# What Are We Doing?

Extreme tail-risk events leading to market illiquidity is something we've experienced previously and have always considered when constructing portfolios.

Our portfolios are diversified across issuers and industry groups. We limit exposure to certain sectors. Maturity profiles vary by client, but in most cases, we maintain frequent natural maturity ladders to provide ongoing liquidity and opportunities to reinvest. By maintaining small relative position sizes, we naturally enjoy the benefits of more frequent maturity points.

Now isn't a good time to sell any corporate or municipal bonds, regardless of whether it's a high-grade credit or one that's recently found itself with negative headlines. All fixed income prices are impacted.

For clients who've advised us they might need liquidity, we're maintaining elevated cash balances. For those that may need additional liquidity, we have an established borrowing facility priced at Fed Funds + 75 bps, which currently translates to a rate of just 1.00% (subject to change).

But opportunity does exist and when possible, we're using excess portfolio liquidity to extend maturities to take advantage of the spread widening on high-grade issuers. Our view is that after the current crisis dissipates, rates will remain low for an extended period of time, and we're using the current environment to lock in longer-term rates at elevated levels.

We hope you and your families remain safe. Our team is fully functional with all systems operating from our remote locations. Feel free to contact us if you wish to discuss how your portfolio is positioned in this environment.

For over 37 years, corporations, high-net-worth individuals, family offices, trusts, foundations and endowments have sought our help to construct diversified portfolios positioned to perform throughout market cycles. Among other industry recognitions, Barron's has ranked us in the top tier on its annual listing of "America's Top 100 Financial Advisors" every year since the survey was introduced in 2004.

Speak with Our Barron's Top-Ranked Team Today.

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