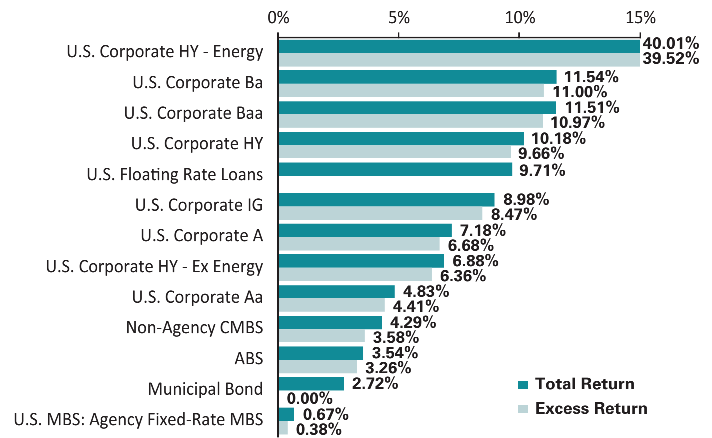
BBH Taxable Fixed Income

Quarterly Strategy Update / 2Q 2020

Hindsight is 20-20

The second quarter of 2020 was extraordinary. Not only did credit solidly outperform, but we saw record issuance of new credit across the rating spectrum despite the unfolding recession that no doubt began in Q2, followed by rebounding Coronavirus incidence and civil unrest in cities across the country. The S&P is only down 5% from the beginning of the year, recovering from more than a 30% decline in late March, and many stocks from unaffected sectors, such as technology, are making new highs. We all understand that markets look at the future more than the present, but what to make of all this?



Past performance is no guarantee of future results
Data reported quarterly as of June 30, 2020
HY = High Yield, MBS = Mortgage-Backed Securities, CMBS = Commercial Mortgage-Backed Securities, ABS = Asset-Backed Securities, IG = Investment Grade
Sources: Credit Suisse, Bloomberg, and BBH Analysis

We will leave the stock market to others, as credit is our daily concern, and we have a fairly clear view of what happened in fixed income, and why. We would rank the important credit factors as follows:

1. The forced selling and illiquidity we saw in credit in March was almost entirely in short maturities. Demand for longer maturities remained robust even in the worst days of March. Furthermore, the ferocity of the drawdown was due, in part, if not in whole, to the withdrawal of algorithmic trading of Treasuries and demand for Treasury liquidity that the private banking system, under current regulations, simply could not meet. Dealer illiquidity in the Treasury market, and the adjustment to traders working at home removed dealer balance sheets temporarily from corporate liquidity[1]. In sum, March's drawdown was at least as much technical as it was fundamental, driven by margin calls and liquidity needs, and, therefore, open to a rapid rebound once the Federal Reserve (Fed) addressed these technical factors and put banks and dealers back in the market.

2. The Fed put an enormous, unprecedented bid under the corporate bond market, while also purchasing a record amount of Treasuries. The result has been the largest increase in money supply (M2) ever. The exposures that rallied fastest were those directly named in the Fed's purchase intentions.

3. Rapid issuance of longer bonds, as well as drawing down credit lines, enlarged issuer's liquidity and reduced refinancing needs while the pandemic raged. Bonds from these newly liquid issuers also rallied in response.

4. Even as producers raised liquidity and cut capital expenditures, oil prices rallied in the second quarter, taking some pressure off energy and energy-related sectors. Energy was the best performing fixed income sector in the second quarter.

5. Severe effects from the pandemic have been concentrated in a few sectors of the credit market – indoor malls, entertainment, consumer cyclical, travel and lodging, airlines and aviation, and consumer and business lending. Even in some of these sectors, reported results have frequently exceeded March/April expectations.

6. As in prior cycles, structured securities (asset-backed securities [ABS] and commercial mortgage-backed securities [CMBS]) pricing reacted on a delay, recovering more slowly than corporates in April, and tightening more rapidly than corporates in May and June as new issue and secondary trading volumes clarified current market levels. Both new issuance and Fed buying (the Term Asset-Backed Securities Loan Facility [TALF] program) have also started later than corporate securities, but are underway.

To summarize, the best-performing obligors in the second quarter recovery have been those that were a) targets of Fed buying, b) able to issue and stockpile liquidity, and c) outside of directly impacted sectors.

[1] For more on this we recommend "Scary Stories to Tell in the Dark – how COVID-19 took down some of the safest trades, and global markets with it", Younger, St. John, and Aggarwal, JPMorgan (North America), 06/29/2020.

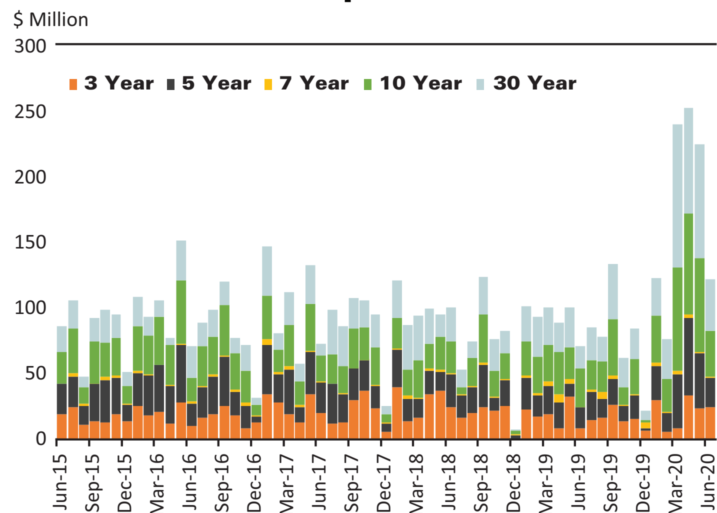
A look at the top and bottom performing subsectors (across our entire coverage universe) in March, in the table below, illustrates the wide dispersion of returns. For instance, Aircraft ABS, Midstream Energy, and Finance Companies and Financials were among the worst performing subsectors in 1Q, subsequently recovering sharply in the second quarter to be the best performing subsectors.

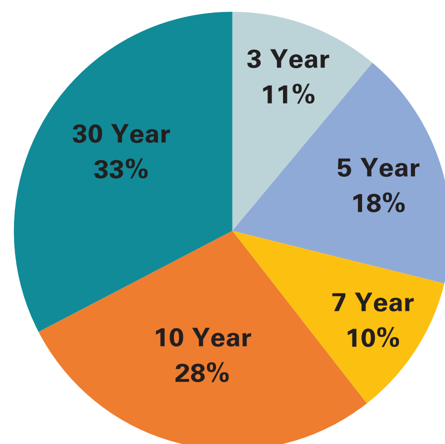
	Return				Percentile Rank			
Subsector	**March**	**April**	**May**	**June**	**March**	**April**	**May**	**June**
Aircraft Equipment ABS	-30.8%	-7.7%	-4.9%	9.8%	0%	1%	1%	99%
Midstream Loans	-28.5%	14.9%	6.2%	0.0%	1%	100%	100%	15%
Conduit Fixed CMBS	-23.8%	-16.2%	-0.9%	7.2%	3%	0%	8%	96%
Cell Tower ABS	-23.7%	9.7%	2.3%	2.9%	4%	97%	84%	86%
Midstream	-23.5%	13.7%	4.6%	2.2%	5%	99%	94%	81%
CRE CLO	-17.3%	3.6%	0.4%	7.6%	6%	78%	33%	98%
Media - Entertainment Loans	-16.6%	8.0%	4.6%	0.4%	8%	96%	92%	44%
Finance - Companies	-15.7%	1.3%	3.2%	2.8%	9%	55%	89%	85%
Financial - Other	-15.4%	0.4%	1.6%	4.1%	10%	38%	76%	93%
Triple Net Lease ABS	-15.3%	8.0%	0.9%	0.1%	11%	95%	67%	31%
Trade Receivables ABS	-1.0%	-0.2%	0.0%	0.0%	90%	26%	18%	16%
Building - Materials	-1.0%	-0.4%	0.4%	0.1%	91%	19%	35%	26%
Prime Auto ABS	-0.8%	0.2%	0.5%	0.1%	93%	30%	46%	25%
FFELP Student Loan ABS	-0.7%	-1.7%	-0.2%	0.9%	94%	9%	13%	64%
Private Equity ABS	-0.7%	0.3%	0.1%	0.0%	95%	32%	22%	18%
Agency	-0.6%	0.4%	0.1%	0.1%	96%	36%	25%	21%
Australian RMBS	-0.5%	-0.8%	0.0%	0.1%	98%	16%	20%	23%
Wirelines	-0.3%	0.6%	0.2%	0.9%	99%	44%	28%	69%
CFO	-0.2%	0.4%	0.1%	0.0%	100%	38%	23%	20%
Chemicals Loans	N/A	3.5%	0.5%	-2.0%	N/A	77%	42%	1%

Past performance is no guarantee of future results
Holdings subject to change
Data reported monthly from March 31 to June 30, 2020
ABS = Asset-Backed Securities, CMBS = Commercial Mortgage-Backed Securities, CRE CLO = Commercial Real Estate Collateralized Loan Obligation,
FFELP = Federal Family Education Loan Program, RMBS = Residental Mortgage-Backed Securitiies, CFO = Collateralized Fund Obligation
Source: BBH Analysis

It was a banner quarter for issuance, with record volumes in both high yield (HY) and investment grade (IG) corporates, while ABS lagged last year's torrid pace until June. Overseas buying was very strong, particularly in longer maturities. According to the Treasury, foreign buyers had been net sellers of corporates in January and February, but became net buyers in late March and April.

Corporate Investment Grade Issuance By Tenor (Gross)





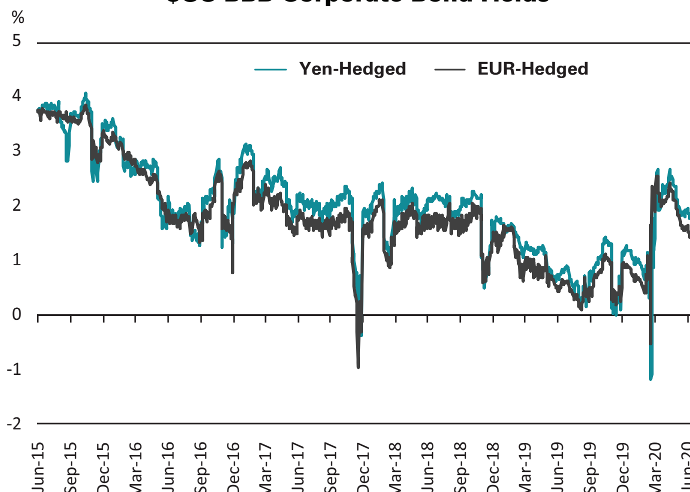
Data reported monthly from June 30, 2015 to June 30, 2020
Sources: JP Morgan and BBH Analysis

Thus far, Fed purchases have been fairly small, with about $8.5 billion of total holdings as of the last week in the quarter, mostly in broad/index exchange traded funds (ETFs). ETF purchases began in mid-May and have been averaging about $300 million per day, while corporate purchases began on June 16th at a similar pace. The volume of purchases has only been enough to show a credible commitment to the program, though the Fed has a staggering $2 trillion of buying power to use in the secondary market if needed. In late June, the Fed published a custom index of bonds totaling $646 billion that could be purchased, about 10% of the corporate index value. Certainly, this puts anyone bearish on U.S. IG credit in the position of "fighting the Fed".

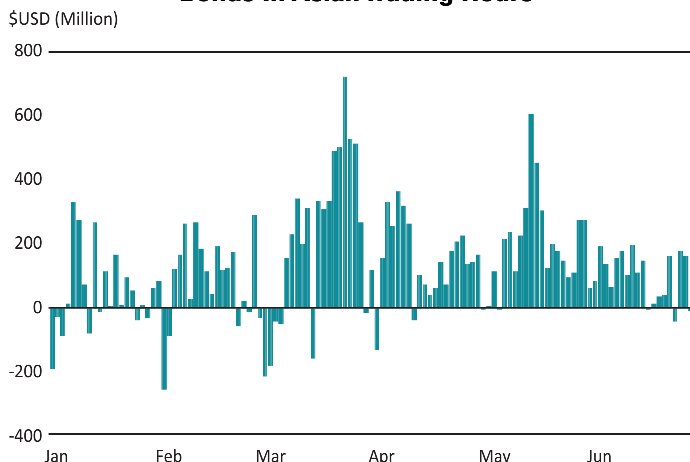
We are convinced that the severity of both the crisis in March, and the rebound in the second quarter, were exacerbated by technical factors, as discussed above. The extent of *fundamental* stress is emerging more slowly, and we are only just one quarter into the recession. This is not to say that the financial stress will not be severe, but simply that it takes more time for financial damage to be realized. Rating agencies have anticipated this: S&P downgraded 161 IG issuers and 1,050 HY issuers in the first half of 2020, more than in all of 2015 or 2016. In our own inventory, 43 issuers were downgraded, although only 4 crossed from IG to HY. In ABS, we saw 5 downgrades (2 to HY) in select aviation and rental fleet securitizations. In corporate credit, 30 downgrades (2 to HY) hit retail, pharmaceuticals, beverages, aviation/defense, energy, automotive, and consumer and business lending. Most of these sectors were directly impacted by pandemic-related stay-at-home policies. The state of New Jersey and New York MTA, among our municipal credits, were downgraded to BBB+ and A+, respectively. We expect downgrades to continue for the remainder of the year, and likely a record volume of rating agency actions.

Weaker companies are already folding, as 130 companies filed for bankruptcy in the first half. For example, in April and May, five highly leveraged borrowers with over $5 billion of debt filed for reorganization (e.g. Frontier, Chesapeake Energy, Latam, Intelsat, and Hertz). Only Frontier and Intelsat are not in pandemic-affected sectors. In the CMBS sector, over 5% of CMBS loans were in "special servicing" including about 25% of hotel and retail loans, collecting only a portion of their rent and facing a high degree of uncertainty over the coming year.

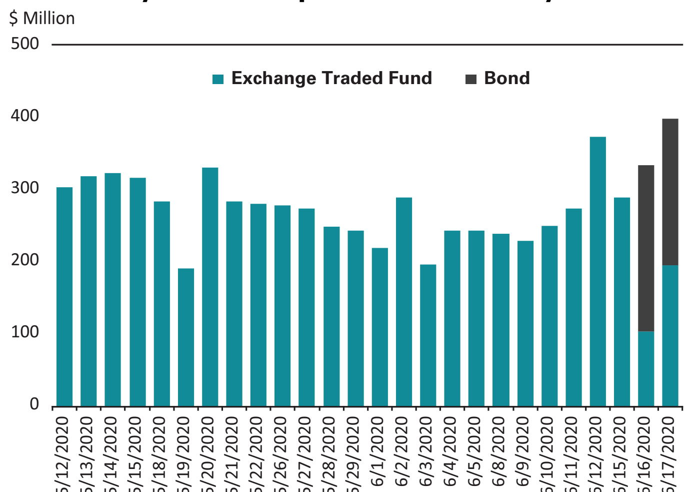
While we purchased credit at a much faster pace than usual in March through May, we kept to issuers we felt were well-positioned in the pandemic. It is our view that because of the gradual effects of lower sales volume, and the possible delay or elimination of income support going into the end of the year, credit is likely to deteriorate and credit markets are vulnerable to a slower, but more fundamentally-driven, pullback. We have added to positions in a few pandemic-affected sectors, such as aviation, midstream energy, and consumer lending, where we were able to purchase with significant protection at very attractive yields.



Data reported daily from June 30, 2015 to July 8, 2020
Sources: Bloomberg and BBH Analysis



Data reported daily from January 2 to june 25,, 2020
Sources: Wall Street Journal, Financial Industry Regulatory Authority, and BNP Paribas



Data reported daily from May 12 to June 17, 2020
Sources: JP Morgan, Federal Reserve, and BBH Analysis

We offer you some comments on pandemic-affected sectors that we hold, even as the list of issuers trading at much higher yields than the rest of our portfolio shrinks. We are monitoring these positions closely, but do not expect impairments in any of these holdings.

1. **Retail and retail real estate**

   Our retailer exposure is limited to Walmart and Nordstrom. The latter should have all its stores open shortly, and is the best positioned credit in the troubled department store sector. Retail properties in CMBS, particularly enclosed malls, are dealing with rent collections below 50% and multiple requests for deferral, but properties are open again and sales traffic is rising. Cash reserves and servicer advances in CMBS can help service the debt for a year or more, but some properties will have to change hands. We believe our high-quality properties, with equity cushions above 50%, will preserve our principal within our exposures here.

2. **Travel and hotel real estate**

   Luxury hotels are still anticipating a slow recovery from occupancy in the 20% range. CMBS in which these are held have substantial cash reserves to make payments for the next year. Most importantly, we rely on the fact that our limited CMBS debt holdings typically represent less than one quarter of the appraised value of the marquis hotel properties – i.e., the value of the land alone usually covers our debt. Discount and long-term stay hotels, like Wyndham Hotels, are doing much better, with well over 50% occupancy. Wyndham can withstand far lower levels of occupancy and still service its debt.

3. **Midstream energy and electric generation**

   While we were initially worried about pipeline volume decreases and counterparty bankruptcies, our credits have performed far better than we expected so far, with only small decreases in volume. In generation, the continuing need for gas capacity in the Northeast keeps our electricity generation companies cash flow positive. All our credits have marshalled substantial liquidity to cover needs in the coming year.

4. **Aircraft leasing and aircraft lease-backed ABS**

   We view the major aircraft lessors (Air Lease, Aercap, BOC) as well-equipped to handle this period of severe stress in aircraft utilization. Senior ABS in this sector can typically handle a 50% decrease in lease cash flows, a level not tested even now, as flight volume slowly recovers. Performance is better in fuel-efficient narrow-bodies, where we tend to focus our investing. Lessors are benefiting from the multiple airline bailouts underway, and have suffered only low levels of lease cancellations. Meanwhile, they are retiring old planes and canceling orders to cut the excess plane inventory rapidly.

5. **Rental fleet ABS**

   Hertz ABS have been paying down in an orderly fashion as used car prices have rebounded, and the company is liquidating its fleet at a rapid clip. The thick cushion between the resale value of their autos and the remaining Hertz ABS debt protects us against impairment.

6. **Consumer and subprime auto lending**

   ABS in these sectors are extraordinarily well-protected, launching with up to 50% credit enhancement. Default levels have risen only moderately and remain lower than in the Great Financial Crisis, nowhere near the levels required to impair tranches we own. We also own HY unsecured bonds issued by the best of the subprime auto issuers, that have strong unique underwriting models which should protect them from significant credit losses. For example, losses at Credit Acceptance continue to run below 1%, and the company is deleveraging as principal repayments exceed new loans.

7. **Business and commercial lending**

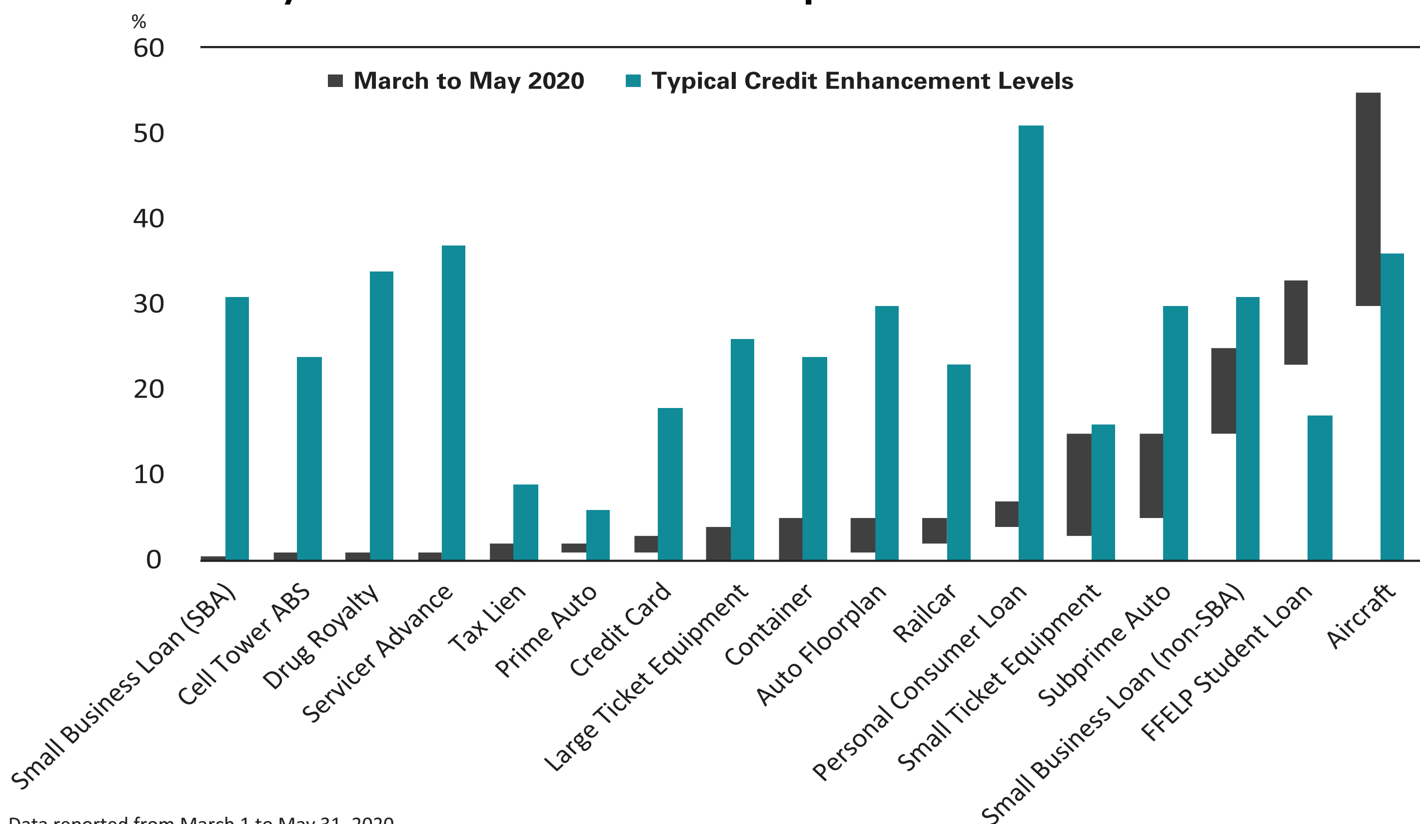
   Small business loan ABS also have very high levels of enhancement. While these issuers are seeing higher levels of deferrals and extensions from Coronavirus-impacted businesses, loan payment rates for the larger issuers we favor are above 80% and climbing. On the corporate side we own debt issued by several Business Development Companies. Loan non-accrual rates for these large lenders have risen modestly and we are amply protected by the low debt leverage of these companies, with equity of 40% or more beneath our notes.

   Given the closure of so many small businesses nationwide, small-ticket equipment leasing has come under some pressure, but non-payment rates are still moderate, generally well below 20%. The leading equipment leasing companies we own maintain lease books that are well

diversified by industry and geography. Small business loan ABS under the U.S. Small Business Administration (SBA) lending program have benefited from government assistance to borrowers and have 0% non-payment rates. However, small business ABS issuers outside the SBA program, like OnDeck and National Funding, have been considerably more impacted by small business closures, with non-payment rates on loans of 15%-25% in April. Their new loan originations are sharply lower as well, so their revolving trusts have gone into early paydown to protect investors. While this has drawn investor and rating agency attention, payback of note principal to investors has been swift with half of the senior notes already retired over just three months.

Our structured team put together the following chart, showing the peak non-payment rates in various sectors of ABS in March through May of this year, and comparing that to the credit enhancement for senior issuance in that sector. Note that only aircraft non-payment rates are above the enhancement level, due primarily to negotiated temporary deferrals. It is important to remember that non-payment rates will be significantly larger than the eventual loss rate due to borrower rehabilitation and collateral recovery. Our quarterly Structured Fixed Income Update has much more.

Peak Non-Payment Rates on Scheduled Principal and Interest for ABS Subsectors



Data reported from March 1 to May 31, 2020
ABS = Asset-Backed Securities, FFELP = Federal Family Education Loan Program
Sources: Wells Fargo and BBH Analysis

We have held little-to-no agency mortgage-backed securities (MBS) over the past years, given the meager compensation and risk of rapid refinancing eroding bond premiums in a declining rate environment. While we were able to add a small amount of attractively-priced MBS in March, the heavy Fed purchasing that followed has once again made MBS too expensive. Furthermore, with U.S. mortgage rates now at historic lows, a refinancing wave in recently issued MBS is likely to persist for months and will rapidly deprive investors of what little coupon they are earning.

As our clients know, we claim to own no crystal ball to predict interest rates. However, we do think about inflation as a potential driver of rates in the future. Our views are outlined in our May 2020 Strategy Insight, *"If Not Now, When?"*. After the post-COVID recovery begins in earnest, which we do not expect until at least next year, there are a variety of inflationary pressures that may, at last, begin to pressure rates higher. For instance, supply chains around the world are being brought closer to home and are becoming more resilient, and businesses reopening will have to invest to protect their clients and employees, both of which should lead to more expensive goods. We encourage you to read the above Strategy Insight for more on this subject, and how inexpensive inflation protection can be.

The second quarter brought a very large technical rally in fixed income, spurred by Fed buying, overseas buying, and the rapid resolution of a liquidity crisis in the bank/dealer market. Meanwhile, in an economy already carrying enormous corporate leverage, the damage done by the Coronavirus will continue to claim victims in corporate earnings and, ultimately, credit quality. As valuations get less compelling, our portfolio purchasing has slowed, and we are likely to be sellers rather than buyers if the trend continues. While investors now have hindsight on the first half's volatility, views ahead may be far from 20-20.

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Past performance does not guarantee future results

Basis point is a unit that is equal to 1/100th of 1% and is used to denote the change in price or yield of a financial instrument

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