March Madness

First and foremost, we would like to extend our thanks and deepest appreciation to our clients and investees who are on the frontline addressing this crisis. Among them are hospitals that are suffering revenue declines while over-taxed with ER volume; medical research organizations engaged in hurried trials of experimental drugs and vaccines, as well as massive public health education projects; insurers waiving co-pays and deductibles for Coronavirus patients; and physician-owned companies, whose boards and shareholders are all serving on the frontlines, risking their own health, to treat an unprecedented wave of patient volumes. Many of our non-healthcare clients and companies have engaged in their own innovative efforts to provide relief and support to healthcare workers and suddenly unemployed workers. It is a privilege to be associated with those of you working so tirelessly and selflessly to make us safer.

Given the extraordinary changes in the markets in March, it is very likely that any data we provide in our Quarterly Strategy Update will be stale within a few weeks. We summarize here a few important points that should outlast the underlying data.

Our Investing:

• **Our aim is to own “durable credits”**¹. For every credit we own, no matter when we purchased it, we considered how it might perform in its own industry’s worst historical condition. This pandemic is, of course, a novel case. Entire industries will not disappear, but stronger competitors will have access to capital markets and consolidate the weaker players. We are constantly reviewing our credits to focus on those that can consolidate and/or have high recovery values for creditors in stressed markets. At the end of this update, we provide a review of our durability criteria and what we are focusing on in the pandemic.

• **The majority of recent price declines in investment grade (IG) credit are fear or liquidity-related, not fundamental. But fundamental credit concerns are present.** During the Great Depression, defaults among bonds originally rated BBB hovered around 1.5%-2% for several years. That was by far their worst historical performance. The worst year since then was 2002, in which the default rate for BBB-rated bonds reached 1%. Bear these magnitudes in mind when considering the high compensation available in credit today.

• **It seems unlikely that late March’s dampened credit volatility can endure.** We are entering a period of tragic and difficult news, with the peak pandemic impact projected during April, and economic data just beginning to arrive. Furthermore, borrowers are operating on reserves at present, but these will become strained over the next few months. Energy bankruptcies have already begun and rating agencies have downgraded over 200 companies, with many more to come. We may just be passing through the eye of the storm at this moment.

• **Because the timing and duration of credit volatility is uncertain, we follow our process diligently.** We came into the recent period positioned in shorter credit, with few high yield bonds in eligible accounts, and with substantial reserves. We have subsequently made substantial purchases, but we have not gone “all-in”, despite the dramatic change in valuations.

• **This is an altogether different scenario than the Financial Crisis.** The Financial Crisis began with the gradual failure of assets that were widely held in the banking system. In this pandemic, about 30% of gross domestic product (GDP) has halted, for a now indeterminate amount of time. Asset preservation will be about issuers with the equity cushions, liquidity, and financing options to bridge the gap.

• **It does not pay to indulge in extreme thinking.** In the middle of March it was easier to be pessimistic than optimistic. In March we witnessed a deluge of selling of robust credits, likely for liquidity, rather than fundamental, reasons. This selling should not be interpreted as a fundamental forecast. While caution is certainly merited, this downturn will end, unleashing significant forces of recovery and value realization. Nobody knows the timing.

• **This will be a good entry point in credit,** so please talk to us about increasing your allocations or creating some new specialty mandates in our areas of differentiated expertise, such as corporate credit, structured product, floating-rate loans, and municipals.

• **Please communicate with us about liquidity needs and new mandates.** We have a wide range of clients, from banks to hospitals to pension funds and insurance companies. It helps us to understand how much of your reserves you are likely to need for your operations.

¹ Obligations such as bonds, notes, loans, leases, and other forms of indebtedness, except for cash and cash equivalents, issued by obligors other than the U.S. Government and its agencies, totaled at the level of the ultimate obligor or guarantor of the Obligation.
Fixed Income Markets

- **Credit underperformance (vs. Treasuries) in March of 2020 was the worst ever at -10.4%**, eclipsing September of 2008. Mid-month corporate excess returns were down more than -16%, before recovering at the end of March.

- **The Federal Reserve’s (Fed) commitment to purchase credit places a huge footprint in our universe of opportunities.** A strong government response, including a slew of Fed programs and the $2 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act passed by Congress have brought liquidity back to the Treasury market, and some liquidity and reasonable price discovery back to markets for the time being.

- **Record new issuance of corporate debt is separating the haves from the have-nots.** Among the haves, $262 billion of IG issuance in March tilted heavily towards higher-rated industrials and banks. These bonds, and other maturities from these issuers, traded with much greater liquidity than the rest of IG. Among the current have-nots, such as high yield corporates and structured credit, valuations for durable credits are as attractive as we have seen in a decade, and price recovery may be as close as the next government program or good news on “flattening the curve”.

- **Treasuries have rallied substantially.** The Treasury yield curve is now positively sloped. Most interesting, at present, is what will happen to T-Bill yields, which were briefly negative, but now hovering around zero. Yields here are reflecting the conflicting forces of the flight to quality ($345 billion flowing into Treasury money market funds) and more than $1 trillion of issuance likely to arrive in the coming months.

Longer-Term Questions

**Who, besides government, will absorb missed rent and interest payments?** Will landlords and lenders end up holding the bag? We expect the cash crunches of individuals and small businesses to impact landlords and creditors. This raises peculiar questions of how these shortfalls can be bridged over the next few months. For example, housing agencies are offering temporary emergency relief to residential borrowers under hardship, and mortgage servicers are prepared to advance the delinquent principal and interest to bondholders. But who will cover the tax and insurance payments? Will servicers continue advancing if they begin to deem their advances as unrecoverable? Also, in commercial real estate, noteholders have a claim on valuable real estate that secures their debt. But if many tenants cannot make rent payments, it is far preferable for master servicers to advance principal and interest payments temporarily than to fire sale properties. Once again, are servicers willing and able to bridge payment shortfalls for three to five months? We expect the next legislation will attempt to plug some of these gaps to help bridge liquidity, but the patchwork nature of the response will leave holes.

**How will the direct and disintermediated credit systems respond to monetary policy and stimulus?** Non-bank lenders are a much larger conduit for both consumer credit and business credit than they have been in the past. Some direct lenders have already pulled lines of credit and/or sharply curtailed lending. Monetary policy is less suited to keep the flow of credit in these channels. Will this exacerbate the credit cycle? Or will private equity and direct lenders be the first to step forward and put fresh money to work, as they were in the financial crisis?

**What effect will the enormous supply of sovereign debt have on fixed income markets?** As investors are clamoring for risk-free assets now, this is not a short-term concern. Yet this will re-shape bond markets in the coming years. The U.S. Treasury will have to issue an extra $2-4 trillion of debt this year. Meanwhile the Fed will take more Treasuries on its balance sheet, perhaps along with large amounts of private credit as well. Government-related debt (Treasuries, mortgage-backed agencies (MBS), and municipals) in the U.S. is already roughly twice the size of corporate and asset-backed borrowing combined. Globally, governments have accounted for most of the increase in global debt since 2007 — from less than $35 trillion to $70 trillion in 2019. In March, global government issuance set a monthly record of over $2.1 trillion\(^2\). Rough estimates for 2020 global government issuance of $15 to $20 trillion implies a 20% to 30% increase in global government debt. Sovereign and sovereign-related debt currently constitutes 72%\(^3\) of the Bloomberg Barclays Global Aggregate Index and appears to be headed to over 80%.

It seems unlikely that, once the pandemic has passed, governments will get down to the serious business of debt reduction. Given aging populations in western countries, and growing government concerns about inequality, it is likely that sovereign debt will grow even more rapidly than it has in the past 10 years. We expect there will be consequences in terms of inflation or debt destruction in the future. For the time being, governments are right not to worry about debt issuance while this interruption occurs.

We will not pretend to know all the implications of these trends, but the combination of large amounts of sovereign debt with low interest rates over the past decade already brought us very tight spreads and now massive volatility. We would expect credit to be more volatile in coming years, as

---


\(^3\) Bloomberg Barclays and BBH Analysis
sovereign-oriented investors move in to get yield and move out quickly in riskier environments. We also expect greater differentiation in sovereign yields as some countries begin to address their debt burdens and others fall further behind. Gone, we suspect, are the days of Italy borrowing at lower rates than the United States. Finally, central banks will have tremendous “yield curve control”, with the ability to buy or sell large amounts of any targeted maturity.

Markets Review

Rates

Rates rallied strongly as the pandemic took hold in the U.S., with short rates rapidly falling close to zero and long rates down almost as much. The Treasury yield curve is once again upward sloping, although not at all steep.

The worst month ever for credit

All forms of credit underperformed Treasuries in the first three weeks of March. Corporate and structured credit alike widened out, with shorter maturities bearing the brunt of margin and panic-driven selling in the middle of the month.

After poor performance in February, IG Credit dramatically underperformed through the first three weeks of March, ending the month down -10.4% vs. comparable Treasuries. AA bonds were down 7%, Single A down -8%, and BBB down -13% in March. The worst performance came in energy, which faced not only reduced demand due to the pandemic, but aggressive Saudi selling of oil intended to prod other producing countries to limit supply.

Already in the first quarter, $119 billion of IG bonds have been downgraded to high yield, and a total of $200 billion downgraded over all grades of credit.

With the Fed intervention in late March, quality issuers came to market in size, partly because of the illiquidity in the commercial paper market, and partly to build a maturity bridge past the cessation of activity in the second quarter. Seventy percent of issuance was single-A or better, compared
to 20%-40% in prior months. New issuance was also longer than usual, avoiding the undisciplined selling at the short end. Despite the chaos, new issuance was many times oversubscribed.

Fund flows in credit

Short duration funds bore the brunt of exiting funds flows. The result was inverted spread curves that reached peak along with spreads.

The Fed Response

The Fed announced a variety of programs intended to bring liquidity back to the Treasury and credit markets. In addition to virtually unlimited credit available to banks and primary dealers, they announced three credit-oriented programs aimed at short IG corporate and structured credit: the Primary Market Corporate Credit Facility (PMCCF); the Secondary Market Corporate Credit Facility (SMCCF), aimed at primary and secondary purchases of short corporate credit; and the Term Asset-Backed Securities Loan Facility (TALF), for AAA asset-backed securities (ABS) issuance. Combined with the funding provided by the CARES Act, these programs have the potential to purchase more than $4 trillion worth of short credit. That is an enormous bid, amounting to more than a third of the total credit universe we address.
As we write this, however, the Fed has not purchased a penny of credit in the secondary market. The mere appearance of this amount of firepower began to change the dynamic in the markets, with spreads reversing course on March 23rd and into the month end (see chart on the right).

The Fed also included fixed income exchange-traded funds (ETFs) in its eligible purchases, which snapped credit-oriented ETFs back from massive discounts to their net asset values (NAVs), and also brought fund flows into the market. As an example, we plot the NAV discount and fund flows for the NEAR fund, an ETF that buys corporate bonds maturing in less than a year. This fund traded at an extraordinary 8% below NAV at mid-month.

While ETFs have reflected, or perhaps even driven, price volatility in this episode, discounts and premiums from NAV are a good indicator of bond liquidity (or perhaps a margin of error on bond pricing services). The Fed’s embrace of these funds improved liquidity yet distorted the most convenient measure thereof.

In the first days of April, the tone has weakened somewhat. As we anticipated above, the sobering increases in case counts and fatalities, as well as the dismal payroll and economic activity data, has no doubt tempered enthusiasm. Most estimates call for a peak in caseloads in the middle of this month, and investors will be looking for confirmation of a turn in the coming weeks.

Our credit process – durable credits are survivors

A “durable” credit, in our process, can pay back creditors in a wide range of economic scenarios. We model every credit we buy for some of the worst conditions in its own industry, in order to assess whether it might be a survivor in such circumstances. For instance, we use Great Depression-level unemployment (25%) to test consumer credit ABS, the flight stoppages after the September 11 attacks to test aircraft leasing, and low energy prices to test our energy-related issuers, such as pipelines and electric generation.

Our credits, and credits in general, enter this crisis in good shape. Many of our credits enjoy cash flows that will not be as sensitive to this pandemic. Nonetheless, this is a new and different stress that we are living through, so we take nothing for granted. Unlike the Financial Crisis, this was not started with a lump of bad assets widely held in the banking system, but an involuntary and widespread cessation of economic activity. Issuers today will have to be able to withstand a severe drop in cash flow of indeterminate length, through no fault of their own operations, management, or underwriting. We are evaluating every credit for its ability to weather this pandemic, and we will not hesitate to exit any that might trade above their potential recovery levels.

There will also be winners. Even in heavily impacted industries, those with strong franchises will have access to capital markets and will likely consolidate market share. Industries will not disappear, but they may be restructured, redeploying the physical, intellectual, and human capital in the sector.
We have included an exhibit of our broad credit criteria by sector below, but in this crisis, we will be particularly looking at:

1. Sufficient liquidity to bridge the economic stoppage:
   - Contractual or less pandemic-sensitive cash flows
   - Financing termed out beyond 2020
   - Cash or liquid assets on balance sheet
   - Means to trap cash flow for creditors (covenants, securitization terms, etc.)

2. Access to capital markets at reasonable levels

3. Valuation or equity cushions
   - Credit enhancements and low loan-to-value levels in structured products
   - Distressed business values (asset or franchise) in excess of our debt exposure

In addition to the new issuance by high quality companies, smaller companies are cancelling capital expenditures, dividends, and buybacks in order to preserve cash. Securitization structures offer interest reserves and cash flow-trapping or early amortization to protect senior investors. Our issuers are rapidly assembling their liquidity bridges.

<table>
<thead>
<tr>
<th>Investment Process and Valuation Discipline: Credit Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Asset Class</strong></td>
</tr>
<tr>
<td><strong>Corporate</strong></td>
</tr>
<tr>
<td><strong>Durability</strong> Business and financial structures that can withstand a wide variety of economic and regulatory scenarios</td>
</tr>
<tr>
<td><strong>Management</strong> Management teams with proven track records of execution, aligned appropriately with creditors’ and investors’ interests</td>
</tr>
<tr>
<td><strong>Leverage and position in capital structure appropriate to cash flow variability</strong></td>
</tr>
<tr>
<td><strong>Transparency</strong> Provides sufficient information necessary to evaluate and understand the issuer and the instrument</td>
</tr>
</tbody>
</table>
After complaining about tight spreads and poor values for a several quarters, and predicting greater future volatility, we got it. As always, it arrived in a novel form. Nonetheless, it is comforting to be armed with an investment process that has done well for us through prior credit cycles, and is specifically geared toward choosing credits for hard times. We are neither complacent nor panicked but following our process every day.

We look forward to our virtual meetings over the coming months, and a return to face-to-face business as soon as it is safe. Please be careful and keep in touch.

---

**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.

Issuers with credit ratings of AA or better are considered to be of high credit quality, with little risk of issuer failure. Issuers with credit ratings of BBB or better are considered to be of good credit quality, with adequate capacity to meet financial commitments. Issuers with credit ratings below BBB are considered speculative in nature and are vulnerable to the possibility of issuer failure or business interruption. High yield bonds, commonly known as junk bonds, are subject to a high level of credit and market risks.

Opinions, forecasts, and discussions about investment strategies represent the author’s views as of the date of this commentary and are subject to change without notice. The securities discussed do not represent all of the securities purchased, sold, or recommended for advisory clients and you should not assume that investments in the securities were or will be profitable.

Brown Brothers Harriman & Co. (“BBH”) may be used as a generic term to reference the company as a whole and/or its various subsidiaries generally. This material and any products or services may be issued or provided in multiple jurisdictions by duly authorized and regulated subsidiaries. This material is for general information and reference purposes only and does not constitute legal, tax or investment advice and is not intended as an offer to sell, or a solicitation to buy securities, services or investment products. Any reference to tax matters is not intended to be used, and may not be used, for purposes of avoiding penalties under the U.S. Internal Revenue Code, or other applicable tax regimes, or for promotion, marketing or recommendation to third parties. All information has been obtained from sources believed to be reliable, but accuracy is not guaranteed, and reliance should not be placed on the information presented. This material may not be reproduced, copied or transmitted, or any of the content disclosed to third parties, without the permission of BBH. All trademarks and service marks included are the property of BBH or their respective owners. © Brown Brothers Harriman & Co. 2020. All rights reserved.