

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 rate 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). Many 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 resulted in funds having to sell assets in 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 (source: Barclays Live) capture the magnitude of the yield spread changes.

- Investment-grade corporate bond spreads (measured by the Bloomberg Barclays U.S. Corporate Index) widened from 95 basis points above 10-year Treasuries in mid-January to 373 on March 23.
- High-yield bond spreads (measured by the Bloomberg Barclays U.S. Corporate High-Yield Index) widened from 315 basis points in mid-January to 1,099 on March 23.
- Agency mortgage-backed security (MBS) (measured by the Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index) spreads widened from 38 basis points in mid-January to 132 on March 19.
- Yield ratios on 10 year AAA-rated municipal bonds versus 10-year U.S. 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 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 Treasuries 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 Asset-backed Securities (ABS) of consumer receivables were trading at modest valuations, but were supported by strong credit fundamentals due to a strong labor 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 (duration measures sensitivity to changes in rates) 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 collateralized loan obligations (CLOs) where permitted (mostly high yield). Many of these sectors (CLO's the exception) are high-quality instruments that should provide a defensive characteristic to the portfolios. This was appealing relative to the more expensively valued corporate sector.
- Our emerging-market debt portfolio was 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 U.S. Core Fixed Income portfolios. The investment managers used in our portfolios responded by covering this position in the U.S. core portfolios and to a lesser extent in global fixed-income portfolios.
- Overweights to structured products detracted from return in virtually all of our portfolios. While there appears to be 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 minimized 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 suffered from an overweight to CLO's, which underperformed the broader asset class. The selloff in this sector did not discriminate among the quality of the collateral or the abilities of the managers. We have not added to this sector, but believe the unique characteristics of our positions will be recognized in a market recovery. Our portfolios did have an underweight to the energy sector which helped relative returns.
- In emerging-markets debt, 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 comparative performance of the Bloomberg Barclays U.S. Aggregate Index, which placed in the 17th percentile of the Lipper U.S. Mutual Fund Core Bond 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, likely 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 capitalize 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 normalization and quite confident that our current positioning will capture the unique opportunities that now prevail in the market.

Index Definitions

Bloomberg Barclays U.S. Aggregate Bond Index: The Bloomberg Barclays U.S. Aggregate Bond Index is a benchmark index composed of U.S. securities in Treasury, government-related, corporate and securitized sectors. It includes securities that are of investment-grade quality or better and have at least one year to maturity.

Bloomberg Barclays U.S. Corporate Index: The Bloomberg Barclays U.S. Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

Bloomberg Barclays U.S. Corporate High-Yield Index: The Bloomberg Barclays U.S. Corporate High-Yield Index measures the performance of the U.S. dollar-denominated, high-yield, fixed-rate corporate bond market.

Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index: The Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

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