

Roosevelt Investments Current Income Portfolio | First Quarter Commentary

Thoughts from our Domestic Fixed Income Team

Market Overview

The first six weeks of 2020 saw a continuation of the momentum with which the U.S. economy exited 2019, but that hardly seems relevant anymore. The spread of the novel coronavirus from China's interior in December to a worldwide pandemic in March has upended the global economy and capital markets in unprecedented fashion. Public health efforts to stem transmission have appeared to rapidly suppress economic activity. Weekly unemployment claims have soared past prior recessionary highs. Swift financial market declines across asset classes reflect these realities. We believe the massive fiscal and monetary stimulus packages brought forth by U.S. and global authorities offer some hope of ameliorating the stark economic fallout and supporting a recovery once restrictive social distancing measures are permitted to subside. In our view, this was reflected in price appreciation off the lows in most risk assets beginning in late March.

A second blow to economic growth and financial markets occurred when two groups of nations led by Saudi Arabia and Russia struggled to agree to reduce crude oil production in response to declining demand for fuel. While the OPEC+ parties ultimately agreed to production cuts, the scale of their action appears to us insufficient, and crude prices remain at multi-decade lows, with economic impacts reverberating across the global supply chain.

Turning to the U.S. fixed income markets, quarterly performance across fixed income sub-groups reflected the impact of the pandemic and crude oil shocks. There was a flight to quality, with U.S. Treasuries and the highest quality corporate bonds acting as one of the few safe havens in this crisis period, while spreads to the weakest-rated credits widened the most. Within the U.S. corporate investment grade universe, an index of intermediate-term AA-rated bonds returned about 1.0% while A-rated bonds lost about 1.0% and BBB-rated bonds lost approximately 6.2% in the first quarter. By sector, the decline in U.S. intermediate-term investment grade corporate bonds was concentrated in the energy sector, which declined about 18.6%, and the real estate sector, which declined about 5.8%, as compared to the broader group's approximate 3.2% decline. Notably, the financial sector held in well, declining just about 1.7%, possibly reflecting the strong capital positions of the banks heading into the crisis, as well as the reduction of claims activity expected in the insurance sector across property, casualty and health. Finally, in terms of capital structure, preferred securities underperformed corporate bonds, as investors in their flight to quality punished holdings with subordinated positions. An index consisting of fixed-rate preferred securities declined about 8.8%, and the most widely held preferred securities exchange-traded fund declined about 14.6%. In addition, fixed-to-float preferred securities generally underperformed their fixed-rate counterparts due to the decline in interest rates in the quarter.

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In mid-March, during the period of steepest price declines, amidst what may have been panicked or forced selling by leveraged investors, the fixed income markets appeared to have seized, and failed to properly function. Bid and ask spreads widened, and little volume was available for purchase or sale, even at what seemed like costly quoted prices. Alarming, this occurred across U.S. Treasury and agency-backed mortgage securities markets, usually the most liquid markets globally, as well as the intermediate corporate bond and preferred securities markets where we typically trade. The Federal Reserve's emergency interventions, which included outright purchases of Treasuries and agency MBS in unlimited amounts, and facilities to finance securities held by primary dealers, commercial paper, and corporate and municipal bonds, have steadily restored market function, and with it, we believe, investor confidence. When markets seized, our portfolio managers and traders tread carefully to ensure that purchases and sales on behalf of clients were transacted at or near our best estimates of fair value. Presently the Federal Reserve interventions have largely stabilized the investment grade corporate and exchange-traded preferred markets, and while the institutional, thousand-dollar preferred sector continues to face some challenges, it too appears to be gradually normalizing. In our view, it is not surprising that this market would lag in its return to normalcy, given its specialty nature and relatively short trading history.

Outlook

We believe the outlook for the economy and financial markets in the near term is largely dependent on three variables. The first is the path of the virus. We continue to observe daily growth in new case counts slowing in the U.S. and other major markets. This suggests the second key variable, the speed at which public health measures may be lifted, also holds some promise. The end of the lockdown economy in the U.S. is likely to require additional testing capacity and could be further supported by the development of therapeutic interventions such as antivirals or vaccines. The final variable is the depth and breadth of the government response. The Federal Reserve has demonstrated that it will support markets during this time of turmoil. However, there is uncertainty as to the scope, timing and magnitude of additional fiscal stimulus, which may ultimately be required to support risk assets.

The downturn we are experiencing now can be deep but short-lived if public health measures and government stimulus are sufficient. It could be longer-lasting if viral transmissions rebound, political obstacles limit further stimulus, or consumer demand shortfalls push more businesses to shutter. The path forward is uncertain, and we are closely monitoring reports from public health, economic, political and financial domains to inform our evolving outlook for credit. That said, the extraordinary commitment demonstrated by the Federal Reserve to support high grade borrowers provides us with some confidence that the worst-case financial scenarios are unlikely to unfold.

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