



Bond Boondoggle

July/ August 2020

- Risky assets rallied through July and into August amid a gradual reopening of the economy and persistent market support by the Federal Reserve.
- Federal support of the bond market has driven yields to record lows while inflation expectations have risen, implying historically low real returns on corporate bonds.
- As Fall approaches, the market's attention will shift to the November election. The impact of potential policies on markets will be evaluated by investors as will the controversial mail-in voting struggle between Democrats and Republicans.

In July, the Fed bought \$1.8 billion of corporate bonds, of which \$110 million were BB-rated junk bonds³. The purchases were spread over 753 individual transactions and signal the lengths they are prepared to go in order to inoculate the markets from the economic fallout of the pandemic.

According to SIFMA, for the year to date through July 31, there has been \$1.524 trillion of corporate bond issuance, \$224 billion of which has been below investment grade.⁵

Corporate Bond Frenzy

On August 10, aluminum packaging company Ball Corp. set an enviable record. Capitalizing on the Federal Reserve's historic support of the corporate bond market and investors' seemingly insatiable demand for yield, Ball sold \$1.3 billion of junk-rated debt that matures in ten years at the paltry yield of 2.875%¹—the lowest ever for a below-investment-grade note (of a similar maturity). The deal, which raised \$300 million more than Ball initially expected due to robust demand, underscores the remarkable reach for yield investors are engaged in around the world as central banks have doubled down on programs designed to keep interest rates low and asset prices high.

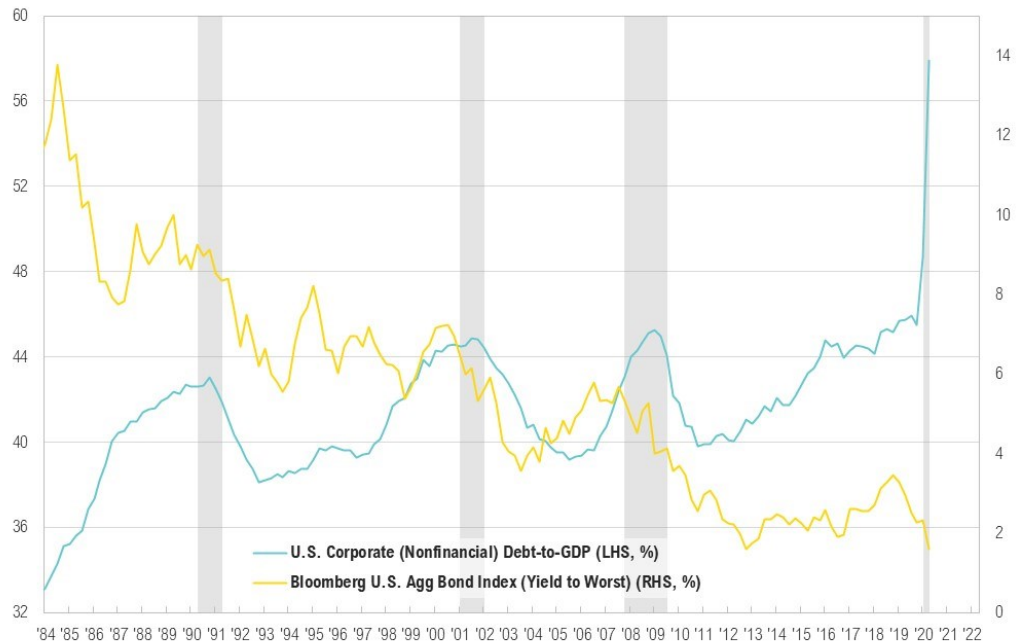
One such program is the Secondary Market Corporate Credit Facility (SMCCF), which is designed to "support market liquidity for corporate debt"². On the same day as Ball Corp's historic capital raise, the Federal Reserve ("Fed") disclosed the list of corporate bonds it purchased in July under this program. For the month, the Fed bought \$1.8 billion of corporate bonds, of which \$110 million were BB-rated junk bonds³. The purchases were spread over 753 individual transactions. While the amounts are insignificant relative to the Fed's almost \$7 trillion balance sheet, the purchases signal the lengths it is prepared to go in order to inoculate the markets from the economic fallout of the pandemic. The list includes bonds issued by Microsoft, Berkshire Hathaway, Alphabet, Apple, Amazon, Ford, Oracle, Cisco, Pfizer and Bristol-Myers Squibb. Collectively, these companies held more than \$732 billion in cash and other short-term investments at the end of June. With presumably strong balance sheets and access to cheap capital, these companies likely have no need for government support. Apple, for instance, has a 2.4% note outstanding that is due in May 2023 which sports a yield to maturity of 0.39%⁴. The purchases themselves are, of course, too small to be having an impact on market liquidity, but that is not the point. The message sent by the Fed is clear—at least for the time being, they will do whatever it takes to support markets.

While few market participants would bemoan higher asset prices, there are concerns with the behavior that such loose monetary policy encourages. According to SIFMA, for the year to date through July 31, there has been \$1.524 trillion of corporate bond issuance, \$224 billion of which has been below investment grade.⁵ This surge in new corporate debt represents a 79% jump relative to the same period last year.

Part of the reason that pandemic-related shutdowns were so devastating to the economy was due to the record-high corporate debt levels coming into the crisis.

Part of the reason that pandemic-related shutdowns were so devastating to the economy was due to the record-high corporate debt levels coming into the crisis, which served to magnify the impact of interruptions in revenues. The ratio of U.S. nonfinancial corporate debt to gross domestic product (GDP) was 45% at the end of last year⁶. That was the highest reading in the post-World War II period. Today, that number is estimated to be 58%⁷. The 12.4% six-month jump in the ratio is the largest increase since 1950 and is more than six times greater than the second largest six-month increase (set in the second quarter of 1970). Corporate debt generally contracts in the wake of recessions—it doesn't explode higher.

U.S. Corporate Debt-to-GDP vs. Corporate Bond Yields, Q1, 1984 - Q2, 2020



Source: Bloomberg, SIFMA, S&P. Q2 net issuance is estimated.

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**—Federal Reserve Chairman,
Jerome Powell**

While presumably good-intentioned, the Fed is responding to the crisis with the same policies that made the U.S. economy so vulnerable in the first place. The case against unlimited support for markets was made by none other than Fed Chairman Powell himself in 2012, when he was on the Board of Governors (comments in reference to further purchases of Treasuries and mortgage backed securities, emphasis added)⁸:

“*I have concerns about more purchases. As others have pointed out, the dealer community is now assuming close to a \$4 trillion balance sheet and purchases through the first quarter of 2014. I admit that is a much stronger reaction than I anticipated, and I am uncomfortable with it for a couple of reasons.*

First, the question, why stop at \$4 trillion? The market in most cases will cheer us for doing more. It will never be enough for the market. Our models will always tell us that we are helping the economy, and I will probably always feel that those benefits are overestimated. And we will be able to tell ourselves that market function is not impaired and that inflation expectations are under control. What is to stop us, other than much faster economic growth, which it is probably not in our power to produce?

Powell's own words suggest Fed members are aware of the potential long-term impact their interventions, however justified by the pandemic, could have on markets. The quote also demonstrates the intense political and social pressure they are under to support the economy during a global pandemic—in an election year to boot!

One potential risk that investors may start to pay more attention to is inflation. The 0.62% month-over-month jump in core inflation for July was the highest increase since January 1991.⁹

An unintended consequence of Fed intervention may be negative real returns on corporate bonds for the foreseeable future.

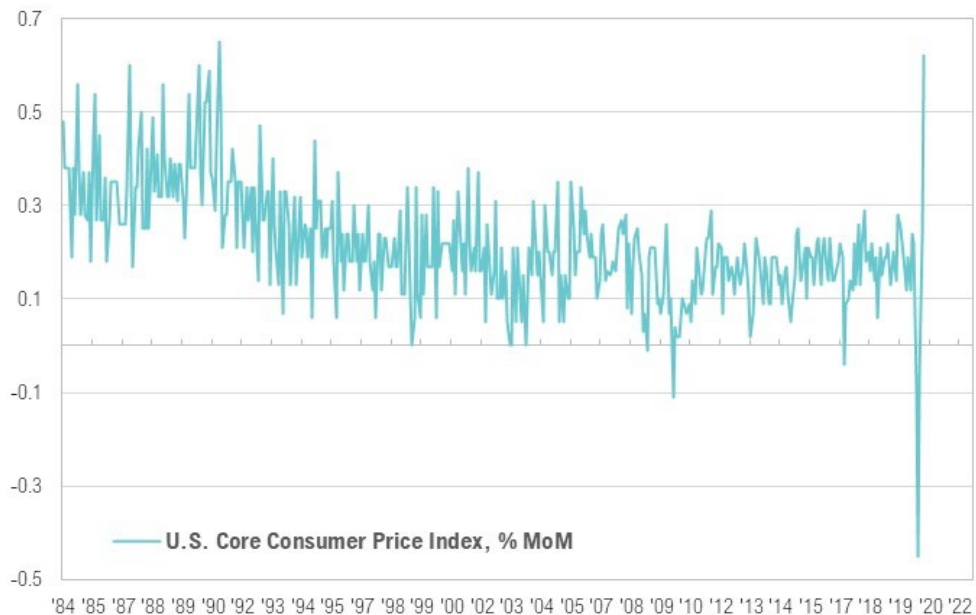
Second, I think we are actually at a point of encouraging risk-taking, and that should give us pause. Investors really do understand now that we will be there to prevent serious losses. It is not that it is easy for them to make money but that they have every incentive to take more risk, and they are doing so. Meanwhile, we look like we are blowing a fixed-income duration bubble right across the credit spectrum that will result in big losses when rates come up down the road. You can almost say that that is our strategy.

My third concern—and others have touched on it as well—is the problems of exiting from a near \$4 trillion balance sheet. We've got a set of principles from June 2011 and have done some work since then, but it just seems to me that we seem to be way too confident that exit can be managed smoothly. Markets can be much more dynamic than we appear to think."

The quote above highlights the challenging predicament that the Fed is in and the far-reaching market implications of their policy decisions. Powell's own words suggest Fed members are aware of the potential long-term impact their interventions, however justified by the pandemic, could have on markets. The quote also demonstrates the intense political and social pressure they are under to support the economy during a global pandemic—in an election year to boot!

One potential risk that investors may start to pay more attention to is inflation. The higher-than-expected jump in core inflation for July, which came in at 0.62% month-over-month⁹—the highest increase since January 1991—suggests that supply disruptions coupled with trillions of dollars of easy money can move the inflation needle.

U.S. Core Consumer Price Index, 7/31/1984 - 7/31/2020



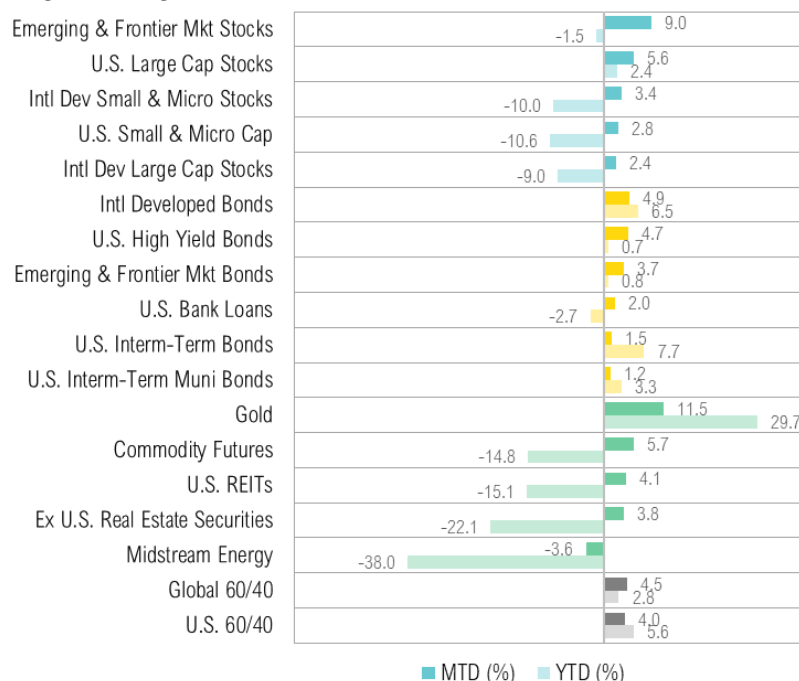
Source: Bloomberg

As of August 13, inflation expectations implied by the U.S. Treasury market are 1.7% per year for the next ten years and 1.6% for the next five¹⁰—both measures are higher than at any point since the Covid-19 crisis started and higher than the yield on the Bloomberg U.S. Aggregate Bond Index (1.13% as of August 13). An unintended consequence of Fed intervention may be negative real returns on corporate bonds for the foreseeable future.

Market Update

July saw all major asset classes continue higher. A 5.6% jump in U.S. large cap stocks helped erase year-to-date losses. Similarly, a strong 4.7% gain in high yield bonds helped push year-to-date returns into positive territory. High yield spreads tightened by 128 basis points, ending the quarter at 5.16%. Gold was the top-performing asset for July, closing the month at \$1,994/ounce. The yellow metal is up nearly 30% year-to-date through July.

July 2020 Key Market Total Returns



Source: Bloomberg

On August 11, with the U.S. presidential election less than 90 days away, Joe Biden announced his running mate would be Kamala Harris, the senator from the State of California and former California Attorney General. According to offshore betting market PredictIt, Biden's odds of winning the election are 59%, down from a high of 64% in late July, but above Donald Trump at 43%¹¹.

In the coming weeks, investors' attention will likely shift to a host of election-related issues including dynamics around mail-in voting and further details on policy platforms.

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Citations

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11. PredictIt: <https://www.predictit.org/markets/detail/3698/Who-will-win-the-2020-US-presidential-election>

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DEFINITIONS

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Intermediate-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Intermediate-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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