The U.S. Reopening: A Brief Guide for Fixed-Income Investors

Lord Abbett experts identify key investment themes—and potential opportunities—in the taxable and tax-free fixed-income spheres.

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U.S. Reopening Scorecard: Fixed Income

	KEY THEMES	POTENTIAL OPPORTUNITIES
U.S. Leveraged Credit	Company management has positioned balance sheets to potentially weather any residual economic softness	Broad opportunity set among high-yield credits, including travel & leisure, retail, transports, energy
U.S. Investment-Grade (IG) Corporate Bonds	Recovery in the IG sector has been aided by U.S. Federal Reserve policy measures, with spreads reaching narrowest levels in nearly five years	Lower-rated IG credits and sectors most levered to the reopening of the economy, such as travel & leisure and energy
Securitized Products	After a period in which housing-related securities led the structured- products segment, momentum may shift to other sectors leveraged to a return to "normalcy"	Consumer asset-backed securities (ABS), commercial mortgage-backed securities (CMBS), and collateralized loan obligations (CLOs)
Municipal Bonds	Key muni-bond sectors appear to have weathered the pandemic well, and credit quality may potentially be strengthened by rising revenues during vaccine-led reopening	Relatively attractive tax-equivalent yields provide broad potential appeal for municipal bonds as the recovery continues

Source: Lord Abbett.

The U.S. Reopening

With increasing signs of a strong U.S. economic recovery following the increased rollout of COVID-19 vaccines, many investors are wondering about the implications of the U.S. "reopening" for their portfolios. Last week, we presented the views of Lord Abbett investment professionals on potential opportunities in equities. This week, we will explore key segments within U.S. taxable and tax-free, fixed income. We surveyed experts including Partner and Portfolio Manager Daniel Solender, Managing Directors and Portfolio Managers Adam Castle and Christopher Gizzo, and Associate Portfolio Manager Devin Hagens.

U.S. Leveraged Credit

We continue to have a broadly constructive view on high-yield credit even while acknowledging that today's valuations are far less dislocated than they were for much of 2020. In our view, management teams have broadly positioned balance sheets to weather any residual economic softness, near term, through an active new issue market, while also working to preserve margins.

We think that as the 2021 recovery unfolds, potential outperformance will likely arise from idiosyncratic opportunities within high yield as opposed to broad market moves. We continue to see upside in so-called "fallen angels" (bonds whose ratings have moved below investment grade), many of which we believe will regain investment-grade status over the coming year or two.

Further, while the pandemic has accelerated the secular struggles of segments of the economy, it has produced structural changes with new beneficiaries. We favor high-yield corporate credits over investment-grade corporate credits, given both relative valuation as well as their shorter duration that would be less vulnerable to any widening of the yield curve caused by long-term interest rates increasing at a faster rate than short-term rates. As we seek to capitalize on the reopening trade, we think that there are good opportunities among select issuers in the leisure and travel, retail, transports, and energy sectors.

U.S. Investment-Grade Corporate Bonds

Investment-grade corporate bonds greatly benefited from the U.S. Federal Reserve's (Fed) breadth of policy measures in response to the COVID-19 pandemic, which included purchasing corporate debt in the primary and secondary markets for the first time. In addition, 2020 was a year of record issuance for investment-grade bonds, as companies were able to take advantage of easy access to credit, refinanced debt as a result of record low rates, and reinforced their balance sheets, resulting in record amounts of cash holdings.

As such, much of the asset class has fully recovered to pre-pandemic levels, with corporate credit spreads recently trading within a few basis points of their tightest level in five years (based on the ICE BofA U.S. Corporate Index) and continued spread compression across ratings, maturities, and sectors. Looking ahead, we remain positive on lower-rated, investment-grade credits and sectors most levered to the reopening of the economy, such as travel & leisure and energy. We also believe that a flexible, multi-sector approach—one backed by teams with deep experience in credit research and security valuation—may be ideally suited to outperform in the current environment.

Securitized Products

Among securitized products, the real winner throughout the pandemic has been residential mortgage-backed securities (MBS). The U.S. housing market boomed during the year of social distancing, as demand for housing was elevated and the supply rather depressed. This has led to home prices that are at extremely high levels, with underwriting standards that are relatively tight, and outperformance of other securitized sectors through most of the pandemic.

However, after underperforming residential MBS since the pandemic began, it is possible that opportunity now exists within the other securitized sectors—namely consumer asset-backed securities (ABS), commercial mortgage-backed securities (CMBS), and collateralized loan obligations (CLOs). We believe that a shift in momentum may favor these sectors that are more leveraged to the return of normalcy as the COVID-19 vaccine continues to be distributed across the U.S.

As mentioned in the March 29 *Market View*, it is our view that the market is still being overly punitive in pricing lower-rated tranches of ABS, CMBS, and CLO deal structures that we consider of good quality, given the notable improvement in lower-end consumer balance sheets likely resulting from the U.S. stimulus programs.

We expect strength within the consumer ABS, CMBS, and CLO spaces broadly, but with significant variation between individual structures and tranches within them. Structures within the ABS space offering exposure to consumer and auto loans, credit cards, and student loans should be particularly well positioned to benefit from the slow return to normalcy and post-pandemic world, in our opinion.

Municipal Bonds

After making it through a challenging 2020—with worst-case scenarios seeming to unfold for many sectors—the municipal bond market has been well positioned for the reopening trade so far in 2021 and appears to continue to have positive momentum early in the second quarter. Despite sectors such as airports having only about a third of their normal travel volume, higher education hamstrung by many universities not having students in classrooms, and transportation systems operating at low volumes, there were mostly only small negative moves in credit quality since the start of the pandemic. Now, with people getting vaccinated allowing the economy to reopen more fully, most of these sectors should revert toward more normal usage or revenue levels, which should help the municipal bond market maintain its historical high credit quality, in our opinion. Additionally, with Federal stimulus funds reaching a wide range of credits, including states, cities, hospitals, transit systems and schools, we think issuers in these categories should be well positioned to handle their expenses in the coming months.

Regarding muni-market technical factors, new-issue supply remains on the lower side as municipal bond issuers don't have as many needs to issue tax-exempt bonds; demand remains solid as investors appreciate the strong quality and lower volatility of the asset class compared to many other markets. The wildcard in the outlook is whether fiscal spending and government borrowing pushes U.S. interest rates markedly higher. This might be a concern for individual investors, who make up a large percentage of municipal bond holders, but we have already seen a relatively large rise in rates thus far this year, and low global rates are likely to put a cap on how high U.S. rates can go. Still, tax-equivalent yields for municipal bonds appear relatively attractive as there is no sign that income-tax rates will decrease any time soon.

A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. Fixed-income investments are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Lower-rated securities are subject to greater credit risk, default risk, and liquidity risk. Credit risk is the risk that debt issuers will become unable to make timely interest payments, and at worst, will fail to repay the principal amount. Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes. Although U.S. government securities are guaranteed as to payments of interest and principal, their market prices are not guaranteed and will fluctuate in response to market movements. The municipal bond market may be impacted by unfavorable legislative or political developments and adverse changes in the financial conditions of state and municipal issuers or the federal government in case it provides financial support to the municipality. Income from the municipal bonds held could be declared taxable because of changes in tax laws. Certain sectors of the municipal bond market have special risks that can affect them more significantly than the market as a whole. Because many municipal instruments are issued to finance similar projects, conditions in these industries can significantly affect an investment. Income from municipal bonds may be subject to the alternative minimum tax. Federal, state, and local taxes may apply. Investments in Puerto Rico and other U.S. territories, commonwealths, and possessions may be affected by local, state, and regional factors. These may include, for example, economic or political developments, erosion of the tax base, and the possibility of credit problems. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors, and each investor should evaluate their ability to invest long term, especially during periods of downturn in the market. Statements concerning financial market trends are based on current market conditions, which will fluctuate.

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Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes. Although U.S. government securities are guaranteed as to payments of interest and principal, their market prices are not guaranteed and will fluctuate in response to market movements.

Asset-backed securities (ABS) are collateralized by a pool of assets such as loans, leases, credit card debt, royalties, or receivables. An ABS is similar to a mortgage-backed security, except that the underlying securities are not mortgage-based.

Collateralized loan obligations (CLOs) are a form of securitization where payments from multiple, middle-sized and large business loans are pooled together and passed on to different classes of owners in various tranches. A CLO is a type of collateralized debt obligation.

Commercial mortgage-backed securities (CMBS) are secured by mortgages on commercial properties rather than residential real estate. The underlying loans that are securitized into CMBS include those for properties such as apartment buildings and complexes, factories, hotels, office buildings, office parks, and shopping malls.

A **credit stack** refers to the capital structure of a securitized product such as an ABS, CMBS, or CLO. In such a structure, the AAA-rated class amortizes first before any of the junior (lower-rated) classes, which only begin to amortize once the AAA class is paid off. The same principle applies down the capital stack with the junior classes amortizing only after more senior (higher rated) classes have been paid off.

Duration is the change in the value of a fixed-income security that will result from a 1% change in market interest rates. Generally, the larger a portfolio's duration, the greater the interest-rate risk or reward for underlying bond prices.

Securitized products (also known as structured products) are pools of financial assets that are brought together to create a new security, which is then divided and sold to investors.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark-bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point).

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. One such comparison involves the two-year and 10-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

The **ICE BofA U.S. Corporate Index** tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market.

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