In a Changing Fixed Income Market, Consider Short Term Credit

In our opinion, the U.S. Fed's response to the pandemic-related economic shock has created potential investment opportunities in short term credit.

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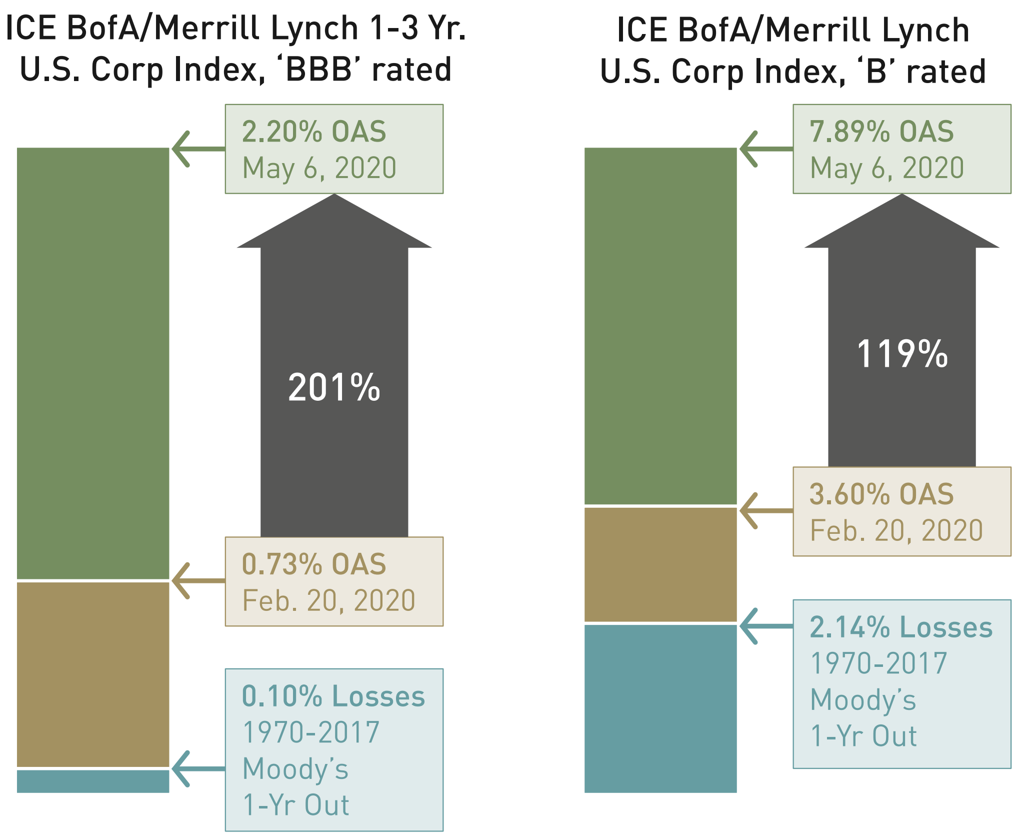
Figure 1. Spreads for short term, high grade corporate bonds are still unusually high relative to longer- dated higher-quality corporates.

Spreads for 'BBB'-rated and 'B'-rated 1-3 year corporates (February 20, 2020-March 6, 2020)



Source: ICE BofA Indexes, Lord Abbett. OAS=option adjusted spread.
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Pandemic-related fears and an economic shutdown shook financial markets in March 2020. The ferocity of the market moves, combined with cash-hoarding behavior from companies, banks, and investors, created a run on cash markets. Borrowing costs for even overnight lending spiked higher despite the U.S. Federal Reserve's (Fed) moves to lower the fed funds rate, while the prices of existing bonds fell, as investors were forced to sell to meet redemptions.

When short term lending markets break down–as they did in March–companies struggle with some basic functions; investors panic that they are losing money they didn't expect to lose; and broader markets can deteriorate quickly as investors worry about the viability of the broader financial system.

Fortunately, the Fed has a tremendous amount of control over available liquidity in the system. Fed Chair Jerome Powell stated in March that the Fed would do "whatever it takes" to ensure that markets were functioning properly; soon after, the Fed rolled out lending programs that were unprecedented in size and scope. Most of these programs dealt with short term lending markets and on expanding liquidity in the financial system. And indeed, many markets have bounced back sharply from their stressed levels of March, led by stabilization of these short term markets.

Key Features of Short term Bonds

While investors may rightly wonder where equity markets go from here, or whether they are appropriately compensated for defaults that may occur in the coming months and even years, we believe they can have much more confidence in the stability of the shorter term bonds going forward.

Simply put, equity and longer dated and lower quality credit have different risks, and different factors that drive performance, than those of short term, high quality bonds.

When investors consider investing in a high yield bond, they require compensation for a wide range of risks, including the risks of default, downgrades, price volatility, and even of limited liquidity. However, because history tells us that default risks are typically very modest for short term, investment grade bonds, much of the spread for those bonds is driven by liquidity risk. Or said differently, investors might reasonably expect to get their money back from these investments, but they receive incremental compensation for the fact that during times of stress, if they want to liquidate their positions in these short term bonds, they may get less than they want.

This drop in price does not mean that the bonds are suddenly more likely to default; it just means that everybody else may also be trying to sell at the same time—the liquidity "run" we referenced earlier.

Markets have come a long way from March, but some of the distortions created by the cash squeeze have not fully corrected. Spreads, or compensation for risk, for short maturity, high grade corporate bonds are still unusually high relative to longer dated and lower quality corporate bonds, despite the major component of this high quality risk—liquidity—being very well addressed by the Fed.

In Figure 1, we see one- to three-year 'BBB'-rated corporate bonds at a 2.20% spread, a more than 200% increase from spreads of 0.73% on February 20, 2020 and a massive premium over 0.10% average losses from defaults over the last several decades. Compare that to 'B'-rated corporates, a below investment grade category which normally has more default risk as a component of total spread and which has seen increased spreads of about 120% since February 20.

We believe with the Fed directly supporting investment grade corporate issuers, and indirectly supporting other short term credit markets, it seems unlikely that those markets will experience again, at least any time soon, the levels of stress experienced in March. As a result, for those who feel cautious about investing during a period of great uncertainty, short term credit may represent a compelling opportunity.

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. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds.

No investing strategy can overcome all market volatility or guarantee future results.

Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

This commentary may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described here.

Glossary of Terms

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.

A **basis point** is one one-hundredth of a percentage point.

The **fed funds rate** is the interest rate at which depository institutions lend reserve balances to other depository institutions overnight on an uncollateralized basis. .

The **option-adjusted spread (OAS)** is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option.

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). The option-adjusted spread (OAS) measures the difference in yield between a bond with an embedded option, such as an MBS or callable bonds, with the yield on Treasuries.

The **ICE BofA/Merrill Lynch U.S. Corporate 1-3 Year Index** is an unmanaged index comprised of U.S. dollar denominated investment grade corporate debt securities publicly issued in the U.S. domestic market with between one and three year remaining to final maturity.

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