Weekly Update

March 27, 2020

Invesco Fixed Income

Invesco

Market correction and Fed action create potential opportunity in high quality bonds

Economic uncertainty continues to grow as the coronavirus spreads globally, and more of the US and world population curtail economic activity to try to mitigate the spread of the virus. We are suffering a sudden stop in growth and the outlook for returning to work is not clear. Unless unforeseen improvements in treatment or prevention are found, the near-term correction in growth is likely to persist.

The first step to growth recovery is capping the spread of the virus, and we look for the peak in infections in the US as a key marker on this path. Countries such as China and South Korea that are ahead of the rest of the world in dealing with the virus are now easing restrictions and beginning to return to work. We are watching both of these countries to understand how the back-to-work process may work.

Policy makers have moved aggressively to support economies and financial markets. Fiscal policy is directed at supporting consumers, strengthening the social safety net and supporting corporations that are directly impacted by this crisis. The US Treasury has also allocated USD454 billion to support emergency lending under Section 13(3) of the Federal Reserve Act.[1] These programs are designed to help improve the functioning of financial markets to avoid a financial crisis. The economic sudden stop creates an immense demand for credit, which the highly constrained financial system cannot provide on its own, and the Federal Reserve (Fed) has had to step in to fill the void (The coronavirus "sudden stop" needs credit support, Invesco Fixed Income, March 2020).

The Fed programs have helped to stabilize high quality bond markets, including the US mortgage market, the commercial paper and money markets, and the investment grade debt market (The Fed's 'whatever it takes' moment, Invesco Fixed Income, March 23, 2020). We believe decisive Fed action to support these sectors has created some areas of opportunity for fixed income investors in high quality assets.

Sector focus: Investment grade

Valuations + Fed buying = potential opportunity

Two months ago, corporate credit spreads were approaching decade tights and investors were complaining that spreads were unattractive. Now, credit spreads are at decade wides, after disruption in the commercial paper market and fears surrounding the coronavirus caused the fastest spread widening in US credit spread history (Table 1).

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Table 1: History of US investment grade credit selloffs

US IG Credit Index 10 largest 1-day selloffs in history (bps)

1	9/15/08	38
2	**3/19/20**	**38**
3	9/17/08	29
4	**3/20/20**	**28**
5	**3/18/20**	**27**
6	**3/9/20**	**25**
7	9/14/01	25
8	3/31/00	24
9	**3/16/20**	**24**
10	**3/12/20**	**23**

US IG Credit Index 10 largest 5-day selloffs in history (bps)

1	**3/20/20**	**128**
2	**3/23/20**	**115**
3	**3/19/20**	**107**
4	**3/18/20**	**92**
5	**3/24/20**	**87**
6	**3/17/20**	**75**
7	**3/12/20**	**72**
8	9/18/08	69
9	**3/13/20**	**65**
10	**3/16/20**	**64**

Source: Bloomberg Barclays, based on the Bloomberg Barclays US Credit Index, data as of March 24, 2020.

Fed addressed liquidity concerns with massive response

As liquidity became very challenged in Mid-March, the investment grade market saw a "dash for cash". This shift caused dealers to widen bid-ask spreads to levels not seen since the financial crisis, and in some instances, there were no bids for even high quality, short-term paper. The market needed a buyer without liquidity concerns to step in. Enter the Fed – it announced on Monday, March 23 that it would begin purchasing corporate bonds for the first time in history. This is a complete game changer in our opinion, and we wouldn't underestimate it.

According to Monday's announcement, The Fed will purchase debt maturing within four years directly from US investment grade companies in the primary market. It will also purchase bonds in the secondary market maturing within five years. In addition, it will purchase corporate exchange traded funds that can buy across the yield curve, potentially improving liquidity and resetting valuations across the curve.

Since the Fed announced its intention to purchase investment grade corporates, liquidity has returned to near normal levels. Bid-ask spreads are still wider than in "normal markets" but they are functioning. In addition, the primary calendar has opened up, providing clearing levels and restoring confidence about where bonds should trade. This primary issuance has been readily absorbed and highly over-subscribed - and the Fed has yet to make any purchases. Companies have been seeking to bulk up their cash balances by borrowing term debt to avoid relying on overnight funding; investors have been taking advantage of large new issue premiums and appear excited to buy at materially wider spreads.

But how much will the Fed actually buy? Will it be impactful? Invesco Fixed Income's estimation is that the Fed will purchase roughly USD500 billion of corporate debt at an aggressive pace. We expect primary issuance in 2020 to total around USD1 trillion. While the Fed will likely not buy all the bonds directly from US companies, it will likely purchase around half of the entire 2020 issuance of investment grade corporate bonds. This is at a time while the European Central Bank is also directly purchasing corporate bonds in Europe and there is coordinated quantitative easing around the world, resulting in trillions of dollars of negative yielding debt globally. In our view, there is not enough corporate debt to fulfill demand from the Fed, European and Japanese institutional buyers searching for positive yield, and traditional US pension plans or insurers who have been hoping and waiting for investment grade spreads to increase for a decade. The surge in demand for investment grade bonds began on Monday and is picking up steam daily, as investors begin to realize that the biggest buyer in the world is about to step in with a balance sheet that is unprecedented in the corporate market.

We realize US economic data will be very negative in the near term, but we believe we are experiencing a potential opportunity based upon newly attractive valuations. More importantly, we believe this potential opportunity is underpinned by a major catalyst to start and sustain the rally.

Sector focus: Municipals

Liquidity, liquidity, liquidity

Market participants in all markets have been seeking liquidity, including in the municipal markets. Sellers of municipals have been willing to accept large discounts, further driving down prices. However, the Fed stepped in on March 20 with the announcement that it will allow short-term municipal bonds to be used as collateral in its emergency lending program. The Fed further expanded its support to municipals by including variable-rate demand notes (VRDNs). Making short-term municipal bonds eligible as collateral in emergency Fed lending has increased the demand for these securities, improved liquidity and allowed the municipal market to find more stable footing.

Looking ahead, we cannot predict when the coronavirus pandemic will abate or how acute market volatility will be going forward. But we believe there will be a bottom at some point. Municipal credits have a long history of low default rates, and while we might receive a temporary tax break or a government check, none of these will permanently lower our taxes. Municipal bonds are one of the few sources of income that is not subject to federal taxes — and that income is now more attractive than it was a month ago.

Below we highlight the impact of the coronavirus pandemic on some key municipal sectors that we follow:

Higher education	Prior to the coronavirus outbreak, Moody's upgraded its 2020 outlook for the higher education sector to stable from negative, citing steady revenue growth and solid reserves. Because of the coronavirus, higher education institutions have announced their transition to online learning, closed dorms and sent students home. We believe higher education institutions generally have resources to help cushion the impact of temporary reductions in revenue and increases in expenses related to the coronavirus. These resources may include cash, investments, endowments, government funding and ongoing contributions from alumni and other donors. But the overall impact on the sector depends on the severity and duration of the virus. The impact on individual institutions will likely vary according to their overall financial strength prior to the virus outbreak. Smaller, poorly capitalized institutions that rely heavily on tuition revenue, and those already challenged by declining enrollment and financial resources, will likely be more significantly affected if the impact of the virus is prolonged.
Public power, water and sewer	These utilities are viewed as essential services, vital to America. We expect these services to continue to be provided and used. In the unlikely event of large revenue declines in these sectors, it is our belief that state and federal governments would step in to provide the necessary support.
Hospitals	Hospitals may face higher expenditures (staffing, overtime, supplies) if inpatient volumes increase and patient stays become lengthy due to COVID-19. The proportion of low-margin business (urgent care and outpatient visits) may rise, as patients seek to determine their illness, and higher-margin business declines as elective surgeries are delayed. Fortunately, a large majority of hospitals have planned for seasonal flu and other outbreaks, and many have liquidity and plans in place to handle a crisis. Because the population most at risk are the elderly, who are covered by Medicare, we do not foresee a huge surge in uninsured patients due to the pandemic.
Airports	Although airports are experiencing decreased activity, they generally maintain strong liquidity and debt service coverage, and we do not expect defaults in this sector. According to Moody's, the median days of cash on hand for the sector was 659 in fiscal year 2018, the highest since Moody's began tracking this metric in 1999.[2] It is worth noting that airports have weathered difficult market conditions before, including the sharp drop-off in travel post 9/11, without default.

Additionally, many of the large airports have either "residual" or "hybrid" use and lease agreements with signatory airlines, in which airlines are obligated to cover the net costs and debt service of the entire airport in the event that revenue from airport operations is insufficient. Failure to do so could result in the termination of airlines' landing slots and/or terminal gates. Some airports have a "compensatory" rate-making framework, in which airlines are only charged for the costs of the facilities they use. These airports could be at risk of a credit downgrade if there is a prolonged downturn in airline activity. However, airports operating under this framework tend to have slightly higher levels of liquidity and debt service coverage. Notably, the credit profile of an airport is largely insulated from the financial profile of its parent government because of Federal Aviation Administration limitations on the distribution of excess revenues to the parent government.

Toll roads

Like the airport sector, toll roads will likely see a decrease in activity but, because of strong liquidity and debt service coverage, we do not expect a material increase in downgrades or defaults. The use of toll roads was healthy prior to the coronavirus outbreak, and we expect it to recover when the crisis abates. Toll roads are also supported by fully funded debt service reserve funds that are typically sized at the lesser of a) the maximum annual debt service, b) 10% of outstanding debt and c) 1.25 times average annual debt service, further providing a financial cushion.[3]

State general obligation bonds

Invesco Fixed Income expects the credit quality of most states to remain stable because of historically high rainy-day funds and the ability to manage revenues and withhold payments to local governments, such as cities and school districts. In fiscal 2019, the median rainy day fund equaled 7.5% of general fund spending, which is an all-time high and compares to roughly 5% before the 2009 recession.[4] States most likely to be hurt by the economic fallout of the coronavirus are those heavily reliant on tourism and the oil and gas sectors. Also, states with high underfunded pension liabilities may need to increase pension contributions because of low market returns, but we believe these states will face increased credit downgrade risk and not increased default risk.

Continuing care retirement communities (CCRC)

CCRCs are at risk, but we believe a repeat of the tragic situation in Washington State becomes less likely as more is understood about controlling the spread of the virus. CCRCs serve the population most vulnerable to the virus but they offer all levels of care with health staff onsite that can detect and treat residents as soon as the virus is detected. Seniors living in a CCRC would likely receive treatment sooner than seniors living at home. However, any CCRC, even one with no contagion, faces the idiosyncratic risk that it could be perceived as a health risk, and that could impact its ability to attract future residents.

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1 Source: US Department of the Treasury, March 23, 2020.
2 Source: Moody's, "Fiscal 2018 Medians Economic growth, lower fares continue to under financial performance (Airports – US)," November 20, 2019.
3 Source: Invesco, data as of March 24.
4 Source: Moody's, "2020 outlook stable with continued revenue growth and record reserve levels (State government – US)," December 3, 2019.

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