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Corporate Bond Issuers, Investors, and the Federal Reserve Respond to COVID-19

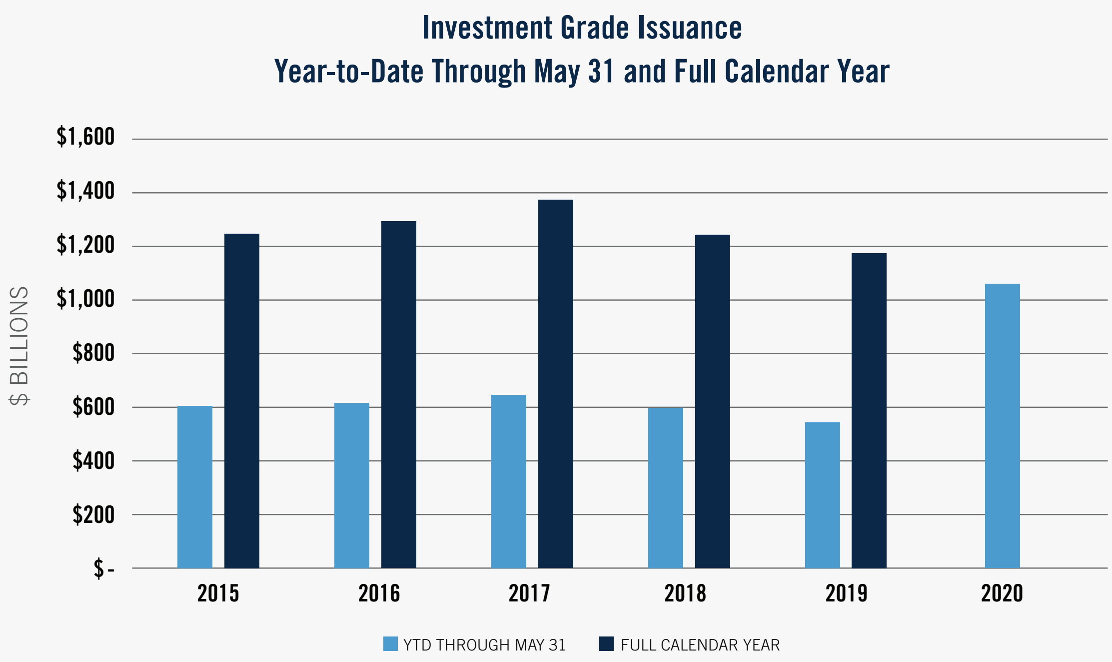
JUNE 29, 2020

This year has been a tumultuous period for the fixed-income markets in general and the corporate credit sector in particular. We started 2020 expecting lower new issuance and tightening spreads reflecting strong economic growth. Instead, we have seen spreads widen to levels not seen since the 2008 Global Financial Crisis. Additionally, while it may seem counter-intuitive, we have seen record new issuance in the face of a sharp recession. This paper will explain what happened and why.

Corporate Supply

Investment grade ("IG") corporate credit issuance surged to record levels in the first half of 2020. Through May 31, 2020, IG cumulative supply is up 90% over a comparable period last year ($1.06 trillion vs. $551 billion).

The chart below displays year-to-date issuance through May 31, 2020, along with issuance for comparable periods in each of the past five calendar years.



Source: BofA Global Research

Given the uncertain U.S. economic outlook and related potential for ratings downgrades, corporate issuers were motivated to access the public markets expeditiously. Issuers tapped the investment grade market to refinance upcoming maturities, pay down bank lines and commercial paper, and bolster balance sheet liquidity. While many BBB-rated companies issued debt to refinance maturing issues, higher quality (A-rated) companies also issued in an effort to boost cash balances to withstand financial distress. We cannot rule out the possibility that these cash positions might fund future acquisitions, but thus far, it appears that most issuers are simply building cash reserves as a low-cost insurance policy.

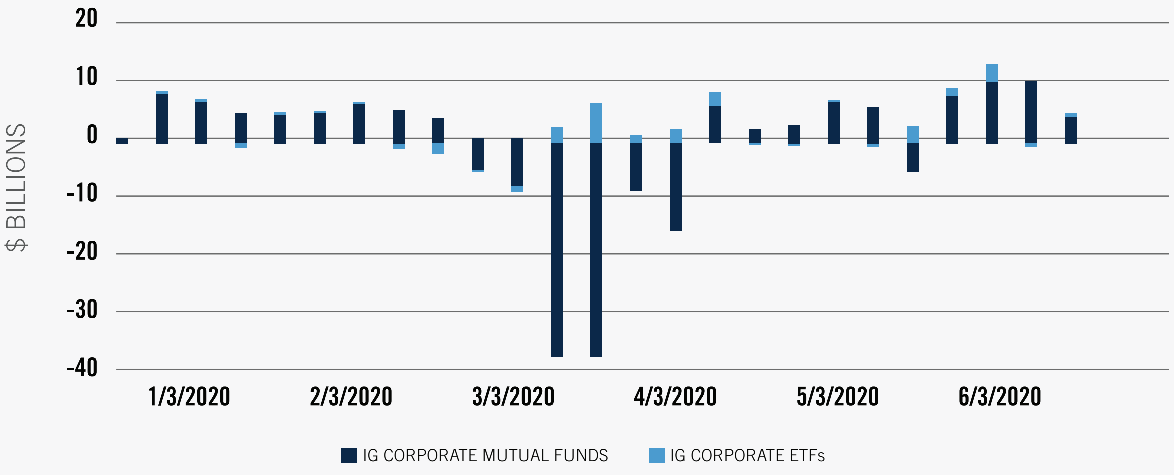
For many issuers, the surge in year-to-date issuance presented the opportunity to prefund maturing debt. UIA-IM is monitoring additional issuance, but it is likely that new issue volume will slow throughout the remainder of the year.

Investor Demand

Although corporate issuance is running at record levels, investor demand has far outstripped supply for two reasons: 1) The dramatic spread widening that began in March and lasted into early May presented investors with the opportunity to buy bonds at attractive levels; and 2) Investors seeking to add corporate exposure found little available supply in the secondary market and turned to the primary (i.e., new issue) market to source corporate exposure. For the four-week period ending June 8, 2020, new corporate issues were on average 4.3 times oversubscribed.[1] Another indicator of demand strength — the typical new issue concession has disappeared. For the four-week period ending June 8, new issues priced on average one basis point tighter than the spread on the issuer's existing bonds. During April, the average new issue concession was +13.8 basis points.

U.S. domiciled corporate bond fund flows also reflect strong investor appetite. Weekly U.S. investment grade corporate bond ETF and mutual fund flows are displayed in the chart below, and after a risk-off period in March-April 2020, investor demand for investment grade turned strongly positive. For the four weeks ending June 19, 2020, investment grade corporate bond ETF and mutual fund inflows totaled $34.8 billion.

IG Corporate ETF and Mutual Fund Weekly Flows
Year-to-Date Through June 19, 2020



Sources: Lipper FMI Weekly Fund Flows and Bloomberg for LQD ETF

Non-U.S. investor demand also supports the corporate credit sector as the U.S. markets benefit from a "flight to safety" in a period of global turmoil. In addition, the Federal Reserve stimulus program continues to include a zero lower-bound on rates. As a result, positive yields available in the U.S. markets appear attractive relative to other markets with negative yields. As of June 18, 2020, negative-yielding debt in global markets totaled approximately $12.5 trillion, and the list of sovereign issuers with negative yielding debt outstanding includes Japan, Germany, France, Italy, and the UK.

1. Source: Citigroup Inc.

Federal Reserve COVID-19 Stimulus

On June 15, 2020, the Federal Reserve Board announced updates to the Secondary Market Corporate Credit Facility ("SMCCF"), and reaffirmed its commitment to the Primary Market Corporate Credit Facility ("PMCCF"). These two facilities were approved by the Treasury Secretary, and funded with $75 billion in equity provided by the Treasury Department under the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") that was signed into law on March 27, 2020. The initial allocation of equity will be $50 billion toward the PMCCF and $25 billion toward the SMCCF. These equity investments fund a special purpose vehicle ("SPV") that will acquire:

1. Investment-grade corporate bonds issued by U.S. companies;

2. Corporate bonds issued by companies that were investment-grade rated as of March 22, 2020, and that remain rated at least BB-/Ba3 at the time of purchase;

3. U.S. listed Exchange-Traded Funds ("ETFs") whose investment objective is to provide broad exposure to the market for U.S. investment-grade corporate bonds; and

4. U.S. listed ETFs whose primary investment objective is to provide exposure to U.S. high-yield corporate bonds.

The Federal Reserve Bank of New York will provide debt financing to the SPV that will allow 10 to 1 leverage for investment grade positions and 7 to 1 leverage for below investment grade positions. Other eligible assets acquired by the SPV may be leveraged in the range of 3 to 1 and 7 to 1 depending on risk. With these leverage guidelines, the Federal Reserve's aggregate purchasing power may be as large as $750 billion, which is 11.6% of the total outstanding market value of investment grade corporate debt (as represented by the Corporate sector of the Aggregate index as of June 2020).

The Federal Reserve's PMCCF and SMCCF are intended to ensure the availability of credit for U.S. corporations and other issuers of U.S. $ debt and facilitate the smooth functioning of the U.S. credit markets during this period of pandemic-related stress.

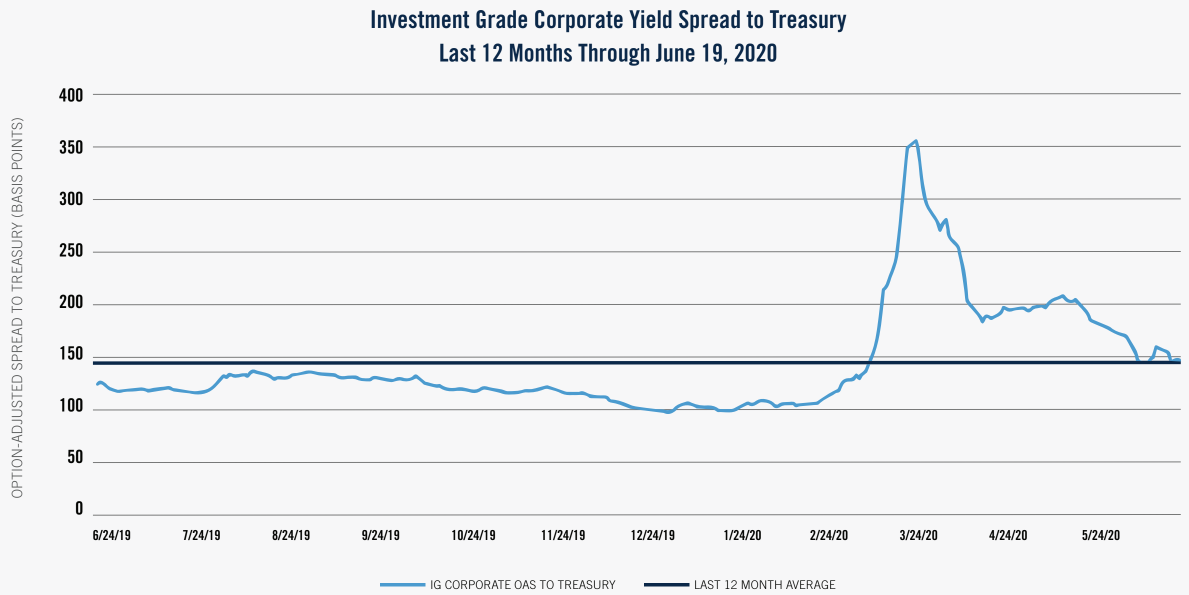
The SMCCF commenced operation on May 12, 2020, and initial purchases focused on corporate bond ETFs. The Federal Reserve's initial report, dated May 19, 2020, detailed $1.3 billion in ETF purchases.

On June 15, 2020, the Federal Reserve announced that it would expand its purchase program and begin buying a broad and diversified portfolio of corporate bonds, with the stated goal of providing market liquidity and availability of credit for large employers. The Fed will target a portfolio matching a market capitalization-weighted Broad Market Index ("BMI"). Bonds that are eligible for the BMI must meet the ratings requirements described above, and have a remaining maturity of five years or less. Bonds issued by insured depository institutions, or depository holding companies or subsidiaries of such holding companies, are not eligible for inclusion in the BMI. The maximum amount of any single issuer's bonds included in the BMI is capped at the lesser of: $11.25 billion (1.5% of the maximum value of the combined PMCCF and SMCCF), or 10% of the issuer's bonds outstanding on any day between March 22, 2019 and March 22, 2020.

Individual issuer weights in the BMI will form the basis of sector weights, with each issuer mapped to one of 12 sectors. The Federal Reserve's purchases will track as closely as possible the sector weights in the index.

Corporate Sector Outlook

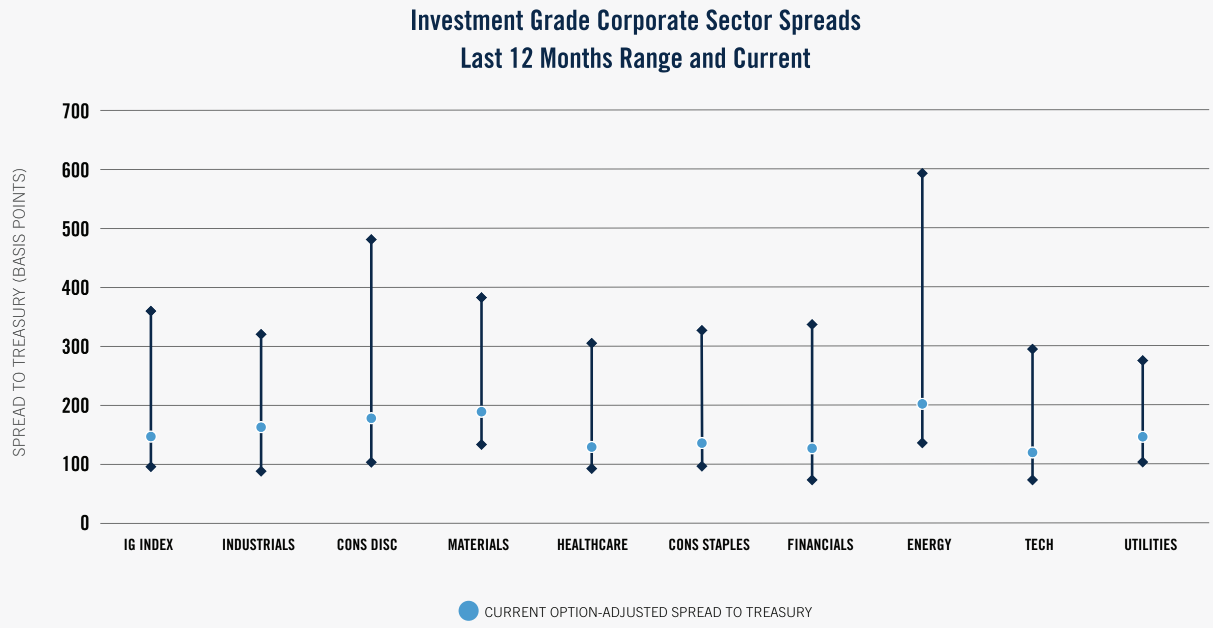
U.S. credit markets, along with all other financial markets, were stressed by the COVID-19 pandemic and related shutdown of the U.S. economy. Credit concerns were certainly justified, and investment grade corporate yield spreads to Treasury widened sharply in this classic "flight to safety."



Source: Bloomberg

Although a vaccine for COVID-19 has not been approved, recent equity and credit market performance indicates that many investors believe the worst is behind us. The U.S. economy is re-opening, and corporate earnings and employment are recovering. Credit spreads have recovered much of the ground lost in the initial de-risking market reaction in February, March, and April 2020.

The range of sector yield spreads over the last 12 months are displayed in the chart below, and the blue dot indicates the most recent spread-level. This chart highlights the wide range that yield spreads have traveled over the past year, and also indicates that current spreads are near the tights for this period.



Source: Bloomberg

UIA-IM's credit team understands that the recovery will not affect all corporate issuers equally, and we expect the coming year will be characterized by substantial performance dispersion by sector and issuer – in other words, we are entering a true "bond-pickers" market. UIA-IM professionals have navigated multiple credit cycles, but this "pandemic cycle" is unique. As described in this paper, the U.S. credit market has been recovering nicely, and new issues have enjoyed extremely strong demand. In this cycle, we have the addition of the Federal Reserve "elephant" as a buyer of corporate credit, at least until the end of September. The additional credit demand and, more importantly, the associated psychological impact of the PMCCF and SMCCF provides investors some additional comfort surrounding a Fed back-stop bid and source of credit market liquidity.

However, the Federal Reserve is launching its buying program post the bulk of the tightening of credit spreads, so in effect the program worked before the Fed's purchase of a single bond or ETF. The Fed purchase program raises the risk of investors pushing spreads tighter and possibly reaching levels that are unsustainable given corporate credit fundamentals. Chairman Powell acknowledged this risk in his recent testimony to Congress, and indicated that the Federal Reserve will monitor credit market performance and slow or reduce purchases, if appropriate. Since the 2008 Global Financial Crisis, UIA-IM investment professionals have managed Agency

MBS portfolios in a sector supported by a Federal Reserve back-stop bid. Understanding the operation of the Federal Reserve program (i.e., monitoring what the Fed is buying and not buying) is essential for success in sectors with direct government involvement.

UIA-IM Positioning

UIA-IM is closely monitoring the interaction of major participants: issuers, investors, and the Federal Reserve. We are of the opinion that spreads will end the year tighter despite some periods of widening throughout, which we believe will become less severe as the economy reopens. In addition to the Fed's corporate program, our comfort in credit fundamentals stems from our analysis of key issuer balance sheets that were reinforced by recent issuance and should provide adequate liquidity to withstand an extended period of distress.

UIA-IM is maintaining an overweight to the spread sectors, including both corporate and securitized credit. As spreads continue to tighten, we will consolidate sector positioning, move up in credit quality, and shorten spread duration. As noted above and in prior communications, we expect the next 12 months will be a "bond-pickers" market, characterized by higher than normal dispersion of individual issuer and sub-sector returns. We are focusing on bottom-up analysis to identify securities that offer attractive fundamental value, and selectively adding these positions to our client portfolios.