SEGALL BRYANT & HAMILL

FIXED INCOME MARKET UPDATE

Third Quarter 2020

QUARTER IN REVIEW

The Corporate Bond Market Takes Advantage of the Fed

Encouraged by aggressive Federal Reserve (Fed) stimulus and low interest rates, corporations have issued over $2 trillion in new debt in 2020 ($1.7 trillion of investment grade and over $300 billion of high yield), already more than any full calendar year in history. This towering wave of new debt is generally viewed as a credit positive as it provides much needed liquidity for many corporations to ride out the impacts from COVID-19 and wait for the economy to normalize. However, while the extra balance sheet cash may be beneficial in the short term, the longer-term impact remains to be seen. Good or bad, yield-hungry investors have been very receptive to all the new corporate debt. In the third quarter, corporate bonds posted strong returns with riskier credits outperforming higher quality credits and Treasuries. Despite the current enthusiasm for corporate bonds, it is important to note various pockets of concern. The high yield default rate continues to tick up, U.S. election uncertainty is high, and further fiscal stimulus is in question; all of which highlights the need for careful security selection. Read on for an analysis of the fixed income market in the third quarter of 2020.

MARKET SUMMARY

Treasuries remain the top-performing broad fixed income asset class year-to-date, but high yield was the top performer in the third quarter, reflecting a continued search for yield and a slight inclination toward riskier assets.

YIELDS & RETURNS (%) [1]

	Duration (years)	Yield	Q3 Return	YTD Return
Treasuries	7.14	0.48	0.17	8.90
Investment Grade Corporates	8.56	2.01	1.54	6.64
High Yield Corporates	3.61	5.77	4.60	0.62
Municipal Bonds	5.44	1.30	4.23	3.33

U.S. TREASURY MARKET

Against a backdrop of economic and political disorder, Treasury yields barely moved from where they began the month and quarter.

TREASURY YIELDS (%)[1]

	Q3 Change	Year-to-Date Change	9/30/2020	8/31/2020	7/31/2020	6/30/2020
90-Day T-Bills	-0.04	-1.45	0.10	0.09	0.09	0.14
2-year Treasury	-0.02	-1.43	0.13	0.13	0.11	0.15
5-year Treasury	-0.02	-1.41	0.27	0.26	0.22	0.29
10-year Treasury	0.03	-1.23	0.68	0.69	0.54	0.65
30-year Treasury	0.04	-0.93	1.45	1.45	1.20	1.41

Treasury returns were close to zero in Q3; only the 30-year Treasury bond dipped into negative territory. However, long Treasuries have been a strong outperformer on the year amid falling Treasury rates and a search for safe havens.

TREASURY RETURNS (%)[1]

	Duration (years)	Q3 Return	YTD
90-Day T-Bills	0.17	0.04	0.64
2-year Treasury	1.91	0.07	3.03
5-year Treasury	4.89	0.18	7.50
10-year Treasury	9.66	0.06	12.77
30-year Treasury	25.50	-0.80	23.91
U.S. Treasury TIPS	5.18	3.03	9.22

BROAD INVESTMENT GRADE

Corporate bonds posted strong returns in the quarter, aided by support from the Fed. Only asset-backed securities have outperformed duration-adjusted Treasuries year-to-date. The Fed continues to increase its holdings of corporates, MBS, and Treasuries.

INVESTMENT GRADE INDEX & SECTOR RETURNS (%)[1]

	Duration (years)	Yield	Q3 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
U.S. Aggregate	6.03	1.18	0.62	0.46	6.79	-1.16
Treasuries	7.14	0.48	0.17		8.90	
Agencies	3.64	0.49	0.36	0.19	5.44	-0.39
Mortgage-Backed Securities	2.03	1.29	0.11	-0.07	3.62	-0.52
Asset-Backed Securities	2.03	0.54	0.79	0.65	4.14	0.70
Intermediate Corporates	4.51	1.36	1.33	1.11	5.61	-1.03
Long Corporates	15.14	3.06	1.91	1.87	8.36	-9.55

Spreads on corporate bonds widened in September but still finished tighter quarter-over-quarter. MBS spreads are now tighter than where they began the year, due in part to the Fed's intervention.

INVESTMENT GRADE SPREADS (basis points)[2]

	Q3 Change	Year-to-Date Change	9/30/2020	8/31/2020	7/31/2020	6/30/2020
Intermediate Corporates	-16	33	103	96	102	119
Long Corporates	-14	52	188	184	182	202
MBS Current Coupon Spread	-20	-8	72	72	70	92

Across the quality spectrum, investment grade corporates produced positive returns for the quarter, led by BBBs. All quality categories are positive for the year while trailing the returns on similar-duration Treasuries.

INVESTMENT GRADE CORPORATE CREDIT QUALITY RETURNS (%)[2]

	Duration (years)	Yield	Q3 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
AAA	12.93	1.65	1.09	1.03	10.67	-3.90
AA	9.49	1.50	0.82	0.73	7.15	-2.80
A	8.48	1.67	1.13	1.00	7.67	-2.86
BBB	8.34	2.39	2.00	1.86	5.67	-4.90

Spreads widened in September for most corporate bond sectors, but the full quarter was marked by tightening across all sectors. Despite the tightening experienced in the third quarter, all sectors are still significantly wider in 2020, led by weakness in Energy and Transportation. Spreads in the Consumer categories, both cyclical and non-cyclical, have widened the least relative to where they began the year.

INVESTMENT GRADE CORPORATE BOND SPREADS BY SECTOR (basis points)[2]

	Q3 Change	Year-to-date Change	9/30/2020	8/31/2020	7/31/2020	6/30/2020
Consumer Non-Cyclical	-9	29	122	115	115	131
Technology	-13	32	106	102	104	119
Energy	-20	72	200	188	199	220
Consumer Cyclical	-24	30	123	122	126	147
Transportation	-22	61	157	158	161	179
Basic Industry	-31	34	166	161	169	197
Communications	-8	47	156	148	149	164
Capital Goods	-25	58	140	140	147	165
Utilities	-5	44	141	134	130	146
Financials	-13	45	126	117	122	139

HIGH YIELD

Third quarter returns favored risk in the high yield market, as CCCs outperformed BBs and Bs. For the full year, the story is reversed, as higher quality categories have outperformed. High yield overall has clawed its way back to a positive year-to-date return, although CCCs have lagged. (Note that aggregate CCC spreads move tighter when default rates rise, as the previously distressed bonds fall out of the index.)

HIGH YIELD SECTOR RETURNS (%)[2]

	Duration (years)	Yield	Q3 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
High Yield Corporates	3.61	5.77	4.60	4.37	0.62	-4.49
BB	4.22	4.38	4.02	3.80	4.24	-1.46
B	3.03	6.05	4.53	4.30	-1.16	-5.75
CCC	2.55	10.10	7.35	7.13	-6.95	-11.46

HIGH YIELD OPTION-ADJUSTED SPREADS (OAS) (basis points)[2]

	Q3 Change	Year-to-Date Change	9/30/2020	8/31/2020	7/31/2020	6/30/2020
High Yield OAS	-109	181	517	477	488	626
BB OAS	-74	200	382	334	339	456
B OAS	-103	216	540	489	501	643
CCC OAS	-258	82	951	978	1012	1209

Like the investment grade corporate category, most high yield corporate sector spreads moved wider in September but ended the quarter tighter than where they began. Transportation bonds (airlines, railroads, etc.) continue to show significant weakness, while Communications bonds (cable, media, wireless, etc.) have made up much of the widening experienced earlier in the year.

HIGH YIELD CORPORATE BOND SPREADS (OAS) BY SECTOR (basis points)[2]

	Q3 Change	Year-to-date Change	9/30/2020	8/31/2020	7/31/2020	6/30/2020
Consumer Non-Cyclical	-94	123	442	401	375	536
Technology	-113	165	400	356	335	513
Energy	-139	197	843	779	812	982
Consumer Cyclical	-131	205	493	464	504	624
Transportation	-185	517	978	981	1076	1163
Basic Industry	-110	176	523	488	503	633
Communications	-67	89	402	358	348	469
Capital Goods	-139	229	498	463	495	637
Utilities	-62	146	381	336	344	443
Financials	-99	250	491	451	459	590

High yield default rates moved higher once again, although the rate of increase slowed. At 8.9%, the default rate now sits at more than a 10-year high but remains much lower than its peak of 14.4% in 2009.

HIGH YIELD DEFAULT RATES[2]

	Q3 Change	Year-to-Date Change	9/30/20	8/31/20	7/31/20	6/30/20
Number of Issuers in Default	14	35	64	61	55	50
Issuer Default Rate	2.0%	5.0%	8.9%	8.5%	7.6%	6.9%
Number of Issuers in Default (ex-commodities)	7	19	34	34	30	27
Issuer Default Rate (ex-commodities)	1.2%	3.2%	5.7%	5.7%	5.0%	4.5%

MUNICIPALS & OTHER

Municipal bonds continued their steady returns in Q3 and remain in positive territory year-to-date. After-tax yields on munis continue to look attractive relative to similar-duration Treasuries.

MAJOR MUNICIPAL BOND INDEX RETURNS (%)[1]

	YTW	Duration (years)	Q3 Return	YTD Return
Short Duration (1-5 Years)	0.53	2.70	0.83	2.70
Intermediate (1-15 Years)	0.96	4.31	1.15	3.35
Long Duration (22+ Years)	2.22	8.53	1.41	3.14

MUNICIPAL YIELDS BY RATING CATEGORY AND DURATION (%)[2]

	AAA	AA	A	BBB
1 Year	0.11	0.17	0.53	0.94
5 Year	0.26	0.48	0.83	1.18
10 Year	0.83	1.03	1.48	1.77
30 Year	1.61	1.90	2.45	2.68

AA MUNICIPALS – HYPOTHETICAL AFTER-TAX YIELDS BY EFFECTIVE TAX RATE (%)[4]

	20%	25%	30%	35%
1 Year	0.21	0.22	0.24	0.26
5 Year	0.53	0.56	0.60	0.65
10 Year	1.28	1.37	1.46	1.58
30 Year	2.38	2.53	2.71	2.92

U.S. Convertibles benefited from a strong equity market in the third quarter to lead the "other sector" returns. Risk tolerance seems to have increased in the quarter, although Emerging Market bonds and Leveraged Loans are still negative year-to-date.

OTHER SECTOR RETURNS (%)[1,2]

	Duration (years)	Yield	Q3 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
Emerging Markets	4.75	6.88	2.07	1.94	-3.12	-10.08
Global Treasuries (Unhedged)	8.64	0.48	2.80	2.64	6.11	-4.55
S&P/LSTA Leveraged Loan 100	--	4.93	4.14	--	-0.66	--
Wells Fargo Hybrid & Pref. Securities Aggregate Index	--	5.36	5.63	--	2.20	--
U.S. Convertibles	1.80	1.15	13.86	--	23.50	--

[1]Source: Bloomberg.
[2]Source: yields from Barclays.
[3]Source: Bank of America Merrill Lynch.
[4]Hypothetical yields are calculated as the AA municipal yield divided by (1-tax rate). Actual tax-adjusted yields will depend on individual tax circumstances.