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The End of the World As We Know It?

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As we sit here evaluating asset markets, one of our portfolio managers, Steve Smith, occasionally thinks about markets in terms of music. Thinking about the issues facing credit investors, both corporate and structured, REM's *It's the End of the World: And I Feel Fine* starts reverberating through our heads. But is it really the end of the world as we know it?

Yes, we are facing a global pandemic and authorities have taken bold and significant action to address the virus on both healthcare and economic levels. Yet, COVID-19 is not the only issue confronting investors at this time—West Texas Intermediate (WTI) crude oil below \$20 is a significant issue as well. It was only a few short years ago, in 2015, that oil falling precipitously caused a severe dislocation in asset prices. So is it really the end of the world as we know it?

Much ink has been spilled analyzing and discussing COVID-19 and we may not be able to add much to the substantive conversation. However, we remind investors that low oil prices are of equal importance to analyze and understand. Current market conditions should have a notable impact on the U.S. energy sector as well as households—investors should heed signals from both of these areas.

The Energy Sector

The launch of an oil war between Saudi Arabia and Russia surprised markets that weekend of March 7. Although it may appear that Saudi Arabia and Russia are in conflict, the true foes for both countries are technology and capitalism. The advancement of fracking technology and capitalism have seen the rise of U.S. exploration and production (E&P) as a significant competitor to both Saudi Arabia and Russia.

The increase in domestic U.S. production has come at a cost to both these countries. Investors need to be wary of the outcome and understand how committed Saudi Arabia and Russia are to breaking U.S. E&Ps. As we have seen in the recent past, capex will most likely be significantly impaired and energy producers across the globe will need to plan accordingly. Our expectations are that both the private and public sector participants will face similar issues as they did in 2015. High yield issuers within the energy sector could experience acute pain.

Chart 1 shows how much spreads widened in this sector back in 2015:

1

U.S. High Yield Energy (ML) Minus 5-Year U.S. Treasury

BPs, As of 3/27/2020



Source: Bloomberg (© 2020, Bloomberg Finance LP), Bank of America Merrill Lynch

We have generally avoided high yield issuers within the sector and have not partaken in recent new issuance from some of the largest investment grade energy corporates. We may reevaluate this exposure on a company-by-company basis, particularly within the investment grade universe.

U.S. Households

The health of the residential real estate market and household balances sheet have been the bulwark of a relatively strong U.S. economy. The exogenous shock of COVID-19 will be severe and hopefully shorter-lived, creating a sharp income shock for households and the commercial real estate market. Social distancing will further impact service industries, including retail, restaurants, and lodgings. The stimulus package should be able to mitigate the near-term stress to some degree. Eventually household consumers will build confidence when they see the slowdown of the spread of the virus and the stimulus package working through the system.

Both corporate and structured credit markets have seen significant dislocations due to COVID-19 and the collapse of oil and natural gas. Spreads on an absolute yield basis have reached distressed levels when looking at a high yield index while structured credit has seen similar moves in cash bonds.

2

U.S. BAML High Yield Master II: OAS

BPs, As of 3/27/2020



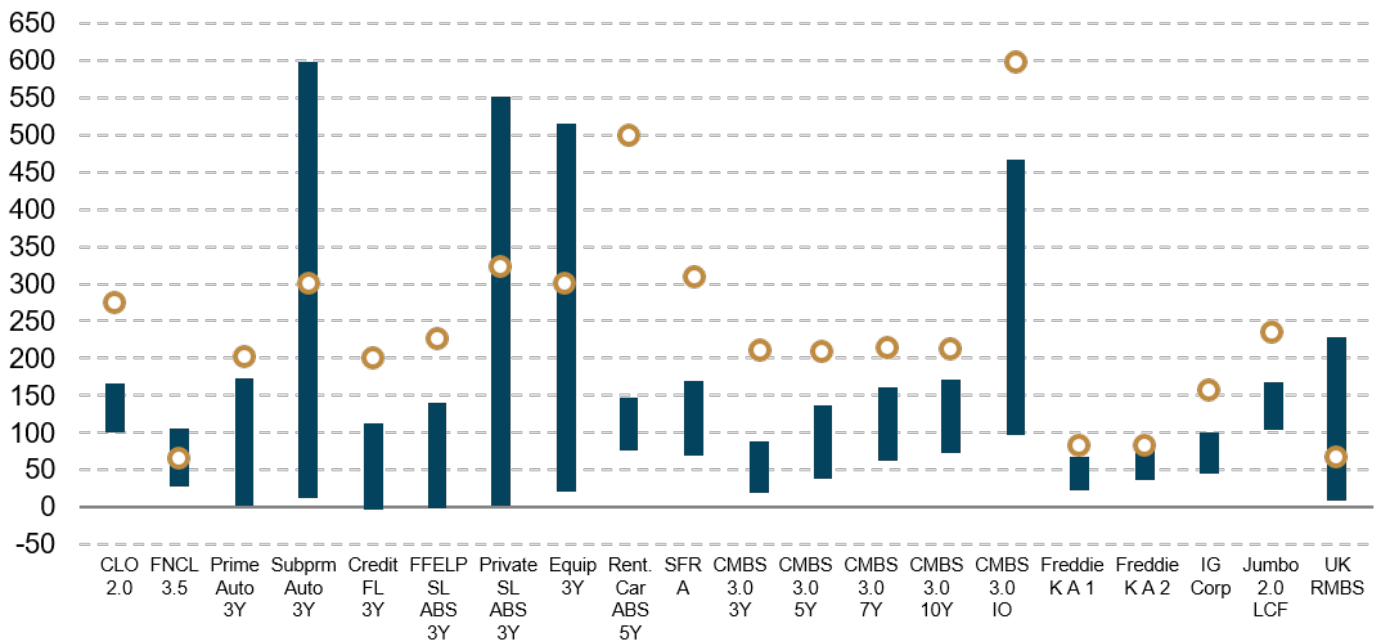
Source: Bloomberg (© 2020, Bloomberg Finance LP)

Certain pockets of the structured credit market have seen spreads widen as well:

3

AAA: 5th Percentile – 95th Percentile

Current, As of 3/27/2020

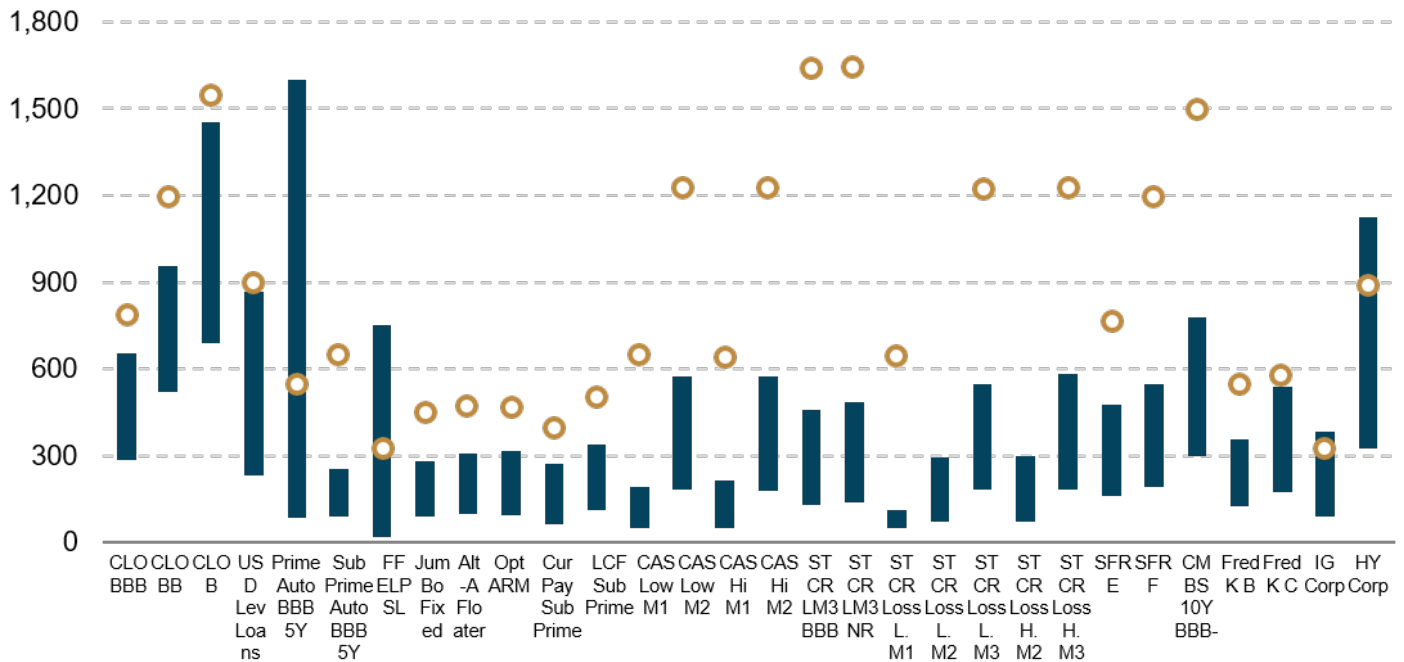


Source: Brandywine Global

4

BBB & Below: 5th Percentile – 95th Percentile

Current, As of 3/27/2020



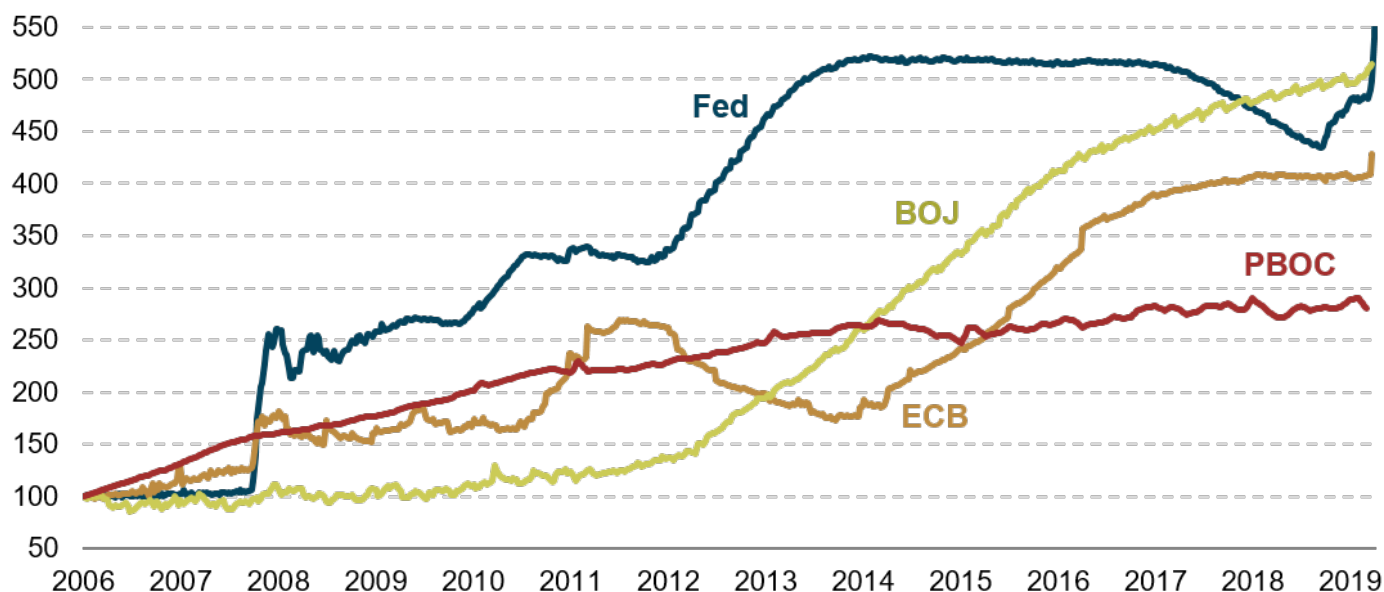
Source: Brandywine Global

Looking at [Charts 3 and 4](#), spread widening has been indiscriminate across investment grade and high yield structured, though yields have sharply risen on floating-rate debt, auto loans, and commercial mortgage-backed securities.

Whether these spread levels widened due to the unwinding of risk parity models or the liquidation of leveraged funds, the reality of the market is these securities are trading at these levels whether justifiable or not. And it's not only these lower quality markets that have seen challenges but also Treasury markets as well, which are normally highly liquid.

No, It's Not the End of the World as We Know It

We have seen a very strong and authoritative response from central bankers and policymakers around the world on both the monetary and fiscal sides. Policymakers have taken swift, decisive action, perhaps because of lessons learned from the Great Financial Crisis (GFC). The Federal Reserve, European Central Bank (ECB), People's Bank of China, and other central banks have all taken steps to support the financial markets and prevent an exogenous demand shock from becoming a financial crisis. The Fed has launched a seemingly infinite quantitative easing program along with providing access to a variety of facilities that were used during the GFC. [Chart 5](#) tracks the size of some of the major central banks' balance sheets since the onset of the GFC:



*Rebased as of January 2007 = 100

Source: Brandywine Global

Similarly, the ECB is looking to support member states and corporations. Additionally, politicians are coming through with fiscal support to plug a hole in GDP caused by a sudden stop of global economic activity due to COVID-19. In our view, these actions are putting a floor under investment grade assets and higher quality, below-investment-grade assets. Although the spread widening presents buying opportunities within higher-quality corporates and structured credit, we suggest proceeding with caution in terms of security selection, particularly given the lag in how long it will take for the benefits of low crude oil prices to work through households and businesses.

...And I Feel Fine.

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