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Fixed-Income Crisis Management

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Until the coronavirus outbreak, it seemed the Federal Reserve (Fed) had successfully delayed the recession and markets were setting up for another year of growth. But it is evident that the spread of the coronavirus is far more severe than just a passing shock, and we are now likely in a global recession that could last for several quarters.

In 2019, the economy was well into the 10th year of its record-breaking expansion, but there were many red flags for those active managers paying attention. Our Macroeconomic and Investment Research Group was developing and refining its recession forecasting tools and calling for a turn in the business cycle by early 2020 absent any intervention from the Fed. Debt levels and leverage ratios in corporate America were rising, thanks to the extended period of easy money and low rates. The investment-grade sector was already dominated by BBB securities that would be vulnerable to a downgrade in an economic slowdown.

Meanwhile, our fixed-income sector teams were observing the tightening of spreads across most sectors, to the kinds of levels that had not been seen since before the financial crisis. The intensity of discussion at our portfolio strategy meetings revolved around risks in the markets that were not being reflected in securities pricing. For several quarters, we had been upgrading credit quality, reducing spread duration, and building liquidity.

As long-term investors, we understood that our conservative portfolio decisions may contribute to a short period of underperformance relative to other strategies that took on more credit risk or spread duration. Even after the Fed executed three mid-cycle rate cuts to extend the expansion, our asset allocation strategy did not materially change. Our portfolio managers continued to upgrade the credit quality of our portfolios and maintain liquidity buffers, even as spreads got tighter. We knew that any kind of exogenous event could pop this “everything bubble.” It could have been a trade war, an oil shock, a rash of downgrades.

While a global pandemic was not on anyone’s radar screen as little as four months ago, as active fixed-income managers the portfolios we manage were already prepared for exactly the kind of market consequences it has precipitated—a collapse in risk asset prices, spread widening, huge volatility, and a rising number of attractive investment opportunities for investors with dry powder. Now that our views have been validated and the market break is occurring, this strategy has

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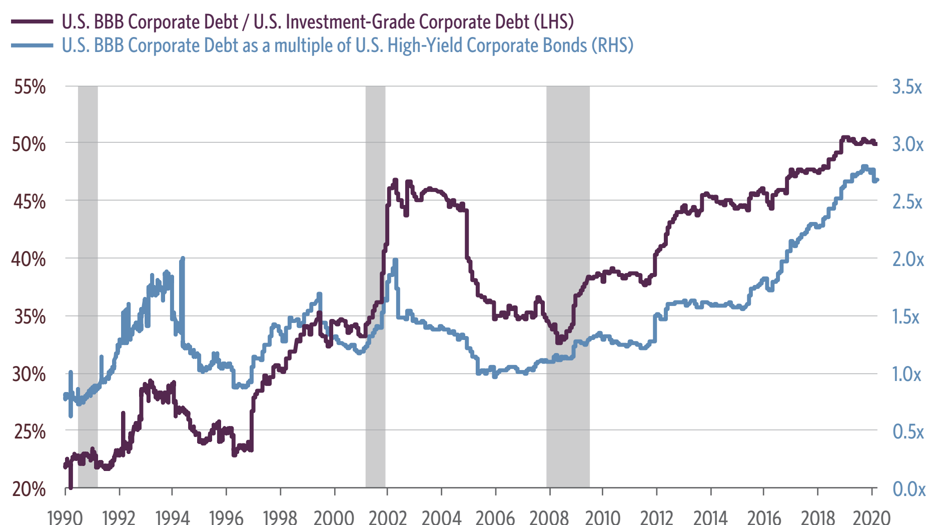
paid off with strong absolute and relative performance. Not only were our clients able to avoid many of the negative effects of the recent market dislocation, but our decision has also positioned us to take advantage of opportunities that are beginning to reveal themselves. A passive or index-constrained strategy will not have the same ability to mitigate risk.

I believe many insurance portfolio managers also remain highly vulnerable to the perilous level of BBB-equivalent NAIC-2 holdings held in their portfolios. We have already observed that the number of idiosyncratic defaults in high-yield bonds and bank loans had been increasing, but now the data are starting to confirm a credit deterioration story that is more widespread.

Insurance portfolio managers should expect more of the same going forward as scores of (barely) investment-grade companies get downgraded and flood the high-yield market as fallen angels. Investment-grade investors, especially insurance companies, must contend with the downgrade risk of BBBs hanging over the market like the Sword of Damocles. Nearly 50 percent of the investment-grade market is BBB, up from 35 percent in 2007. Bloomberg data show the cohort of BBB-rated corporate debt in broadly followed investment-grade corporate benchmarks has more than quadrupled in size over that period, from $800 billion to $3.3 trillion. For context, U.S. after-tax corporate profits are only 1.3 times bigger than in 2007. More specifically, about 8 percent of the investment-grade market was BBB- in 2007, just one notch above high yield. As of April 17, 2020, that share is 13 percent.

BBB-Rated Debt Growth Has Outpaced Growth of Other Corporate Ratings



Source: ICE Bank of America Merrill Lynch. Data as of 4.17.2020. Market size is based on debt outstanding in the ICE BofA Merrill Corporate Bond Index and the ICE BofA Merrill Lynch High-Yield Index. Shaded areas represent recession.

The insurance industry in general has participated in this ongoing shift. While the industry has stayed more selective than the index, insurance portfolios have experienced a 110 percent increase in NAIC 2 holdings (equivalent to BBB) since 2006, on only 38 percent growth in overall bond holdings. The $1.3 trillion in NAIC

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2 securities held by the U.S. insurance industry—as compared to $600 billion in 2006—comprises 29.4 percent of the insurance industry bond portfolios, up from 19.4 percent in 2006.

Insurance Company Exposure to NAIC 2 Holdings Keeps Rising

NAIC 2 Bonds as a Percentage of Invested Bonds of the U.S.-Domiciled Life and P&C Businesses

Source: Guggenheim Investments, SNL. Data as of 12.31.2019.

Now faced with the economic fallout from the COVID-19 outbreak, many companies just barely hanging on under the weight of the debt burden are coming under potentially unbearable stress. Based on historical averages, 11 percent of BBB corporate debt has been downgraded to high yield over a five-year period. As of April 17, 2020, however, 22 percent of the companies in the Bloomberg Barclays Investment-Grade Corporate Bond index already have leverage multiples that are consistent with a high-yield rating (including some A-rated companies). BBBs with high leverage exist across most industries—energy, tech, healthcare, materials—leaving very few places to hide. Given the quality of today's cohort, we expect 15–20 percent of BBBs could get downgraded to high yield over the next 12 months. This equates to $500 billion–$660 billion and would be the largest fallen angel volume on record over such a short period of time. Quite simply, it would swamp the high yield market.

In February 2020, markets previewed the negative impact of a large debt-laden investment-grade company getting downgraded to high yield. Kraft Heinz (KHC), a well-known household brand with a market cap of over $30 billion, saw its corporate bond rating slashed from BBB- to BB+ by both S&P and Fitch in one day. The downgrade made 19 KHC bonds totaling $22 billion in total outstanding ineligible for the most broadly followed investment-grade corporate bond index benchmarks. On average, KHC's bonds fell 6.5 percentage points of par over the course of two days around the downgrade, but the longer maturity 20+ year bonds, those less likely to find a natural home among high-yield investors, fell 11 percentage

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points of par. The price loss could have been worse if the downgrade had occurred against a more volatile market backdrop, or if multiple large downgrades were happening over a short period of time.

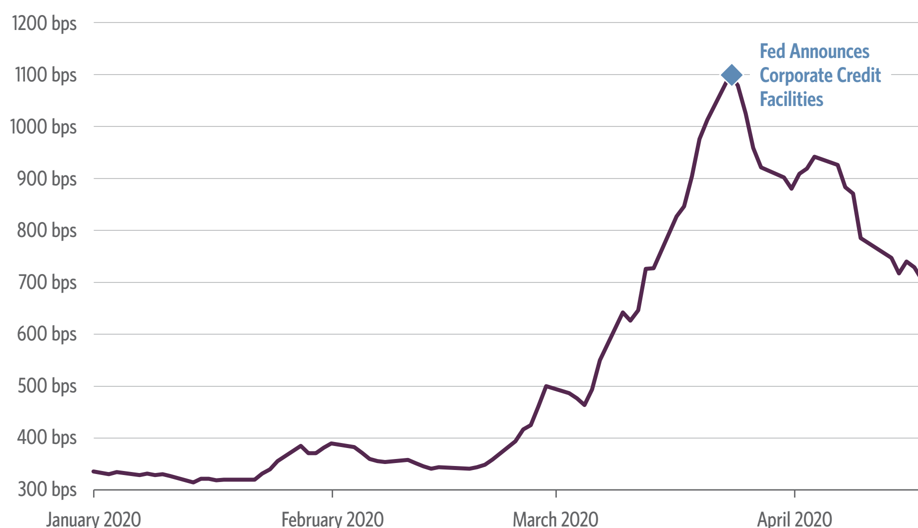
Since KHC's downgrades, several other large investment-grade issuers have been downgraded to high yield, including Occidental Petroleum (Oxy) and Ford Motor Credit Co (Ford). Oxy's 6.2 percent coupon 3.15.2040 maturity bond, which traded at a price of over 120 percent of par at the beginning of the year, as of April 17, 2020, trades around 67 percent of par. Ford's 4.75 percent coupon 1.15.2043 maturity bond traded at an average price around 90 percent of par at the beginning of the year, now it trades around 70 percent of par. Through April 20, over $140 billion of investment-grade corporate bonds have been downgraded to high-yield.

This analysis portends major problems for the U.S. insurance industry and its holdings of $213 billion in below investment-grade securities (BIG), or 5.0 percent of their bond portfolio, as of Dec. 31, 2019. In the prior recession, insurers' BIG holdings increased $100 billion to 7.5 percent, up from 4.7 percent of the bond portfolio. In 2002, the BIG position reached 7.2 percent of the portfolio. Given the current composition of the portfolios and the depth of the crisis, BIG holdings could approach and even breach the 10 percent level. This would erode the capital ratios of insurers and potentially lead to mass downgrades akin to the prior recession.

Ultimately, we will reach a tipping point when investors will awake to the rising tide of defaults and downgrades. The timing is hard to predict, but insurers should not allow themselves to be lulled into complacency. We believe that insurance portfolio managers are best served by experienced active fixed-income managers, not so much for their skill in seeking out compelling yield opportunities at this point, but for their ability to mitigate risk.

High-Yield Market Approves of Fed Backstop

Bloomberg Barclays U.S. High-Yield Corporate Option-Adjusted Spread



Source: Guggenheim Investments, Bloomberg. Data as of 4.17.2020.

The Fed has been trying to do virtually everything in its power in a time of crisis. Most notably, its plan to buy high-yield debt and provide financing to companies, which it announced April 9, resulted in credit spreads tightening dramatically.

The market may like the Fed's actions, but Fed purchases cannot turn bad debt into good debt. A buyer who is not careful can mistake Fed liquidity for credit strength and pay the price down the road when the downgrades start in earnest.

The strong response by the Fed has caused a bounce in values after the sharp sell-off in risk assets, so insurance portfolios—especially those that are overweight NAIC-2 assets—can sell into strength. Fixed-income markets remain vulnerable to further spread widening as the downgrades start to mount. As active managers, we believe that deploying risk mitigation strategies today will position our insurance clients to pick up undervalued credits during more opportune times. Better to sell when you can rather than when you must.

Important Notices and Disclosures

Investing involves risk, including the possible loss of principal. Investments in fixed-income instruments are subject to the possibility that interest rates could rise, causing their values to decline. High yield and unrated debt securities are at a greater risk of default than investment grade bonds and may be less liquid, which may increase volatility.

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