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March 25th Investment Update

Chris Schildz:

Welcome to Conversations with Commerce Trust where Commerce Trust Company shares a commentary on economic matters important to you. We plan on making podcasts like this one available on a more frequent basis during the Coronavirus outbreak. Today we have Chief Economist and Director of Fixed Income management, Scott Colbert. And director of our tax exempt bond fund strategy, Brian Musielak. Scott is going to lead us off with a quick update and Brian will focus on activity in the municipal bond market. Scott, certainly a huge market surge in a favorable direction yesterday. The US stimulus package is approved. What can we expect next?

Scott Colbert:

Well, it feels a lot easier to do this today than it would have several days ago. But clearly from an economic point of view, the shock is big. It's strong and likely to be lasting for quite a while. It's rather apparent to almost everybody now that we are currently in a recession with as bad as the March statistics are likely to be, they'll backdate the recession at the beginning of the year. We know that we're going to have an unbelievably weak second quarter with hopefully the stimulus package offsetting some of that, but that takes a while for the stimulus package to work. The third quarter should start to see somewhat of stabilization and we're optimistic that because we know what the problem is, the Coronavirus, to the extent that we can begin to get our arms around that and push that back, we're likely to see some signs of life as we approach the end of the year.

Scott Colbert:

This will be the deepest recession we've ever had, but hopefully it won't be any longer than the average recession. The average recession lasts 11 months. If they backdate this to March one. Most of you are worried about when the stock market is going to bottom. Nobody really knows. We will say that we've had a major balance off of a waterfall decline both Monday with the strong rebound, almost 11% in the market, the largest they say since 1933. And of course we're having a follow-on effect today with the Dow up about 150 points. The market is still down as I sit here talking to you, 25% peak to trough the S&P 500 and the S&P typically falls 34% on average when we have a recession. And given that it's clear we have a recession, the market pretty much moved like it does an average basis.

Scott Colbert:

We still think that the market likely goes back and retest these lows. It's why we haven't recommended rebalancing yet, i.e. selling your winners on a relative basis, the bonds that have held up better and buying the stocks. But of course, it generally takes a lot of time for the stock market to bottom. And we could be wrong about that too, but we're still cautious on that and think we need to let a little time play out. I don't think too many people would be upset getting in with the stock market down 25% rather than missing the opportunity for it to go down 40 or 50. A lot of people are asking what's going on in the fixed income market and that's what Brian will address here, particularly in the muni market. But oddly enough, I think everybody knows that treasury interest rates have come down.

Scott Colbert:

The fed has done a nice job. They lowered short term interest rates from 1.5% to essentially zero. Treasury rates have fallen with the fed embarking upon unlimited quantitative easing, meaning they're willing to print an unlimited amount of money to buy longer term securities. That's helped calm the treasury market down. And the 10 year treasury note has fallen from about 1.9% to something just a little more than 0.8% or almost more than a percent so far this year.

Scott Colbert:

And of course mortgage rates are starting to slowly come down as well now. There was a lot of dislocation in the government mortgage market, but the fed programs are having some effect there. What hasn't improved at all, and has actually gotten worse of course, is the credit markets. Corporate bond spreads have widened, meaning that even though treasury rates have gone down, the average cost to borrow for a corporation in this company, as you might expect with all of the potential problems they're likely to have, have widened.

Scott Colbert:

For example, the average corporate bond had a yield ... Investment grade corporate bond had a yield of about 2.9% to start the year. And as we sit here this morning, it was about 4.5 to 4.6%, so it's actually higher. And so what you've seen is you've seen your fixed income portfolios, your investment grade bond portfolios actually decline in price. Now they haven't declined in price anywhere near what the stock market has. But nonetheless, they've actually gone down a bit in price despite the fact that interest rates, treasury rates have gone down. The credit spreads have more than compensated for that. So we wanted to get ahead of that a little bit and talk to you about what you're likely to see as your third quarter statements come out. And some of you may be surprised to actually find the bond prices can actually fall a bit in a market where treasury rates are actually rallying. But Brian would like to address that now and I'll help out to the extent I can.

Chris Schildz:

Thanks Scott. Brian, can you focus on the municipal markets please?

Brian Musielak:

Absolutely. Thanks Chris. Thanks Scott. As Scott mentioned, we have seen some dislocations in bond markets, not treasury markets, right? So the treasury market as Scott mentioned, had moved down in yield. And had been down in yields in much of the large part from what the fed is doing, but the credit market, the corporate bond market and the municipal bond market, both had been moving in the other directions really within the last couple of weeks. And this is a very similar trade that we saw put on back during the financial crisis. In times when investors get nervous, they want to build cash, they want to build a liquidity buffer. And we've seen this certainly in corporate bonds, and now we're seeing it in the municipal bond market. So where there's the institutional investors are looking and desperate for liquidity, they're raising cash.

Brian Musielak:

And as a result they're selling their municipal bonds in large part because they tend to be the more liquid part, the safer part of their portfolio. So as you're looking to raise cash, you're trying to do it in the least painful way as possible. What's a little more unique to the municipal market is the amount of fund flows and the impacts there. So when you think about all the muni bonds, bond funds that are out there, we had a record amount of demand over the last year, year and a half. We had record amounts of flows going into those bond funds. Well as a result of that, those funds of course had to buy muni bonds in order to put that cash to work. And up until we got to March, at the beginning of March of this year, that had driven muni bond yields down to the all time lows that we've ever seen.

Brian Musielak:

That because the demand for munis were so high. Once the concern started taking over the market, we've seen a complete reversal of those fund flows. And what happened in the course of the time over a period of a year and a half, we're starting to get back in terms of outflows just in the course of the last two weeks. So we've seen over $12 billion flow out of these municipal bond funds. And of course what that creates is the managers then have to sell underlying bonds to meet those redemptions. And in large part, they're selling into what is a weak bond market right now. And so for the last two weeks we've seen interest rates or bond yields go from about a half a percent for a five year bond, now down to about two or up to about two and a half percent. And so that's obviously a very big move in the market.

Brian Musielak:

And as Scott said, that's going to have an impact on the mark to market values. But to put it in context, in terms of your own individual portfolio, here at Commerce, if you build an individual bond portfolio, or even if you have a bond fund, we're not selling into this pressure. We're seeing yields now, they're really just back to 2018 levels, which will coincide with the market values. And as you know, with the individual bonds, you see those prices go up, you see them go down a value, but at the end of the day you get your face value back. And so that's what's important in terms of the portfolio. Now, just to talk a little bit about credit, obviously as Scott mentioned, we're going to have pretty severe economic slowdown here. We're thinking the duration may be shorter than past recessions. And as a result of that, you're going to see tax revenues at the state and local government level go down.

Brian Musielak:

But when you think about how we entered this, I think it's very important to put it into context. We came into this in a position of strength. Not only was obviously the economy was very strong heading into this, but also too, when you look at state and local governments, they had built up rainy day reserve funds, big balance sheet strength, tax revenues were very strong. And so on average, if you look at states across the board, they're maintaining about 20 to 30 days cash on hand, meaning that if all revenue stopped and they continued to have their expenses, they'd have about a month's worth of cashflow to override that. And so that's very important to understand that position of strength because that'll help cushion the ultimate blow to this. The other thing is obviously we talked a little bit about the fiscal stimulus.

Brian Musielak:

It's passed through the Senate. Obviously it's got to get through the House and get signed. We're confident that, that's going to move its way through, but if you look at part of that stimulus, we haven't got all the details to it, but obviously that's going to come down to the state and local level. So, we do think there'll be some fiscal support again to help cushion some of this blow that we're experiencing from the economic activity.

Brian Musielak:

And lastly, just part of our process here at Commerce, we tend to err on the side of caution and have higher quality till to what we're doing. And so from that standpoint, again, we're just trying to find as much cushion as possible to start and have this throughout. And that'll get us through as we go through these tough economic times ahead.

Chris Schildz:

Thank you very much, Brian. Scott, did you have any concluding thoughts to wrap it up?

Scott Colbert:

Well, I might mention that the only way for fixed-income investors ever to make more money in the future is to have a higher interest rate environment. We've watched rates come down and down and down. This is an opportunity to the extent that you want to lock in higher yields and higher rates. The fixed income markets are gradually healing. The government programs that the fed has put in place have gone a long way to stop the bleeding, so to speak, and to stop the rise in rates in the credit markets. And then the additional monies that the federal reserve is going to be getting post of the stimulus package to essentially lever into the credit markets and buy and help buy and help support the markets, is likely to drive interest rates down again in the future.

Scott Colbert:

That's the ultimate goal because of the extent that we lower rates across the board for everybody, that helps the economy move forward. Unless, you're a saver. And so we would recommend that you consider to the extent that you're holding any cash and would like to lock in some longer rates, you need to be thinking about bonds. On the other hand, ultimately when we want to rebalance to the extent you have a balanced portfolio, we'll probably likely have to reduce some of those bond positions and buy some of those stock positions that have been beaten up even more than the fixed-income. The great news is though, this stock market having based puts a level on credit spreads. Those credit spreads are improving.

Scott Colbert:

And even as Brian and I are sitting here talking to you today, the interest rates are coming down on these municipal securities and the corporate bonds. They are compressing towards treasuries and they're actually improving in price. Just as we ... Even as we talk here with the stock market having put in a base. And ultimately it's game of credit. Commerce is great with its credit picking strategies and we're very, very detailed in terms of trying to avoid any potential losses in the fixed-income market. And ultimately as these securities mature, you get your money back and you get to reinvest them. That's the nice thing about the bond market.

Chris Schildz:

Thanks to Scott and Brian for their insights and candor. This was Conversations with Commerce Trust Company. If at the end of this podcast you still have questions unanswered, we encourage you to contact your portfolio manager for further discussion.

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