COUNTRY Trust Bank®
Special Report - The Coronavirus Impact on Fixed Income Markets

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Key Points:

- **During March, investors began indiscriminately selling all types of bonds in favor of cash positions. This included the highest quality and most liquid bonds.**
- **The Federal Reserve executed a variety of unprecedented actions during the quarter to boost liquidity and ease lending conditions.**
- **We feel the volatility has created some attractive opportunities in certain segments of the bond market.**
- **Generally, it makes sense for investors in multi asset portfolios to continue to rely on their bond allocation to provide ballast.**

When a ship sails through rocky seas, it requires ballast. The ballast is any heavy substance placed in such a way to improve stability and control of the ship. It helps ensure a safe voyage arriving at ones intended destination safely. In investing, investment grade bonds have historically acted as a form of ballast for portfolios. March 2020 has certainly tested this theory.

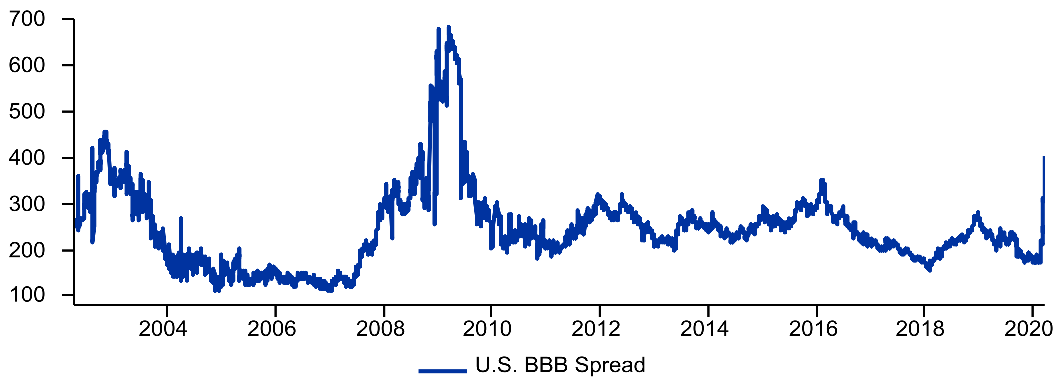
Bond Market Volatility

The Coronavirus has sown fear and disruption throughout the U.S. financial system over the last 30 days, as discussed in our Special Report released March 11th. The fixed income markets were not immune to the effects. Investors sought safety during the first half of the quarter pushing bond yields to unprecedented lows. The yield on the 10-year U.S. Treasury closed at a record low of 0.54% during early March but reversed towards month end as trading within fixed income markets became erratic. The fear morphed into panic and investors began indiscriminately selling all types and qualities of bonds in favor of cash positions. This included the highest quality and most liquid bonds.

There are a variety of reasons for this. One likely cause for the selling is due to fears an increase in government spending will create inflation. Many long-term investors were also rebalancing portfolios by selling bonds and adding to stocks. Hedge funds and other leveraged investors could be forced sellers in order to meet margin calls. The selling pressure was so pronounced during the month, bond dealers were unable to make markets by taking additional inventory on their balance sheets. Post 2008-09 financial crisis regulation has limited their ability to take on this risk. As a result, the bond market was not trading efficiently. This inefficient trading caused dislocations in the marketplace making it difficult if you were a seller of bonds but created opportunity for buyers.

The interest rate corporate bonds pay over treasuries widened substantially during the quarter and volatility has significantly increased in this market. The interest rate difference or spread on U.S. corporate bonds rated BBB widened from 178 basis points as of December 31 to 403 by March 24th (Figure 1). We expect this volatility will continue as corporate earnings and cash flow estimates remain uncertain.

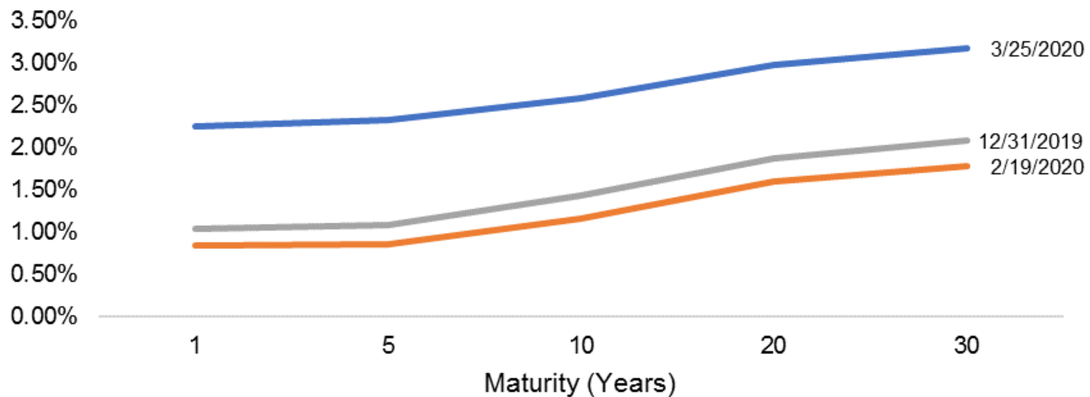
Figure 1



Source: Refinitiv Datastream

There is also good value in municipal bonds. As of 3/24, AAA rated municipal bonds had a yield to maturity of 2.50% (Figure 2). Unlike corporate bonds, this yield is usually federally tax exempt.

Figure 2



Source: Refinitiv

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Federal Reserve Response

In response to these events in fixed income markets, the Federal Reserve executed a variety of actions during the quarter to boost liquidity and ease lending conditions. They implemented numerous initiatives to improve liquidity and functioning of short-term financing markets. They cut the target range for the federal funds rate by 1.50% during two emergency meetings to a target range of 0-0.25%. The Fed also restarted their asset purchase program, directly buying treasuries, corporate bonds and mortgage backed securities. This was a technique used extensively during the 2008-09 financial crisis but at that time only included treasury and mortgage backed securities. They reestablished an asset backed securities lending facility to support the student loan, credit card and auto lending markets. They also implemented programs to support lending to small businesses.

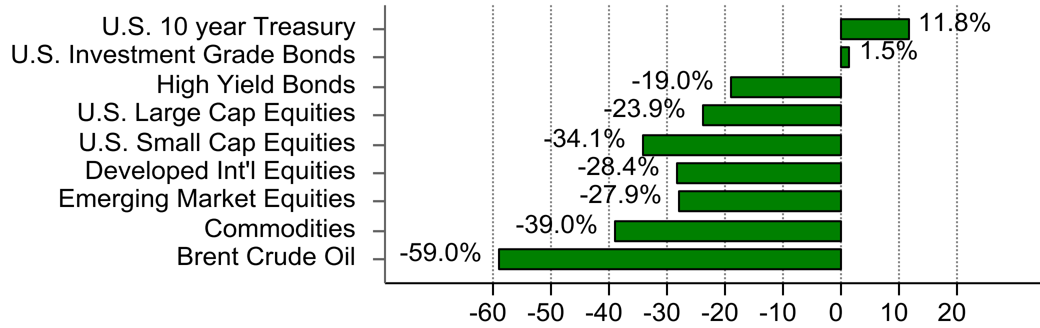
The Fed's actions are an attempt to keep financial markets functioning normally as well as provide stimulus during uncertain times. However, further action may be needed to facilitate the smooth functioning of financial markets. In our view, these moves alone are unlikely to stimulate consumer demand, which has been negatively impacted by coronavirus containment efforts. We believe accommodative monetary policy needs to be paired with fiscal policy to effectively support the economy.

What we are Seeing

The dislocations in the bond market caused many below investment grade or high yield bonds to experience significant losses during the quarter. Investors who had been investing in these lower quality bonds for their higher income saw how risky these bonds can be during periods of market stress. However, we feel the volatility has created some attractive opportunities in certain segments of the bond market. Over the last few weeks, we began seeing opportunities in preferred stock, emerging market bonds and floating rate loans. We might be early on this call but feel long term this allocation makes sense for portfolios with fixed income positions.

While we have seen significant declines in some areas of the bond market, investment grade bonds continue to be an important piece of multi asset portfolios. We saw the value of this diversification during the quarter as U.S. Investment Grade Bonds managed a positive return of +1.5% through 3/24/2020. U.S. Large Cap Stocks returned -23.9%, U.S. Small Cap Stocks -34.1% and Developed International Stocks -28.4% over the same time period (Figure 3).

Figure 3

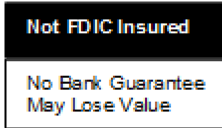


Source: Refinitiv Datastream

What Investors Should Do

The current coronavirus global pandemic we are experiencing has created unprecedented volatility in fixed income markets. High quality bonds have proven their worth as a haven as other asset classes have declined. Generally, it makes sense for investors in multi asset portfolios to continue to rely on their bond allocation to provide ballast as they sail towards their long-term investment goals.

COUNTRY Trust Bank Wealth Management Team



Past performance does not guarantee future results. All investing involves risk, including risk of loss.

All information is as of the report date unless otherwise noted.

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Definitions and Important Information

The federal funds rate is the interest rate at which depository institutions lend reserve balances to other depository institutions overnight. The Federal Open Market Committee, which is the primary monetary policymaking body of the Federal Reserve, sets its desired target range.

The yield curve plots the interest rates of similar-quality bonds against their maturities. The most common yield curve plots the yields of U.S. Treasury securities for various maturities. An inverted yield curve occurs when short-term rates are higher than long-term rates.

Figure 1,2 and 3: Chart data comes from Refinitiv (formerly Thomson Reuters) Datastream, a powerful platform that integrates top-down macroeconomic research and bottom-up fundamental analysis.

A basis point is one hundredth of one percent, used chiefly in expressing differences of interest rates.

Stocks of small-capitalization companies involve substantial risk. These stocks historically have experienced greater price volatility than stocks of larger companies, and they may be expected to do so in the future.

Stocks of mid-capitalization companies may be slightly less volatile than those of small-capitalization companies but still involve substantial risk and they may be subject to more abrupt or erratic movements than large capitalization companies.

International investing involves risks not typically associated with domestic investing, including risks of adverse currency fluctuations, potential political and economic instability, different accounting standards, limited liquidity and volatile prices.

Fixed income securities are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. Debt securities typically decrease in value when interest rates rise. The risk is usually greater for longer-term debt securities. Investments in lower-rated and nonrated securities present a greater risk of loss to principal and interest than higher-rated securities.

Diversification, asset allocation and rebalancing do not assure a profit or guarantee against loss.

All indexes are unmanaged, and returns do not include fees and expenses associated with investing insecurities. It is not possible to invest directly in an index.

U.S. Investment Grade Bonds are defined by the iShares Core U.S. Aggregate Bond ETF. It seeks to track the investment results of the Bloomberg Barclays US Aggregate Bond Index. The Bloomberg Barclays US Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States.

High Yield Bonds are defined by the SPDR Barclays Capital High Yield ETF. It seeks to track the investment results of the Bloomberg Barclays High Yield Very Liquid Index. This index tracks the performance of below-investment-grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

U.S. Large Cap Equities are defined by the S&P 500 Index. The S&P 500® Index is an unmanaged index consisting of 500 U.S. large-cap stocks. Since it includes a significant portion of the total value of the market, it also considered representative of the market. The index does not reflect investment management fees, brokerage commission and other expenses associated with investing in equity securities.

U.S. Small Cap Equities are defined by the Russell 2000 Index. The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set. The Index does not reflect investment management fees, brokerage commission and other expenses associated with investing in equity securities.

Developed International Equities are defined by the MSCI EAFE Index. This index is broadly recognized as the pre-eminent benchmark for U.S. investors to measure international equity performance. It comprises the MSCI country indexes capturing large and mid-cap equities across developed markets in Europe, Australasia and the Far East, excluding the U.S. and Canada.

Emerging Market Equities are defined by the MSCI Emerging Markets Index. This index captures large and mid-cap representation across 26 emerging market countries. The index free float-adjusted market capitalization index and represents 13% of global market capitalization.

Commodities are defined by the S&P GSCI Index. This Index is a widely recognized benchmark that is broad-based, and production weighted to represent the global commodity market beta. The index includes the most liquid commodity futures.

Brent Crude Oil is a trading classification of sweet light crude oil that serves as a major benchmark price for purchases of oil worldwide. Brent is the leading global price benchmark for Atlantic basin crude oils. It is used to price approximately two thirds of the world's internationally traded crude oil supplies.