October 29, 2020

Bates Expert Interview:

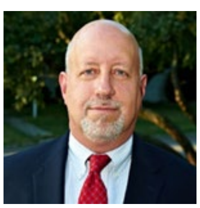
Reflections on the Impact of COVID-19 on the Fixed Income Market

We asked Bates Group experts and consultants with deep experience in fixed income and municipal securities to share some perspective on how the pandemic has impacted investors over the past six months. Here are some of their insights on recent market volatility, Federal Reserve intervention, credit ratings, and the likelihood of potential investor litigation going forward.

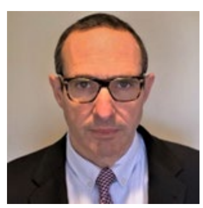
Joining the conversation were:

Stephen Behnke, a Bates Group Director, expert and consultant with extensive fixed income securities and retail brokerage experience, including suitability, supervision, IA matters, and complex securities.

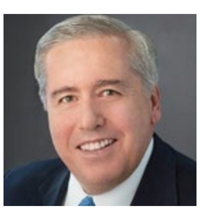
Pamela Peterson, a Bates Group expert and consultant with experience in compliance, municipal securities underwriting, and the rules and practices involving primary and secondary sale of municipal bonds.



Stanley Fortgang, a Bates Group Director, expert and consultant with experience in equities, fixed income, hedge funds, regulatory, compliance, mutual funds, and other financial-related matters.



Jody Scharf, a Bates Group expert and consultant with experience in trading protocol and sales, Broker-Dealer rules and regulations, and all aspects of corporate and municipal bond protocols.



Stephen Hoopes, a Bates Group expert and consultant and an investment banker with experience in the fixed income capital markets, including municipal and corporate securities.

5005 Meadows Road, Suite 300
Lake Oswego, OR 97035
(503) 670-7772 | (888) 960-2809
www.batesgroup.com | contact@batesgroup.com

Here's what Bates leaders are talking about: (Answers have been edited and condensed for length and clarity.)

Question: *The pandemic began to disrupt financial markets in mid-March 2020. How have debt markets been affected?*

Stephen Hoopes: In mid-March of 2020, the municipal market suffered a significant sell-off due to concerns about the pandemic's impact on state and local governments' revenue streams. New issuance dried up, as did market liquidity. This initial sell-off was eventually tempered by cross-over buyers entering the market to take advantage of higher tax-equivalent yields and by other buyers who viewed municipals as a safer haven than the stock market. Credit became a greater focus for investors as they parsed the market to identify those issuers who were most likely to suffer significant negative economic impacts from the pandemic. But as buyers and liquidity have returned to the municipal market in recent months and tax-exempt yields have retreated to more "normal" levels, the intense credit focus has been partially offset by investors reaching for yield.

Households hold approximately 46% of all municipal debt. Households are also more likely to buy and hold securities. Increased demand and the retreat of yields to more "normal" levels helped to soften the impact of the market disruption on retail investors—unless they sold during the early stages of the pandemic. Notably, not all institutional investors have fared as well. Significant outflows from bond funds in March 2020 forced many to realize some losses within their portfolios.

Jody Scharf: The pandemic affected the market in many ways. The initial reaction was measured, but fear crept into the markets due to uncertainty and media hype—this happened quite rapidly. Spreads widened in credits such as airlines, hotels, convention centers, and in states whose economies housed directly-affected industries. The market as a whole got hit hard across the board. For example, the CDS (investment grade) index mid-February 2020 (pre-COVID) was 44, and by mid-March, it had ballooned to 151. It is currently around 54, so it is easy to see the dramatic decline as well as the comeback in the spread.

That comeback was largely the result of Fed moves to push interest rates to near zero, and also moves on quantitative easing as the Fed sought to buy a multitude of fixed income products in the open market.

From a macro standpoint, with rates being at historically low levels, the search for income/yield has become more difficult. Portfolio managers as well as financial advisors tend to reach for more yield and stress the risk threshold of clients beyond what their risk levels allow for. In general, this has been done by reaching for lower quality and longer maturities. This should be disclosed, of course, but very often it is not.

Further, the amount of BBB credits in the market is at an all-time high against the percentage of the fixed income market. For example, twenty years ago BBB credits were 20% (approximately) of the market. Today it is closer to 55%. That is an approximate number, but important to consider.

Q: *What should we understand about the steps the federal government and the Federal Reserve took to address the market volatility?*

Stanley Fortgang: Beginning almost immediately after the first cluster of cases developed in my hometown of New Rochelle, NY, the federal government—and, more importantly, the Federal Reserve Bank—took a series of actions in an attempt to calm markets and sooth investor fears.

These included: an $8.3 billion emergency aid package, a Federal Reserve-led $1.5 trillion liquidity program, cutting rates to zero and establishing credit facilities to smooth the functioning of commercial paper, corporate bonds and municipals.

When we look at financial markets since the end of March and beginning of April 2020, it is easy to forget how serious a financial problem the country was facing. In the days following the outbreak, equity markets fell approximately 30%. Discussion ensued about emergency measures, including rumors of market closures. Interest rates, already quite low, fell even further in a classic flight-to-quality scenario.

The rebound in asset prices since then is nothing short of remarkable, and while many factors obviously played a role, it is hard to overstate the importance of government action in calming financial markets down so quickly.

Stephen Behnke: On March 23, 2020, the Federal Reserve announced the creation of a Municipal Liquidity Facility from which public bodies could borrow, and a Primary and Secondary Corporate Credit Facility allowing the purchase of up to $750 billion in corporate bonds and ETFs. While only $12 billion of that money had been spent through July 2020, the program had a substantial influence on the market, allowing BBB corporate spreads which spiked to +433 bps in March (eventually narrowing to +260 bps today).

While only the State of Illinois has tapped the MLF to date, the safety net helped keep municipal yields near historic lows and allowed state and local governments to borrow in advance of anticipated declining revenues. The Fed's action allowed corporations to issue record amounts of bonds. Through September 1, 2020, $1.9 trillion of corporate debt has come to market, providing companies with much needed liquidity.

As a result, yields throughout the curve have fallen since the Fed announcements, and the yield curve (Treasury 2-10) steepened only 47 bps, despite heavy supply and the future inflationary implications of monetary and fiscal stimulus measures.

Stanley Fortgang: Interestingly, debt markets have been remarkably stable through the 6-plus months of the crisis. This is mostly due to the realization that interest rates really have nowhere to go. Fed funds are at zero, ten-year treasuries have been stuck at 0.5%, and indices of public debt remain at low yields.

The backstops initiated by the Fed have given market participants the comfort to remain relatively calm, so while there have been short term hiccups in places like municipals, the overriding theme has been stability. This stability has led to increased debt issuance as issuers take advantage of an appetite for any yield being offered. They are happy to oblige and lock in attractive long-term borrowing rates.

The yield curve has had bouts of steepening as inflation fears occasionally hit the market, only to reverse each time as there remain absolutely no signs of inflation on the horizon. Over the long term this remains a concern, but that period just keeps extending further and further out.

Q: How have credit rating firms reacted to the market volatility and uncertainty?

Stephen Hoopes: During the initial months of the pandemic, the credit rating firms were slow to react as they appeared to be trying to gauge the depth and duration of the pandemic's impact on the various sectors within the overall economy. Both Moody's and S&P have since ramped up their reviews of those credits they deem to be most vulnerable to the pandemic. These include convention centers, stadiums, toll roads, public transportation, universities, hospitals, airports and entertainment venues.

They are also focusing on state and local governments that have high unfunded pension obligations and those that are particularly reliant on sales, income and hotel taxes. Through the middle of September 2020, Moody's downgraded 125 of the approximately 12,000 municipal market issuers that they track. S&P is on roughly the same pace. The amount of work involved is staggering and is ongoing. A backlog in reviews will pose a significant credit risk, particularly for retail investors.

That said, the municipal market has historically had a very low default rate. The intense economic stress resulting from the pandemic could push a significantly larger number of municipal issuers to the brink of default if the federal government does not step in to provide additional significant aid to states and local governments. States cannot go bankrupt, but some, like Illinois, were already under tremendous financial stress prior to the pandemic. Issuers like those at-risk entities mentioned will all come under increasing risk of default if the pandemic persists well into 2021, as many experts predict.

Q: What is the risk of default in the coming months?

Stephen Hoopes: Many municipalities were under financial stress prior to the onset of the pandemic due to high debt burdens and large unfunded pension obligations. The pandemic has exacerbated these challenges with the economic shutdown, high unemployment and the costs of facing this medical crisis. Municipalities that are tourist destinations or who rely heavily on sales, hotel and income taxes will be hit hardest. Most will be hard pressed to tax their way out of the financial crisis due to the enormity of the issue.

Fortunately, most municipalities have a few additional tools available to them to relieve some of the financial stress. Many are pursuing taxable refinancings to extend the repayment of near-term debt to buy some financial flexibility and maximize liquidity. Others are cutting services, restructuring their overall operations and cutting staff. Some may consider the sale of certain assets. As a final resort, some municipalities, in states where it is allowed, may be forced to consider filing for Chapter 9 Bankruptcy.

The pandemic has created a serious financial burden for many local governments. Without significant additional assistance from the federal government, an increasing number of municipalities will be at risk of default or bankruptcy.

Q: What kind of litigation might we anticipate as a result of investor losses during this time?

Stephen Behnke: Despite the Fed's actions, the risk of investor losses prompting litigation is substantial. The massive growth of corporate debt has been noted by market observers and the Fed for several years. At the end of 2019, corporate bonds outstanding topped $9.6 trillion, up 20% in 5 years. Over half of the corporate universe of bonds is now BBB rated up from 20% from 2001. Disturbingly, much of the proceeds were used to fund stock repurchase, and not re-invested into the business. Corporate debt has risen faster than earnings growth and thus companies' ability to support their debt has declined.

Wall Street underwrote this massive supply of debt at historically low interest rates and despite deteriorating balance sheets. As a result, investors buying this debt saw the average credit rating of their portfolio holdings decline. Retail investors starved for current income were caught in the dilemma of buying lower-rated and longer-dated bonds to capture yield.

Rating agencies cut or put on watch the ratings of more than 20% of companies in March 2020, the fastest pace ever. Further downgrades would force many bond funds to realize losses per the terms of their prospectus. At the same time, credit defaults are likely to grow if the economic recovery falters.

Stanley Fortgang: I see the greatest litigation trigger point being, as it often is, volatility. In these types of markets where prices move dramatically from period to period, there will always be big losers and sometimes big winners. For better or worse, investors who lose money—usually by selling into a panic—will often turn to arbitration panels to "right" the "wrong" they believe has been done to them.

So far, the best strategy has been to hold on as financial assets have been resilient in the face of unprecedented events. Fed action has maintained stability over the longer term even as bouts of extreme volatility continue to occur. History shows that those negatively impacted by short term decisions that lead to losses will usually seek redress.

Pamela Peterson: Institutional investors are, by their very nature, sophisticated market players. (Per FINRA rules, in order to open an institutional account, they must satisfy certain "big-boy" criteria and actively affirm their sophistication and desire to make their own trading decisions.) These facts deprive them of the ability to assert claims arising out of investor suitability and limits their ability to assert claims related to product suitability, so long as a product's features were adequately described, or the institutional investor had full access to books and records and senior management of an issuer. For these reasons, litigation from these investors is likely to focus on issues of actual fraud committed by issuers or placement agents. The strongest defenses issuers or sellers would assert may have to do with the inability to foresee the precise effects of the pandemic infection and uncertainty around the U.S. government's response vis-à-vis the international community.

If an institutional investor operates under an Investment Policy Statement requiring that only investments above a certain rating can be held, a widespread decline in fixed income ratings may require a massive sell-off, a flight to quality. (Note: brokerage firms generally cannot accept the responsibility for keeping an account in compliance with an IPS unless *all* the investments are held at that firm. That's extremely rare.) It's hard to predict how this would play out—massive sell-offs typically mean that a seller is willing to accept lower and lower prices to get out of lower-rated investments. However, it's unclear how the credit declines here could be blamed upon any action of broker-dealers or RIAs. Again, one needs to consider the specifics of each security, as well as what information was available to the institutional investor at the time of purchase, to see if there's anything that can be litigated.

Q: *Given the litigation risks you describe, what kind of counsel are you giving to your clients on investor risk during this time?*

Pamela Peterson: As a veteran of the work-outs that followed the collapse of auction rate securities, one thing I can tell every municipal bond dealer to remember is: communicate, communicate, communicate. Nothing makes retail investors madder than radio silence from their brokers. Now is the time for every brokerage firm to push out general and specific risk disclosure to clients: credit risk for cash-strapped issuers; interest-rate risk if rates begin to trend sharply upwards in an uncertain political environment; and the unpalatable fact that "high yield" equals "high risk." Given the longer holding periods for municipal bonds, your firm may or may not have communicated these ideas at the time of purchase but can communicate them now or reiterate them as you discuss whether to hold or sell these investments. Doing so can avert real trouble in potential litigation.

In addition, it is important to understand that municipal bonds come from about 33,000 issuers, and there's simply no easy way to categorize them because of that very diversity. Dealers should be well aware of the backing for each issue and make that clear to buyers and holders. For example, airport bonds backed solely by passenger facility revenues have been heavily impacted by COVID-19 (almost nobody's flying), but general obligation bonds for high-income communities are less affected (most managerial-level workers adapted well to work-from home). Similarly, an analysis could be completely different if comparing a revenue bond backed by a lockbox scheme. The point is: don't generalize, know the actual credit structure, and make sure that your retail clients understand the advantages and/or disadvantages of each fixed income investment.

Conclusion:

We are still in the middle of the pandemic and significant uncertainty remains. While macro moves will continue to guide discussion about the broader markets, investment risk remains tied to awareness about specific information on specific fixed income investments. We will continue to bring you insight from our experts on the broader market as well as investor risk, compliance and litigation.

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Contact:

Andrew Daniel

Director and Expert, Securities Litigation

E: adaniel@batesgroup.com

T: 503-724-8995