# 5
## Market-Moving Events in 3Q 2020


1. Money Market Fund Flows
2. Velocity of Money
3. Yield – It Is All Connected
4. Fixed Income Markets
5. Credit Primary Markets


# 5
## Events We are Watching In 4Q 2020


1. Unwind of Excess Liquidity
2. Long-term Social Changes
3. Where Do Investors Go for Yield
4. Implications of Massive Deficits
5. Volatility into Year-end


Welcome to the Smith Capital Investors 5X5. We explore topics from the third quarter of the year and issues facing us in the last three months of 2020. (Use the links above to jump to a section.)

# 5 Market-Moving Events in 3Q 2020

## Introduction:

What a year!  And where do we start this discussion?

We are all very much aware of the risks this year: COVID-19, a global recession, significant societal disruption, unconventional fiscal and monetary policy, and an upcoming domestic election to top it all off. Away from the obvious, we find it helpful to visit the second and third derivative impacts that the fixed income market has undergone in the last quarters – many of which are the outcomes of the increased liquidity in the system, promoted by Central Banks around the globe.

Massive liquidity has fueled a combination of low rates, a flat yield curve and opened up companies' access to the credit markets, facilitating the raising of liquidity, the refinancing of debt, and the shoring up of capital structures. There have been great opportunities presented to fixed income credit investors over the last several months in what many have called some of the best buying opportunities of their careers. Infrequent issuers that lost access to the commercial paper markets and other short-term financing termed out revolvers and took advantage of the opportunity to issue longer-term debt - raising over 1.57 trillion year-to-date.

As we reflect on the beginning of the year, there was a growing push for fundamentally improving companies to follow through on their prior debt reduction commitments – many leveraged capital structures fueled by prior M&A and shareholder-friendly activities. In many cases, this focus has been completely pushed aside, if not forgotten. The low yield environment seems to have pushed management teams into the dilemma of choosing to take advantage of the available cheap debt capital versus rightsizing their capital structure/reducing debt. We see many management teams that continue to push their leverage metrics and some that may be setting themselves up for rating agency downgrades, if not just simply creating additional risk and greater downside.

In a yield-hungry world, we watch with a level of skepticism as money moves in and out of different segments of the marketplace - with investors seeking yield and returns in this zero-interest-rate world. Recall there is still over 16 trillion of negative-yielding debt in the world today with demographics and conventional old school asset allocation models pushing more and more investors into a more aggressive hunt for yield.

While the correction created some of the best investments in credit seen in decades and an opportunity for those in need of yield, the opportunity was short-lived and required a flexible process.

As a reminder, this is where our active, fundamentally driven investment process comes into play. We are willing to deviate from the risk-laden index with a goal of producing portfolios that offer better risk/reward outcomes at different stages of the cycle. While many have ingested the marketing mindset that they should accept the index as 'take what the market will give you', we see risks and drawdown potential in the indices on the horizon that give us significant pause. Note the duration on the Bloomberg Barclays U.S. Corporate Bond Index is 8.7 years and the duration on the 30-year U.S. Treasury is 24 years.

If we've learned one lesson from the last several months, we are once again reminded when we undergo unconventional monetary and fiscal policy, the result is a dramatic repricing of risk assets. This continues to be the case today as we deal with a market that is manipulated by an overly accommodative Fed.

## 1. Money Market Fund Flows – Dry Powder Deployment

- Money Market Fund flows peaked in May, ballooning total assets to $4.6tn. **As the flight-to-safety during the early months of the pandemic played out, we knew it would only be a matter of time before we started to see this trend reverse course, particularly when holding cash pays next to nothing**. We have now seen nine straight weeks of outflows from money market funds totaling -$213.1bn. Over that same time, fixed income and equities have seen flows of +$111bn and -$40.4bn, respectively. The current mismatch in asset flows leaves us wondering – when, and to what velocity does sideline cash begin to find its way back into risk assets?

- **Investment Grade Credit has not seen a negative week of flows since the reporting week ending April 1st.** This was the trough for net flows, bottoming at -$109.5bn. Year-to-date inflows currently sit at +$211.9bn representing a ~$321bn swing. We view it as highly probable that demand for investment-grade credit continues as investors' never-ending hunt for yield – a now scarce resource in the industry – trudges on.

- **High Yield flows have eased with the recent increase in volatility seen in equity markets along with record levels of supply.** Looking back to the end of March, high yield has shown immense demand with year-to-date inflows totaling +$46.4bn. The intervention by the Federal Reserve in credit markets – however small (or potentially large) – paired with the current low yielding environment, has pushed investors further out the risk curve and will likely remain a key component for high yield demand. Just last week, the high yield market reported one of the largest inflows on record (+$4.91bn).

- Equity Flows have been the real question mark throughout this 'new normal'. The new highs reached by the Nasdaq and S&P 500 at the onset of September have been met with large outflows, perhaps the opposite outcome one would expect. **Year-to-date equity outflows, driven by mutual funds, sit at -$175.2bn.** There was a glimmer of hope for a flow reversal in mid-September as equities saw their largest inflow to date of +$25.3bn. Interestingly enough, this was subsequently met with last week's outflows of -$26.1bn. Irrespective of this fact, the Nasdaq and S&P 500 remain up ~32% and ~9% year-to-date, respectively.

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### BOTTOM LINE

There remains an enormous amount of dry powder on the sidelines ($4.3tn). The current uncertainty, largely surrounding events in Washington, is likely to keep investors hesitant to act quickly**. While the timing of dry powder deployment may be unpredictable, we think investors should be prepared for the probable tailwind it is going to provide to risk assets when reallocation occurs.** Keep a close eye on flow data.

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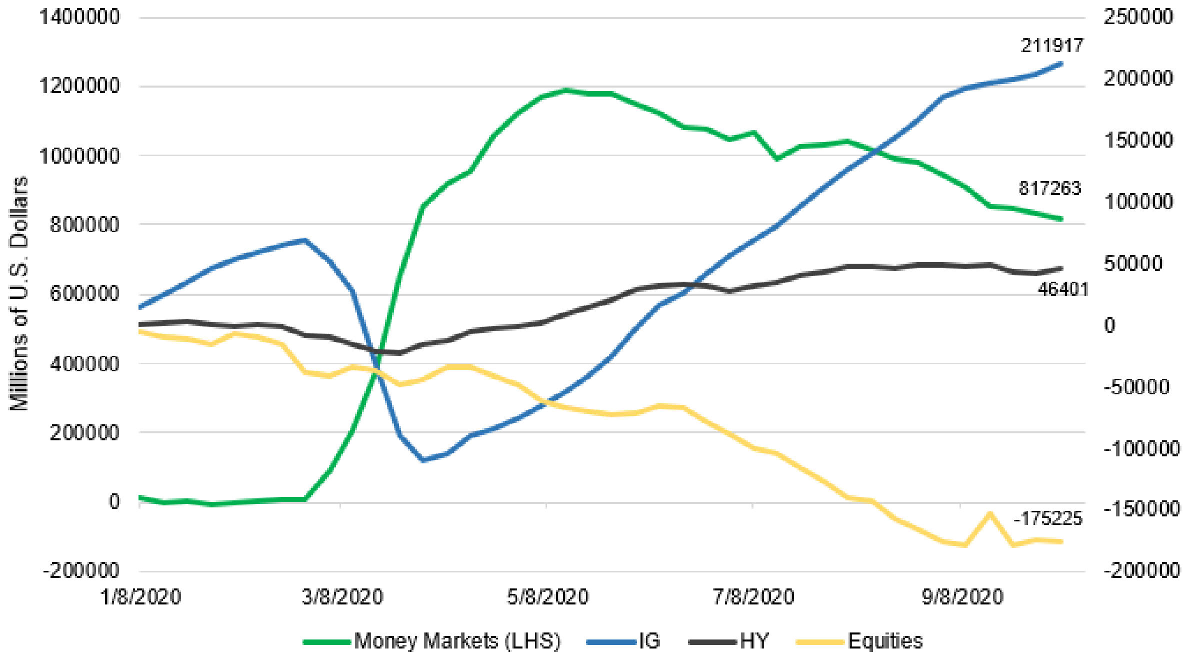
YTD Fund Flows ($mm)




Source: Wells Fargo Securities, EPFR/Informa Business, Smith Capital Investors October 7, 2020

## 2. Velocity of Money at All-time Lows

- **In light of the massive growth in money supply, the velocity of M2 Money** has seen a steady decline since the Global Financial Crisis "GFC", with the latest plummet driven by:
    - **i.** The COVID economic fallout showing through in GDP, and
    - **ii.** The ballooning of the Federal Reserve's balance sheet, which has nearly doubled year-over-year, from $3.9trn on 9/25/2019 to $7.1trn on 9/23/2020

  While the former – GDP, the numerator in the equation – matters, the latter is much more impactful to the money velocity ratio and will likely continue to be the driving factor in the new world of QE, zero rates, and MMT.

- **Inflation needs velocity.** "More stimulus means more economic activity, which will drive prices higher, right?" Contrary to what 'opening the spigot' and printing money might suggest for inflation, the effect is artificial, as more and more of it sits on the Fed's massive balance sheet each year. It suggests the question: How will we see real growth if 25% of GDP is 'propped up' by the Fed's QE backstop?

- **An increase in precautionary savings** is contributing to lower velocity as well, with consumers and firms reluctant to spend in this environment. Investors are more likely now than ever to hold cash in lieu of interest-bearing assets such as U.S. Treasuries.

- **The Fed has increased the amount of reserves** in the banking system to stimulate economic activity, yet they have little control over banks and customers. With rates already at zero, pumping more liquidity into the system may not work.

- **Following the past two recessions,** (2001 and 2008), velocity saw a slight recovery – most recently, post-GFC, one might attribute this to the experiment of QE successfully spurring economic activity to offset the increase in the money supply – but it was only a matter of time. This time around with the COVID crisis, the Fed extended its QE program into corporate debt markets through the PMCCF and SMCCF… it is no wonder velocity disappeared overnight!

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**BOTTOM LINE**

A sudden halt in economic activity, coupled with a stimulus injection into the 'arm' of the U.S. economy, led to a cliff in the velocity of money this year. This declining trend is nothing new, but **as the global economy sees more stimulus, zero rates, and rising deficits, the quantity of money 'stuck in the system' will only rise. As a component of inflation (or lack thereof, lately), the velocity of money will remain low as long as economies rely on the trillions in stimulus and QE to which they have grown accustomed. We are watching this closely as well as the significant amount of captured capital in the system.**

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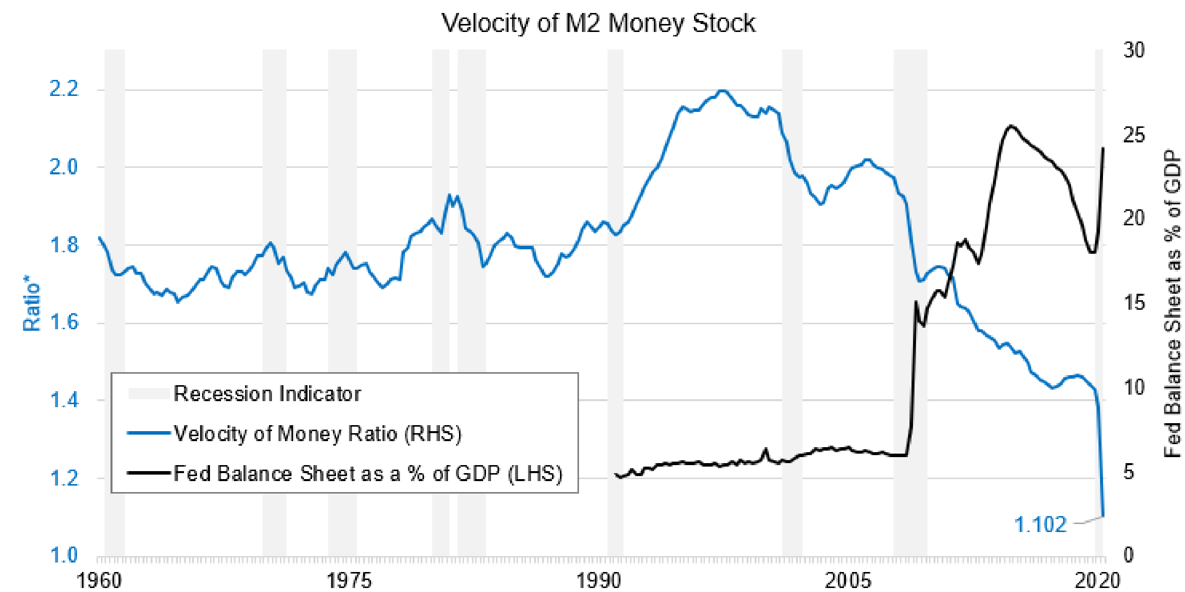


$$* \text{ Ratio} = \frac{\textit{Quarterly Nominal GDP}}{\textit{Quarterly Average Money Stock}}$$

Source: Federal Reserve Bank of St. Louis, Bloomberg, April 1, 2020

## 3. Yield – It Is All Connected

Yields are at or near record lows. Demand for yield from both natural and unnatural buyers has driven competition for yield up and rates down. In 1989, a 1-year CD yielded over 7.5%. Today, a saver or investor would have to look to the lowest rungs of the junk bond market to replicate a similar yield and take on a material increase in duration risk. Are risk profiles really that different?

- Generically, in credit markets yield is a relative measure of how much one is being compensated for a given amount of risk, or how much one would have to pay to service a liability. As the old saying goes and is often true, "one person's asset is another person's liability."

- In March, the yield on the Bloomberg Barclays U.S. Aggregate Index spiked nearly 100bps from a then-all-time low as risk increased and investors demanded more compensation for undertaking that risk.

- **Since March, the yield on the same index has reversed and plumbed new record lows**.

- All of the risks that caused that spike in yields have not reversed, which highlights a powerful technical force additionally hammering the decline of yields.

- **A yield agnostic competitor is in the market and in a big way—the Fed.**

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**BOTTOM LINE**

Given changing risk profiles, it is important to assess the risk of each position. We must then decide if we are being compensated appropriately for the risk versus buying bonds with the biggest return profiles irrespective of risk. **We believe now more than ever active fixed income management is crucial, with a keen focus on the preservation of capital. The so-called 'easy money' has been made. We now move into a segment of the cycle where 'security selection' and 'security avoidance' become critical.**

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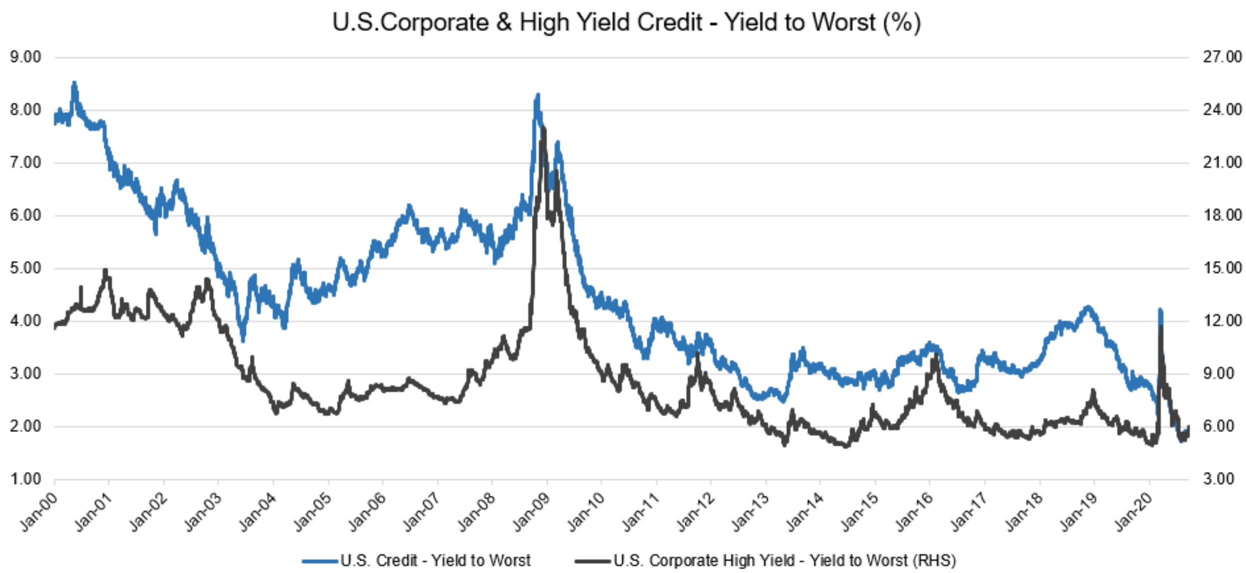


Source: Barclays Trading, Barclays Research, Markit, Bloomberg, and Refinitiv September 20, 2020

## 4. Fixed Income Markets – Look at All that Duration!

With nominal interest rates continuing to decline and a large-scale recovery in credit spreads occurring, durations on most major fixed income asset classes continue to increase as issuers across segments look to take advantage of ultra-low, long-term borrowing costs.

- The **Corporate and U.S. Treasury sleeves of the Bloomberg Barclays U.S. Aggregate Index** (Aggregate Index) registered a dramatic duration increase. Both segments of the market currently sit near all-time highs with the Bloomberg Barclays U.S. Corporate Bond index at **~8.7 years of duration** and the Bloomberg Barclays U.S. Treasury Index at ~7.1 years of duration - both almost a year longer than one year ago and 30% longer than the index duration low from a decade ago.

- The overall Aggregate Index duration has risen, in conjunction, from 5 years to 6 years in the last 12-months and up from mid-4 years a decade ago. At the present, this increase is being constrained by a decade-low model duration for MBS (more on this later).

- We believe model durations for **MBS currently do not accurately reflect the dynamics affecting that market.** A reversion to the 10-year average duration of this index from its current lows would take the overall Aggregate Index duration closer to 7 years – a brutally long extension.

- **The above-mentioned durations - ex the MBS index - are at record highs.** This duration increase has come in the face of declining yields and longer duration issuance for all the relevant asset classes. From a risk-adjusted return standpoint, the **risk in the Aggregate Index has continued to increase as durations extend while the return component of yields has declined to generational lows**.

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### BOTTOM LINE

**We would expect this trend to continue as investment-grade corporate borrowers continue to set record low yields for long-term borrowing costs**. Several investment-grade borrowers issued new 30-year debt in the 2-2.5% range, with high-quality BB-rated high yield issuers tapping the market with 10-year debt near or below 3%. We believe that active management rather than static duration targets will be a key avenue for alpha generation and preservation of capital going forward.

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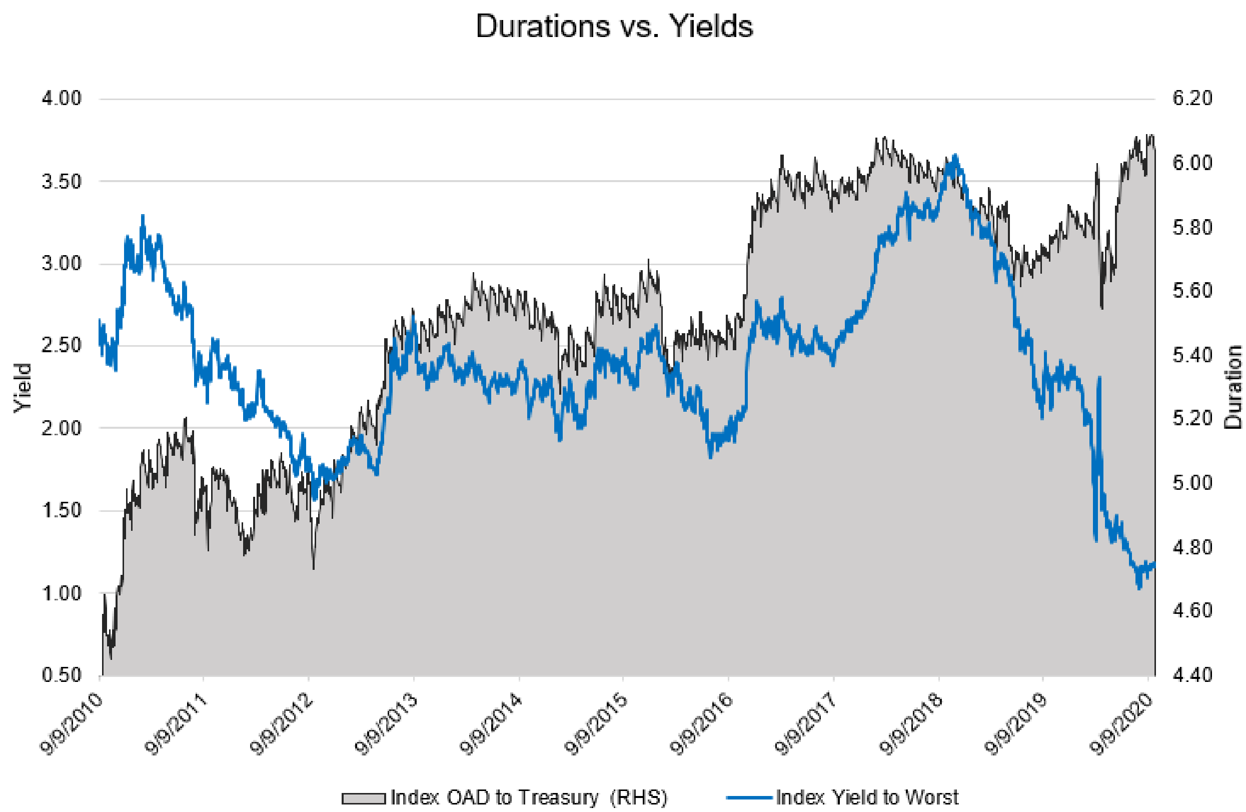


Source: Bloomberg Barclays U.S. Aggregate Index OAD vs YTW September 30, 2020

## 5. Credit Primary Markets

- With **new issue supply** in investment-grade credit breaking another monthly record in September, in 6 out of the last 7 months[1], investors have looked to the primary market to put inflows to work. This is in the face of a recently-shrinking credit index (companies falling out of investment-grade, companies tendering for bonds) and the investible universe (-$6.8bn index according to JP Morgan estimates[2], -$20bn investible universe in September according to Credit Suisse estimates[3]). Over $1.5tn has been issued YTD vs. a comparable run rate of $919bn for the same period in 2019, a 67% y/y increase.

- Fresh off a recession-inducing pandemic, **corporations rushed to raise liquidity** both as a reaction to a potential freeze up in funding markets (memories of the GFC still fresh in many minds 12-13 years later) as well as for insurance in the event of multiple waves of the virus or lack of a sustained economic recovery. Add in the lowest U.S. Treasury yields in a lifetime coupled with compressing credit spreads and the incentive was there for most corporate treasurers to tap the market for whatever they could get. If you are Google, why wouldn't you borrow $2.25bn at 1.10% for 10yrs and $2.0bn at 2.05% for 30yrs[4]? Others followed the same logic.

- Given YTD Investment Grade fund flows of +$211.9bn[5] plus a commitment from the Fed to keep short-term interest rates near zero until a 2% inflation goal is achieved or exceeded, **investors are looking for and demanding yield of any kind**. This has clearly been expressed in the credit spread compression on the Bloomberg Barclays U.S. Aggregate Corporate Avg. OAS (Option Adjusted Spread) from a COVID-wide of 373 bps on March 23rd to the tights on August 11th of 124 bps (and 137 bps as of September 29th). We are quickly approaching the all-time tights in investment grade.

- **Trading liquidity** has strangely morphed into bifurcated markets: bonds issued within the rolling past 2-3 weeks, and those not. Observations from the trading desk have noted marked differences in "primary" versus "secondary" bonds, with bid/ask spreads averaging 2-3 bps for the former and 5-8 bps for the latter.

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**BOTTOM LINE**

[1] Bloomberg - IG ANALYSIS U.S.: Supply Breaks Record for 6th Time in 7 Months
[2] JP Morgan Daily Credit Strategy & CDS/CDX AM update September 29, 2020
[3] CS Credit Strategy Daily (Cash Supply/Demand) September 17, 2020
[4] As of pricing on 8/3/2020
[5] Wells Fargo Securities Credit Flows: Supply & Demand: October 7, 2020

**The essentiality of balance sheet flexibility and liquidity, coupled with extremely low interest rates and spread recovery, has juiced both demand and supply in the corporate bond market to create a perfect storm for record-breaking issuance**…….as well as commensurate demand.

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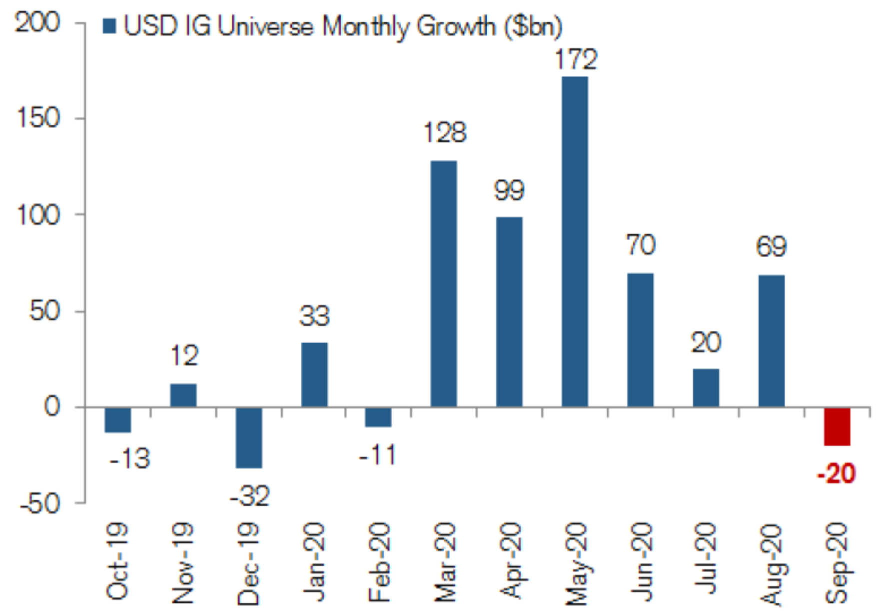
IG investible universe actually shrinking this month




Source: Credit Suisse, Bloomberg

September 2020

# 5 Potentially Market-Moving Events We are Watching in 4Q 2020

## Introduction:

As we look ahead to the final quarter of what has been an unparalleled year on many levels, we remind ourselves that the landscape will continue to change, but our fundamental process remains the same. Within the security selection component of our process, we will continue to look for companies that are fundamentally improving and committed to a strong capital structure. We will also be very watchful for defaults and downgrades – expecting both to accelerate over the next 6-12 months. Valuations in the fixed income market are being driven not only by flows, but via the Federal Reserve's policy actions. The Treasury market has new risks given the low outright yields, increasing duration, the economic environment, and massive debt and deficits. Credit markets have largely recovered from the COVID crisis levels and, similar to U.S. Treasuries, have low yields and long durations. Securitized markets offer low yields and duration extension risk. And finally, we will push into year-end with an election at a time that the economy is showing signs of the 'plateau stage' of a square root recovery ($\sqrt{\phantom{xx}}$). This may bring additional market volatility as well as further societal needs and changes. It promises to be an interesting period in time.

## 1. Unwind of Excess Liquidity from Company Balance Sheets

In response to the uncertainty associated with the global pandemic, non-financial companies raised an estimated $350bn of cash by cutting costs, reducing capital spending, and tapping the primary markets for new debt and equity offerings.

- As time passes, management teams gain more clarity on the trajectory of the economic recovery and the impact on corporate cash flows. In many cases, the impact on cash flows have been less draconian than initial expectations, leaving companies with cash balances in excess of what is needed to effectively manage the business**. How these cash balances are deployed could have a material impact on individual credits as well as on the overall market.**

- A combination of EBITDA declines and record debt issuance has led to increases in leverage for many companies. One natural way, then, to deploy excess cash would be toward reducing debt. Recently we have seen a pickup in debt tender offer activity from companies including JP Morgan, Coca Cola, AB InBev, CVS, Target, L Brands, and Advance Auto Parts. **Often, these tender offers target short-dated maturities intending to extend the maturity runway for the company and reduce future refinancing risk.**

- Excess cash could also be used to help fund mergers and acquisitions (M&A). We have already seen a pickup in M&A activity, with nine deals worth $5 billion or more announced in August. This is the largest tally for that month since 1999, according to Refinitiv. Elevated cash levels can also make companies more attractive targets for buyouts from private equity companies or pressure from activist investors – especially when companies have shown a long-standing path of value destruction. **With accommodative capital markets and large amounts of private equity funds available for investment, we expect M&A activity to be robust in the coming months.**

- **Finally, we would expect some of the elevated cash on corporate balance sheets to be used for share repurchases and dividends.** We may even see a return of one-time special dividends as we progress into year-end (note – we may see some fairly significant tax changes in the new year). Recent sizeable share repurchase announcements include AMC Networks' tender offer for up to 20% of its shares outstanding and DaVita's successful repurchase of 6.5% of its outstanding shares.

### BOTTOM LINE

While it may not be clear exactly how excess cash will be deployed, we are certain that it will not sit on balance sheets indefinitely when opportunities to use that cash to create value are present. **In the coming months, the release of cash reserves will serve as a catalyst to drive differentiated outcomes across companies and individual securities.** Investors with a thorough understanding of management's capital allocation priorities could stand to benefit.

We are paying very close attention to financials where there seems to be an abundance of captured capital on the balance sheets. While regulated and forced to be more conservative due to the environment, we would not be shocked to see some surprise announcements over the next 12 months.

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Note: Y/y change calculated using current-quarter cash blance versus the same quarter one year ago.
Source: Barclays - "How Will Corporations Spend Their Cash Hoard?" September 25, 2020

## 2. Long-term Social Trend Changes

We are very aware of the social changes we are undergoing as the world works through the impacts of COVID-19. Everything from education to employment, travel, and consumer preferences are evolving. Sectors such as Technology, Autos, and Housing have taken center stage while some Brick and Mortar Retailers and International Travel have both struggled. **As we continue to work through the rolling waves of COVID, there are permanent changes on the horizon, many of which are tied directly to the consumer and their preferences.**

- Will the work from home (WFH) trend accelerate? This not only changes individuals' geographic preferences – think less New York City/San Francisco, more suburban – this also **changes the landscape for office space demand.**

- Grocery, retail (both discretionary and nondiscretionary), and home delivery services pivoting to online will not only reduce the need for brick and mortar retail, but it will also allow people to move from high-density areas to more rural areas. **This is positive for vehicle sales and a negative for apartment buildings in large cities.**

- And with the "home" taking on a new meaning – office, entertainment, and dining space – anything **housing related has witnessed the benefit of a sector supported by low interest rates while the flip side is a service industry that is pivoting, adapting, and struggling in the face of declining demand and capacity constraints.**

- Finally, does improved efficiency create permanent job losses? The waterfall of small changes is currently being felt in **the tourism/hospitality industries as well as restaurants and small businesses.**

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### BOTTOM LINE

**The evolution of social changes, both temporary and permanent, will weigh not only on individual companies but sectors and geographies.** With low rates and the combination of fiscal/monetary support, consumers have choices. This means that companies, as well as cities and states will need to adapt to the changing landscape. The potential range of outcomes will impact individuals, lenders, borrowers, small businesses, large corporations, cities, states, and global partners to name a few. Efficiencies, connectivity, education, and healthcare will all be of high importance. One thing is certain, the longer it takes to control the virus, the less likely we are to return to the pre-COIVD world.

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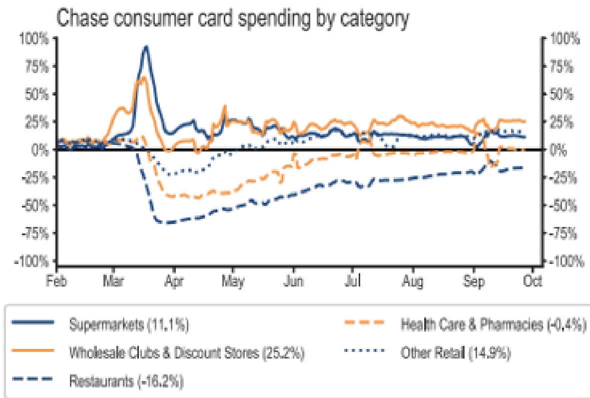
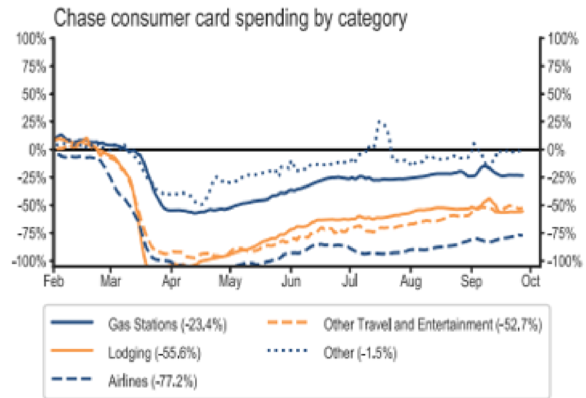
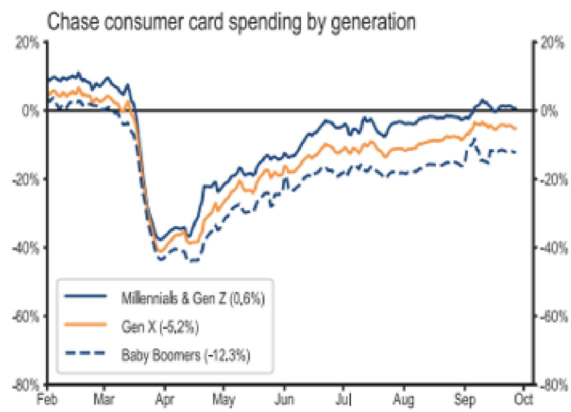


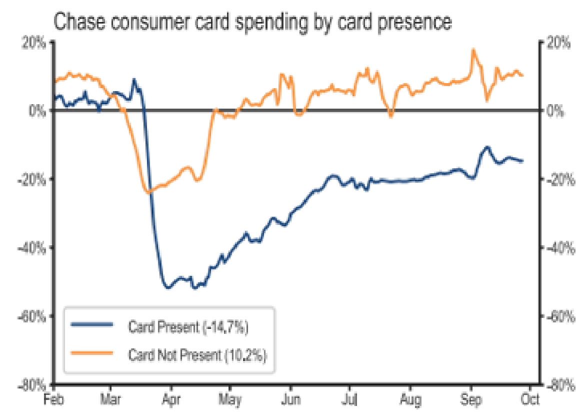

Source: J. P. Morgan. % change over-year-ago in 7-day average.




Source: J. P. Morgan. % change over-year-ago in 7-day average.




Source: J. P. Morgan. %oya of 7-day average of nonrecurring categories.




Source: J. P. Morgan. %oya of 7-day average of nonrecurring categories.

JP Morgan all data as of October 1, 2020

## 3. Where Do Investors Go for Yield

- In order to understand the probability of inflows or outflows for different asset classes, it is helpful to understand recent flow and performance data as well as the current valuation entry point.

- **As noted above,** YTD -$175.2bln has flowed out of equities and into money market funds (+$817.2bln) and Investment Grade Credit (+$211.9bln).

- **Despite outflows, U.S. equity returns have held in well considering the scope of the underlying economic turmoil.** As of October 13, 2020, the S&P 500 is up nearly 9%, the Dow Jones is basically flat, and the NASDAQ up 32% YTD. Valuations appear stretched on a historical, traditional multiple basis with the S&P P/E ratio at ~27x, but the dividend yield on the index of nearly 1.7% compares favorably to 10-year treasury yields ~0.73%.

- **Strong inflows have helped credit markets this year**, with the Bloomberg Barclays U.S. Credit Index up 7% YTD and the Bloomberg Barclays U.S. Corporate High Yield Bond Index up 2.2% (ex. Energy the index was up 3.2%). Despite low historical yields, U.S. credit spreads have retraced less than 90% of the widening experienced earlier this year, and Bloomberg Barclays U.S. High Yield ex. Energy spreads less than 80%. **Even after recent tightening, current spread levels remain elevated relative to the last five years**.

- **Currently, money markets are yielding close to 0%, with Investment Grade Corporate Credit ~1.9%, and U.S. High Yield ex. Energy about 4.9%. Will money continue to seek out yield? We think so! But it may not be all found in the fixed income markets.**

### BOTTOM LINE

**Analyzing fund flow data, understanding the underlying long-term drivers of invested capital, and having an idea of where we are in the business cycle can shed light on what markets may be the beneficiaries of additional flows.** While risk premiums have come down relative to levels seen in March, investors and savers still require both income and capital appreciation to meet investment and life goals. To continue to meet these goals, we **would not be surprised to see money flow away from low-yielding assets into higher-yielding assets as well as those with higher long-term probabilities of capital appreciation**.

We remind investors daily that the fixed income markets are hardly as exciting as they were several months back. We have been in recovery periods like this before where we can get anchored to the very cheap valuations of the recent past. While the fixed income market can generally feel like an expensive insurance policy, we continue to believe there will be new opportunities on the horizon. And if the risk factors on the horizon prove to be bigger than expected, that expensive insurance will prove to be very valuable.

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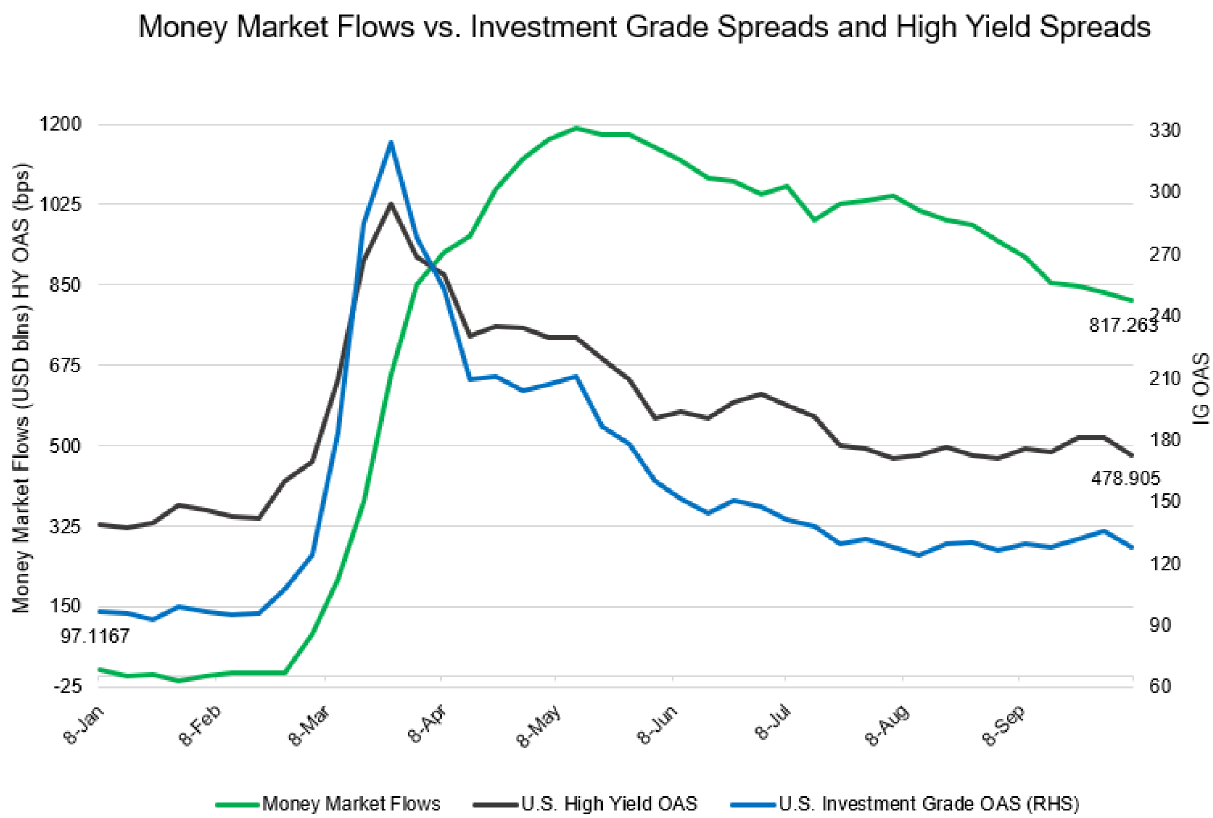


Source: Barclays Trading, Barclays Research, Markit, Bloomberg, and Refinitiv, Smith Capital Investors October 7, 2020

## 4. Implications of Massive Deficits

The budget deficit continues to expand as government support remains necessary to soften the impacts of the COVID-related recession. For today, the market has become numb to the massive debt and deficits, but we believe the eventual unwinding will prove extremely difficult even in the most optimistic of scenarios.

- The Congressional Budget Office (CBO) projects by the end of 2020, debt held by the public will equal 98% of GDP; this number soars to 195% of GDP by 2050, based on current legislation.

- In theory, rising debt and deficits not only slow growth but can also create inflation which is then reflected in Treasury rates rising and increasing the costs of servicing the debt, potentially creating a vicious cycle. **However, this has yet to materialize given the Fed's ability to purchase Treasuries and potentially impose 'Yield Curve Control', if necessary, to keep a lid on rates.**

- Currently, the average interest rate on marketable U.S. Treasuries is 1.7%, compared to 2.5% in 2019 and 6.7% in 2000. This allows the government plenty of runway to focus on supporting the economy with additional stimulus measures.

- Coincidently, Modern Monetary Theory (MMT) was rising in popularity before we entered the most recent recession. The Theory suggests that **the Government should use fiscal policy to step in when the private sector needs support.** MMT believes that a deficit for the government is a surplus for the private sector and therefore responsibly running a larger deficit is shifting from one balance sheet to the other. The tag line in the marketplace is "deficits don't matter for countries that can fund in their own currency". Our formal 'economic' educations keep us very skeptical of such theory and question the point when large deficits and huge debt balances reach a reconciliation period. But in the meantime, we watch and wait for opportunities for the Government to make different decisions around how they commit taxpayer dollars. Hopefully, they are reminded that incentives drive behaviors and behaviors can be a great source of economic growth.

### BOTTOM LINE

As active managers, we constantly worry about complacency in the market. While the market is currently displaying confidence in the Fed's ability to manage rates and inflation - allowing the Government to continue supporting the economy with higher debt and deficits - this can turn on a dime. Remember we could see a quick and aggressive reversal in Treasury yields based on a change in sentiment or a shift in the consensus around the outlook. This change could spill over into other markets – we believe the bond markets offer the ultimate discount rate for all markets.

**Only time will tell if the Federal Reserve can successfully manage inflation and inflation expectations and if the Government can smoothly shift between the public and private sectors**

**when the time comes to unwind the massive debt**. We are going to pay more attention to shifts in sentiment and changes in expectations, as complacency can quickly turn into fear.

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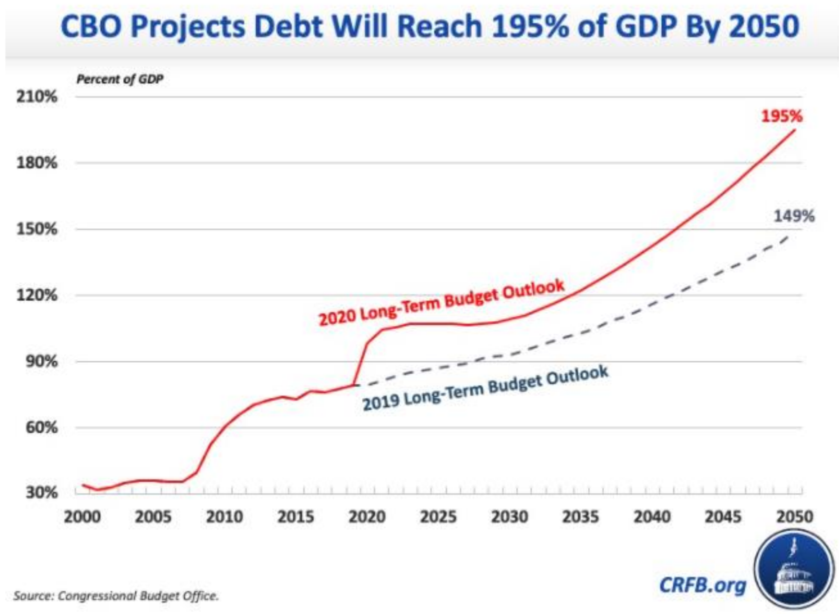


September 21, 2020

## 5. Volatility into Year-end – But What Kind?

- With politics and extreme monetary policy conditions front-of-mind across all markets, volatility indicators (both actual and implied) stand at divergent extremes when comparing equities and fixed income.

- **Equity options continue to imply high levels of future volatility, with measures like the VIX sticky at high levels despite generally strong equity markets** (typically volatility comes off as markets rally). Options are pricing in particular choppiness around the election, not surprisingly, with investors paying up for options through November and for coverage against large moves.

- **Fixed income markets tell a very different story**. With the Fed having successfully anchored interest rates and interest rate expectations, rate volatility has cratered to historic lows. And while implied volatilities do show some elevation around the election date, the **levels remain very subdued in a historic sense.**

- Tangentially (though perhaps not!), markets continue to take the Federal Reserve at its word, with no rate hikes priced into the U.S. rates curve until 2023.

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**BOTTOM LINE**

While the equity and bond markets are signaling different things about expected future volatility, that may not be a huge surprise in the context of the market's current narrative. The Fed has anchored front-end rates through its recent policy actions. The U.S. output gap is so large that in an upside economic scenario, longer-dated rates are unlikely to sell-off materially despite whatever pandemic and election outcomes play out. Risk assets such as equities will be significantly influenced by these events. **Our message is to be wary of that consensus view. Choppy equity markets are a reasonable expectation, but the elevated fear levels implied in options may dissipate, leading to further upside in risk assets.** That, in turn, with a more favorable economic outlook (say in the case of positive virus developments, to pick one scenario) **could lead interest markets to reassess the risks, leaving the long-end of the bond market in particular quite vulnerable.**

We find ourselves asking the question – if everyone is expecting higher volatility into year-end, what happens if it does NOT happen? See the earlier comments around the large cash balances and the need for yield. And maybe there is a group of investors that might find they want a little additional equity exposure into a lower volatility environment.

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Source: Smith Capital Investors, Bloomberg, September 28, 2020

## Conclusion:

In a world of heightened risk and uncertainty, we continue to acknowledge what can go wrong. But also how far the economy has come with the support of both fiscal and monetary policy. The repricing and recovery in markets this year led to a once in a lifetime opportunity to generate significant returns. We laugh that it feels like we have had three of these in our careers. We believe there are still opportunities in the fixed income space via fundamentally improving credit stories and actively managing duration and interest rate risks. Given how far markets have improved, as well as the expected volatility on the horizon, we have reoriented the portfolios to provide more dry powder for future opportunities.

We default back to the fundamentals, relying on our investment process which starts with bottom-up analysis. Our two core tenets – risk-adjusted returns and preservation of capital - have taken on even more meaning during this time. And we think they are going to be ever more critical to long-term success.

We thank you for the confidence you have placed with us, and we look forward to continuing to serve you and meet your fixed income needs. As we like to close out all of our communication:

## Let's talk – Smith Capital Investors


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