Investment Grade Market Update

AUGUST 2020: OUTLOOK AND IMPLEMENTATION

	August 2020	YTD/YTD Change
Total Returns	-1.38%	6.94%
Excess Returns	0.05%	-3.51%
Yield	+0.09%	-0.89%
Spread	-4	+36
Price	-$2.18	+$5.15

Source: Bloomberg Barclays U.S. Corporate Investment Grade Bond Index

- August was the fifth consecutive month with positive excess returns after markets sold off in March. Earnings, while lower, were not as bad as the market expected, and we believe the overwhelming majority of the Investment Grade universe avoided burning cash. While we would have expected such an outcome to result in lower supply, August supply surged to $160 billion as issuers took advantage of record-low yields. We believe the path of least resistance for spreads is lower as we enter the final third of the year.

Fundamentals

- For the better part of the past six months, we've been cautioning that earnings estimates were unreliable. We felt that this environment was too unusual for earnings models to adjust to in a neat fashion. Instead, we recommended analysts and investors focus on margin control and cash flow. Indeed, estimates were wildly inaccurate; fortunately, they were far too low. The average earnings beat of 23% was easily the widest on record as the trailing five-year average earnings beat is below 5%. Just 14% of companies missed earnings, the lowest figure on record.

	YoY EPS Growth	% Beating Estimates	Size of Beat/Miss
All Securities	**-7.2%**	**81%**	**22.9%**
> Consumer Discretionary	24.7%	66%	N.M.
> Health Care	7.6%	84%	19.5%
> Utilities	6.7%	82%	6.6%
> Information Technology	2.9%	93%	14.3%
> Consumer Staples	-0.4%	87%	12.7%
> Real Estate	-4.3%	58%	2.4%
> Telecommunication Service	-10.8%	82%	18.3%
> Materials	-25.7%	86%	17.1%
> Industrials	-29.4%	89%	67.0%
> Financials	-30.4%	79%	16.4%
> Energy	-55.0%	65%	-14.0%

- With all but one company in the S&P 500 having reported (Kroger), collective revenues and earnings have fallen by 10% and 7%, respectively. Indeed, one of the most apparent takeaways from this quarter was the ability for companies to hold margin despite declining sales.
- This should bode well for the technical outlook as the extra liquidity companies raised earlier in the year likely remains on the balance sheet. This should reduce the desire to tap the markets and potentially lead to debt repayment.

Technicals

- While August is typically a seasonally slow period for issuance, this was not the case this year. $160 billion of supply hit the market, the largest August on record, and more than twice the 10-year average of $73 billion. Whether this was a pull-forward of future supply or a continuation of corporate stockpiling of low-interest debt remains undetermined. We'll find out in September.
- Mutual fund flows were steadily positive throughout the month, averaging $5 billion/week, slightly below July's pace. YTD fund flows returned to positive territory in June and now total $110 billion.
- The Federal Reserve has accumulated a $13 billion portfolio of short IG bonds and ETFs. Their pace of buying has slowed dramatically and they are very marginal buyers of the asset class. To date, no issuers have tapped the Federal Reserve's Primary Lending Facility.

Valuations

- Spreads ended the month at +129, on top of long-term averages. Spreads have retraced 87% of the move wider YTD.
- Yields backed up a few basis points this month, but at 1.93%, they remain within 11 bps of the all-time lows achieved early in the month of August.

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