Tortoise℠

Global credit economic summary and outlook

First quarter 2020

Tortoise

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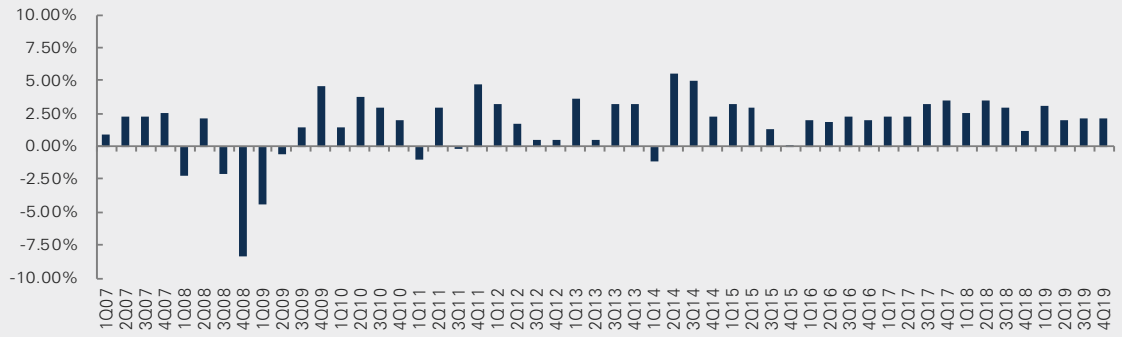
Domestic

Summary

In the first quarter of 2020, global economies experienced severe stress as COVID-19 spread worldwide. In the U.S., economic activity progressed normally in the first six weeks of the year. As the crisis unfolded, within a matter of a few weeks the U.S. economy transitioned from a steady state to a near complete halt in some industries.

U.S. GDP growth, quarter-over-quarter seasonally adjusted annual rate



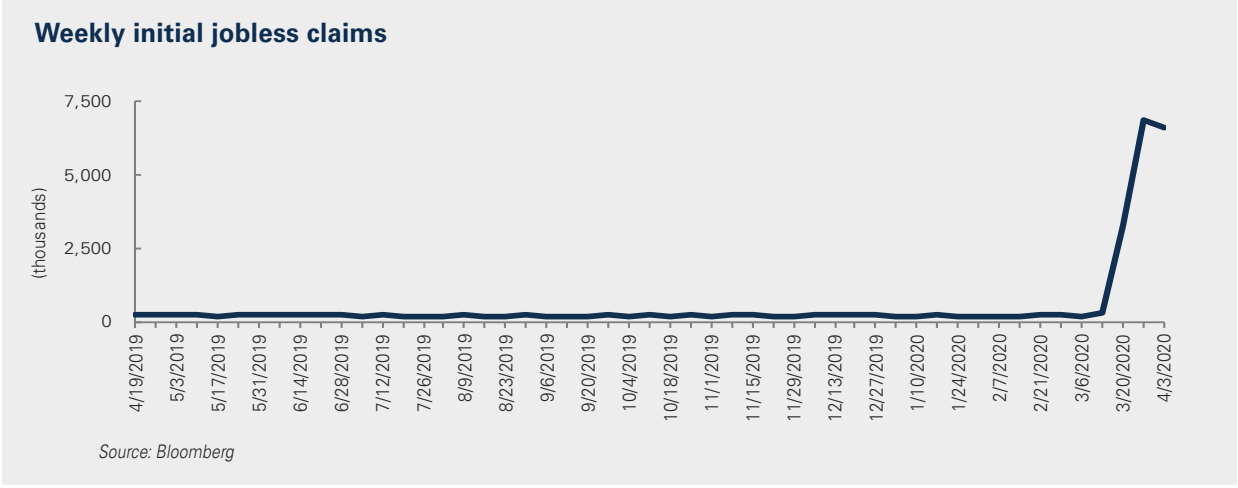
Source: Bloomberg

The U.S. government began limiting travel from China on January 31, 2020, and in mid-March it began restricting travel from Britain and Europe. On February 26, President Donald Trump announced the appointment of Vice President Michael Pence to lead the nation's COVID-19 effort; three days later, Trump introduced a team of responders in the first of what became a daily series of televised press briefings focusing on the pandemic. California (on March 18) and New York (on March 22) were among the first states to enact stay-at-home orders. Notably, certain states still haven't implemented stay-at-home orders (Iowa, Nebraska, North Dakota, South Dakota, Utah, and Wyoming).

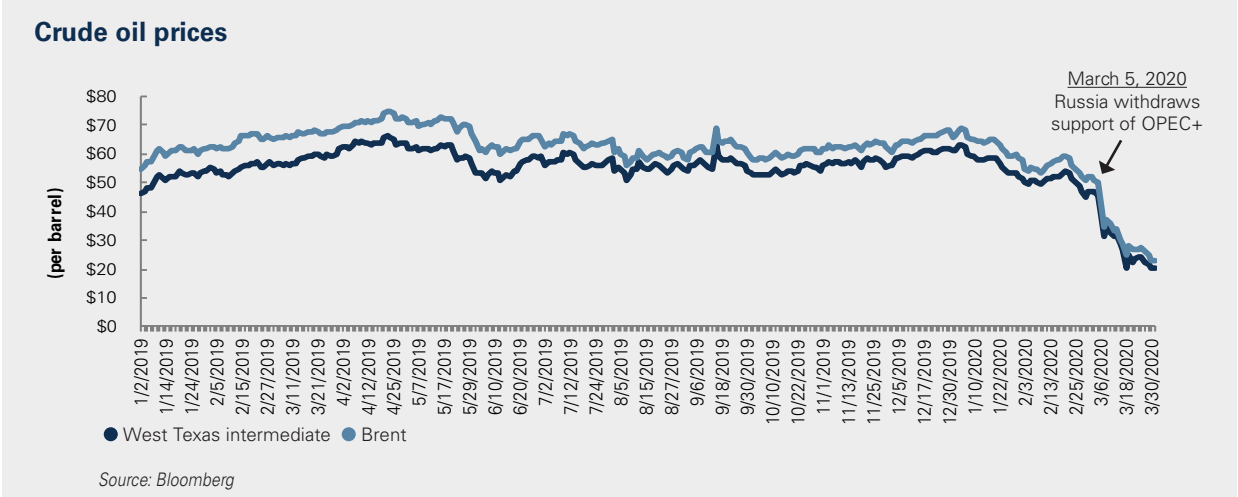
In the U.S., the commercial impact of COVID-19 first appeared in the travel, hotel, and retail industries. By some accounts, U.S. airline passenger traffic fell by 90% in late March 2020. Stay-at-home orders and mandated business shutdowns eventually weighed on nearly all areas of the economy.

Various estimates forecast a potential U.S. GDP decline of -30% in the second quarter and -5% for the full year 2020. On April 3, 2020, the March nonfarm payrolls employment report announced a loss of 701,000 jobs and an increase in the unemployment rate to 4.4%; however, the Bureau of Labor Statistics notes that the report is based on a survey conducted prior to mid-March 2020, so it doesn't reflect the full effect of COVID-19 social distancing. Weekly initial jobless claims, a more forward looking indicator, suggests that over 15 million workers lost employment in the three weeks ended April 3, 2020.

Unfortunately, backward-looking March economic data fails to fully capture the extent of the decline in U.S. economic activity. The University of Michigan Consumer Sentiment Index ("UMCSI") preliminary figure from April, however, provides some forward-looking insight into the potential trend. Announced on April 9, 2020, the preliminary UMCSI for April 2020 experienced its largest decline on record, falling 18.1 points to 71, the lowest level since 2011.



OPEC+ tensions emerged in the second quarter of 2020, but faded in priority as COVID-19 advanced. The issue figured prominently in news flow on March 5, as Russia withdrew its support of an OPEC+ (a group comprising OPEC members, Russia, and certain other countries) plan to reduce oil production. Oil prices declined rapidly, as markets priced in the potential for increased supply. The lower oil prices called into question the profitability of nearly the entire U.S. shale oil industry. In addition to the OPEC+ supply shock, energy markets also absorbed a severe demand shock, as stay-at-home orders and other effects of the COVID-19 pandemic negatively affected fuel consumption. The combined effect of OPEC+ tensions and COVID-19 drove a 66% decline in the spot price of Cushing, Oklahoma West Texas Intermediate (WTI) crude oil in the quarter to $20.48 per barrel on March 31, 2020.



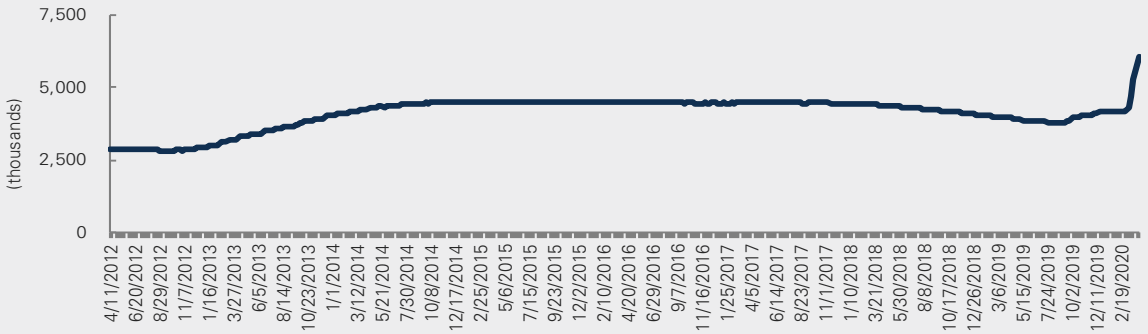
If there is any good news regarding the current environment, it starts with the fact that the U.S. economy was on solid footing prior to the COVID-19 pandemic. In addition, policy makers implemented aggressive fiscal and monetary policy actions to support impacted workers and employers, and provide liquidity to financial markets.

With regard to fiscal policy, on March 27, 2020, Congress passed the Coronavirus Aid, Relief and Economic Security Act (the CARES Act), a $2 trillion emergency coronavirus spending bill, which authorizes direct cash payments to millions of Americans, a supplement to state unemployment insurance, aid to businesses (including airlines) that maintain employment, and numerous other initiatives. The Joint Committee On Taxation estimates that the CARES Act will distribute approximately $292 billion in direct cash payments to individuals. The CARES Act also authorized Fannie Mae, Freddie Mac, and other constituents in the mortgage finance industry to offer forbearance plans, foreclosure delays and other assistance to borrowers.

The Federal Reserve moved forcefully to provide a bridge to support the economy until environment improves; its actions include lowering short-term rates to essentially zero and reinstituting asset purchases, and launching an alphabet soup of programs in support of market liquidity, municipalities, and small and large companies. On March 15, 2020, the Federal Reserve announced it would lower the target range for the federal funds rate to 0% to 0.25%, and also begin purchasing at least $500 billion in U.S. Treasury Securities and $200 billion in agency mortgage-backed securities. On March 17, 2020, the Federal Reserve acted to improve the functioning of financial markets and support market liquidity by establishing the 1) Commercial Paper Funding Facility; 2) Primary Dealer Credit Facility; and 3) Money Market Mutual Fund Liquidity Facility. On April 9, 2020, in statement that included certain previously disclosed programs, the Federal Reserve announced it would provide up to $2.3 trillion in loans to support market liquidity, large municipalities, small and large companies, and jobs. The programs include: 1) a $349 billion Paycheck Protection Lending Program, as introduced in the CARES Act; 2) a $600 billion Main Street New Loan Facility; 3) a Primary Market Corporate Credit Facility and a Secondary Market Corporate Credit Facility, funded with $75 billion; 4) a $100 billion Term Asset Backed Securities Loan Facility; and 5) a $500 billion Municipal Liquidity Facility.

Total assets of the Federal Reserve Banks' Combined Balance Sheets reflect the degree to which it has committed funds to support the economy in recent weeks.

Federal reserve balance sheet – total assets



Source: Bloomberg

Outlook

Estimating future economic trends will be extremely difficult given the unprecedented swiftness and severity of the collapse in commercial and consumer activity. However, it is clear that the U.S. economy has entered a recession, and the nature of any recovery will depend on how quickly the virus can be contained. We believe a sharp rebound in growth is unlikely and expect a more prolonged slump.

The ultimate duration of the COVID-19 pandemic remains one of the most important determinants regarding future economic trends. In addition, final resolution of the dispute between OPEC+ members could significantly affect oil prices and the economic viability of the U.S. oil production industry.

It is possible that within the U.S., certain regions will lift stay-at-home orders before others. In addition, as they lack recent precedents, analysts and other experts currently lack good insight into how consumer and commercial activity will resume as stay-at-home orders are lifted.

In the future, while people will broadly strive to engage in past practices and pursuits they enjoyed pre-COVID-19, we believe there is a potential for a "new normal" to impact the way people act and how businesses transact in certain instances.

Some reports suggest COVID-19 infections could surge again, and policy responses including new stay-at-home orders could become regional. Broad availability of a COVID-19 vaccine doesn't appear possible until the spring or summer of 2021.

When the most immediate threat of COVID-19 passes, policy makers, consumers and commercial enterprises may reconsider a range of emergency preparedness issues. COVID-19 experiences may force some manufacturing activities back to the U.S.

In our view, the CARES Act and additional spending measures will only partially mitigate the impact of the COVID-19 pandemic. We believe the post-COVID-19 economic recovery will be more "U-shaped" than "V-shaped", and that financial markets remain potentially volatile.

International

Summary

The global economy largely resembles that of the U.S., as both are recently significantly shaped by COVID-19. Nearly all the world's major economies will experience declining GDP in 2020, an abrupt reversal from projections as recent as January 2020 which expected all the world's major economies to grow. A differentiating factor is timing, as COVID-19 appears to have started in China, weeks before it spread widely to other countries.

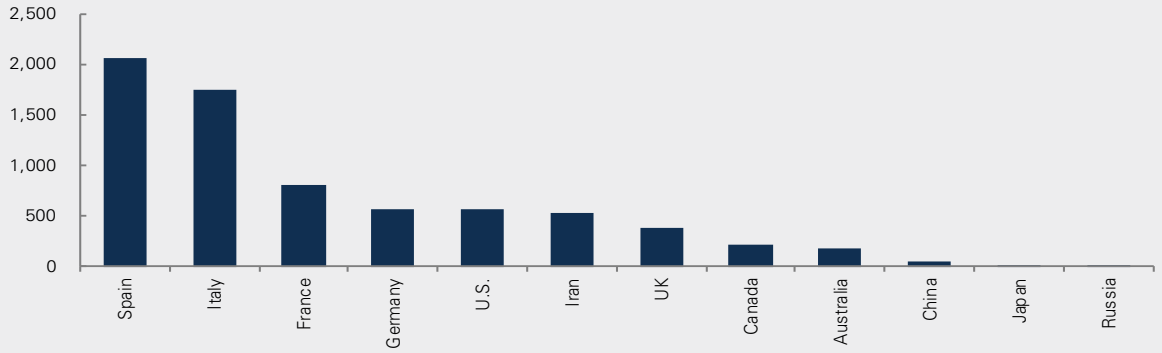
On January 11, 2020, China's Wuhan Municipal Health Commission reported the first death associated with COVID-19, a novel new coronavirus; the 61-year old man suffering from other medical complications was said to have died on January 9 of respiratory failure caused by severe pneumonia. Within a few days, other countries announced cases of COVID-19, with many connected to travelers from China.

On January 30, the World Health Organization (the WHO) declared COVID-19 a global health emergency. In mid-February, press reports focused on the severity of outbreaks in South Korea, Italy and Iran. However, by mid-February, China began reporting significantly fewer new cases of COVID-19, creating a roadmap of hope for other regions to follow, although some suspect Chinese officials may be managing reported data. Finally, on March 11, the WHO declared the COVID-19 outbreak a pandemic. Through March 2020, many of the world's largest economies, including the U.S., Japan, the United Kingdom, and France, continued to report an increasing number of new cases. In some countries, such as Singapore and India, the rate of infection appeared slower, or delayed.

The spread of COVID-19 effectively shut down a meaningful portion of the world economy, in some areas leaving only the most essential services in operation. Travel, hotels and other leisure and group activities universally appear the hardest hit, nearly regardless of location. Areas reliant on tourism will likely experience the most severe economic effects of the COVID-19 pandemic.

Bloomberg data suggests Italy and Spain rank highest among advanced economies with regard to COVID-19 cases relative to total population. Germany, which doesn't rank high in terms of COVID-19 case concentration, nevertheless faced economic challenges prior to the pandemic. A severe COVID-19 effect could weigh heavily on these already weak economies. As a note of caution, data remains suspect, as some question remains regarding the degree to which source records are created uniformly throughout the world; also, the pandemic has not yet reached full penetration in some regions.

Advanced economies – COVID-19 cases per million people



As of 3/31/2020. Source: Bloomberg

The similarities between the International and U.S. economic environments include stay-at-home orders and quarantined populations, shuttered businesses, higher unemployment, decreased travel and transportation activity, volatile financial markets, closed public spaces, coordination of public health resources and, of course, government stimulus. Indeed, governments world wide responded similarly to the COVID-19 pandemic, with a mix of fiscal and monetary policy efforts to maintain the functioning of financial markets, ensure liquidity, and provide support for consumers and commercial enterprises. Notably, on March 24, 2020, Japanese Prime minister Shinzo Abe and International Olympic Committee President Thomas Bach agreed to postpone the Tokyo 2020 Olympics, originally scheduled to start on July 24, by at least one year. The delay and cost to reschedule will significantly reduce the economic boost the event will bring to the region.

On April 14, 2020, the International Monetary Fund released its 2020 World Economic Outlook, with the caveat that it is surrounded by extreme uncertainty and risk exposure to the downside. Previously, in January 2020, the IMF projected global GDP growth of 3.3% in 2020 and 3.4% in 2021. The April 2020 IMF report projects global GDP to fall -3.0% in 2020 (-6.1% in advanced economies, including the U.S., euro area, Japan, UK, Canada, and certain others), assuming containment efforts peak in the second quarter of 2020 and recede the rest of the year. The IMF also estimated that global GDP would rebound to +5.8% in 2021 (+4.5% in advanced economies), assuming policy actions prevent widespread bankruptcies, excessive job losses and system-wide financial strains.

World output growth

	Estimate	Pre-COVID projection January 2020		Updated projection April 2020	
	2019	2020	2021	2020	2021
World	2.9%	3.3%	3.4%	-3.0%	5.8%
Advanced economies	1.7%	1.6%	1.6%	-6.1%	4.5%
United States	2.3%	2.0%	1.7%	-5.9%	4.7%
Euro area	1.2%	1.3%	1.4%	-7.5%	4.7%
Germany	0.6%	1.1%	1.4%	-7.0%	4.2%
France	1.3%	1.3%	1.3%	-7.2%	4.5%
Italy	0.3%	0.5%	0.7%	-9.1%	4.8%
Spain	2.0%	1.6%	1.6%	-8.0%	4.3%
Japan	0.7%	0.7%	0.5%	-5.2%	3.0%
United Kingdom	1.4%	1.4%	1.5%	-6.5%	4.0%
Canada	1.6%	1.8%	1.8%	-6.2%	4.2%
Emerging market and developing economies	3.7%	4.4%	4.6%	-1.0%	6.6%
China	6.1%	6.0%	5.8%	1.2%	9.2%
India	4.2%	5.8%	6.5%	1.9%	7.4%
Russia	1.3%	1.9%	2.0%	-5.5%	3.5%
Brazil	1.1%	2.2%	2.3%	-5.3%	2.9%
Mexico	-0.1%	1.0%	1.6%	-6.6%	3.0%

Source: International Monetary Fund 2020 World Economic Outlook

The IMF believes that COVID-19 could ultimately cause $8 trillion in lost 2020 and 2021 global GDP, more than the combined annual GDP of Germany and Japan. Moreover, if the pandemic doesn't recede in the second half of 2020 as expected, the IMF cautions that containment periods could lengthen, causing a worsening of financial conditions and further breakdowns in global supply chains. In that case, the IMF warns that global GDP could fall 6% in 2020 and even more in 2021.

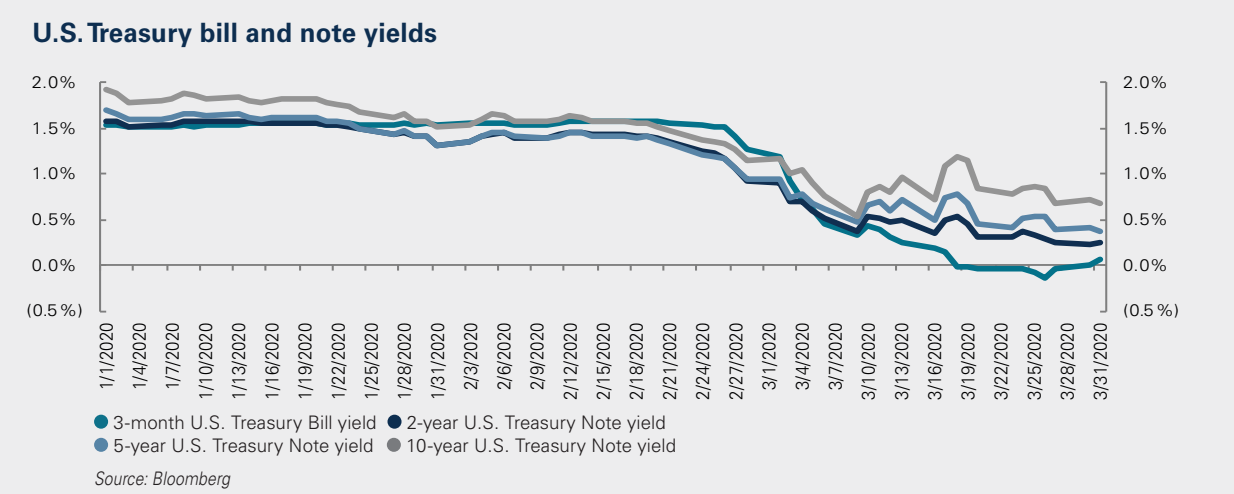
Outlook

Future global economic trends remain extremely difficult to estimate and highly dependent upon the duration of the COVID-19 pandemic, the manner in which governments lift stay-at-home orders and the pace at which consumers and commercial enterprises resume normal activities. Our view regarding the likely prospects for a "U-shaped" recovery extend to the global economy, as well as that of the U.S. The global economy also is subject to "new normal" trends arising from the COVID-19 pandemic, including the redistribution of materials and component supply chains, emergency preparedness, and consumer preference.

Sector analysis

U.S. interest rates

U.S. Treasuries began the first quarter of 2020 trading within a definable boundary, as the 10-year U.S. Treasury Note yield set a range of 1.50% to 1.92%. In late February, a flight to quality ensued as investors came to realize that the COVID-19 virus would spread widely and significantly affect the world economy. The yield on 10-year U.S. Treasury Notes reached as low as 34 basis points intraday on March 9, 2020. The 30-year U.S. Treasury Bond began the quarter yielding 2.39% and ended the quarter yielding 1.32%, representing a decline in yield of more than 100 basis points. In fact, the entire yield curve shifted in a parallel move downward setting all-time lows for every point on the curve. Additionally, in early March, the entire yield curve briefly traded below 1.00%. By the end of the quarter, the yield curve had steepened as the 2-year to 10- year spread widened to 42 basis points, versus 35 basis points at the beginning of the period.



The rate decline tapered as the Federal Reserve announced programs to support the Treasury and credit markets and Congress passed the CARES Act. The overwhelming support of the Federal Reserve and Congress initially reduced Treasury yields again, especially on the short end, and tilted the yield curve into a steepening bias. Investors expect U.S. Treasury supply to balloon to record levels as spending under the CARES Act and other measures could surpass more than $2.5 trillion. Although the short end of the curve will absorb most of the new supply, the massive issuance should lead to higher rates on the long end of the U.S. Treasury yield curve.

Securitized products

Securitized markets yields increased in the first quarter in response to the worldwide spread of COVID-19 and economic impact from stay-at-home orders and mandated business closures. Returns on mortgage-backed securities, one of the few fixed income sectors to weather the storm relatively unscathed, lagged comparable U.S. Treasuries by only 83 basis points in the quarter. The asset class benefited from the Federal Reserve's decision, announced on March 15, 2020, to renew quantitative easing and purchase at least $200 billion in agency mortgage securities to restore order to the dislocated markets and support the overall housing industry. Later, on March 23, the Federal Reserve announced it would purchase unlimited quantities of agency mortgages and U.S. Treasury securities.

A combination of liquidity and credit risks negatively affected returns in ABS and CMBS markets. The liquidity risks started to moderate following the government's aggressive fiscal and monetary policy initiatives, but the sectors remain exposed to increased fundamental credit risk. In the first quarter of 2020, the ABS and CMBS sectors underperformed U.S. Treasuries by 3.22% and 5.86%, respectively. The Federal Reserve's plan to restart the Term Asset Backed Securities Loan Facility to support ABS and CMBS markets could help build a bridge to support the markets until the economy eventually recovers; but in the short term, sharply weaker employment and economic activity will weigh on both sectors.

Credit Spotlight

The Federal Reserve's Liquidity Bazooka

Extreme times call for extreme actions. Some market pundits long believed the Federal Reserve didn't have many additional tools left to address times of market crisis. They may have just been proven wrong.

On March 23, 2020, in the midst of a pandemic induced market meltdown, the Federal Reserve added a new chamber to its liquidity 'bazooka' only days after reintroducing several liquidity tools first used in the 2008 financial crisis. The Federal Reserve's new tools resemble those already implemented by the European Central Bank and The Bank of Japan; yet many students of Federal Reserve policy felt strongly that it would never adopt those strategies. The Federal Reserve's new tools include a Primary Market Corporate Credit Facility (PMCCF) and a Secondary Market Corporate Credit Facility (SMCCF), that will pursue primary and secondary market purchases of primarily investment grade corporate bonds, and certain ETFs. The Federal Reserve also introduced the Term Asset Backed Securities Loan Facility (TALF), the Commercial Paper Funding Facility, and large scale portfolio purchases of U.S. Treasuries and agency mortgage-backed securities.

The Federal Reserve designed the new facilities to work in tandem with the previously announced reintroduction of the Commercial Paper Funding Facility (CPFF) and the restart of large scale Federal Reserve purchases of U.S. Treasuries and agency mortgage-backed securities. The CPFF will purchase commercial paper from U.S. companies and tax exempt entities rated A-1/P-1 or better as of March 17, 2020. The TALF is aimed at providing a funding backstop to a subset of the highest credit quality portions of the asset-backed securities market. The TALF was initially sized at $100 billion, an amount which could increase, if needed. Notably, the Federal Reserve restarted its purchasing of agency mortgage-backed securities following an announcement on March 15; and subsequent daily mortgage securities purchases totaled $50 billion, dwarfing average daily new issue mortgage origination of $7 billion, thereby largely stabilizing the agency mortgage backed securities market.

We believe the PMCCF and the SMCCF significantly improved liquidity in the investment grade and high quality high yield markets. The PMCCF funds the purchase of new issue corporate bonds maturing in four years or less directly from domestic companies (excluding depository institutions) with material operations in the U.S. rated at least 1) Baa3/BBB- as of March 30, 2020 and 2) Ba3/BB- at the time the facility makes the purchase. Initially sized at $100 billion, the PMCCF could be expanded up to $720 billion, based on initial purchase rules set forth by the Federal Reserve. The SMCCF funds the secondary market purchase of eligible issuer (same as under the PMCCF) corporate bonds rated at least BBB-/Baa3 and having a maturity of five years or less, and certain ETFs. Initially sized at $100 billion, the SMCCF could likely be expanded up to $530 billion ($500 billion in bonds and $30 billion in ETFs), based upon initial purchase rules established by the Federal Reserve.

Clearly the Federal Reserve still has fire power left in its 'bazooka'. And while the facilities have already improved liquidity and contributed to stabilizing financial markets, liquidity is only one side of the problem. Significantly reduced earnings, and in some cases solvency concerns, reside on the other side of the equation. Currently, however, the Federal Reserve policies appear to have at least temporarily mended markets.

Our recent focus of gradually reducing risk in the securitized sectors helped cushion the impact of the March selloff, but it did not completely insulate the portfolios. A timely overweight to the agency mortgage sector helped performance, as the mortgage sector comprised one of the best performing segments of the market. In the ABS sector, we also recently reduced allocations, but security selection in some lower rated issues detracted from performance in the first quarter of 2020. Additionally, a strategy to upgrade the quality and lower the allocation in CMBS helped mitigate the sharp selloff in commercial mortgages. Current valuations present attractive opportunities, but we will remain disciplined and methodical in our approach to investing in the securitized markets.

Investment grade credit

The first quarter of 2020 subjected investment grade credit markets to a challenging environment; the spread on the Bloomberg-Barclays Credit Index (the Credit Index) widened 165 basis points during the quarter and generated negative 1,272 basis points of excess returns over similar duration U.S. Treasuries.

The quarter began on firm footing with some resolution surrounding the U.S.-China trade war and Brexit as well as tentative signs of improving global growth. However, the rapid spread of COVID-19, which quickly turned into a global pandemic, created significant stress in the corporate bond market. Stay-at-home orders, mandatory business shutdowns, rising unemployment, and the prospects for slower economic growth subjected corporate issuers to volatile capital markets, a sudden earnings shock, and questions regarding liquidity reserves.

The sudden flood of uncertainty caused some investors to withdraw funds from the asset class. In addition, risk premiums increased, especially for issuers in certain industries and / or those thought to lack sufficient liquidity reserves. As a result, many corporate credit spread curves inverted briefly. In addition, volatile energy markets added to the financial market stress as a simultaneous shock in demand due to COVID-19 and a potential supply increase due to disagreement among OPEC+ members drove oil prices lower.

Investment grade credit markets stabilized as Congress passed the CARES Act and the Federal Reserve announced several asset purchase programs aimed at providing liquidity. These efforts appear to have directly helped the Credit Index to recover a meaningful portion of its losses prior to quarter end. The best performing industries and sub-segments of the Credit Index, on an excess return basis, comprised supranationals, home construction, pharmaceuticals, banking, and technology. The worst performing industries and sub-segments during the quarter included energy, leisure, gaming, airlines, and metals and mining.

In late March, we increased our investment grade credit weighting to neutral from underweight, due to vastly improved valuations as well as improved demand technicals, partially offset by very weak credit fundamentals. From a fundamentals perspective, we expect that financial performance will decline substantially in the near term for many investment grade corporate issuers and industries, as a result of temporary government-mandated business shutdowns, logistics and supply chain disruptions, and a worsening macro economic environment.

Corporate balance sheet leverage stood near a post-crisis peak heading into the quarter and will continue to lead to credit rating downgrades for those companies exhibiting the weakest balance sheets and / or the greatest exposure to the economic carnage wrought by COVID-19. As the effect of COVID-19 spread through the economy and capital markets, many companies drew down on committed credit lines and / or issued notes to improve near term liquidity. Recent actions by the Federal Reserve, including the funding of the Primary Market Corporate Credit Facility, the Secondary Market Corporate Credit Facility, and the Commercial Paper Funding Facility, will provide a backstop to enable U.S.-based investment grade issuers continued access to debt capital markets.

Many investment grade corporate issuers halted share buyback programs in the first quarter of 2020 to reduce cash outflows as business prospects waned in the wake of the COVID-19 pandemic. Dividends remain somewhat sacrosanct, but nevertheless represent a potential source of cash conservation, if future financial performance weakness surpasses current expectations.

Investment grade corporate bond demand technicals weakened during the quarter on record outflows, and then reversed in late March, at least partially due to the Federal Reserve's creation of a Secondary Market Corporate Credit Facility to buy substantial amounts of investment grade corporate bonds with a maturity of five years or less and investment grade corporate bond exchange traded funds (ETFs). In addition, lower U.S. short-term rates as well as higher corporate bond yields have reduced foreign currency hedging costs and provided many foreign investors with one of the most attractive currency-hedged market opportunities in the last several years. Further, the pace of outflows has declined substantially. Once the pandemic slows, the large supply of negative yielding global debt should continue to push investors into the highest yielding developed market bonds, those of the U.S. With regard to supply technicals, corporate bond issuance reached record high levels in the quarter, especially in March, as companies scrambled to issue debt at almost any cost to create liquidity reserves sufficient to last through COVID-19's wake of economic devastation. We expect this strong pace of issuance to continue, yet moderate as the pandemic weakens.

From a valuation perspective, the Bloomberg-Barclays U.S. Corporate Bond Index yield spread reached 373 basis points on March 23 and ended the quarter at 272 basis points, both a historical record outside of the financial crisis and extremely attractive relative to most points in time. Additionally, the market liquidity issues that emerged in March caused an extreme flattening of the corporate credit curve.

In the near term, we expect dismal earnings reports from most investment grade corporate issuers, elevated corporate new issuance activity, and volatile credit spreads. However, the Federal Reserve's monetary policy 'bazooka' and the CARES Act should soften the blow until the economy restarts. Given the attractiveness of current valuations as well as various forms of government support, we remain market weight investment grade corporate credit with an intense focus on industry allocation, issuer selection, and in particular companies with strong credit fundamentals and solid prospects for business stability in the wake of COVID-19.

High yield

The U.S. High Yield market suffered a sharp and historic loss in March 2020, as The Bloomberg-Barclays U.S. High Yield Index (the High Yield Index) returned -11.46% in the month. For the entire first quarter of 2020, the High Yield Index returned -12.68%, as risk markets priced in an unprecedented global economic lockdown to limit the spread of COVID-19. The high yield market briefly re-tested cycle-low spreads in January, reaching an option adjusted spread (OAS) of +315 basis points. In March, the market gapped wider and the OAS ended the quarter at +880 basis points (544 basis points wider). On March 23, prior to recovering some of its losses late in the quarter, the High Yield Index OAS reached +1,100 basis points, the widest spread level since 2009. The High Yield Index finished the quarter yielding 9.44% (YTW), near the wide end of the intra-quarter range of 4.98% on January 21 and 11.69% on March 23.

As one would expect, lower-rated credits performed the worst, as CCCs returned -20.55% in the period, versus -12.97% for Bs and -10.15% for BBs. At a sector level, the decline in oil prices led the energy sector to return -38.9% in the first quarter of 2020, earning it the distinction as the worst performing industry by a wide margin. Sectors hit hard by stay-at-home orders also reported negative returns in the period, including transportation (-20.9%) and consumer cyclicals (-14.3%, includes leisure, gaming, retail, and lodging). In contrast, consumer non-cyclicals (includes healthcare, supermarkets, and food and beverage) faired relatively well, returning -6.2%.

Technicals proved challenging as retail outflows totaled $13.0 billion in March 2020, the second largest monthly outflow on record, bringing year-to-date outflows to $16.7 billion, and nearly reversing all of the $18.8 billion in positive flows from 2019. New-issue volumes, which had been running at a healthy pace to start the year, came to a screeching halt in March, with just four deals pricing. In early April, however, the market appeared receptive to higher-quality issuers willing to provide collateral.

Aside from flows and new issues, the high yield market faces the major technical challenge of absorbing a large quantity of bonds previously rated investment grade and recently downgrade to high yield. Kraft Heinz, Ford Motor Company, and Occidental Petroleum represent three of the largest new 'fallen angel' additions to the high yield market. In the first quarter of 2020, ratings agencies downgraded over $100 billion in investment grade corporate bonds to high yield, and most strategists expect this total to balloon in coming months, potentially increasing the quantity of high yield bonds by as much as 50% versus level of December 31, 2019. The recent announcement that the Federal Reserve will include certain fallen angels into its pool of eligible bonds for purchase will likely partially help the market absorb the large quantity of downgraded debt.

As high yield investors look forward, they face clearly deteriorating corporate credit fundamentals. Ratings agencies have already started lowering their credit ratings on companies affected by the economic shutdown. According to JPMorgan, agencies upgraded only eleven issuers in March while they downgraded 170, leaving the upgrade / downgrade ratio (dollar volume basis) for the first quarter of 2020 at just 0.2. Many companies withdrew quarterly and / or annual earnings guidance, setting the stage for first quarter earnings season and its accompanying schedule of earnings conference calls to be the first opportunity for many investors to assess how high yield issuers performed during the COVID-19 pandemic and what challenges may lay ahead. Based on JPMorgan data, the high yield bond default rate increased to 3.35% at the end of March, and some investors expect default rates of as high as 8% to 13% within the next year.

As of early April, with spreads having tightened to trade inside of 800 basis points, implying a YTW of approximately 8.5%, it appears as if the market is already growing sanguine, and possibly pricing in a "V-shaped" recovery. We remain more cautious that COVID-19 fallout could be more severe and long-lasting. In addition, the number of fallen angels and defaulted issuers will almost certainly continue to increase. As such, we remain biased to higher-rated credits and highly selective in the aforementioned affected sectors, particularly for issuers that entered the crisis with weak balance sheets and poor free cash flow profiles.

Leveraged loans

Leveraged loans experienced unprecedented volatility during March, as prices plummeted 20 points from the beginning of the month to their lowest point (mid-70s) before rallying partially back at month-end. The Credit Suisse Leveraged Loan Index (the CSLLI) experienced its largest single-day moves in both directions during the month, returning -12.46%, the second-worst monthly performance behind October 2008. In the first quarter of 2020, the CSLLI returned -13.19%, very near the high yield market's -12.68% total return. Yields and spreads ended the first quarter approximately 400 basis points and 500 basis points wider, respectively, at 10.3% and 974 basis points (both to a 3-year take-out). As was the case in the high yield market, lower-rated credits and the commodity sectors led the declines, with split-B/CCCs returning -23.5% in the quarter and energy returning -34.9%. Less cyclical sectors, such as food and drug (-3.5%) and cable (-5.6%), faired significantly better.

Weak technicals contributed to the downward price action in March. After decelerating over the second half of 2019, outflows from retail loan funds increased again in the first quarter of 2020 to $11.6 billion, with $9.0 billion in outflows occurring in March alone, representing the second largest monthly outflow on record. Additionally, new CLO creation ground to a halt in the last few weeks of the quarter, while existing CLO structures sold large quantities of lower-rated loans in an effort to manage their allocations to CCC-rated credits. A dearth of new issues in March partially offset these trends, as just over $4 billion priced, representing the slowest month since January 2010.

While the leveraged loan default rate remained low in the first quarter of 2020, reaching 1.87% at the end of the period, a wave of recent downgrades (approximately $74 billion of single-Bs in March alone) and a spike in the distress ratio portend a significant decline in loan issuer fundamentals. Many of the recently-syndicated loans exhibiting high leverage and weak credit documentation may fare poorly in the next few quarters as the economy struggles through the COVID-19 pandemic.

Although loan prices rebounded approximately 10 points off their lows, we remain cautious in sectors directly impacted by stay-at-home orders. Within the leveraged loan space, we prefer higher-rated credits and manageable leverage profiles that don't rely on aggressive EBITDA growth assumptions to meet pro forma leverage targets. We expect more opportunities to selectively add risk as the market continues to digest the depth and duration of the economic downturn. Lastly, we retain a modest preference for the high yield market over loans, given the Federal Reserve's apparent commitment to including certain fallen angel bonds in its purchase plans.