September 18, 2020

Eaton Vance

EV Forward

How Eaton Vance managers navigate today's markets

Summary

- As the 2020 presidential election enters the final stretch, nearly 8 in 10 registered voters (79%) say the economy will be very important when they decide who to vote for, according to a poll conducted last month by the Pew Research Center. The impact of the election extends beyond economic concerns, however, to include potential changes to US tax policy and geopolitics. In this month's issue, our senior leaders assess what the top issues of this year's election might mean for investors.
- Investment teams across Eaton Vance's range of affiliate managers seek to actively capitalize on opportunities presented by volatile investor sentiment, while ensuring that the portfolio risk profile remains appropriate for the specific strategy.
- Eaton Vance strategies are designed to seek fundamental value that helps build client wealth over the course of many business cycles. In our view, times like these underscore the value of active management. We believe in carefully assessing the dynamics of fluctuations driven by political change or other disruptions, and in taking action that best serves the long-term interests of our clients.

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CENTRAL BANK POLICY

Eric Stein, CFA
Co-Director of Global Income
Eaton Vance Management

Upcoming US election has major implications on tax policy and geopolitics

Boston – In the US presidential election, the polls have tightened over the past several weeks and market-implied betting probabilities have started to close. At this point, however, I think Joe Biden should still be considered the frontrunner.

Recent momentum for President Trump depends heavily on what happens with the economy and the coronavirus pandemic. Only a month ago, large majorities of potential US voters expressed fear about how much the pandemic seemed to be accelerating, which lowered the probability of Trump's reelection. Now, with the number of new infections slowing somewhat in the US, Trump's prospects of winning — implied by either the polls or the market — appear to be going up.

Geopolitical impacts of US presidential election

Much has been said about the economic impacts of President Trump getting reelected, Biden winning but the Republicans keeping the Senate, or Biden winning with a clean Democratic sweep of Congress. Certainly, there would be a big impact on tax rates and regulatory policy depending on these outcomes.

I think it's also important geopolitically whether Trump or Biden wins. Clearly, the Trump administration has shifted the narrative on China — essentially the only bipartisan issue in Washington where everyone has been trying to out hawk each other. If Biden gets elected, I don't expect him to go soft on China as Trump has claimed, but rather to be far more hawkish than he was as Vice President in the Obama administration.

That being said, I anticipate that Biden's approach would be different — far more multilateral with US allies in Asia and with Europe more in the fold than it has been under President Trump. So I think the geopolitical ramifications of the US election should not underestimated and could even be more important than the impacts from a domestic tax and regulatory policy perspective.

> "I think the geopolitical ramifications of the US election should not underestimated and could even be more important than the impacts from a domestic tax and regulatory policy perspective."

New approach to US monetary policy

Federal Reserve Chair Jay Powell's speech at the virtual Jackson Hole Conference in late August went somewhat as expected, but still included quite big news. The new approach that Powell mentioned is really ***flexible inflation targeting***. What that means to investors is the Fed won't let previous undershoots of inflation go unnoticed. If inflation is under the Fed's 2% target, policymakers will try to overshoot to get back to an average of 2% inflation over some time period.

That is certainly more dovish policy from the Fed, designed to try to get real interest rates lower, inflation expectations higher and economic growth stronger. Right now, it's not that impactful because no one expects the Fed to raise rates any time soon.

However, let's say we get a significant recovery over the next year or so — maybe with a COVID-19 vaccine and a rebounding economy. We might normally expect the Fed to start raising rates then. What I think this policy change from the Fed signals is that we shouldn't expect rate hikes even if the economy picks up next year.

Bottom line: With inflation continuing to undershoot, the Fed is going to keep interest rates even lower and monetary policy even easier for longer. So I would say that is quite big news from a central bank policy perspective.

COVID-19 UPDATE

Marshall L. Stocker, PhD, CFA
Director of Country Research
Eaton Vance Management

Politics drive perceptions of COVID-19 pandemic

Health policy developments

- Dr. Fauci says life will not return to normal until "well into 2021, maybe even towards the end of 2021." He has expressed concern that the US is plateauing at around 40,000 [new] cases a day and daily deaths of around 1,000.
- Brookings Institute fellow Robert Litan proposed that each American who receives a COVID vaccine be paid $1,000 by the government, which would recognize the positive externality that accrues to the community when enough people are vaccinated. He also suggested holding back most of the payment until 80% of Americans are vaccinated. Harvard's Gregory Mankiw opined in the New York Times that this is a good idea and "textbook economics."
- In California, the "Right to Know" bill would require employers to notify their employees of COVID-19 cases, as well as alert county public health departments. Companies haven't always notified public health officials or even their own employees of outbreaks.
- The White House ordered the end to COVID-19 airport screenings for international travelers. As of this week, international flights will no longer be funneled into one of 15 airports for screening purposes.
- A federal judge ruled unconstitutional Pennsylvania Gov. Tom Wolf's pandemic restrictions that required people to stay at home, placed size limits on gatherings and ordered "non-life-sustaining" businesses to shut down.
- JPMorgan sent some of its Manhattan workers home this week after an employee in equities trading tested positive for COVID-19, just days after the biggest US bank told senior traders they'd be required to return by September 21.

Bearish virus developments

- EVM's Federico Sequeda reports that the correlation between lagged mobility and new case growth has shot up in the US, noting that this correlation can show whether public policy and individual behavior can change the link between economic activity and the virus. In Germany, the opposite is observed, where increased mobility has not correlated to increased case growth.
- According to a pre-publication study, COVID-19 dissects heart muscle fibers into small, precisely sized fragments which could permanently damage heart cells. The finding was made in heart cells of in a lab dish, but the researchers found evidence that a similar process could be happening in the hearts of COVID-19 patients as well.
- Research published last week in the journal JAMA Cardiology found that 4 out of 26 college athletes had signs of a heart condition called myocarditis after recovering from COVID-19. Researchers were surprised the condition is only noticeable on an MRI as blood tests and EKGs do not reveal any symptoms.
- France recorded almost 10,000 new COVID-19 cases in a 24-hour period last week, marking its highest single-day count since the start of the outbreak and exceeding the first wave peak.
- The CDC found people with COVID-19 were twice as likely to have eaten out at a restaurant very shortly before becoming sick.

COVID-19 UPDATE

Bullish virus developments

- Researchers at Massachusetts General Hospital have found that increased internet searches on gastrointestinal symptoms predicted a rise in COVID-19 cases weeks later.
- The 20-second saliva test trialed at Heathrow Airport has been launched for broader use. Per test cost is similar to a "paperback book" and requires a $20,000 machine that can process hundreds of tests per day. No details on how quickly the test's manufacturer plans to ramp up product distribution.
- Chinese vaccines will be ready for use in November as clinical trials have been progressing smoothly and preparations are being made to go into mass production, says China CDC's chief biosafety expert Wu Guizhen.

Economic and market impacts

- According to a KFF Health Tracking Poll, 36% of Democrats say COVID-19 is the most important issue when deciding how to vote for President, making COVID-19 their number one issue. For Republicans and independents, COVID-19 ranks third and fourth, respectively, in that list.
- The Organization for Economic Cooperation and Development (OECD) said the economic hit from COVID-19 has been several times worse than the last financial crisis, with the recent global GDP contraction of 6.9% far weaker than the 1.9% growth decline recorded in the worst quarter of 2009.
- George Washington University's enrollment is down about 17% from last year, reports Bloomberg, an early indication of the impact of COVID-19 on US higher education. Some 67% of schools expected enrollment to decrease, and most forecast lower tuition revenue, according to a poll last month by the National Association of College and University Business Officers. Those with big international populations forecast the steepest declines.
- UK house prices are set to fall by nearly 14% from 2020 levels, according to the Centre for Economics and Business Research. The UK's residential property market has so far defied the economic fallout as house prices rose in August by the most in 16 years, driven by a tax break and demand that built up during lockdown, according to Nationwide Building Society.

Source: Eaton Vance research as of September 18, 2020.

INCOME MARKETS

Payson Swaffield, CFA
Chief Income Investment Officer
Eaton Vance Management

Mixed messages: Fed clarity contrasts with muddle from Congress, elections

With Labor Day in the rearview mirror, bond market investors are confronted with stark policy contrasts coming from Washington: the relative clarity of the US Federal Reserve compared with the very murky picture posed by the congressional stalemate and the presidential election. Here are our takeaways in the current environment:

- **Market volatility** is likely to increase, with the path of COVID-19 infections as the overarching uncertainty factor. An example is the pace of school reopenings — the normal productive capacity (and spending habits) of parents may be significantly reduced if they have to continue as stay-at-home teachers.
- **Fed policy is clear:** Lower short-term rates for longer (through at least 2023 based on the September policy meeting) with a bias to let inflation run above its 2% target until the unemployment rate is very low. The Fed's stance has resulted in inflation expectations creeping up from 1% last March to 1.7%, as indicated by the 10-year inflation breakeven.[1]
- **Corporate bonds have benefited greatly** from Fed policy, which has included purchases of corporate investment-grade debt and high-yield ETFs. This has contributed to a general tightening of credit spreads to pre-COVID levels, with the exception of floating-rate loans.
- **In leveraged credit, transparency about anticipated defaults is now better,** and we believe that defaults won't reach the levels we expected in March. In our view, loans have lagged other credit sectors because the floating-rate feature was viewed as a negative. But with rates at rock-bottom levels, we believe loans offer value, because we don't expect the Fed to resort to negative short-term rates.
- **By contrast, a cloud hangs over the municipal bond market,** with no agreement in Congress over new relief for cities and states. The muni market has nevertheless rallied, driven by investor hunger for yield, leaving the high-quality sector less attractive on a risk-adjusted basis. Certain high-yield muni bonds — BBB or lower — may offer better risk-adjusted return. For example, hospitals were hard hit by COVID-19 and prices fell in March, but they have bipartisan support in Washington. A potential Democratic sweep would certainly be a significant tailwind for the municipal sector.

[1]Inflation breakeven is a commonly accepted measure of the expected inflation rate, defined as the difference in yield between nominal Treasury bond rates and the real yield on Treasury Inflation Protected Securities (TIPS).

The impact of the coronavirus on global markets could last for an extended period and could adversely affect a strategy's performance.

Income — About Risk: The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the US and global markets. As interest rates rise, the value of certain income investments is likely to decline. Investments in debt instruments may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments.

EQUITY MARKETS

Edward J. Perkin, CFA
Chief Equity Investment Officer
Eaton Vance Management

Consensus calls for a Biden win and a Blue Wave in Congress, but what if that confidence is misplaced?

Biden may not be a foregone conclusion

While COVID-19 continues to be the dominant driver of markets, investors have begun to focus more and more on the November 3 elections. Nate Silver — considered the guru of political forecast modeling, with an impressive track record — sees Biden as the favorite, at a 76% chance of winning based on his latest simulations.[1]

Polling tends to tighten as Election Day approaches, especially with three debates still to come amid the uncertainty of the pandemic and the state of the US economy — and the potential for better news on both those fronts. I am inclined to believe that although Biden is the clear favorite, the consensus could be overconfident in his chances.

Sectors are more likely to feel election impacts than the broad markets

For those willing to lean in, industry groups generally presumed to be hurt by a Biden victory have reached levels that may offer attractive risk/reward opportunities. These include banks, managed care, defense and utilities.

Senate control deserves far more attention than the Presidential race

Under the scenario where consensus thinking turns out to be correct, and we get a so-called Blue Wave with Democrats sweeping the Presidency, Senate and House of Representatives, market participants and company managements are likely to take two actions in the final 58 days of 2020. (If the election is close and counting mail-in ballots delays the final tally, that window of time would be even more compressed.)

1. I anticipate that investors may flip from their usual end-of-year tax *loss* harvesting to tax *gain* harvesting. That way, they could book gains under what we can presume to be a more favorable tax regime.
2. I expect corporate management teams to pay special dividends in December, pulling forward anticipated future dividend payments to the current regime. Under a different administration, dividends may be taxed at a higher rate, and payouts could also be limited by regulation — such as capping dividend payments at trailing twelve month earnings levels, which we have already seen with the banks.

Investors need to invest with their heads, not their hearts

In my experience, successful investing is not about predicting the future with pinpoint accuracy. Rather, I believe we should aim to contemplate a range of scenarios and their likelihood, then compare those probabilities to market prices to infer what is priced in. The intensity of political polarization means that many have strong emotional stakes in the election outcome, but markets may have a different interpretation of the results. So I think we should try to avoid letting our political preferences overwhelm prudent investing decisions.

Possibility of post-Election Day volatility is real

Not that long ago, investors complained about the lack of volatility and catalysts for market action. No more. In these strange times of global pandemic, recession, looming election and high-frequency traders playing with the Fed's easy liquidity, I suspect the roller coaster ride is likely to continue.

[1]FiveThirtyEight, "Biden is favored to win the election" as of September 17, 2020. https://projects.fivethirtyeight.com/2020-election-forecast/

The impact of the coronavirus on global markets could last for an extended period and could adversely affect a strategy's performance.

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RESPONSIBLE INVESTING

John Streur
President
Chief Executive Officer
Calvert Research and Management

Who will we trust in 2021?

No matter who wins the election, it won't be the federal government.

Americans' trust in the federal government relative to their trust in corporations continues to decline. Furthermore, the majority of Americans do not have faith in the government to heed the call to end systemic racism. Instead, they see their own employer as the institution most trusted to do so — even though the majority observe racism in the workplace.

In the US, we are more likely to trust a corporation than those we elect.

Most Americans trust and expect corporations to take action on our most serious social and environmental challenges. At the same time, they also believe that companies are not doing enough on these issues.

Responsibility to act shifting

These are findings in surveys[1] conducted over the past few months, and they make it clear that a further burden of responsibility to address racism, inequality, climate change and other critical issues is shifting, perhaps inexorably, from the federal government to corporations. Americans' growing concern over confronting these issues is also prompting this shift.

In the US, we know we are facing some serious challenges, and we no longer think the federal government is up to the task of meeting them head-on. But we are Americans, and we trust that corporations will pick up the slack and get the job done!

I believe that most corporations around the world have understood this need and the shift of burden for years. A few excellent companies have responded to these changes early, quickly and in a disciplined manner geared to stay current. As time goes on, this aspect of corporate strategy, operations and culture becomes increasingly important to long-term value creation. This is one reason that environmental, social and governance (ESG) strategies have taken off in investment management.

Election outcomes will not deflect ESG momentum

The 2020 election outcomes will not change these dynamics. One reason I believe this is that corporations welcome the shift in power. Enough said.

In many cases, across sectors, American companies are working to improve aspects of their ESG performance. These efforts may be encouraged, in part, by competition among companies on certain ESG factor performance metrics. In effect, this dynamic is essentially a market-driven solution.

It appears that the momentum behind ESG market-driven solutions is strong enough to have gained considerable traction over the past four years, during an administration that is broadly seen as actively hostile toward ESG. It is possible that there is a countercyclical dynamic at play. When a Democrat gets into office, gun sales spike out of fear that the Democrats will curb gun sales. It may follow that when a Republican gets in, ESG sales spike out of fear the Republicans will attempt to curb ESG initiatives or products.

The major long-term drivers of ESG's growth and importance will not change, and any near-term adjustment following the November presidential election is likely to be counterintuitive and short-lived.

It will be best for the long-term health of our social and economic system for the federal government to quickly build trust with the American public and people throughout the world. Companies cannot get all the needed work done, as quickly as it needs to be done, without the federal government fully participating, and this would be best served if both parties could eliminate the polarization they actively drive. Instead, all parties — governments, companies, investors and the public — need to act in a concerted manner and get back to the important work of confronting our broad spectrum of challenges and solving these problems together.

[1]Source: Survey data from https://www.edelman.com/research/legacy-mistrust and Test of Corporate Purpose

TAX PLAN COMPARISON

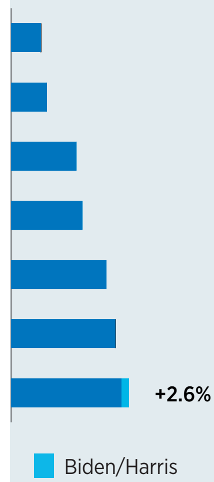
What would a Biden presidency mean for your taxes?

As the 2020 presidential election kicks into high gear, Democratic nominee Joe Biden is proposing another sweeping change to the current tax code — just three years after the Tax Cuts and Jobs Act (TCJA) of 2017 was the largest single overhaul of the US tax code in more than three decades.

Here's how the Biden/Harris plan compares with current tax law:

Current Law	Biden/Harris

Individual Income Tax Rates

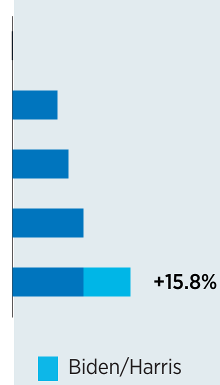


Federal Income Tax Brackets for 2020

	Single	Married
10%	\$0 – \$9,875	\$0 – \$19,750
12%	\$9,876 – \$40,125	\$19,751 – \$80,250
22%	\$40,126 – \$85,525	\$80,251 – \$171,050
24%	\$85,526 – \$163,300	\$171,051 – \$326,600
32%	\$163,301 – \$207,350	\$326,601 – \$414,700
35%	\$207,351 – \$518,400	\$414,701 – \$622,050
37%	\$518,401+	\$622,051+

Current Law	Biden/Harris
\$10,000 cap on state and local tax (SALT) deductions 20% deduction for qualified business income (QBI), REIT dividends and PTP* income (known as 199A).	Repeal individual tax provisions of TCJA including SALT cap and QBI deduction

Capital Gains



Income Thresholds for Capital Gains

0%	\$0 – \$78,500
15%	\$78,500 – \$250,000
18.8%	\$250,000 – \$488,850
23.8%	\$488,850 – \$1,000,000
23.8%	\$1,000,000+

*PTP = publicly traded partnership

TAX PLAN COMPARISON

	Current Law	Biden/Harris
Wealth Tax		
	Doubled estate tax exemption from $5.6M to $11.2M	Eliminate tax breaks that reward special interests Limit benefit for itemized deductions to 28% rate Limit foreign tax havens
Payroll Taxes		
	Employee and employer both pay 6.2% Social Security tax on wages < $137,700	Employee and employer both pay 6.2% Social Security tax on wages < $137,700 > $400,000
	1.45% Medicare tax on all wages Employee only pays 0.9% Medicare tax on wages	
Corporate Taxes		
	Lowered corporate tax rate from 35% to 21%	Raise corporate tax rate from 21% to 28% Impose 15% minimum tax on book income Double foreign profits tax rate from 10.5% to 21%

Wage Thresholds for Employee Payroll Tax

Single	Married
$200,000+	$250,000+

Source: Biden/Harris campaign, Committee for a Responsible Federal Budget (CRFB), Washington Council Ernst & Young as of August 2020.

Eaton Vance does not provide tax or legal advice. Prospective investors should consult with a tax or legal advisor before making any investment decision.

CORE EQUITIES

Matthew Hereford, CFA
Vice President and Principal
Atlanta Capital Management

As the market becomes less concentrated and the economy recovers, we believe investors will turn more toward high-quality stocks

- It's been a very interesting year, to say the least. We've had a strong rebound in equities from their March lows, driven by a concentrated market. Similar to 1999 and early 2000, it's primarily large-cap, technology-oriented names dominating returns, and I see a lot of "animal spirits" at work.
- In the mid-cap space, many software stocks are trading at not 20, 30 or 40 times ***earnings***, but at 20, 30, 40 or 50 times ***sales*** — and in some cases even higher. It's been a risk-on market, and the portfolios we manage tend to have lower betas, so our performance has been mixed in the current environment.
- The concentrated character of this market actually reinforces confidence in our strategies. It doesn't take a huge shift in capitalization from the top index names to potentially drive fairly strong share price movements in some of the other index positions. We pursue a high active share in our strategies and believe that we are well positioned if the market were to shift.
- We are optimistic about the future prospects of the consumer-related names held in our portfolios, which have been punished in the short term by the pandemic and unemployment. In our view, a bet against our strategies' positioning is a bet against the reopening of the economy or a potential vaccine — and we have full confidence these events will occur.
- Looking ahead, it's not only what we own that makes us excited, but it's also about what we don't own — where we see valuations as being so stretched. As capital comes out of those expensive names, we believe investors will likely turn to some of the high-quality stocks that are owned in our strategies.

Equities — About Risk: The value of investments may increase or decrease in response to economic and financial events (whether real, expected or perceived) in the US and global markets. The value of equity securities is sensitive to stock market volatility. Smaller companies are generally subject to greater price fluctuations, limited liquidity, higher transaction costs and higher investment risk than larger, more established companies.

US SMALL CAP

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With returns broadly diversified across Russell 2000 holdings, small caps have room to run, and active management can play a critical role

- While small-cap stocks have rebounded from their March 2020 lows, the Russell 2000 Index remains 12% below its all-time high reached two years ago. In contrast, both the S&P 500 and Nasdaq reached all-time highs just this September.
- The well-publicized concentration in large-cap indexes is a key reason those indexes have continued to climb, while the Russell 2000 has not. There is a notable lack of concentration in small caps, which has not received much attention.
- The top five stocks in the S&P 500 make up a whopping 22% of the index, while the top five stocks in the Russell 2000 comprise only 1.9% of the index. Interestingly, three of those top five stocks are casino companies, driven by that industry's recent strength.
- Given the top positions in the Russell 2000 only account for about 40 basis points each, not owning any individual index position rarely has a meaningful impact on performance, as it does in large cap.
- This lack of weight in a single position leaves us free to ignore those companies that do not meet our quality and/or responsible investing criteria. That is particularly important as the number of unprofitable companies within the Russell 2000 has surged to 45% as a result of the pandemic-driven recession.
- While 2020 has been an extremely unique year marked by volatility and market peaks that have come during a massive recession, we're encouraged to see that our robust Quality, Valuation and Time (QVT) investment process has provided downside protection along with upside potential.
- Irrespective of market-cap size, equity markets will be shaped by the path of the coronavirus, US Presidential election and economic recovery.

US Small Cap — About Risk: The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the US and global markets. The value of equity securities is sensitive to stock market volatility. Smaller companies are generally subject to greater price fluctuations, limited liquidity, higher transaction costs and higher investment risk than larger, more established companies.

INTERNATIONAL EQUITIES

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Greater European cohesion, momentum in Japan, US election uncertainty and a weaker dollar all bolster the case for international equities

- The US dollar (USD) dropped to a two-year low on September 2, down 10% from its March highs, and further weakness appears likely. A weaker USD could potentially boost portfolio results for international equity investors, where currency conversion works in their favor.
- Japan's recent path of governance and regulatory reform is likely to be continued by new Prime Minister Yoshihide Suga, Shinzo Abe's successor and close ally. We believe this positive momentum, coupled with a shift toward cyclical economic recovery, bodes well for Japan's markets and businesses.
- Greater European cohesion and high levels of US government debt compared to eurozone government debt should favor international equities. The International Monetary Fund projects that US debt will be 43 percentage points higher than eurozone debt coming out of the COVID crisis.
- An obvious way for the US to address its debt level is to increase corporate taxation and to spend less, both of which will be impediments to US economic and earnings growth. A Democratic victory in US elections would likely mean higher corporate tax rates and lower profits.
- Those countries with a large export economy and big manufacturing base — like Japan and Germany — are best positioned to benefit from a global, cyclical economic recovery, which we believe is underway.
- In recent months, we have increased an overweight to Europe in our portfolios. This reflects our positive outlook for European regional cohesion, rather than positioning specifically for the US election.
- In our view, now is a particularly opportune time for investors to consider allocating to international equities, which offer an attractive counterpoint to US equity markets.

International Equity — About Risk: The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the US and global markets. The value of equity securities is sensitive to stock market volatility. Investments in foreign instruments or currencies can involve greater risk and volatility than US investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. Investing primarily in responsible investments carries the risk that, under certain market conditions, a strategy may underperform those that do not utilize a responsible investment strategy.

LEVERAGED CREDIT

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Positive tone persists for leveraged credit, but caution is warranted

The positive tone for the leveraged credit sectors of high-yield bonds and floating-rate loans continued past Labor Day. Despite the policy stalemate in Congress over further stimulus and the uncertainty surrounding the presidential election, US Federal Reserve policy continues to backstop the market, successfully encouraging credit risk-taking and fueling a remarkable recovery since March.

Turning to high yield, the risk-on attitude was evident in market performance, with the riskiest segment of the market having the strongest showing in September. The ICE BofA US High Yield Index returned 0.98% in August, although overall performance in the first two weeks of September softened to -0.40%.

- The recent softness can be attributed to elevated supply, weaker demand and a tech-led sell-off in the equity markets. As of September 11, the yield on the index stood at 5.56% — a little more than half its peak in March.
- At the same time, based on historical spreads, the spread on the index as of September 11, at 526 basis points over US Treasurys, was still 30 bps wide of its long-term median.
- After a major run since March (15.97% in index return for the five months ended August 31) is there still room for spread compression? We are seeing some bullish signs emerge from Wall Street. For example, strategists at Merrill Lynch and Goldman Sachs have both stated their opinions that peak defaults are now in the rearview mirror.
- Our own view tilts toward more caution. We believe the best value in high yield can be found through careful due diligence and our proprietary relative value analysis, leaning away from bets on bi-modal outcomes and avoiding credit mistakes.

The floating-rate loan market in August notched its fifth consecutive month of positive returns — most recently, an advance in August of 1.49%. That brings total returns for the five month period ended on August 31 to 13.52%.

- The S&P/LSTA Leveraged Loan Index yielded 5.54%, as of September 30, on a par with high yield bonds and surpassing emerging markets debt (as measured by the JP Morgan EM Bond Index EMBI). In a world where the Bloomberg Barclays Aggregate Index barely tops a 1% yield, we believe the loan market offers relative value.
- To see why, the Index price of 92.85 on August 31 reflects a default rate of about 24%, if recoveries stay at the historical 70% level. In comparison, the total cumulative default rate for the three years following the 2008 global financial crisis was 15%.
- We believe loan prices will continue to grind higher, with fits and starts along the way.
- New deals in the loan market are coming with higher coupons above the benchmark Libor, most with Libor floors. The floors serve as an important income support feature, especially as they become more prevalent in the Index again.

MUNICIPAL BONDS

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Nisha Patel, CFA
Director, Portfolio Management
Parametric Portfolio Associates

While state budgets remain under pressure, tax receipt revenues are a far cry from projected declines

- Municipal bonds have rallied slightly on the front end of the yield curve, and are up modestly on the long end month to date — underperforming US Treasurys that rallied amid heightened equity volatility. Muni-to-Treasury ratios are still elevated with the 10-year yield ratio at about 125%. Municipals also look relatively cheap compared to corporates.
- On the demand side, municipal mutual fund inflows overall have been positive for 17 consecutive weeks, showing a year-to-date total of $19.2 billion. By contrast, for the third straight week, high yield muni funds recorded outflows of $88 million. For the year, high yield outflows still remain negative at $6.1 billion.
- On the supply side, the primary market has started to heat up: JPMorgan estimates positive net supply of about $6 billion in September and October, with the reinvestment of maturing capital declining to less than $25 billion monthly over that period. This would be a sharp turnaround from the net negative supply that we witnessed from June through August.
- The primary calendar for the coming week stands at a projected $10.6 billion of issuance. Breaking that down, taxable issuance represents $2.7 billion and tax exempt is about $8 billion, while $6.6 billion appears to be negotiated deals and $4 billion is coming as competitive.
- The positive technicals of the summer seem to be fading, and this weakening of technicals could weigh on the muni market, which might explain some of the light secondary trading over the past couple of weeks.
- Turning to politics, chances of a new round of stimulus before the US presidential election are becoming slimmer by the day. Last week, the Senate voted on a smaller package with no additional aid for state and local authorities. As the votes split on party lines, 52 to 47, it fell short of the necessary 60 for passage.
- State tax receipts for the year through July have declined only 2.9% on average, according to JPMorgan. So while state budgets definitely remain under significant pressure, the reported numbers are a far cry from what was once projected as significant declines in state tax revenue.

SHORT DURATION GOVERNMENT INCOME/AGENCY MBS

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Risk mitigation is the key to investing in mortgage-backed securities

- As economic data from around the globe continues to show a strong bounceback from the coronavirus-induced declines earlier in the year, many risk markets have fully recovered and many sell-side research firms are considering this the beginning of a multi-year economic expansion in the US.
- There are certainly some notable bright spots in the economic picture today, especially with the amount of support that financial markets are getting from the Fed, but our team continues to believe that the US economy is going to take longer to fully recover than what the market is pricing in.
- The Fed is still pumping a substantial amount of money into the markets in response to the COVID-19 crisis, and its balance sheet is now over $6.3 trillion (as of September 9, according to the Federal Reserve Bank of New York), up from about $3.6 trillion this time last year.
- Most notable to us is the sheer magnitude of the Fed's purchases in the agency mortgage-backed securities (MBS) market. We began the year with the Fed projected to let roughly $20 billion in Agency MBS roll off its balance sheet per month, which equated to the Fed being a net supplier of around $240 billion in agency MBS for the 2020 calendar year. However, their about-face on asset purchases in March and the consistent buying since then has resulted in the Fed purchasing over $1 trillion in agency MBS over that period.
- Despite Fed support, spreads in the agency MBS market remain wide. Today, they are at 120 basis points over Treasurys versus a longer-term average of 78 bps according to Bloomberg. One reason is the current record supply of agency MBS. This is partially due to the level of refinancing, which remains elevated because of low mortgage rates.
- It has also been caused by an extremely hot housing market, which appears to be making up for the spring selling season that was largely missed due to social distancing. In fact, according to Redfin data, nearly 50% of homes were listed and sold within a two-week period in August. We expect those market technicals will eventually reverse and work in our favor, especially as the Fed's buying continues.
- Going forward, we think that the agency MBS space still offers some attractive opportunities. Compared to investment grade credit, in particular AA- and A-rated corporate bonds, investors can go up in quality and up in yield by rotating into agency MBS.
- At the same time, other investors, who have likely seen the yields on their favorite money market fund drop to close to zero, have an opportunity to take that first baby step on the risk spectrum from their money market fund to potentially earn substantially more income.

Short Duration Government Income/Agency MBS — About Risk: The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the US and global markets. Securities with longer durations tend to be more sensitive to interest rate changes than securities with shorter durations. As interest rates rise, the value of certain income investments is likely to decline. Mortgage- and asset-backed securities are subject to credit, interest rate, prepayment and extension risk. Investments in debt instruments may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. US Treasury securities generally have a lower return than other obligations because of their higher credit quality and market liquidity. While certain US government-sponsored agencies may be chartered or sponsored by acts of Congress, their securities are neither issued nor guaranteed by the US Treasury.

Index Definitions

Bloomberg Barclays US Aggregate Index is an unmanaged index of domestic investment-grade bonds, including corporate, government and mortgage-backed securities.

Bloomberg Barclays Municipal Bond Index is an unmanaged index of municipal bonds traded in the US.

Bloomberg Barclays High Yield Municipal Bond Index is an unmanaged index of fixed rate, non-investment grade municipal bonds traded in the US.

Bloomberg Barclays US Corporate Investment Grade Index is an unmanaged index that measures the performance of investment-grade corporate securities within the Bloomberg Barclays US Aggregate Index.

ICE BofA US High Yield Index is an unmanaged index of below-investment-grade US corporate bonds.

ICE BofA US Corporate Index is an unmanaged index that measures the performance of investment-grade corporate securities.

S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

JP Morgan Emerging Markets Bond Index (EMBI) is an unmanaged index of USD-denominated bonds with maturities of more than one year issued by emerging markets governments.

Libor is basic rate of interest used in lending between banks on the London interbank market and also used as a reference for setting the interest rate on other loans.

Nasdaq Composite is an unmanaged index of the common stocks and similar securities listed on the Nasdaq stock market.

Standard & Poor's (S&P) 500 Index is an unmanaged index of large-cap stocks commonly used as a measure of US stock market performance.

Russell 1000 Index is an unmanaged index of 1,000 US large-cap stocks.

Russell 1000 Growth Index is an unmanaged index of US large-cap growth stocks.

Russell 2000 Index is an unmanaged index of 2,000 US small-cap stocks.

Russell Midcap Index is an unmanaged index of US mid-cap stocks.

MSCI Europe Index is an unmanaged index of equity securities in Europe.

MSCI World Index is an unmanaged index of equity securities in the developed markets.

MSCI World Small-Cap Index is an unmanaged index of global companies having small market capitalizations.

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