AAM
Insurance Investment Management

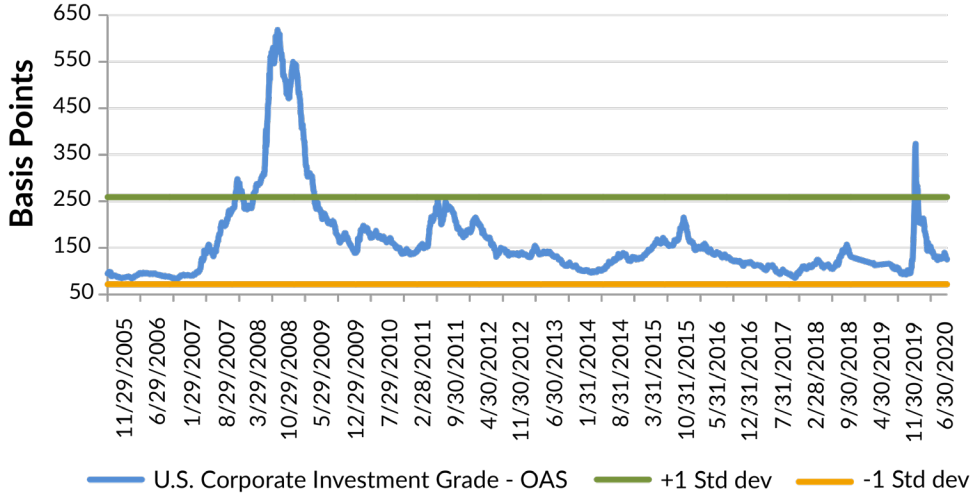
Where is the Value in the Corporate Market?

Elizabeth Henderson, CFA | Director of Corporate Credit and Principal

Market Summary and Outlook

The Investment Grade (IG) Corporate bond market (per Bloomberg Barclays Index) generated modest returns in the third quarter of 2020, with an excess return versus a duration neutral Treasury of 1.1%. The IG market underperformed the S&P Index, which returned 8.4% and High Yield market (per Bloomberg Barclays) at 4.0%. The option adjusted spread (OAS) of the market tightened 17 bps in the third quarter, with cyclical sectors and BBBs generally outperforming.

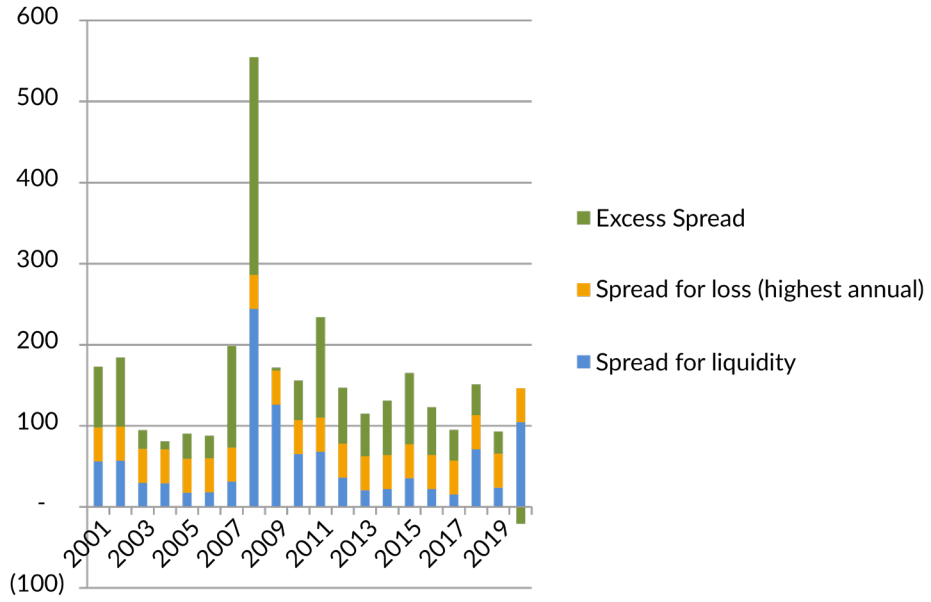
Exhibit 1: Corporate IG OAS - Quick Recovery and Return to Neutral



Source: Bloomberg Barclays Index, AAM

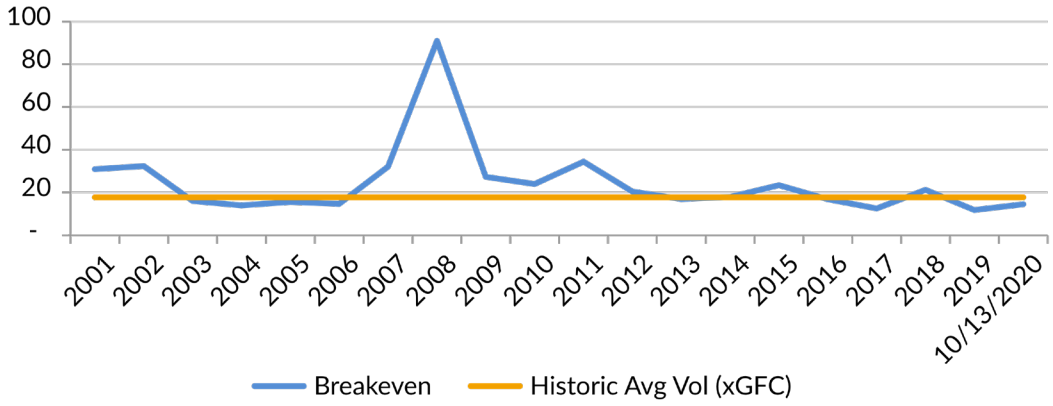
We continue to expect a widely available vaccine in the middle of 2021, with a treatment likely before that time and federal legislation providing additional fiscal stimulus becoming law in early 2021. The Federal Reserve is expected to remain accommodative for some time. Accordingly, we believe a recovery is on the horizon, which is supportive for risk assets. After raising a record level of cash, we believe IG companies have sufficient liquidity to weather a protracted recovery. And, it's highly likely that the Federal Reserve has ample room in its primary and secondary market facilities to support the IG corporate market if market liquidity worsens. In this environment, IG corporate bond spreads should trade in a relatively narrow range, implying a lower level of volatility versus other risk assets, limiting downside risk from a trading/technical perspective. That said, our analysis shows that the average spread of the market is reflecting little to no spread for volatility (Exhibits 2 and 3). This simply causes us to dig deeper to find value in the market. We have done that in sectors that have underperformed and more illiquid parts of the market, as that premium has increased.

Exhibit 2: Composition of IG OAS – An Increased Liquidity Premium Leaves No Room for Volatility



Source: Bloomberg Barclays (OAS, duration), Bloomberg (bid/ask spread medians which is used to measure liquidity premium, by multiplying it vs. duration), Moody's (maximum IG loss rate over time)

Exhibit 3: OAS Breakeven vs. Volatility – OAS Lacks Compensation for Historic Level of Volatility

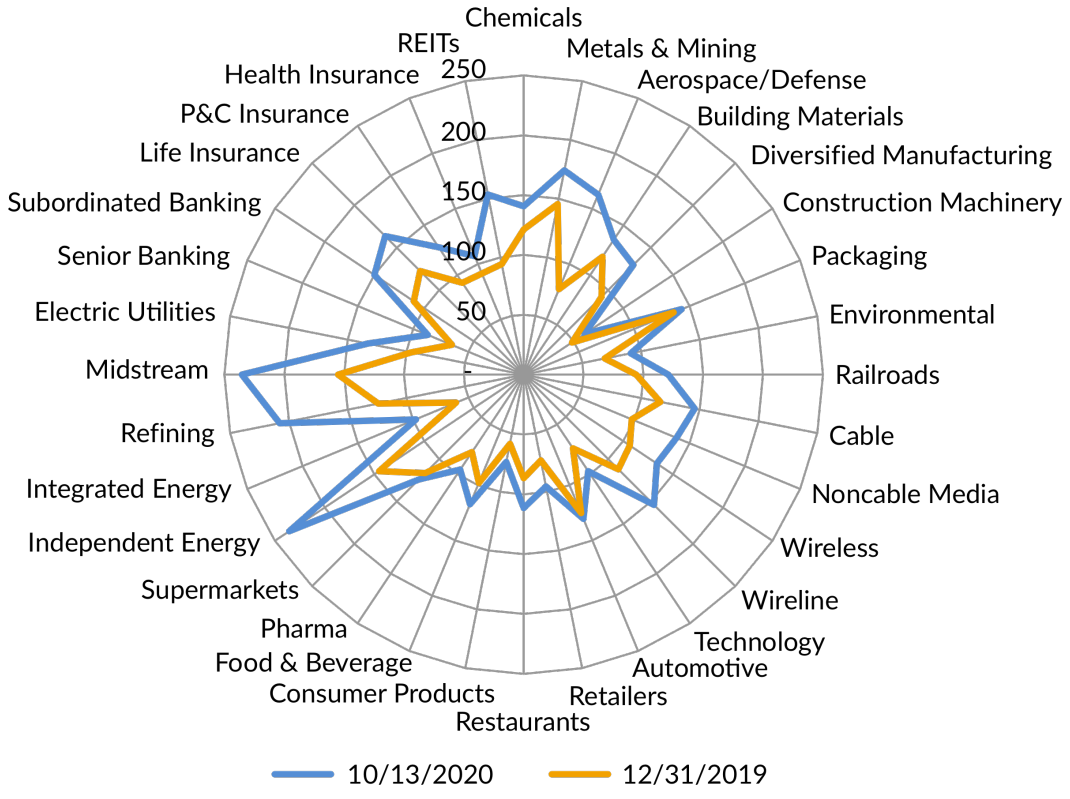


Source: Bloomberg Barclays, AAM (breakeven = OAS/duration); Historic Avg Vol (xGFC) = average annual volatility of OAS since 2000, excluding 2008-2009; Y axis is capped for visual purposes (2008 value is 91)

From a fundamental perspective, credit metrics are expected to remain stressed over the next six months. While second quarter may be the bottom for earnings, we expect last twelve month leverage ratios to continue to deteriorate, as the improvement in EBITDA should be gradual over the next 6-12 months. Our estimate is for EBITDA to return to pre-COVID 19 levels sometime in 2022, as the Capital Goods, Leisure, and Commodities sectors take some time to recover. Importantly, while the rating agencies have been patient over the last few months, we believe they will begin to take action if the recovery disappoints. Approximately $200 billion of the $6 trillion in Corporate bonds in the IG Index have spreads that reflect high yield ratings (AAM Analysis of Bloomberg Barclays Index), of which about half we believe are at risk of falling to HY. To date this year, over $200 billion has fallen out of the IG index (Bloomberg Barclays Index). In summary, we believe the market is pricing downgrade risk fairly rationally today.

As spreads have tightened, we have been selling bonds with unattractive spreads and buying those that provide attractive compensation for liquidity and/or industry risk premiums that we calculate in the near to intermediate term. For example, we have sold bonds in sectors that have been more immune or benefitted in this environment such as Pharmaceuticals, Food and Beverage, Senior Banks and Technology. We have also reduced our exposure to the Healthcare sector given upcoming political risk related to the increasing probability of a Blue Sweep. Conversely, we have added to sectors that we believe offer attractive risk adjusted income opportunities (i.e., Midstream, Refining, Insurance and REITs) as well as adding Private Placements, a market which has become more attractive due to the increased liquidity premiums.

Exhibit 4: Sector OAS Comparison – BBBs and Cyclical Sectors have Wider Spreads Today



Source: Bloomberg Barclays, AAM

Elizabeth Henderson, CFA *is a Principal and the Director of Corporate Credit at AAM with 24 years of investment experience. She is responsible for the Corporate sector, in addition to the analysis of investment grade Telecommunications, Media and Technology credits. Additionally, Elizabeth is a member of AAM's "Outsourced CIO" Committee. Prior to joining AAM, Elizabeth was a Director at Fitch Ratings with responsibility for following public and private telecommunications and media companies. She is a CFA Charterholder as well. Elizabeth graduated with honors from Indiana University with a BS in Finance and earned a MBA in Finance, Analytical Consulting, and Marketing from Northwestern University's Kellogg School of Management.*