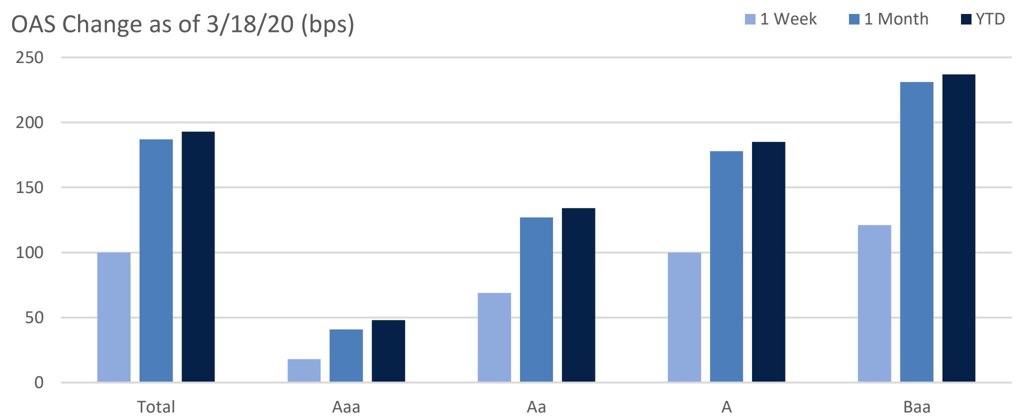
CORONAVIRUS AND THE CORPORATE BOND MARKET

MARCH 20, 2020

Fixed income conditions have significantly deteriorated in recent days as investors try and process growing healthcare and economic concerns. At Appleton, we only invest in investment grade bonds and strongly favor larger, more liquid issuers. Nonetheless, dislocation is widespread and we wanted to address a few common questions while cautioning against unnecessarily selling at current bid levels.

To what extent have corporate spreads widened?

High yield spreads have widened by 417 basis points since the beginning of March, while IG issues have gapped out by 159 basis points. The market is pricing in a recession and associated credit concerns. Rapid spread expansion also reflects an illiquidity shock, as forced selling meets diminished demand.



Source: Bloomberg Barclays US Credit Index

Why are high quality bonds also under pressure?

In extreme risk-off environments, widespread forced selling from mutual funds and other parties into markets lacking buyers can create illiquidity and acute pricing anomalies. Higher quality issues tend to be sold first, as there are few and typically weak bids for less liquid, lower-grade credits.

What are policymakers doing to try and improve credit conditions?

By cutting bank reserve requirements to zero and offering essentially unlimited repo financing, the Federal Reserve ("Fed") is seeking to stem a liquidity crisis. These moves have made it easier for banks to lend and corporations to draw upon credit revolvers without impacting bank balance sheets. Several firms, notably Kraft Foods and ABInBev, promptly did so.

The Fed also reopened its emergency commercial paper funding facility on 3/17 in response to a backup in commercial paper rates. This gives the Fed an ability to step-in and buy USD-denominated commercial paper, a common source of short-term corporate funding, from US issuers.

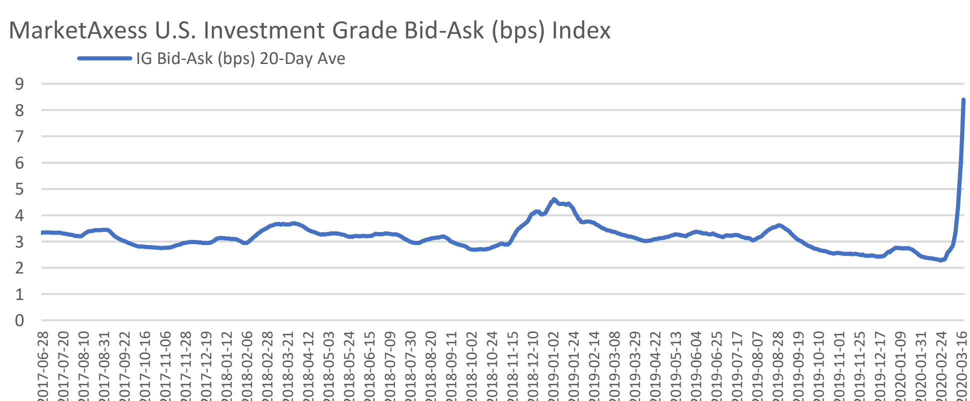
While the intent is to serve as a backstop for private lenders rather than a primary lender, the Fed's presence should help stabilize the commercial paper markets and induce greater confidence.

Is there further downside risk in the Investment Grade corporate market?

There could be although we feel the market has already priced in most of the damage. While we don't buy high yield bonds, we follow this asset class closely for relative value and market sentiment reasons. As of March 18th, Strategas Research reported that high yield spreads were pricing in about an 8% high yield default rate. That's within recession norms, although spreads could widen further if conditions worsen.

What are the risks of selling now?

Selling high quality bonds into this environment does not make sense to us unless a client absolutely needs to do so. IG bid-ask spreads, which have averaged just over 3 bps over the past year, have widened in recent days to more than 8 basis points. This cost of liquidity harms sellers. Broker-dealer balance sheet constraints and extremely poor sentiment have created liquidity ills that can harshly penalize bond sellers across the quality range.



Source: MarketAxess

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How are your energy and financial sector bond holdings doing on a relative basis?

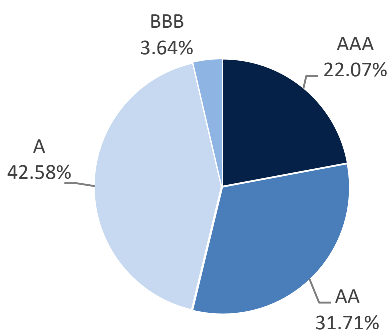
The energy sector is being hit hard due to a coronavirus-related drop in demand and a Saudi-Russian price war. Our exposure is higher quality than the sector at large and is outperforming on a relative basis as a result. While our energy holdings are under some pressure, our high-quality focus is currently being rewarded.

Our financial sector names will see net interest margins squeezed as the curve flattens, although the Fed's move last weekend should help steepen the curve and improve liquidity, both of which may be supportive of credit.

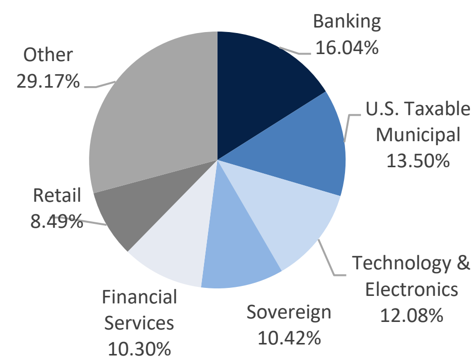
Where do you see potential value among corporate bonds?

Highly strained markets often result in price diverging from value. For example, a significant number of BBB corporate issuers priced this week with extreme concessions that reflect junk bond, not IG risk. We are trying to differentiate issuers that will ultimately retain their credit standing from those likely to fall in quality. With the market largely pricing in a sharp anticipated fall in credit quality, and given today's liquidity constraints, we are finding opportunities to buy good bonds at what we feel are heavily discounted prices.

APPLETON HIGH GRADE INTER. GOV'T/CREDIT STRATEGY CREDIT PROFILE



APPLETON HIGH GRADE INTER. GOV'T/CREDIT STRATEGY SECTOR PROFILE



Composite data and characteristics as of 12.31.19; Source: Appleton Partners, Investortools: Perform, and/or Bloomberg Finance L.P. Evaluations and market averages subject to change based on market conditions. Credit Profile: AAA includes cash and pre-refunded bonds.

Accessibility and communication are important in any environment, although these attributes are especially valuable during uncertain and volatile times. Appleton Partners is committed to sharing our market and portfolio management perspectives as developments unfold. We hope these briefs are helpful and also invite you to reach out to us directly and/or visit www.appletonpartners.com/Insights for additional commentary and insights.

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