Investment Strategy Update

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Investors decide that following the Fed is the best to do

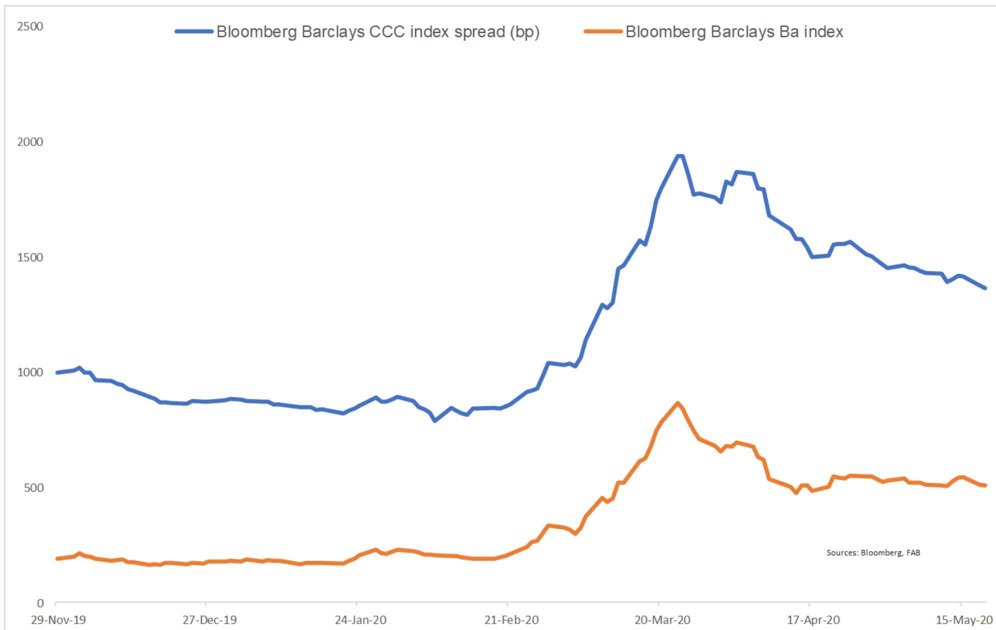
♦ One week into the Fed's high-yield buying program, the average US junk bond yield premium over Treasuries has fallen 24 basis points.

♦ Since 9 April, when the Fed said it would buy junk debt, the average spread has fallen 74 basis points.

♦ Meanwhile, distress has increased in the US, with 99 defaults recorded this year, more than in all of 2019.

♦Even with Fed support, however, investors are seeking higher quality bonds, which are outperforming.

♦ FAB AAC remains underweight in equities and overweight in gold.



"Don't fight the Fed" is an old adage in Wall Street. Perhaps the contemporary version of that would be "follow the Fed." That seems to be the stance investors are taking, with most of the asset classes in which the central bank has intervened directly performing relatively better. Yesterday may have offered a real-time example of that as yield premiums for high -yield bonds dropped even as the stock market fell more than 1%.

Junk bonds and equities tend to be correlated because both of them are used to finance companies that have high growth potential and offer higher risk. However, the Federal Reserve is only buying junk bonds, so investors seem to be piling into them even when they start getting worried about the valuations in the stock market.

Indeed, in many ways, junk bonds have enjoyed an epic rally thanks especially to Fed support. The average yield premium of bonds in the Bloomberg Barclays US Corporate High-Yield index has fallen 74 basis points since 9 April, when the Fed announced its 'Secondary Market Corporate Credit Facility', through which it pledged to buy debt of companies which were recently rated BBB– and fell to junk, as well as junk bond ETFs.

The program only began to be implemented for real on 13 May, a week ago. Since then, the spreads have tightened 24 basis points, but all the other 50 basis points were driven in part by expectations of the Fed intervention in the market. The impact of the program in just a week also suggests the asset class still has some room to rally, even as valuations in the stock market reach extremes and defaults in the US increase.

Since the start of the year, 99 companies defaulted on their debt, 20 more than the 79 that defaulted throughout all of last year, according to Bloomberg data. Fitch

The spreads of junk bonds have fallen a lot but higher quality debt has outperformed

Ratings recently noted that it expects record sovereign defaults among the most indebted countries and that the four defaults which have already happened this year match the total number of such missed payments seen last year.

To be sure, even as investors follow the Fed into junk bonds despite higher defaults, they are doing so cautiously. The average CCC-rated bond in the Bloomberg index continues to pay a premium twice as high as what it did in January. Spreads for these riskier bonds have fallen 30%, while, the premium for Ba bonds, the ones closest to investment grade, have fallen 42%. Quality trumps yield even in the junk world.

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