SEVENS REPORT

Sevens Report Alpha Webinar #121 – Status of the Bond Market

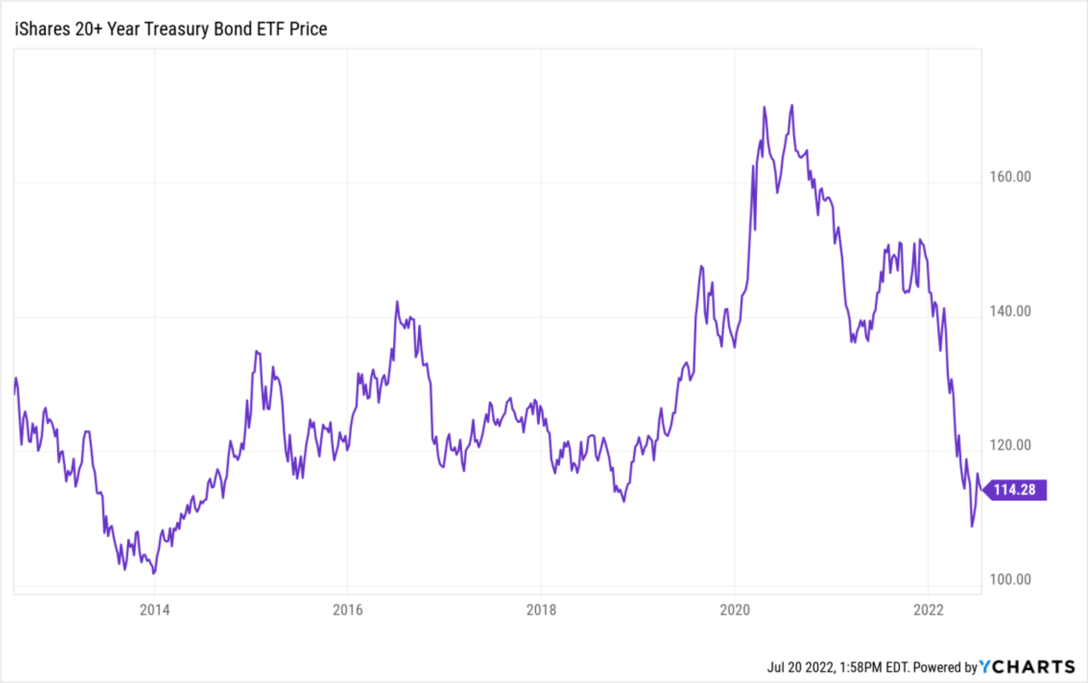
July 21st, 2022

Tom Essaye, President Sevens Report Research

A Historically Bad Year for the Bond Market

- Many major fixed income markets have just finished the worst 1st half performance on record, as multiple parts of the fixed income markets saw double digit declines throughout the first six months of 2022.
- But, those historic declines have now pushed yields on fixed income products to levels we have not seen in years.
- As such, I wanted to provide a comprehensive overview of the fixed income market and cover performance, current yields, risks and opportunities so that investors can potentially seize opportunities in the fixed income space.

Long Dated Treasuries



- TLT (iShares 20+ Year Treasury Bond ETF)
  - Performance: -22.6% YTD.
  - Current 30-Day SEC Yield: 3.07%.
  - Effective Duration: 18 years.
  - Monthly Var: 5.82%.

Long Dated Treasuries

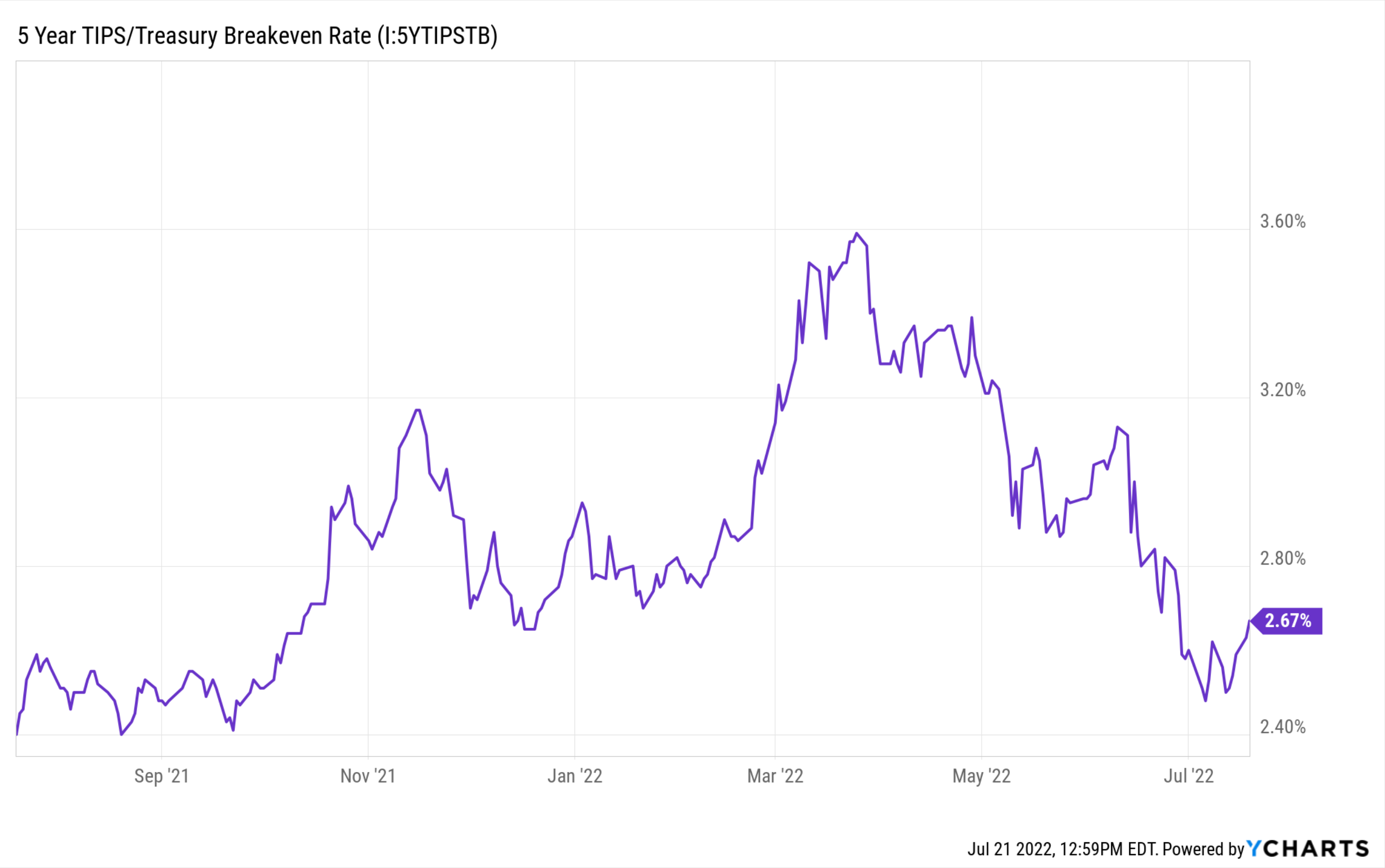
Risks

- Inflation.
  - Key metric to watch: 5-year TIPS/Treasuries break evens.
  - If longer-run inflation expectations move above 3% and towards 4%, that will hurt longer-dated bonds.
  - U.S. government budget concerns.
  - Erosion of the U.S. Dollar as the global reserve currency.

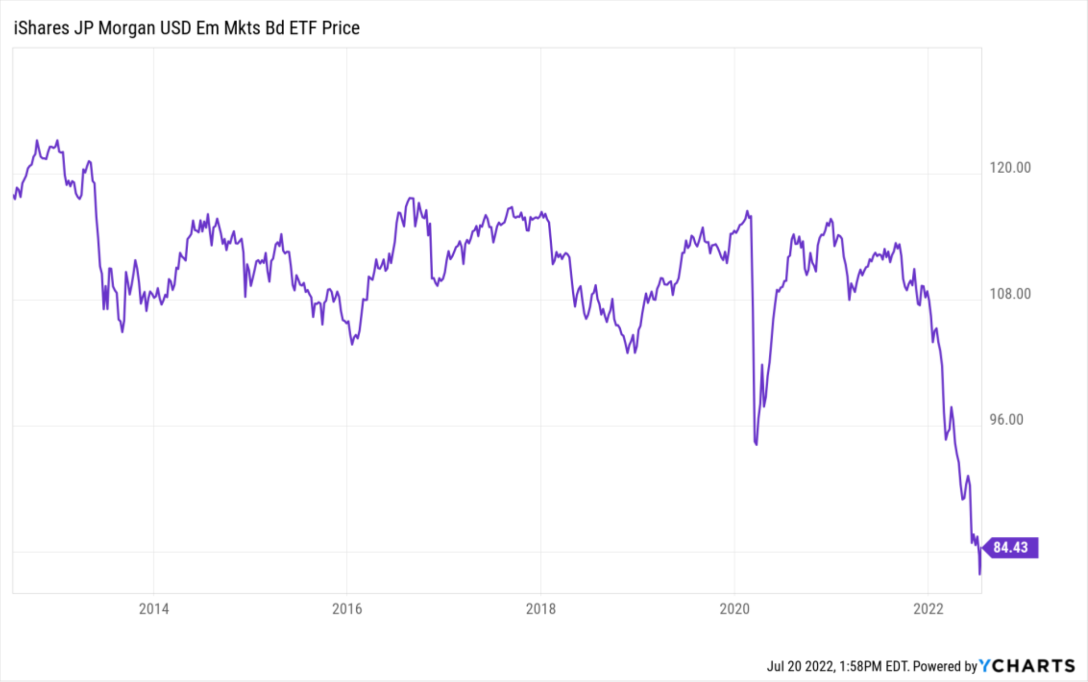
Opportunities

- The yield on TLT is at a multi-year high and fixed income investors can seize a 3.00% risk free yield for the first time in years.
- If the global or U.S. economies enter a recession or economic slowdown, we will see domestic and international capital move into Treasuries the same way they always have and longer dated Treasuries could easily recoup much of the YTD losses.

Long Dated Treasuries



Emerging Market Bonds



- EMB (iShares JP Morgan USD Emerging Markets Bond ETF).
  - Performance: -21.23%.
  - Current 30-Day SEC Yield: 6.15%.
  - Effective Duration: 7 years.
  - Monthly Var: 4.57%.

Emerging Market Bonds

Risks

- Global recession.
- Widespread defaults.
- Continued U.S. dollar strength.
- Chinese economic slowdown.
- Geo-political unrest.

Opportunities

- Sovereign defaults for countries in most EM bond funds are far more rare than is commonly thought – so while Sri Lanka and Russia are in technical default, most EM bond holdings are relatively healthy.
- Potential for a dollar peak.
- If global recession fears are overdone, substantial opportunity for capital appreciation.

Emerging Market Bonds

	Government Bond Yield[1], Latest (%)	5Y CDS Spread[2], Latest (Bps)	Interest Expense[3], 2022 (% GDP)	Government Debt[4], 2022 (% GDP)	Sovereign Debt Vulnerability Ranking[5] (Lower Rank, Higher Risk)
El Salvador	31.8	3,376	4.9	82.6	1
Ghana	17.1	2,071	7.2	84.6	2
Tunisia	32.1	1,200	3.0	87.3	3
Pakistan	16.8	1,492	4.8	71.3	4
Egypt	13.2	368	8.2	94.0	5
Kenya	14.6	1,134	4.4	70.3	6
Argentina	20.7	4,470	1.7	74.4	7
Ukraine	60.4	10,856	2.9	49.0	8
Bahrain	6.6	327	4.5	116.5	9
Namibia	9.4	593	4.2	69.6	10
Brazil	6.0	299	7.2	91.9	11
Angola	12.0	834	4.0	57.9	12
Senegal	10.2	602	2.1	75.3	13
Rwanda	8.9	567	2.5	72.0	14
South Africa	7.3	315	4.7	70.2	15
Costa Rica	7.6	294	5.2	69.4	16
Gabon	11.7	873	2.4	57.4	17
Morocco	7.3	330	2.4	77.1	18
Ecuador	13.3	1,006	1.3	62.2	19
Turkey	10.1	839	3.0	43.7	20
Dominican Rep.	7.9	450	2.9	59.4	21
Ethiopia	33.9	3,035	1.1	48.3	22
Colombia	7.3	297	2.9	60.6	23
Nigeria	12.8	990	2.3	37.4	24
Mexico	5.5	178	4.5	58.4	25

	Government Bond Yield[1], Latest (%)	5Y CDS Spread[2], Latest (Bps)	Interest Expense[3], 2022 (% GDP)	Gross Government Debt[4], 2022 (% GDP)	Sovereign Debt Vulnerability Ranking[5] (Lower Score, Higher Risk)
Cote D'Ivoire	9.1	539	2.0	51.8	26
Serbia	6.2	318	1.7	55.6	27
Hungary	4.8	175	1.6	75.9	28
Uruguay	4.6	133	2.4	65.7	29
Romania	6.1	292	1.6	56.0	30
Iraq	8.0	667	0.7	35.0	31
Panama	5.2	137	2.2	56.0	32
Oman	6.4	287	1.5	44.0	33
Indonesia	4.8	145	2.6	42.7	34
Philippines	4.6	130	2.1	60.0	35
Croatia	3.8	115	1.3	78.1	36
Israel	4.2	55	2.3	67.1	37
Guatemala	6.5	264	1.7	30.6	38
Malaysia	3.7	105	2.2	69.3	39
China	3.1	86	1.0	77.8	40
Vietnam	4.9	162	1.0	41.3	41
Peru	5.0	127	1.3	34.4	42
Poland	3.8	117	1.3	53.3	43
Qatar	4.1	71	1.4	46.0	44
Kazakhstan	4.6	248	-0.2	27.6	45
Chile	4.7	116	0.4	38.3	46
South Korea	3.4	54	-0.3	52.0	47
UAE	4.1	70	0.7	31.7	48
Saudi Arabia	4.2	72	0.3	24.1	49
Kuwait	3.4	76	-11.0	12.3	50

Methodology: [1]Weighted-average yield to maturity of the country's dollar bonds included in the Bloomberg Emerging Markets Sovereign TR Index. See **BSSUTRUU Index** and explore on **PORT<GO>**. [2]Latest five-year credit default swap spread. See **SOVR<GO>**. [3]Difference between the primary and overall budget balances, as projected by the International Monetary Fund. [4]Gross general government debt, as projected by the IMF. Interest and debt figures for Ukraine and Ecuador reflect 2021 estimates. [5]Composite rank is drawn from the average ranking across the four indicators. In a tie, the country with the wider CDS spread receives the lower rank.

Bloomberg, CMA, International Monetary Fund

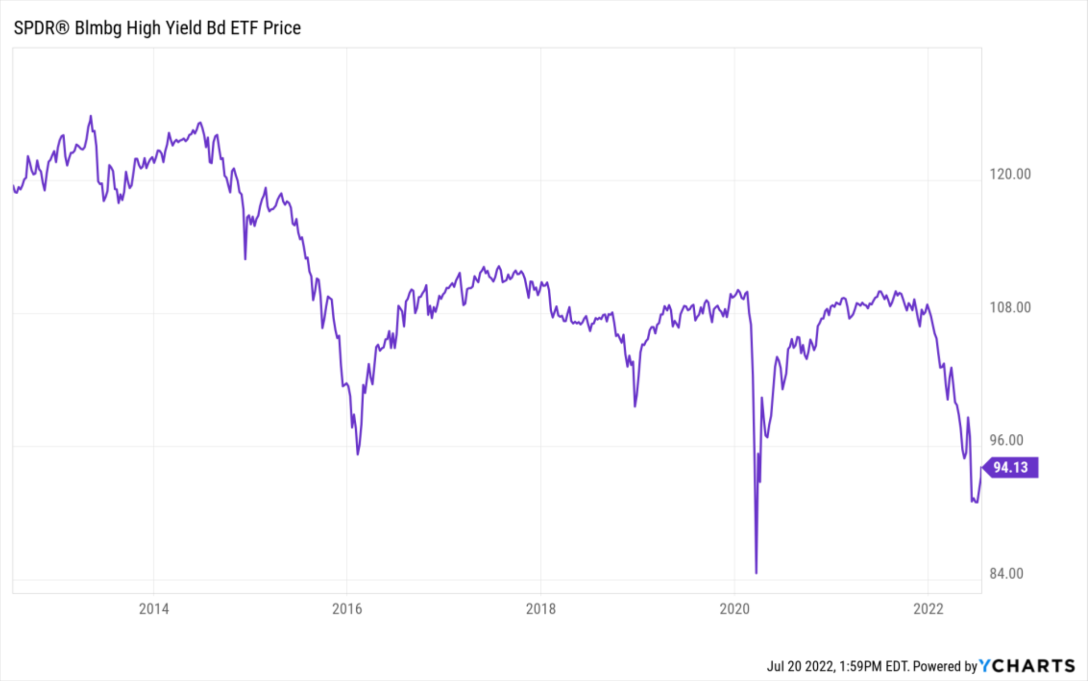
Top 10 bond funds with largest Russia exposure

Ticker	Name	% of portfolio
LAOSX	Western Asset Macro Opportunities IS	8.4%
PELBX	PIMCO Emerging Markets Local Currency and Bond Fund Institutional	7.8%
EBNAX	American Funds Emerging Markets Bond A	6.5%
PRELX	T. Rowe Price Emerging Markets Local Currency Bond Fund	6.1%
AEXDX	American Century Emerging Markets Debt R6	6.1%
PFSIX	PIMCO Emerging Markets Full Spectrum Bond Institutional	5.9%
WAARX	Western Asset Total Return Unconstrained Fund I	5.6%
FSEDX	Fidelity Series Emerging Markets Debt Local Currency Fund	4.7%
SITEX	SEI Emerging Markets Debt F (SIT)	4.6%
SEDAX	SEI Emerging Markets Debt A (SIIT)	4.5%

Note: Includes top U.S.-domiciled open-end mutual funds and exchange-traded funds in terms of USD exposure to Russian fixed-income as of 12/31/2021 and 1/31/2022, depending on the latest available holdings data. Funds are represented by their oldest share class.

Source: Morningstar Direct

High Yield (Junk) Bonds



- JNK (SPDR Bloomberg High Yield Bond ETF).
  - Performance: -11.9%
  - Current 30-Day SEC Yield: 8.18%.
  - Effective Duration: 4 years
  - Monthly Var: 3.04%

High Yield (Junk) Bonds

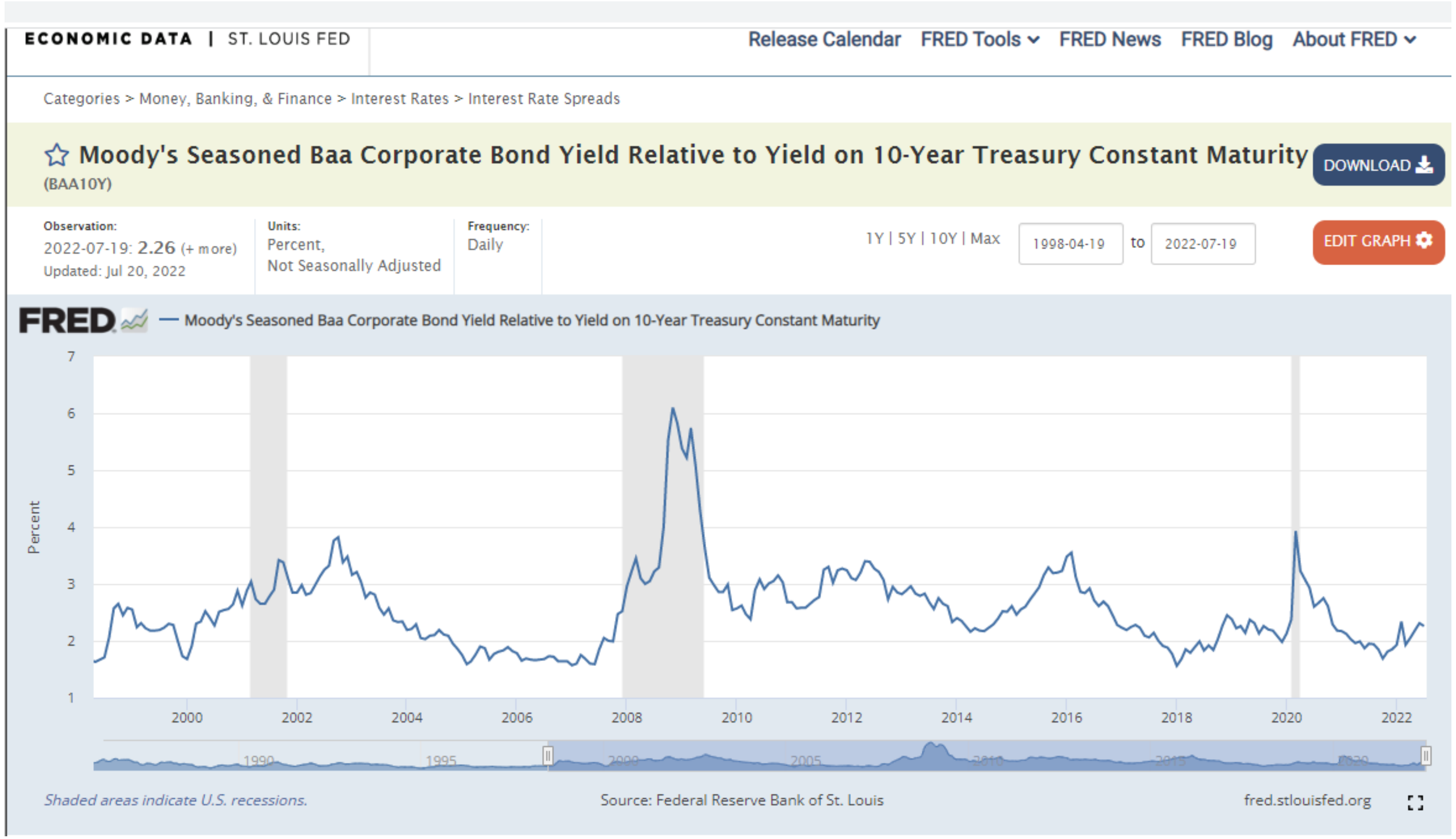
Risks

- Earnings drop
- Recession fears
- Continuation of general "Risk Off" investor behavior.

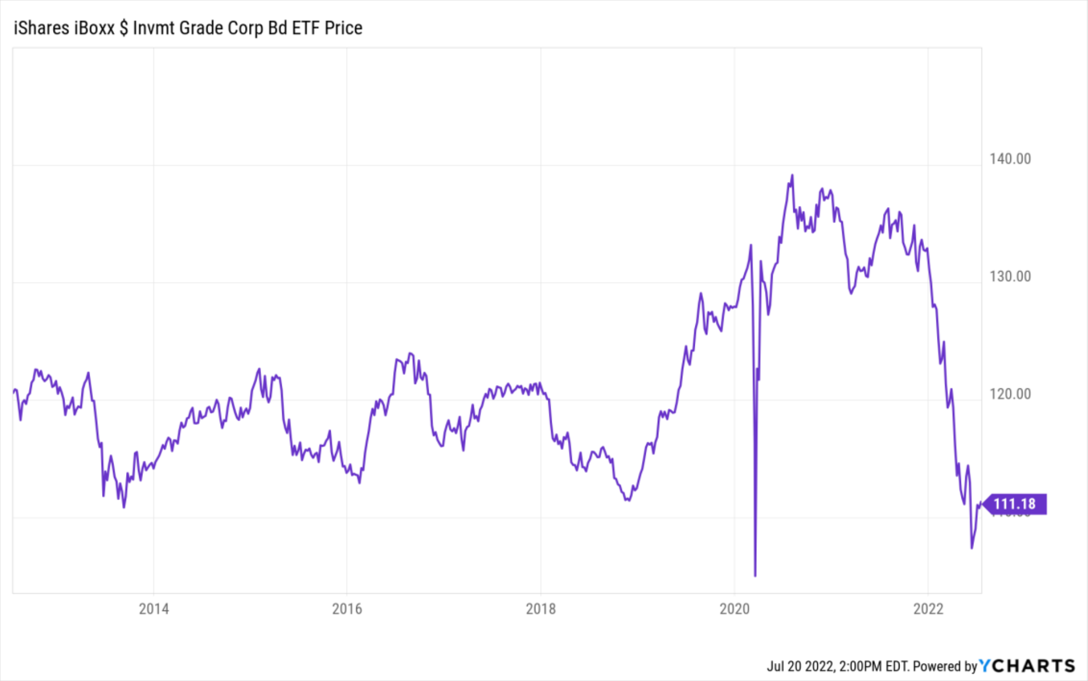
Opportunities

- Corporations remain very strong from a liquidity and capital standpoint, much stronger than in previous bear markets.
- If the earnings decline and any economic downturn is shallow (as many predict) then junk debt will bounce back hard.

High Yield (Junk) Bonds



Investment Grade Bonds



- LQD (iShares iBoxx Investment Grade Corporate Bond ETF).
  - Performance: -14.84%
  - Current 30-Day SEC Yield: 4.30%.
  - Effective Duration: 9 years
  - Monthly Var: 3.82%

Investment Grade Bonds

Risks

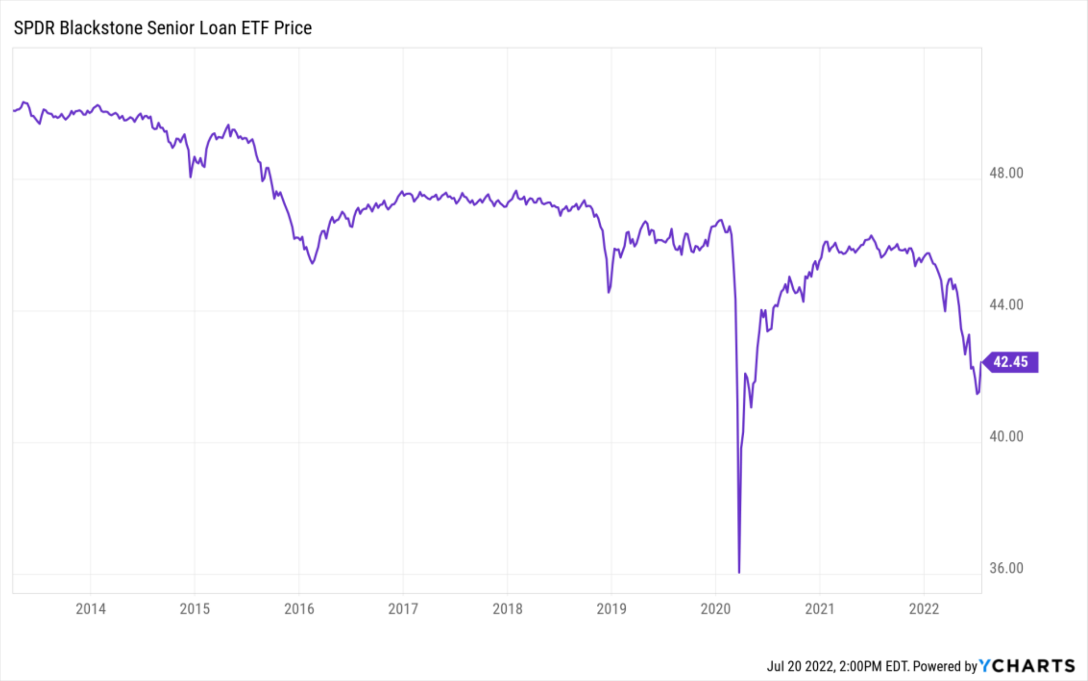
- Re-ratings.
- If we see a material decline in earnings (well below the current $210-$230 range) then that will likely be followed by a re-rating of many investment grade bonds to junk.

Opportunities

- Corporate cash on hand is near record levels.
- Corporate balance sheets are very strong.
- There isn’t the leverage or over-extension that we saw during the last two bear markets.

Investment Grade Bonds

Senior Loans



- SRLN (SPDR Blackstone Senior Loan ETF)
  - Performance: -4.90%
  - Current 30-Day SEC Yield: 4.93%.
  - Effective Duration: Two months
  - Monthly Var: 2.37%

Senior Loans

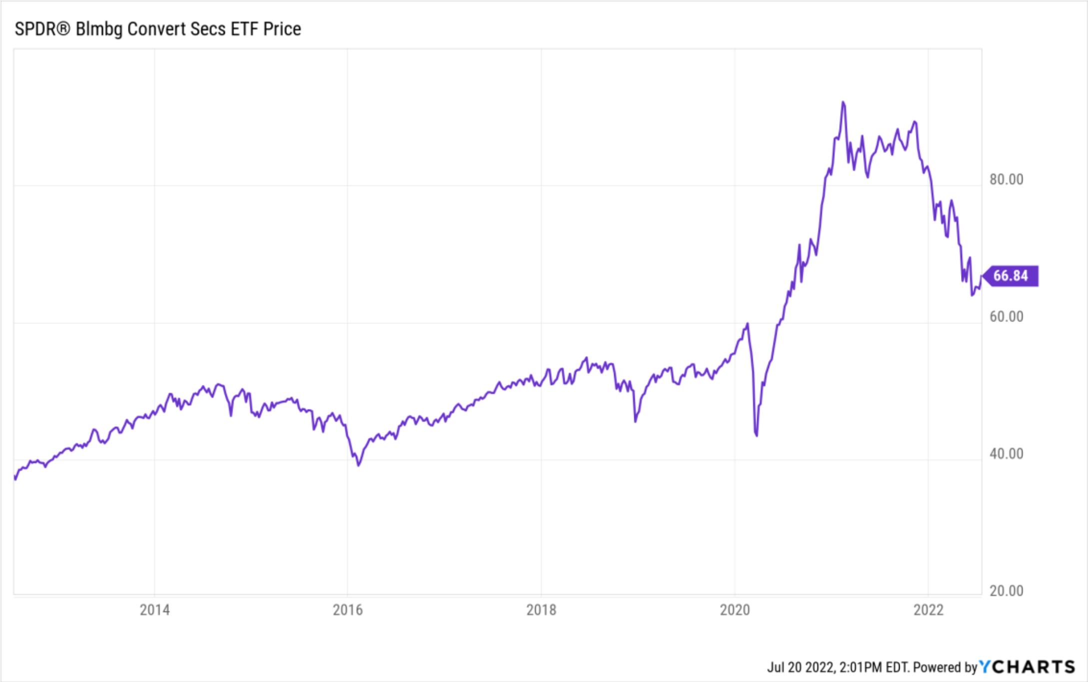
Risks

- Falling short-term rates
    - Senior loans are revolving and re-set every few months. If there is a sustained decline in short-term rates (i.e. Fed blinks) then yields on senior loans will fall.
- Significant corporate stress (less risk than junk debt but more than investment grade).

Opportunities

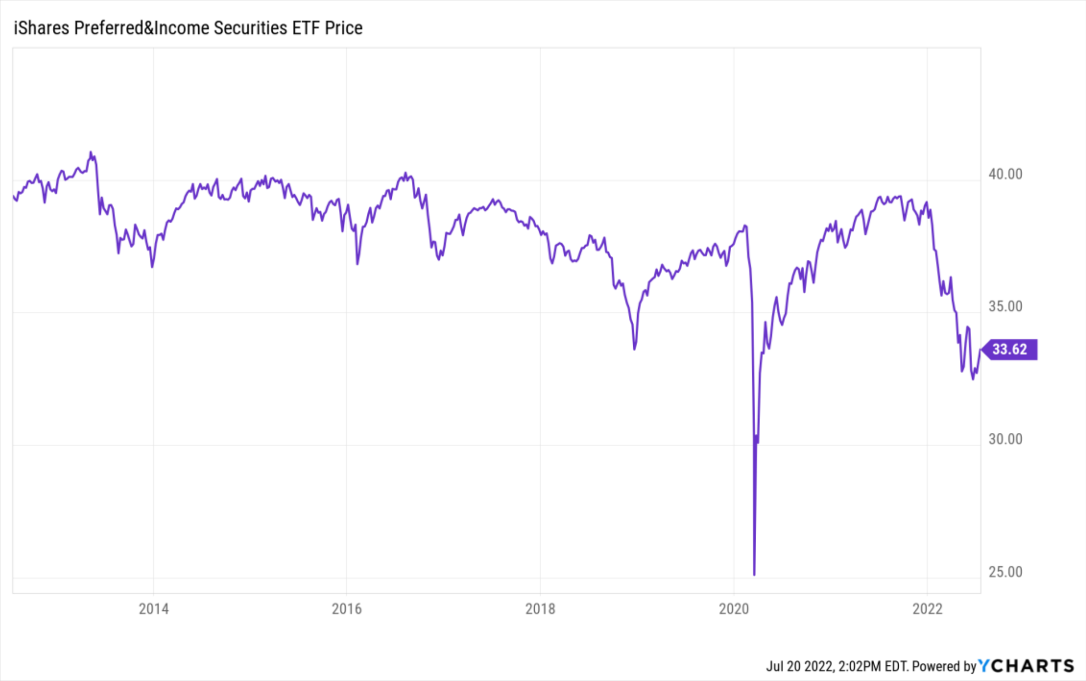
- Again, companies have record cash on hand.
- Short term interest rates will likely continue to rise, increasing yields on revolving short-term debt.
- Senior loans are often collateralized by physical assets, and in inflationary periods that reduces risk.

Convertible Bonds



- CWB SPDR Bloomberg Convertible Securities ETF
  - Performance: -19.53%
  - Current 30-Day SEC Yield: 4.58%.
  - Effective Duration: Two years.
  - Monthly Var: 7.42%

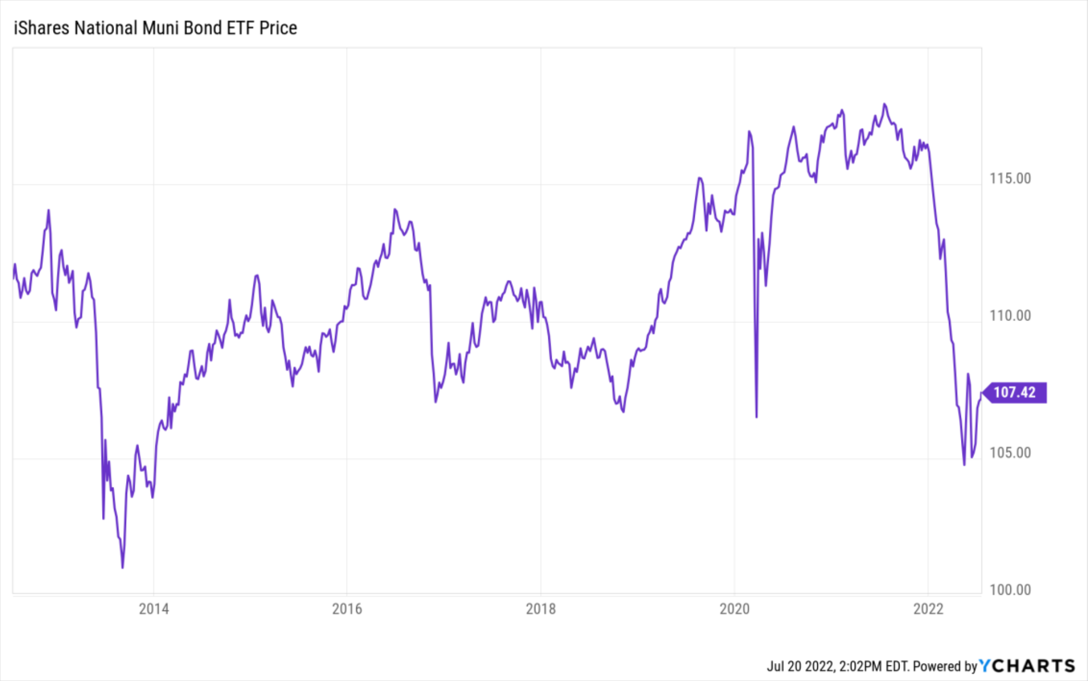
Preferred Stocks



- PFF iShares Preferred & Income Securities ETF.
  - Performance: -13.25%
  - Current 30-Day SEC Yield: 5.11%.
  - Effective Duration: N/A
  - Monthly Var: 4.45%

SEVENS REPORT

Municipal Bonds



- MUB (iShares National Muni Bond ETF).
  - Performance: -6.96%
  - Current 30-Day SEC Yield: 2.79%.
  - Effective Duration: Six years.
  - Monthly Var: 2.25%

Municipal Bonds

Risks

- Defaults
  - As the economy slows select municipal bonds, including those focused on industrial projects and other industry-specific projects (nursing homes, etc.) could see an increase in default risks.
- Higher inflation.

Opportunities

- State and municipalities are flush with cash.
- According to Nuveen, state rainy day funds recently reached a higher of $132 billion.
- State and local tax collections increased 22% in 2021 vs. 2020 and are 20% above 2019.
- Funding from the various stimulus plans helped keep local budget increases muted.

Municipal Bonds

Year		Treasury	Municipal (AAA)	Municipal (A)	Municipal TEY* (AAA)	Municipal TEY* (A)	Muni (AAA)/Tsy Ratio	Muni TEY* (AAA)/Tsy Ratio
1	2023	3.12	1.45	1.87	2.45	3.16	46%	78%
2	2024	3.13	1.73	2.16	2.92	3.65	55%	93%
5	2027	3.05	2.02	2.52	3.42	4.26	66%	112%
10	2032	2.93	2.49	2.99	4.20	5.06	85%	143%
20	2042	3.34	2.83	3.36	4.79	5.68	85%	143%
30	2052	3.10	2.99	3.52	5.06	5.95	97%	163%

**Taxable equivalent yield @ 40.8% tax rate*

Source: Raymond James Municipal Bond Investor Weekly

Takeaways

- Inflation remains the key primary variable. If inflation is peaking and we see a sustained decline, then fixed income is attractive here.
  - Key point – inflation just can't peak. It has to peak and decline, because if inflation levels off between 3% and 4% that'll hurt bonds going forward.
- If rates have peaked and we are entering a slowdown, the long end of the curve is attractive over the short end (more yield, higher demand).
- The intensity of the slowdown matters. If the slowdown is brief, that will be bullish for riskier debt: Emerging market debt, Junk debt, Senior Loans.
- If the slowdown is intense, then Treasuries remain the best place to hide.
- Select muni bonds are offering very attractive tax equivalent yields. As long as any slowdown isn't too intense, these are also attractive.