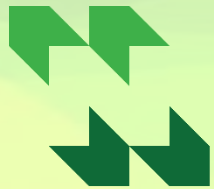

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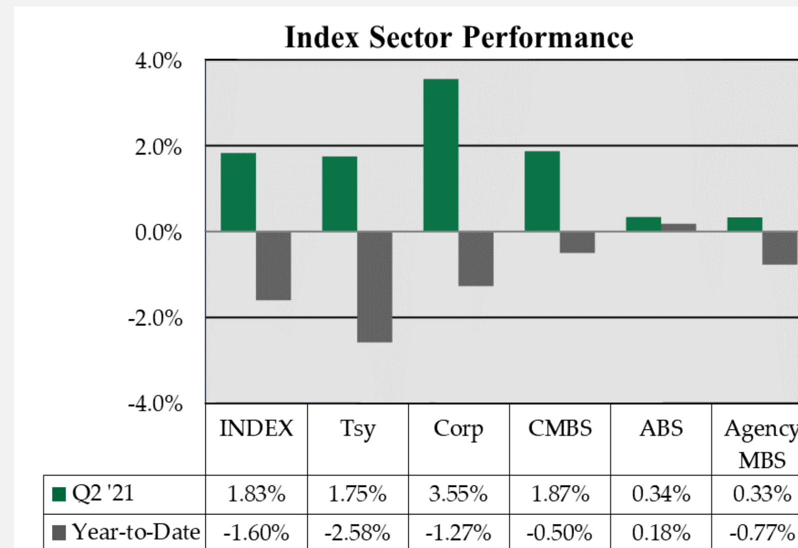
SECOND QUARTER 2021 *INVESTMENT REVIEW*

FIXED INCOME OVERVIEW

The bond market was a somewhat boring place to be during the second quarter as a mixed bag of economic news, muted job trends, tight credit spreads, and a range-bound but flattening Treasury market resulted in positive returns for the quarter. The benchmark 10-yr Treasury started the quarter at 1.74% and finished June at 1.47%, so there appears to be enough believers that rates will stay low awhile longer. Treasuries and CMBS performed in line with the Bloomberg Barclays Aggregate Index, which was up 1.83%. Corporate debt performed very well, finishing over 3.5%, while ABS and fixed-rate MBS posted returns in the 0.3% range. The Bloomberg Barclays Intermediate Government/Credit Index finished at 0.98% for the quarter while some shorter duration indices were essentially flat.



	INDEX	Tsy	Corp	CMBS	ABS	Agency MBS
Q2 '21	1.83%	1.75%	3.55%	1.87%	0.34%	0.33%
Year-to-Date	-1.60%	-2.58%	-1.27%	-0.50%	0.18%	-0.77%

Source: Bloomberg

CREDIT SPREADS

Investment grade corporate credit spreads (green line) tightened about 10 basis points during the second quarter to close at 81bps, as the bid for spread remained strong. The move in high yield spreads (blue line) was more dramatic as strong money flows pushed spreads approximately 35 bps tighter to record low yields for the asset class. (Cont.)

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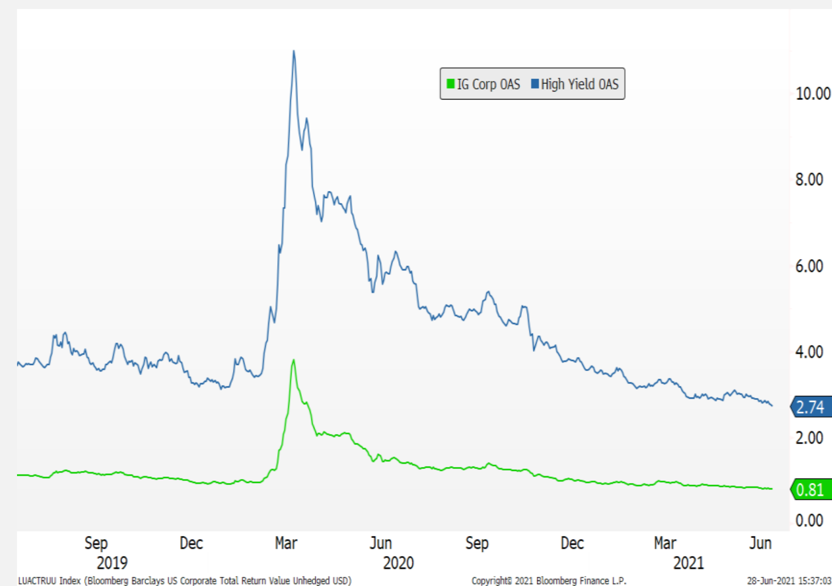
CREDIT SPREADS

(Cont.) Our portfolios once again welcomed this general trend tighter, as many of our sectors performed well in this environment (corporates, munis, CMBS). Although markets are trading at relatively tight levels, we are still finding a few reasonable values and are looking to trade up in quality and liquidity when possible and thankfully, the market has remained conducive to this objective.

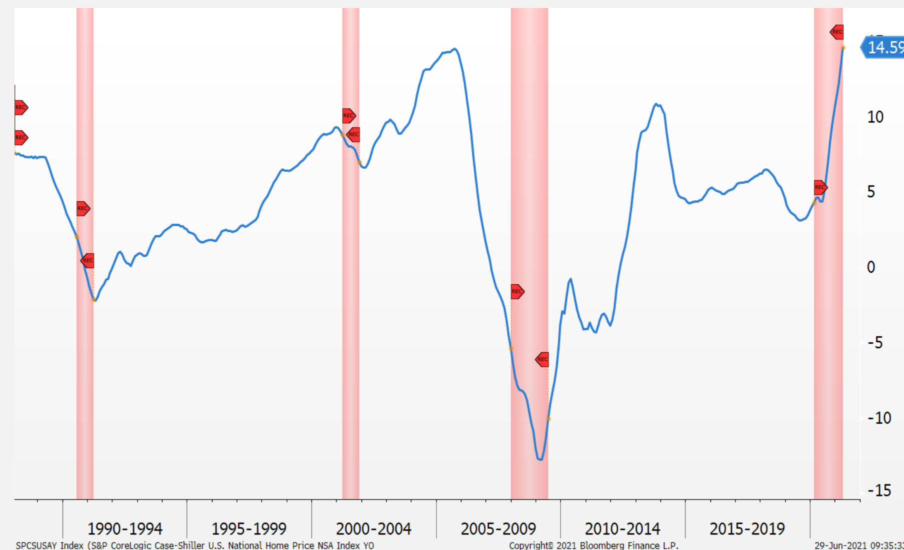


Source: Bloomberg

THE ECONOMY

As the reopening of the U.S. economy unfolds, we note that low mortgage rates and demand for properties away from city centers are fueling gains for the U.S. housing market. The S&P CoreLogic GCase-Shiller National Home Price index rose 14.6% from a year ago, its largest gain in over 30 years. So much for home prices going down during recessions.

It certainly appears as though home prices could remain elevated as economists at Zillow Group, Inc. point to a relatively small inventory of available homes for sale given the demand, while builders point to high material prices, supply shortages and a lack of workers. It is not only homebuilding that wrestles with these dynamics, as many businesses seek workers and wrestle with higher costs. Speaking of workers, the employment market seems to be lagging and this has Federal Reserve Governors as well as many politicians a bit stumped.

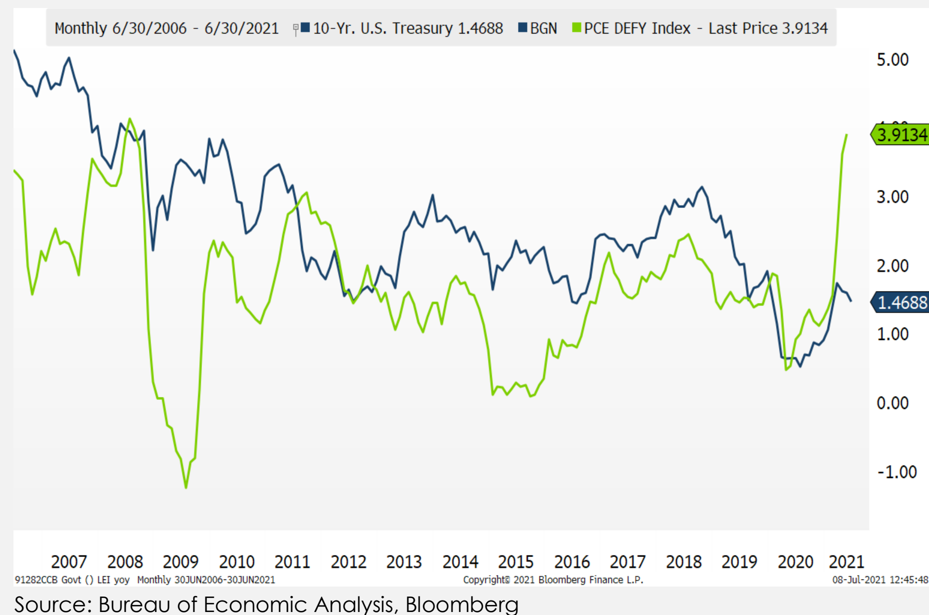


Source: S&P Core Logic, Zillow, Bloomberg

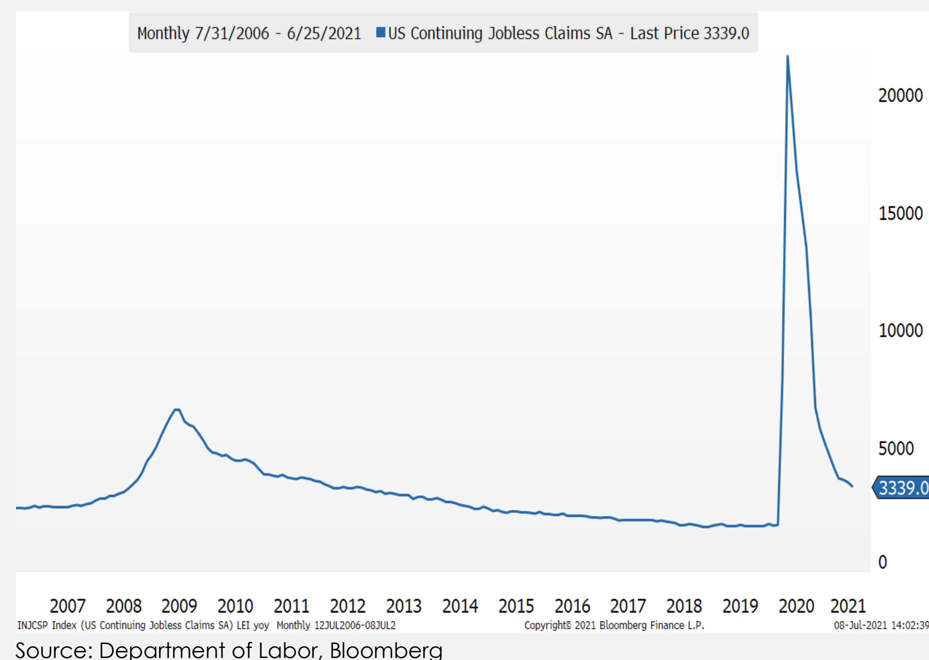
FISCAL AND MONETARY POLICY

The much-anticipated June FOMC meeting delivered a somewhat hawkish surprise with median projections for two hikes in 2023. Part of the Fed taper will also include an unwinding of their $14bn corporate credit portfolio. Our team does not see this as much of a disruption as there have been a few corporations that recently brought new deals which were larger in scale than the entire Fed credit portfolio! We mention this not to diminish what the Fed has done, but that the unwind should be a sign that the Fed is confident in the recovery. Powell and the Fed however, managed to appease the markets by sticking with the transitory inflation theme as their projections for 2022 inflation moved from 2.0% to only 2.1%. With the Personal Consumption Expenditure deflators currently at 3.9% year-over-year, it is no wonder that some are questioning the interest rate and inflation disconnect.

The Federal Reserve might have a tough time pleasing everyone as they deftly attempt to balance inflationary pressures with a transitioning labor market as workers seem slow to fill job openings and retirements have been on the rise. Fed Chair Powell's recent trip to Capitol Hill highlighted how politicians seek answers from just about everyone but themselves and it is here where things get tricky. President Biden has agreed to a relatively small $1.2 trillion bipartisan Senate infrastructure proposal, but odds of it passing, if linked to a separate and larger Spending Bill, are less certain. At stake are American jobs that would create demand in many industries including construction, manufacturing, transportation, and distribution to name a few. Given that there is usually a multiplier involved with job creation, the potential scope looks to be impactful and cannot come soon enough for many.



Source: Bureau of Economic Analysis, Bloomberg



Source: Department of Labor, Bloomberg

THIRD QUARTER 2021 STRATEGY

The fixed income market finds itself at a rather precarious spot as most sector spread levels are at multi-year tights while at the same time, the U.S. Treasury market has put on a bit of a rally. It is possible that something will need to give in the back half of the year and we are proceeding with some caution and remain underweight duration across mandates.

Within the corporate arena, we have reduced some industrial exposure and shortened duration positioning in some tight trading credits. Following bank earnings in mid-April, we saw record size issuance from several of the money center banks and added in this area only to unwind and shorten some of our exposure. Spreads have tightened but overall bank paper continues to look attractive and we remain overweight in this sector.

Our structured team is also taking the bottom up approach and have used market strength to upgrade overall portfolio quality and liquidity since the cost to do so has been relatively small. Within CMBS, it seems as if Single Asset Single Borrower (SASB) paper is cheap to conduit deals. One deal we like is BX 2019-OC11, which is secured by the Bellagio in Las Vegas. The AAA class, one of our largest SASB positions, has come in a long way since we began buying a year ago at 100+ bps wide to conduit last cash flows. The basis is now 15 bps, and we expect this will compress further as Las Vegas reopens and travel continues to pick up. In esoteric ABS, we like certain whole business names to which we have added. Private student loans were also a favorite, but spreads have come in and with the recent rate moves we will likely look to sell at premium dollar prices where we are concerned about a pickup in prepay speeds.

Mark R. Anderson, CFA

Chief Strategy Officer

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