DuPont Capital

Fixed Income Market Review and Outlook

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Market Overview

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In 1965, Frank Sinatra released the hit song "It Was a Very Good Year." I looked back and found that 1965 was a good year for the stock market as the S&P returned +12.5%. Well, the record label should have released it again this past year because 2019 will go down as a terrific year for investors. Equity returns were fantastic and bond returns were also surprisingly strong, particularly given the low level of interest rates at the beginning of the year. The S&P was up over 31.5% and the Bloomberg/Barclays Aggregate returned 8.7%. It is uncommon that a 50%/50% blend of stocks and bonds produces a return close to 20%. These great returns came despite political turmoil and/or new administrations in numerous countries, weak growth in Europe and Japan, a significant increase in oil prices, no resolution to Brexit, impeachment proceedings against President Trump, drone strikes on Saudi Arabian oil facilities, and the trade wars between the U.S. and China, Europe, Canada, and Mexico. The list of potential speedbumps goes on and on, but so did the rally in stocks and bonds.

Overshadowing all of the issues mentioned above were the easier monetary policies that are pervasive across most of the globe. The U.S. reversed course early in 2019 -- from the tightening monetary policy of 2017 and 2018 -- by easing several times in 2019. The Federal Reserve cut rates three times last year, including one move in the 4th quarter. Economic growth was positive, but not too strong; easier monetary policy, low inflation, and decent corporate profits combined to make a "Goldilocks" scenario for financial markets. 2019 was definitely a very good year.

In fixed income, returns for all asset classes were strong for the year, but Treasuries stumbled late in the year to pull down overall investment grade returns. For the 4th quarter, the Bloomberg/Barclay's Capital Aggregate Index returned 0.2%. Treasury returns were negative in the quarter, breaking a string of four straight quarters of returns over +2%. Mortgages and Agencies managed small positive returns of less than 1%. Corporate bonds provided the highest return within investment grade fixed income with a quarterly return of 1.2%. This capped a stellar year for investment grade corporates with a return of 14.5% for all of 2019. High yield and emerging markets debt were the highest performers in fixed income for the quarter.

The following tables show the returns for the various fixed income sectors and rating categories for the 4th quarter and for all of 2019:

Sector	4th Quarter 2019 Return*	2019 Return*
U.S. Treasuries	-0.79%	6.86%
MBS	0.63%	6.44%
Inv. Grade Corporates	1.18%	14.54%
High Yield	2.61%	14.32%
Emerging Markets Debt	1.81%	15.04%
EMD — Local	5.20%	13.47%

Credit Rating	4th Quarter 2019 Return*	2019 Return*
AAA	-0.18%	6.67%
AA	-0.04%	9.51%
A	0.72%	12.99%
BBB	1.69%	16.44%
BB	2.45%	15.51%
B	2.61%	14.80%
CCC	3.74%	9.52%

* Returns are from Bloomberg Barclays' indices except Emerging Markets Debt, which is from JP Morgan. All figures are as of 12/31/2019.

U.S. Treasuries

The Federal Reserve cut the Federal Funds Rate once in the 4th quarter, moving the rate from 1.75% - 2.00% to 1.50% - 1.75%. This occurred in October and was the 3rd and final cut of the year. The Fed stated in December that it expects to keep the Funds Rate at current levels for the near future. Treasury yields rose for intermediate and longer maturities in the 4th quarter. Yields for 2-year maturities and shorter declined slightly. Despite the increase in most Treasury yields, the ten-year yield is still significantly below where it was in November of 2018 when yields peaked. On November 8, 2018, the 10-year Treasury closed at 3.24%. At the end of 2019, the yield stood at 1.92%, a decline of 132 bps. For the 4th quarter, the two-year Treasury declined by 5 bps while the yield of the five-year, ten-year, and thirty-year Treasuries rose by 14, 24 and 27 bps, respectively. For all of 2019, the two-year declined 90 bps and the ten-year by 77 bps.

Spread Products

Spreads were much tighter across the various credit sectors during the quarter as investors continued to look for yield and take on more risk. Investment grade corporates, high yield, and EMD posted positive returns due to a combination of the spread tightening and coupon income. Spreads are now very close to the tight levels of the end of 2017. Below is a table that shows spreads for investment grade corporates, high yield, and EMD as of year-end 2016, 2017, 2018, and the end of the third quarter and year-end of 2019 :

Sector	12/31/2016	12/31/2017	12/31/2018	9/30/2019	12/31/2019
Investment Grade Corporates	+127	+96	+154	+117	+96
High Yield	+442	+364	+541	+402	+357
Emerging Markets Debt	+342	+285	+415	+337	+291

* Spread data are from the Bloomberg/Barclays U.S. Corporate Index for IG Corporates, Bloomberg/Barclays U.S. High Yield Index for high yield and from the JP Morgan EMBI Global Diversified Index for Emerging Markets Debt.

Investment grade corporates tightened by 21 bps during the quarter and were 58 bps tighter for the year. Financials outperformed industrials and utilities, while longer duration corporates had slightly higher returns than shorter duration corporates. New corporate issuance was moderate in the 4th quarter. For all of 2019, investment grade corporate issuance was $1.1 trillion, which is down 3% from 2018. This was the lowest total since 2014. In mortgages, Commercial Mortgages (CMBS) underperformed fixed rate pass-through mortgages and Asset-backed Securities (ABS). Mortgages greatly underperformed corporates in 2019 and slightly underperformed Treasuries.

High yield performed well in the 4th quarter, and outpaced higher rated corporates due to the combination of significant spread tightening and rising interest rates. Lower rated high yield greatly outperformed higher quality, with CCC's returning +3.7% as compared to +2.5% for BB-rated bonds. The average high yield security rose 1½ points to $101.2. High yield spreads tightened 45 bps from 402 to 357 over Treasuries. For the year, spreads have tightened 184 bps, recovering all of the widening from the 4th quarter of 2018. The current spread for high yield is much tighter than the long-term average of 500 to 525. The yield-to-worst declined by 46 bps to 5.19%, due to the tighter spreads. Default activity increased slightly during the quarter from 2.5% to 2.6%. However, the current level is much higher than earlier in the year when it briefly was at 0.9%. The increase is concerning but still lower than the historical average of 3.5%. We believe defaults should stay below this level as long as U.S. economic growth remains close to 2% and commodity prices do not decline significantly. Oil prices are important to monitor since over 11% of the high yield universe is composed of energy-related companies. Recovery rates are only at 26%, which is well below long-term averages.

U.S. Dollar Emerging Markets Debt performed very well with spreads tightening by 46 bps for the quarter to close at 291 over Treasuries. Local currency EMD performed even better and was the highest returning fixed income asset class, rebounding from poor performance last quarter. U.S. Dollar EMD returned +1.8% while EMD local currency bonds rose +5.2%. Stable global economic growth and progress on the trade war helped EMD, outweighing continued problems in Lebanon and Venezuela. Yields for U.S. Dollar EMD fell by 22 basis points to 4.93%.

The Economy

Fourth quarter U.S. economic growth continued to be moderate with consumers continuing to spend and with a healthier housing market. Overall, growth remained firmly in positive territory, but still below the first quarter of this year. The first official estimate of GDP growth for the 4th quarter will be released on January 30. The Federal Reserve Bank of Atlanta's GDPNow model, a running estimate of growth during the quarter, was projecting +2.3% growth as of January 3. The final number could change significantly before the first official number is released, and most estimates are in the range of 1.5% to 2.5%. This would be similar to the growth rates of the last two quarters, which were 2.0% and 2.1%.

Retail sales bounced back later in the quarter after a slow September. Overall, retail sales were -0.4%, +0.4% and +0.2%, respectively, in September, October, and November. Year-over-year retail sales were up 3.3%, which is lower than last quarter but still healthy. Consumer Confidence remains reasonably high due to the strong labor market. The Universe of Michigan's consumer sentiment index moved to 99.3 in December, the highest reading since May. The housing market data remained strong as housing starts and new home sales showed gains. Housing prices were up +2.2% year-over-year as measured by the S&P/Case-Shiller Home Price Index. This increase is +0.2% higher than 3 months ago but close to the lowest year-over-year gain in over seven years. The combination of stagnant home prices and lower mortgage rates has helped increase activity over the last few months. Measures of manufacturing activity were mostly weak, reflecting the uncertainty over the trade war, problems with Boeing, and the GM auto strike that ended in late October. The ISM manufacturing index fell to a decade low of 47.2 in December, down from 51.7 six months ago. Durable goods orders were weak, but industrial production improved in November.

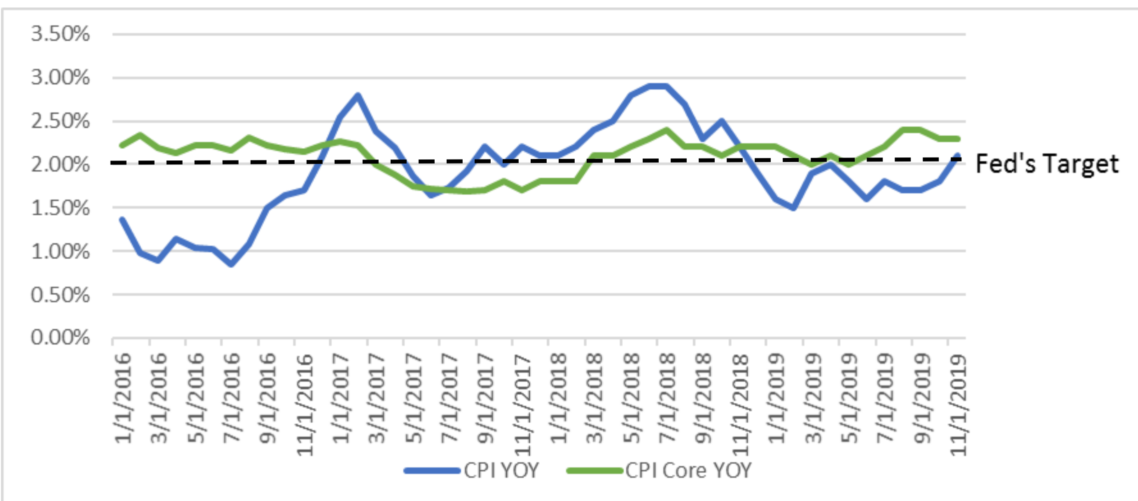
The non-farm payroll gains were strong over the last several months. Over the past three months, non-farm payroll increased by 193,000, 156,000 and 266,000 in September, October, and November, respectively. This put the three-month average at 205,000. As of November, the YTD job gains have averaged almost 180,000. The unemployment rate hovered around 3.5%, which is close to the 50-year low. Average hourly earnings have risen 3.1% year-over-year, which has been fairly consistent over the last year. Initial jobless claims rose during the quarter, with the current 4-week moving average at 233,250. This is up from 212,000 at the end of September. In summary, the labor market remains very strong.

Inflation

Commodity prices were up for the quarter, with oil prices much higher. West Texas Crude rose about 13% to $61.1 dollars a barrel. Oil prices rose as the outlook for economic growth improved and the first step of the trade agreement between the U.S. and China was orally agreed upon. Over the past year, oil prices have mostly traded in a range between $50 to $65 a barrel, so we are closer to the upper-end of this range. The Bloomberg Commodity Index rose more than 4% over the past three months.

The Fed targets an overall annual inflation rate of 2%, a pace it views as appropriate for economic growth and price stability. Current inflation, as measured by the year-over-year Consumer Price Index (CPI) and Producer Price Index (PPI), was around the target for both the headline and the core data (ex-food and energy) over the last three months. The CPI increased +2.1% year-over-year, up from +1.7% at the end of last quarter. Core CPI grew by +2.3% over the past year, close to the highest level of the current economic expansion. The PPI increased only +1.1%, with Core PPI up +1.3% year-over-year. Below is a chart that shows the CPI since the end of 2015.

Consumer Price Index



Source: Bloomberg

Although the CPI data mentioned above are the most commonly referred to data for inflation, the Fed's preferred measure is the price index for Personal Consumption Expenditures (PCE). This measure remained well below the Fed's target, with an overall year-over-year increase of 1.5% and a Core PCE deflator increase of +1.6%. In summary, inflation is close to the Fed's target.

Portfolio Positioning

In the **Government** sector, our Core and Core Plus portfolios have durations that are shorter than the benchmark by about -0.3 to -0.4 years. We continue to have a moderate underweight to Treasuries as we find better value in the other sectors. We also hold a very small position in inflation-indexed U.S. Treasuries (TIPS).

In the **Mortgage** sector, the mortgage rate did not respond to the 4th quarter treasury steepening, finishing the quarter where it started, which was at 3.99%. Likewise, mortgage re-financings, though elevated from the start of 2019, remained flat for the 4th quarter. The mortgage benchmark returned +0.71% in the 4th quarter, ending the year with a +6.35% return for 2019. Even though the CMBS benchmark lost -0.33% in the 4th quarter, it still finished up +8.29% for 2019. The current coupon 30-yr FNMA rate ended 2019 at 2.71%, significantly lower than the 3.50% rate at the beginning of the year. Even so, the current coupon mortgage spread to treasuries, now at +102 bps, was near where it started 2019, +98 bps. Investment opportunities are in short supply with many investment options at a tight spread to treasuries. We are offsetting our non-agency structured paydowns through opportunistic purchases as they become available to us. We believe that the higher yields of these issues should position us well for future outperformance. Our overweight CMBS exposure continues to slowly decline through gradual pay downs as we have abstained from adding additional CMBS at the current tight spread levels. We are underweight Asset-Backed-Securities.

Our **Investment Grade Corporate** strategy focuses on issues with the potential to outperform the benchmark on a risk-controlled basis. Although not undervalued, we continue to believe that investment grade corporate bonds represent the best value in the investment grade fixed income markets and hold an overweight of about 2% to this sector in our Core Fixed Income portfolios. We believe that corporates should provide higher returns than mortgages and Treasuries due to the yield advantage and supportive credit fundamentals. We are currently overweight the basic industry, insurance, electric utility and consumer cyclical sectors where we find some good value. The portfolios are underweight technology, banking, and consumer non-cyclicals. Regarding ratings, we are overweight BBB and AA-rated corporates and underweight A and AAA-rated. We are also over-weight intermediate maturities and underweight longer corporates. Security selection will be important due to the uncertainties regarding economic growth, the upcoming Presidential election, and the trade conflict, all of which could have an impact on specific industries and companies.

High Yield performed very well during the quarter, mostly due to the rise in equity prices and the risk-on mentality of investors. The high yield market is expensive given the large decline in yields and tightening of spreads this year, and we remain cautious. Spreads could stabilize or tighten slightly further in the near-term, but if equities decline or if economic growth shows recessionary signs, high yield could widen quickly and significantly. In our high yield portfolios, we are selectively deploying cash in restructuring situations as well as in more liquid investments that we believe will add value in the long term.

Emerging Markets Debt performed well during the quarter as moderate global growth and progress on the trade war with China led to good investor demand. Despite the much tighter spreads, we continue to believe that EMD will provide better returns than higher quality fixed income over the next year. Global economic activity continues at a moderate pace and we do not believe a recession will occur in the U.S. over the next six months to a year. This will support the current economic expansion in the U.S. and abroad. The first phase of the trade agreement with China should be signed in January and this has lessened fears of a further escalation to the trade war. The second phase will be much more difficult, and this could lead to future uncertainty. Fortunately, many Central Banks, including the Federal Reserve, have moved to the easier side with the markets expecting additional rate cuts in several countries over the next year. Our research continues to focus on identifying key positive drivers for EM countries that could lead to future credit improvement. Currently, we see good opportunities in Brazil, Mexico, and Ukraine. We also see good long-term value in some of the more distressed countries, including Lebanon and Argentina. We have also slightly increased our exposure to local currency EMD as the dollar could show some weakness in 2020.

THE LOOK FORWARD

As Frank Sinatra sang many years ago, "It Was a Very Good Year." The question is, will financial markets have another good year in 2020?

The good news is that we start the year with the Goldilocks scenario of moderate growth, low inflation, and very accommodative central banks. The Federal Reserve cut rates three times last year and the cuts removed what was the largest risk to U.S. economic growth: the Fed choking off the economy by raising rates too far.

The U.S. economy is on solid footing and, in our opinion, there is very little risk of a recession over the next year. We believe growth will be between +1.5% and +2%, and that inflation will be moderate and hover close to the Fed's target of 2%. We expect consumer spending to be moderate due to the strong labor market. The benefits from the tax cuts have faded a little, but spending should hold up enough to help keep the economy moving forward.

Growth in Europe and Japan will likely remain weak, but should stay slightly in positive territory. The political landscape is not stable in Europe, with issues in France (anti-government protests), Germany, Italy, Spain, and the United Kingdom (Brexit). Japan is plagued by an aging population and chronic slow growth. China will continue to use the many tools at its disposal to prop up growth to keep it around the 5% level. The first phase of the trade agreement should be signed soon, but the next phase will be much more difficult and may not get done before the election. Growth in China may disappoint in 2020, but should be able to hit 5%.

As noted earlier, U.S. interest rates fell significantly over the past year, with the ten-year declining from a peak of 3.24% in November of 2018 to the quarter-end level of 1.92%. The lower interest rates should continue to help the housing market and contribute to growth. Fundamentally, with growth and inflation close to 2%, interest rates should rise moderately, but fundamentals are not the only driver of interest rate levels. We expect rates to rise slightly in 2020, but we don't think it pays to deviate significantly from the index in terms of duration.

We did not make significant changes to our fixed income portfolios in the 4th quarter as we mostly just stayed the course and enjoyed the ride. Investment grade corporates, high yield, and emerging markets debt have tightened considerably over the past year, but some attractive opportunities still exist. We believe returns will be in the low single digits for investment grade fixed income over the next year. Corporate bonds are trading tighter than long-term averages but should outperform Treasuries due to good fundamentals. Emerging markets debt, both U.S. dollar and in local currency, rallied this year, but valuations are still slightly attractive. Emerging market currencies look under-valued and may provide better returns. While we are cautious in fixed income overall, we see value in some sectors, countries, and specific securities.

From an absolute return perspective, it has been a great year to be a fixed income investor. Returns have been far higher than expected due to the significant decline in U.S. interest rates and large spread tightening in investment grade corporates, high yield and EMD. With interest rates at such low levels, these equity-like returns will most likely not continue. As I said last quarter, I wanted to say that the high returns won't continue, but U.S. interest rates are still between 1.5% and 2% and could get sucked lower toward zero. Although we don't expect negative rates in the U.S., it could happen. So, for now, we want to keep our positioning closer to the benchmark and limit risk in our fixed income portfolios. For fixed income, I don't think Frank Sinatra will be singing that 2020 was a great year, but he probably won't be singing "That's Life" either.

SUMMARY

To summarize our outlook:

1. The Goldilocks scenario of moderate growth and low inflation remains intact. However, valuations across most asset classes are stretched and priced for continued perfection. It is best to be cautious.
2. We believe U.S. economic growth will be around 2% in 2020. The Fed's quick change of heart in early 2019 that resulted in lower interest rates will continue to help fuel the economy and keep the U.S. from a recession.
3. Europe and Japan will continue to have weak growth in the range of 1% to 1.5%. China will keep fiscal stimulus going to keep growth at a moderate level, but the country's growth may be weaker than expected.
4. The Federal Reserve will stay on hold for at least the next several months unless some geopolitical event causes significant market volatility.
5. Interest rates may rise slightly in 2020, but will remain below the more recent peak from November of 2018.
6. The second phase of the trade agreement with China will be much harder to complete and will not happen before the 2020 election.
7. We expect that core inflation will remain close to the Fed's 2% target, with strong global competition, technology advances, and demographics offsetting the tight labor market.
8. Fixed income returns will be muted as very low interest rates and tight credit spreads have reduced opportunities.
9. Volatility could rear its ugly head in 2020 due to political uncertainties in the U.S. and abroad or due to increased tensions between the U.S. and the Middle East.

About our Firm

DuPont Capital Management is an SEC registered investment advisor based in Wilmington, Delaware. Since the firm's establishment in 1993, we've had a long history of developing global investment opportunities in both traditional and alternative strategies across equity, fixed income and alternative investments. Our investment team structure gives us the ability to be flexible and adapt to changing market conditions. DuPont Capital's focus is delivering consistent investment management results for our clients. Our history of institutional asset management is rooted back to 1942 when our former parent company, DuPont, established a pension plan for its employees. Corteva Inc. succeeded DuPont as sponsor of the DuPont Pension Plan in 2019. DuPont Capital is a wholly owned subsidiary of Corteva and continues to manage the legacy DuPont Pension Plan.

DuPont Capital's President and CEO, Valerie Sill believes in education and diversity of experience as represented in our investment teams which are comprised of PhDs, engineers, medical doctors, and scientists. We believe their global expertise creates a portfolio implementation edge that benefits our clients.

Fixed Income Team Summary

- 8 Portfolio Managers
- 3 Research Analysts/Traders
- 1 Portfolio Specialist

Fixed Income Capabilities

- Core Fixed Income
- Emerging Markets Debt

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