DuPont Capital

Fixed Income Market Review and Outlook

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Market Overview

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An inverted curve. Is this good or bad? Typically, an inverted yield curve has caused great concern for financial markets as it has usually been a good indicator of an upcoming recession. Currently, investors are hoping for a different type of inverted curve: one that shows declines in the number of daily COVID-19 infections and deaths. The financial markets are more focused on the daily comments from Dr. Anthony Fauci than they are from Federal Reserve Chairman Jerome Powell. These are unusual times.

After a fantastic year for investing in 2019 in both equities and fixed income, the first quarter of 2020 was abysmal. The rapidly spreading COVID-19 virus resulted in unprecedented lockdowns in many countries which essentially stopped many sectors of the global economy. Equity markets saw massive declines and gave up years of gains. Yields on U.S. Treasuries moved to all-time lows and Central Banks across the globe moved quickly and aggressively to provide liquidity. The Federal Reserve cut rates by 150 bps points in less than two weeks to take the Funds Rate back to 0%. They also restarted Quantitative Easing by purchasing bonds, but this time are also including investment grade corporate bonds.

The S&P was down about -20% while U.S. Treasuries soared in price. Volatility was extremely high, and it was common in March for stock prices to change by more than 1% on a daily basis. In fixed income, returns for Treasuries were very strong while the riskier sectors such as high yield and EMD declined over -10%. For the 1st quarter, the Bloomberg/Barclay's Capital Aggregate Index returned +3.2%. Treasuries had a return of +8.2% with long Treasuries up over +20%. Mortgages were up +2.7% and Agencies were close to 0%. Corporate bonds suffered and had the lowest returns within investment grade fixed income with a quarterly return of -3.6%. This followed last year, which was a stellar year for investment grade corporates with a return of +14.5% for all of 2019.

The following tables show the returns for the various fixed income sectors and rating categories for the 1st quarter of 2020:

Sector	1st Quarter 2020 Return*
U.S. Treasuries	8.2%
MBS	2.7%
Inv. Grade Corporates	-3.6%
High Yield	-12.7%
Emerging Markets Debt	-13.4%
EMD – local currency	-15.2%

Credit Rating	1st Quarter 2020 Return*
AAA	5.8%
AA	1.5%
A	-0.6%
BBB	-7.4%
BB	-10.2%
B	-13.0%
CCC	-20.6%

Source: Bloomberg
* Returns are from Bloomberg Barclays' indices except Emerging Markets Debt, which is from JP Morgan. All figures are as of 3/31/2020.

U.S. Treasuries

As mentioned earlier, the Federal Reserve cut the Federal Funds Rate 150 bps in March over a two-week period moving the rate back to a range of 0% - 0.25%. The Fed has moved to a "whatever it takes" mentality to provide as much liquidity to the markets as possible. They are ramping up bond purchases again and will even include some corporate bonds along with Treasuries and mortgage-backed securities. Liquidity in trading Treasuries is fairly poor with much wider bid/offer spreads than usual. Yields for all Treasuries declined significantly, and many yields hit all-time lows during March. For the 1st quarter, the two-year Treasury declined by 135 bps while the yield of the five-year, ten-year, and thirty-year Treasuries fell by 132, 122, and 104 bps, respectively. The two-year finished the quarter at 0.23% while the ten-year closed at 0.70%.

Spread Products

Spreads were much wider across all of the various credit sectors during the quarter as investors fled riskier assets in anticipation of a recession caused by the coronavirus. Investment grade corporates, high yield, and EMD posted negative returns with the latter two asset classes declining by double-digits. Spreads are now at recessionary levels. Below is a table that shows spreads for investment grade corporates, high yield, and EMD as of year-end 2016, 2017, 2018, 2019, and the end of the first quarter of 2020:

Sector	12/31/2016	12/31/2017	12/31/2018	12/31/2019	3/31/2020
Investment Grade Corporates	+127	+96	+154	+96	+276
High Yield	+442	+364	+541	+357	+899
Emerging Markets Debt	+342	+285	+415	+291	+626

* 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 widened by 180 bps during the quarter and are almost three times what they were at the beginning of the year. Financials and utilities outperformed industrials, while longer duration corporates had worse returns than shorter duration corporates. It is interesting to note that long treasuries returned +20.9% while long corporates returned -4.5%, a difference of over 25%. Corporate bond issuance was a record $262 billion in March, shattering the previous record of $178 billion in May of 2016. This is a great sign that some corporations have access to the capital markets to help them get through the tough months ahead. In mortgages, Commercial Mortgages (CMBS) underperformed fixed rate pass-through mortgages. Mortgages outperformed corporates in the first quarter, but still greatly underperformed Treasuries.

High yield declined significantly in the 1st quarter, driven by the fear of a recession and much lower oil prices. Lower rated high yield greatly underperformed higher quality, with CCC's returning -20.6% as compared to -10.2% for BB-rated bonds. Sector returns were very bifurcated with sectors such as energy, lodging, and retail getting hit very hard while other sectors such as utilities, technology, and healthcare held in much better. Energy was down almost -40%. The average high yield security declined 15½ points to $85.7. High yield spreads widened 542 bps from 357 to 899 over Treasuries. The current spread for high yield is much wider than the long-term average of 500 to 525 and reflects a recessionary environment. The yield-to-worst rose by 425 bps to 9.44%, due to the wider spreads. Default activity increased during the quarter from 2.6% to 3.4%, the highest level in 3 years. Defaults will most likely pick up significantly over the next year due to a much weaker economy stemming from the virus as well as stress in the energy sector due to the conflict between Saudi Arabia and Russia. Although a cut in oil production would be helpful, global oil demand will remain weak for some time and it is doubtful that oil prices will get back to $60 in 2020. Oil prices are critical for high yield since over 10% of the high yield universe is composed of energy-related companies.

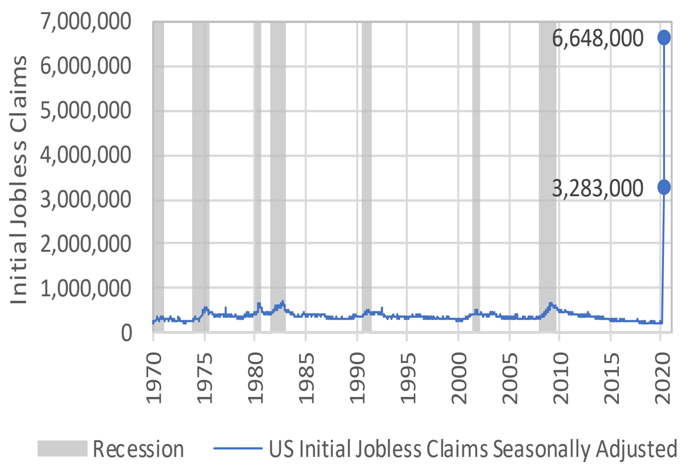
U.S. Dollar Emerging Markets Debt spreads widened by 335 bps in the quarter to close at 626 bps over Treasuries. Local currency EMD had even weaker performance and was the worst returning fixed income asset class. U.S. Dollar EMD returned -13.4% while EMD local currency bonds declined -15.2%. Several countries are heading toward restructuring including Lebanon, Argentina, and Ecuador. There could be several more if global growth remains weak for an extended period or if oil prices stay below $40. Yields for U.S. Dollar EMD rose by 207 basis points to 7.00%.

The Economy

Usually in this section, I review in detail how economic growth has been over the previous quarter. For the first quarter, most of the data is irrelevant due to the coronavirus. U.S. growth was strong in January and most of February before the significant economic impact of the virus started to surface. The Federal Reserve Bank of Atlanta's GDPNow model, a running estimate of growth during the quarter, was projecting +2.7% growth for the 1st quarter as of March 27. This estimate mostly contained data from the first two months of the year before businesses closed or people began working from home. The economic activity in March will be negative and will greatly bring down growth for the whole quarter. More importantly, growth in the 2nd quarter will most likely be the worst single quarter in decades. Some estimates are for growth to be down -30% to -40%.

The most illustrative data point that shows how dramatically things changed in the U.S. is the weekly unemployment claims. This data was running near historical lows of between 210,000 and 240,000 before companies started laying people off in mid-March. Claims soared to 3.28 million for the week of March 21, a record high. For the week of March 28, claims moved much higher again to 6.65 million.

Below is a chart that shows historical initial jobless claims going back to the 1970's with recessions highlighted.



Source: Department of Labor
As of March 27, 2020

The non-farm payroll gains were strong at the beginning of 2020, but collapsed in March as the effects of the virus took hold. Non-farm payrolls fell by -701,000, the first decline since 2010. Many industries have been hurt, but none more than the food service sector that saw jobs decline by -417,900. The unemployment rate rose from 3.5% to 4.4%, and several estimates are for unemployment to move up to at least 15% over the next few months. In an even more dire estimate, the Federal Reserve's St. Louis district in late March estimated the U.S. could see as many as 47 million people lose their jobs as a result of the coronavirus-driven shutdown. Job losses of that magnitude would bring the country's unemployment rate to about 32%, a figure higher than what was seen during the Great Depression.

Inflation

Inflation has also moved lower, driven by the significant and rapid decline of oil prices. The decline was due to lower demand caused by the decline in global economic growth and the price war between Saudi Arabia and Russia. The price war started when Russia refused to participate in supply cuts proposed by OPEC. This led to a fall in oil prices and Saudi Arabia responded to Russia's decision by discounting oil prices by $6 to $8 a barrel. Oil prices crashed and this crushed the stock market further.

For the quarter, West Texas Crude declined a staggering 66% to $20.5 dollars a barrel. Other commodity prices mostly declined with the Bloomberg Commodity Index falling by more than 20% 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 +2.3% year-over-year, up from +2.1% at the end of last quarter. Core CPI grew by +2.4% over the past year, close to the highest level of the current economic expansion. However, the CPI data will decline over the next few months as the decline in oil process filters into the data. The PPI increased only +1.3%, with Core PPI up +1.4% year-over-year.

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 below the Fed's target, with an overall year-over-year increase of 1.8% and a Core PCE deflator increase of also +1.8%. In summary, inflation is close to the Fed's target, but will most likely fall due to weaker economic activity and significantly lower oil prices.

PORTFOLIO POSITIONING

In the **Government** sector, our Core and Core Plus portfolios, we have durations that are close to the benchmark. We continue to have an 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).

Mortgage sector dynamics, as the rest of the world, have been driven by the intimidating coronavirus. First, you have the historically low rates that have caused mortgage refinance applications to reach levels not seen since late 2008. Prepayments had a 44% month-to-month increase in March. Prepayments would have been higher if not for the social distancing policies and mortgage origination capacity limitations. Second, the mortgage basis jumped from a 100 bp level in early February to over 200 in mid-March due to the flight-to-quality caused by the virus. A massive Fed buying program reduced this spread back to 140 bp level by the end of March. CRT deals trading at premium levels quickly retreated to trade in the low to mid-80 dollar prices on fears that a growing number of unemployed borrowers would not be able to make their monthly mortgage payments causing credit losses to rise.

With many malls shut down, travel fears and travel limitations caused the BBB CMBS spreads in the retail and hospitality sectors to widen from 300 bp level to a 1,050 bp during the month of March. The ABS sector was impacted not only by fears of borrowers' ability to make credit card and auto loan payments, but also due to talk of governmental programs to relax borrower payments. This could possibly leave debt holders in the lurch. Eventually, the volatility will dissipate over time. For now, lucrative structured mortgages can be found if you have cash to purchase distressed issues coming from forced liquidations by leveraged REITs, hedge funds and every day mutual funds with skittish investors jumping ship. This plays well into our general strategy of providing market liquidity at times of market stress. We have picked up numerous solid issues with substantial credit support through credit enhancement, excess collateralization, low LTVs and discounted purchase prices.

Our **Investment Grade Corporate** strategy focuses on companies with the potential to outperform the benchmark on a risk-controlled basis. Investment grade corporate spreads widened significantly during the quarter and are at extremely wide levels, reflecting a recession. We believe that investment grade corporate bonds represent the best value in the investment grade fixed income markets and have been gradually increasing our allocation to corporates in our Core and Core Plus portfolios. It is difficult to know how long the economy will be dragged down by the virus, but credit spreads are very wide and should provide a good relative return over the long-run. We currently hold an overweight of about 4 % to corporates in our Core Fixed Income portfolios. We favor the basic industry, insurance, capital goods, and electric utility sectors. 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. In Long Duration, we had very little exposure to long corporates and are now greatly increasing our allocation due to the much more attractive spread levels. We feel that the current level of spreads provides a very good opportunity, but we need to be very selective. Security selection will be important due to the significant uncertainties regarding economic growth which will have an impact on specific industries and companies.

High Yield was hit hard during the quarter, impacted both by the fear of a recession caused by the virus as well as the massive drop in oil prices. The high yield market is cheap given the large rise in yields and widening of spreads this year, but we are proceeding cautiously. Spreads could widen further if the virus is not contained, but current levels could be a good long-term buying opportunity. In our high yield portfolios, our strategy is two-fold: 1) we are adding slowly to companies that we believe will not be hurt as much in the upcoming recession, and 2) we are starting to identify and research potential distressed situations. Defaults will rise and potential opportunities will be created for experienced investors.

Emerging Markets Debt declined significantly during the quarter, both for hard and local currency. Spreads for hard currency sovereigns are at the most attractive levels since the 2008 financial crisis. We believe that EMD is cheap and will provide an attractive return over the long-run. Our research continues to focus on identifying key positive drivers for EM countries that could lead to future credit improvement. We have been gradually adding positions to our EMD portfolios. Our focus has been on some of the higher quality countries that we were underweight and are now trading at more attractive valuations. Our main overweights are Brazil, Mexico, and Ukraine. We are underweight some of the higher quality countries such as Philippines, Qatar, and UAE. In local currency our main allocations are to Brazil, Mexico, and Poland.

The Look Forward

We are in unprecedented times. We started the year with the Goldilocks scenario of moderate growth, low inflation, and very accommodative Central Banks. The financial markets were coming off a fantastic year and mostly continued on a good path early in 2020. Experienced investors are always looking for signs of trouble whether it comes from oil price shocks, financial bubbles, political turmoil, too tight monetary policies, etc. However, no one could have seen this coming. The coronavirus started spreading across the globe in February and accelerated in March. Governments basically shut down their countries, forced business and industries to close, and strongly encouraged people to stay home. The change was so abrupt that economic data was irrelevant for several weeks as it did not have any resemblance to what was going on in the world. The focus was less on economic data and more on daily medical data showing the increase in the spread of the virus.

The good news is that the U.S. economy was on very solid footing in February with historically low unemployment, rising wages, good corporate earnings, and a stock market trading at an all-time high. However, the rapid and severe economic decline is not typical, to say the least, and the timing of the rebound is much, much harder to predict. We are not medical experts, but believe that the curve (virus and not yield) will flatten later in April or May. Hopefully, the economy will start up slowly again in the latter half of May or early June. The economic pain will be very high, but we are confident that Congress, the President, and the Federal Reserve will do "whatever it takes" to ease the pain as much as possible to get the country back on track. The rebound will most likely be slow and jagged, but it will come.

As noted earlier, U.S. interest rates fell significantly over the past quarter and are at or near all-time lows. Interest rates could remain volatile, but we believe rates stay low for an extended period of time and it is wise to keep durations close to the benchmark. The U.S. government will have to pay for the historic stimulus packages and issuance will increase significantly over the next year. This will pose another challenge to financial markets.

Valuations are very cheap in all fixed income sectors except Treasuries. We believe that the various credit sectors will recover and provide good relative returns over the long-run. However, there will be pain involved as default rates will rise and many companies across the credit spectrum will be downgraded. This is very troublesome as the investment grade corporate market is comprised of close to 50% of BBB-rated securities, only one notch above high yield. Despite this, we are cautiously optimistic on investment grade corporates and are adding to our allocation. Security selection is crucial as many industries and specific companies will have significant problems, so all corporates will not participate in a rally when it does occur. Structured mortgages have also gotten cheaper and some very good opportunities exist.

We believe high yield and emerging markets debt also have good value and we are gradually adding positions. Again, caution is warranted, and defaults and restructurings will increase in both asset classes. We believe there will be good opportunities in distressed securities, but it is a little too soon to move in. Again, returns could be strong in both asset classes over the long-run, but we are moving in only after extensive research.

These are unprecedented times. We strongly believe the U.S. will recover, but slowly, over the next few months. There are very good opportunities in the fixed income markets, but significant, in-depth research is needed to uncover them as some companies and countries will have extreme difficulties over the coming year. Be safe and help to not just flatten, but to invert the curve.

SUMMARY

To summarize our outlook:

1) The Goldilocks scenario of moderate growth and low inflation rapidly disappeared due to COVID-19 and we are in unprecedented times.

2) Economic growth collapsed in March and the 2nd quarter could be the worst quarter since the depression.

3) We believe U.S. growth will rebound later in 2020, but the recovery won't be immediate, and some growth has been permanently lost.

4) The Federal Reserve is in a "whatever it takes" mentality and will provide as much liquidity as possible to keep the economy going.

5) Interest rates are at extremely low levels, but should remain low for an extended period of time.

6) Valuations in all segments of fixed income except Treasuries are cheap and will provide good relative returns over the long-run.

7) We are methodically adding credit to our portfolios in investment grade corporates, high yield and emerging market debt.

8) Security selection is extremely important as downgrades and defaults will rise significantly.

9) Remain cautious, be safe and help invert the curve.

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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