Fixed Income Market Review and Outlook

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Market Overview

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Sesame Street. That is what I think of lately when I am reading different people's views on the economy. There was a segment on Sesame Street called "The Letter of the Day" and it focused on one letter of the alphabet. Currently, everyone has an opinion about what letter the economic recovery will look like. Is the recovery going to be shaped like a "V", "U", "W", or an "L"? How about a backward "J"? Maybe, it won't look like a letter, but more like the Nike swoosh. So, what is the letter of the day? I am not sure, but so far, the financial market's **performance** has certainly looked like a "V".

In the equity market, the 2nd quarter was the best quarter in years for the S & P and the NASDAQ as they were up +20% and +30%, respectively. These gains leave the S & P down only -3% for the year while the NASDAQ hit an all-time high during the quarter. In fixed income, the recovery in credit also resembled a "V". High yield and Emerging Markets Debt both had returns in double-digits, leaving both asset classes down only -3 to -4%. Investment grade corporates were up +8%, pushing returns for the year to +5%, which is surprising given the horrible economic environment. Treasuries did not change much at all with much lower volatility. For the 2nd quarter, the Bloomberg/Barclay's Capital Aggregate Index had a return of +2.9%, driven by the strong performance in corporate bonds.

The following tables show the returns for the various fixed income sectors and rating categories for the 1st and 2nd quarter of 2020 as well as Year-To-Date:

Sector	1st Quarter 2020 Return*	2nd Quarter 2020 Return*	YTD 2020 Return*
U.S. Treasuries	8.2%	0.5%	8.7%
MBS	2.7%	0.9%	3.6%
Inv. Grade Corporates	-3.6%	9.0%	5.0%
High Yield	-12.7%	10.2%	-3.8%
Emerging Markets Debt	-13.4%	12.3%	-2.8%
EMD – local currency	-15.2%	9.8%	-6.9%

Credit Rating	1st Quarter 2020 Return*	2nd Quarter 2020 Return*	YTD 2020 Return*
AAA	5.8%	0.7%	6.6%
AA	1.5%	4.5%	6.0%
A	-0.6%	7.0%	6.4%
BBB	-7.4%	11.2%	3.0%
BB	-10.2%	11.5%	0.2%
B	-13.0%	8.6%	-5.5%
CCC	-20.6%	9.1%	-13.3%

Source: Bloomberg
* Returns are from Bloomberg Barclays' indices except Emerging Markets Debt, which is from JP Morgan. All figures are as of 6/30/2020.

U.S. Treasuries

Treasury prices did not change much over the quarter after experiencing massive price increases earlier in the year due to the flight to quality. In the 2nd quarter, investors were much more focused on buying credit and equities and less on the safety of Treasuries. However, the Federal Reserve was the backstop for Treasuries and was the major buyer as they ramped up bond purchases in March. As of late June, the Fed was holding over $4 trillion in Treasuries. In the 2nd quarter, the two-year Treasury declined by 7 bps while the yield of the five-year and ten-year fell by 8 and 4 bps respectively. The 30-year Treasury yield rose by 6 bps. The two-year finished the quarter at 0.16% while the ten-year closed at 0.66%.

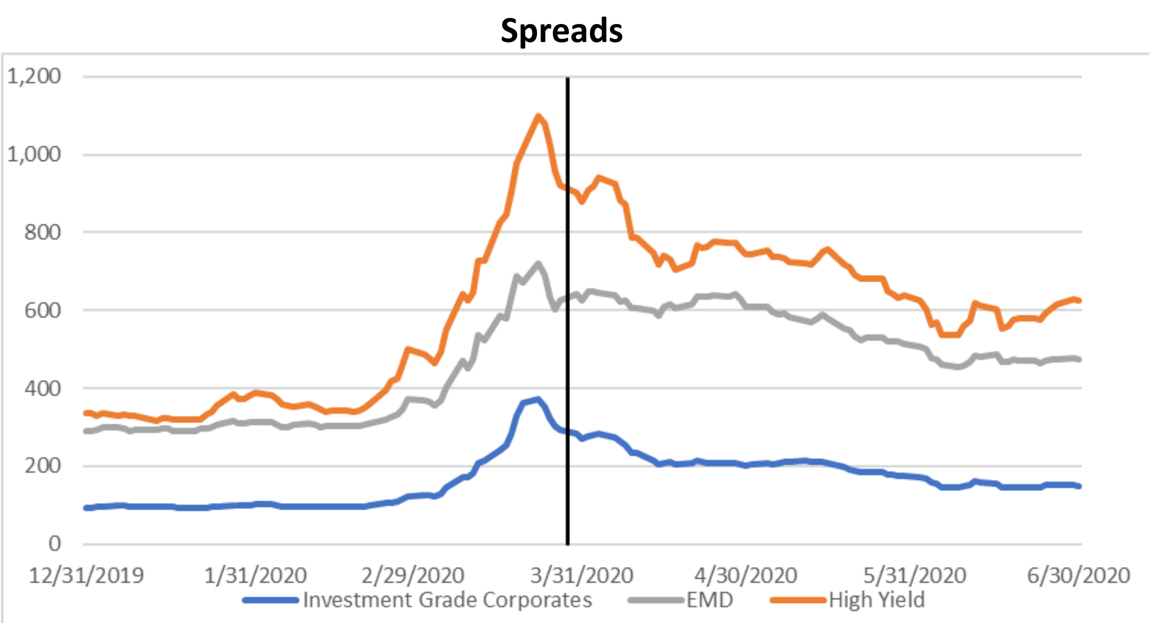
Spread Products

Spreads were much tighter across all of the various credit sectors during the quarter as investors rushed back to credit due to the support by the Federal Reserve and investor optimism about the economic recovery. Investment grade corporates, high yield, and EMD posted strong returns with the latter two asset classes rising by double-digits. Spreads are tighter for all three segments of credit but still above long-term historical averages. Below is a table that shows spreads for investment grade corporates, high yield, and EMD as of year-end 2017, 2018, 2019, and the end of the 1Q and 2Q of 2020:

Sector	12/31/2017	12/31/2018	12/31/2019	3/31/2020	6/30/2020
Investment Grade Corporates	+96	+154	+96	+276	+150
High Yield	+364	+541	+357	+899	+626
Emerging Markets Debt	+285	+415	+291	+626	+474

* 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.

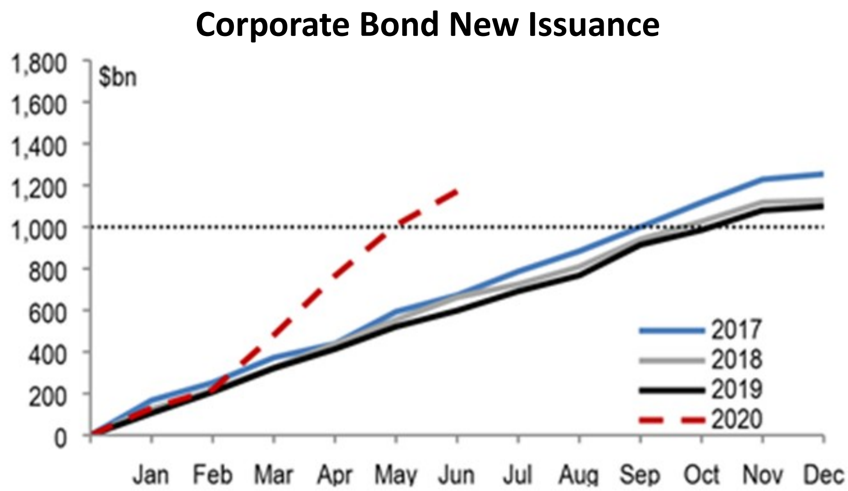
To illustrate the volatility in spreads in 2020, below is a chart with spreads for the three segments over the course of the first half of 2020. Spreads widened from mid-February until the peak on 3/23 and began tightening when the Fed announced several new programs to support the markets including a new Q.E. program that included buying corporate bonds.



Source: Barclays/Bloomberg, JP Morgan
As of June 30, 2020

DuPont Capital

Investment grade corporates tightened by 126 bps, making back much of the widening from February and March. Industrials and utilities outperformed financials, while longer duration corporates had higher returns than shorter duration corporates. Last quarter, I pointed out that long Treasuries returned +20.9% while long corporates returned -4.5%, a difference of over 25%. This quarter, there was a partial recovery as long corporates returned +11.4% while long Treasuries returned only +0.3%. Corporate bond issuance set records both for the month of April at $284 billion and for a quarter at $692 billion in the second quarter. April, March, and May stand as the top three months of issuance on record. Below is a chart that shows issuance over the last several years. This year should easily top the previous record set in 2017.



Source: JP Morgan & Dealogic
As of June 30, 2020

This is a great sign that corporations have access to the capital markets to help them get through the tough months ahead. Companies in some of the hardest hit industries such as airlines, lodging, casinos, retail, and energy were able to access the debt market, helping to provide cash to fund operations for the near-term.

In mortgages, Commercial Mortgages (CMBS) rebounded and out-performed fixed rate pass-through mortgages. Despite the partial recovery, there is significant uncertainty in some areas of CMBS due to the current problems in areas such as retail and hotels in addition to the unknown future implications of the success of employees working from home. Asset-backed securities also recovered some of the weak performance from earlier in the year.

High yield rebounded significantly in the 2nd quarter, driven by rising equity prices, investor optimism on the economic recovery, and higher oil prices. Higher-rated high yield continued to out-perform lower quality, with BB's returning +11.5% as compared to +9.1% for CCC-rated bonds. Energy companies bounced back as oil prices rose with a 2Q return of +40%, but returns for the year are still down -15%. The average high yield security rose over 10 points to $95.9. High yield spreads tightened 245 bps from 899 to 654 over Treasuries. The current spread for high yield is still much wider than the long-term average of 500 to 525. The yield-to-worst fell by 257 bps to 6.87%, largely due to the tighter spreads. Default activity increased significantly during the quarter from 3.4% to 6.2%, the highest level in 10 years. Defaults will most likely continue to increase over the next year due to the weaker economy stemming from the virus as well as stress in the energy sector due to the lower oil prices. Oil prices are important for the asset class since over 12% of the high yield index is composed of energy-related companies.

U.S. Dollar Emerging Markets Debt performed very well with spreads tightening by 152 bps in the quarter to close at 474 bps over Treasuries. Local currency EMD also performed well, but lagged U.S. dollar EMD. U.S. Dollar EMD returned +12.3% while EMD local currency bonds rose +9.8%. Higher quality countries led the rally in the beginning of the quarter, but many lower-quality countries snapped back in June. Overall, yields for U.S. Dollar EMD declined by 148 basis points to 5.52%.

The Economy

Economic activity is challenging to interpret due to the staggering declines in March and April, followed by the bounce-back in May as states reopened their economies. For example, retail sales fell by -8% and -14% in March and April and then increased +18% in May. Another example would be durable goods orders declined -17% and -18% and then advanced +16% in May.

The Federal Reserve Bank of Atlanta's GDPNow model, a running estimate of growth during the quarter, was projecting -35.2% growth for the 2nd quarter as of July 2. This estimate mostly contained data from the first two months of the quarter, so it doesn't capture some of the recovery in June.

One strong positive that will help the recovery is the Personal Savings Rate. It had been running between 7.4% and 8.4% from early 2019 to February 2020. The savings rate started to spike in March as the lockdowns began and people spent far less of their incomes as they were forced to stay at home. Despite the rapidly growing unemployment rate, disposable income remained high as the unemployment checks from both the state and federal governments kept incomes high. The savings rate ratcheted up to 32% in April and 23% in May. As states reopen further, spending should increase, and the savings rate will decline towards more normal levels.

The non-farm payroll data was unprecedented. April showed staggering job losses of 20.8 million. This grim data started to reverse as some states started reopening their economies with gains of 2.7 million in May and 4.8 million in June. The gains in June were in some of the hardest hit industries including leisure and hospitality adding 2 million jobs while retail added 740,000. The unemployment rate peaked in April at 14.7% and fell to 11.1% in June. Despite the improvement, this is well above the recent low of 3.5% in February. Jobless claims are also very bleak. New unemployment claims were 1.43 million during the week of June 27. This is down from the peak of 6.86 million in March, but are still extremely high on a historical basis. Since mid-March, more than 50 million people have filed for unemployment. Continuing claims were reported at 19.3 million which is down from the peak of about 25 million.

Inflation

Inflation moved lower due to the decline in global economic growth. Oil almost doubled in the 2nd quarter after collapsing earlier in the year. For the quarter, West Texas Crude rose from $20.5 dollars a barrel to $39.3. Other commodity prices mostly rose with the Bloomberg Commodity Index rising by more than 5% 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 well below the target for both the headline and the core data (ex-food and energy) over the last three months. The CPI increased +0.1% year-over-year, down from +2.3% at the end of last quarter. Core CPI was higher, but still only grew by +1.2% over the past year. The PPI actually decreased by -0.8%, with Core PPI down -0.4% 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 moved lower and remained well below the Fed's target, with an overall year-over-year increase of +0.5% and a Core PCE deflator increase of +1.0%. In summary, inflation is far below the Fed's target, and will not be a focus of the Fed over at least the next few months.

PORTFOLIO POSITIONING

In the **Government** sector, our Core and Core Plus portfolios 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).

The **Mortgage** markets have recovered somewhat since the COVID panic in March. The mortgage basis has been trading in the +120 to +135 bps range since the end of April. The Treasury curve steepened slightly in the second quarter with rates remaining close to historical lows. Refinancing activity, though down from the mid-March peak, remains elevated in response to the low rates. The Fed purchases of agency mortgages have supported residential mortgage-backed securities (RMBS) quite well with current purchase rates near $23 billion per week. Additional Fed purchases of Agency backed issues and the TALF program have supported other structured product areas such as CMBS and ABS. One structured product sub-sector with little support is the non-agency RMBS. Spreads in this sector are coming back very slowly with lower credit borrowers still a concern. Liquidity remains plentiful in the mortgage TBA market.

Overall the market response to the many dynamics brought on by COVID has been better and quicker than expected. We remain cautious on redeploying our available capital until the risk-reward is favorable to do so.

Our **Investment Grade Corporate** strategy focuses on companies with the potential to outperform the benchmark on a risk-adjusted basis. Investment grade corporate spreads tightened significantly during the quarter but are still wider than historical averages. We believe that investment grade corporate bonds represent the best value in the investment grade fixed income markets and we increased our allocation to corporates in our Core and Core Plus portfolios as spreads widened in February and March. It is difficult to know if the economic recovery will be sustainable through the rest of the year, but we believe credit spreads are attractive and should provide a good relative return over the long-term. We currently hold an overweight of about 4 1/2% to corporates in our Core Fixed Income portfolios. We favor the basic industry, insurance, consumer cyclicals, energy, 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 at the beginning of the year and have greatly increased our allocation due to the much more attractive spreads. 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 recovered much of the losses from earlier in the year, supported by the rise in equity prices and oil prices. The high yield market is still attractive, but we are buying cautiously since spreads tightened so quickly. Spreads could widen further if the economy shuts down again or if oil prices decline. Despite the recovery, current levels could be a good long-term buying opportunity. In our high yield portfolios, our strategy is two-fold: 1) we have purchased companies that we believe will be able to make it through this economic downturn, and 2) we are conducting research on potential distressed situations. Defaults will rise and potential opportunities will be created for experienced investors.

Emerging Markets Debt recovered significantly during the quarter, both for hard and local currency. Spreads for hard currency sovereigns have tightened but are still at attractive levels. We believe that EMD will provide an attractive return over the long-term, but the road will be bumpy. Our research continues to focus on identifying key positive drivers for EM countries that could lead to future credit improvement. We added many positions to our EMD portfolios, mostly in March as spreads widened. We have had a two-part strategy; 1) buy higher yielding countries and companies that we feel will be fine in the long-run, but suffered earlier this year due to the weak economic environment and lower oil prices and 2) buy some of the higher quality countries that we were underweight in Asia and the Middle East. Overall, 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.

DUPONT CAPITAL

The Look Forward

Last quarter, I said that we thought credit had great value and that we were adding positions to our portfolios across investment grade corporates, high yield, and emerging markets debt. Although we expected the credit markets to recover and provide strong returns, we certainly did not expect it to happen so fast. Investment grade corporate spreads widened 180 bps in the 1st quarter and tightened 126 bps in the 2nd, so 70% of the widening was recovered in just three months. In high yield and EMD, 45% to 50% of the widening was recovered. This is very fast when you consider the high level of uncertainty that still exists due to the virus. It once again proves the saying "don't fight the Fed." The massive liquidity provided by the Fed and other central banks offset everything else and led to a fast and furious rebound.

Some of the recovery in spreads was also related to a pick-up in economic activity as consumer spending rebounded quicker and stronger than expected in May and June. After falling by a cumulative 18% between February and April, as lockdowns were imposed in most states, consumption rebounded by 8% in May. The data points to a further solid rebound in June. The high savings rate mentioned earlier should help keep consumption high over the next few months. However, the resurgence in infections, which has forced some states in the South and West to impose new restrictions on activity, could weigh on spending in July and beyond.

Valuations are still attractive in all fixed income sectors except Treasuries. However, the quick rebound in credit and mortgages over the last three months has taken away much of the value and opportunities are more challenging to find, particularly since the length and depth of the recovery is uncertain. In addition, defaults and downgrades will continue to increase as some companies and sectors have been hit hard by the impact of the virus. The investment grade corporate market is comprised of close to 50% of BBB-rated securities, only one level above high yield. Strong security selection is crucial to avoid these potential problems. We will continue to cautiously add positions to our portfolios as we find opportunities with good long-term value.

What letter will we get for the economy? I am hoping for a "V", but I don't think it will be that easy.

Summary

<u>To summarize our outlook:</u>

1) U.S. economic growth is recovering, but the road will be bumpy and difficult at times.
2) The rebound in equity and credit markets was fast and furious. Maybe too fast?
3) "Don't fight the Fed." The Federal Reserve is in a "whatever it takes" mentality and will provide as much liquidity as possible to keep the economy going.
4) Interest rates are at extremely low levels but should remain low for an extended period of time.
5) Valuations in all segments of fixed income except Treasuries are attractive and will provide good relative returns over the long run.
6) Security selection is extremely important as downgrades and defaults will continue to rise.
7) Be safe.

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

For additional information please contact:

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