DuPont Capital

Fixed Income Market Review and Outlook

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Market Overview

Mark Foust
Senior Portfolio Specialist

34 Years' Industry Experience
MBA - Pennsylvania State University
BS - Carnegie-Mellon University

Back in 1973, Bob Seger released a song called "Turn the Page". It is about the emotional and social ups and downs of a rock musician's life on the road. I am certainly no rock musician, but I am ready to "turn the page" on 2020. Between COVID-19, the economic lockdown, increased instances of racial injustice, massive volatility in the financial markets, the Presidential impeachment, historic wildfires in California, and the extremely contentious U.S. Presidential election, I am looking forward to 2021. It can't be worse, right? I am hopeful, but you never know. At least there was some good news as the economic recovery continued in the 3rd quarter and, at this time, still most closely resembles a "V-shaped" recovery. It is too early to tell, particularly with COVID-19 spiking in many countries.

In the equity market, despite a challenging September that saw declines, the 3rd quarter was strong for the S&P 500 with returns of +8.9%. These gains pushed the S&P into positive territory for the year. In fixed income, the recovery in credit also continued. High yield and Emerging Markets Debt both had strong returns of +4.6% and +2.3% while investment grade corporates were up +1.5%. Similar to equities, these gains occurred despite a decline in September. Treasuries did not change much at all and had returns close to 0%. For the 3rd quarter, the Bloomberg/Barclay's Capital Aggregate Index had a return of +0.6%, driven by the high performance in corporate bonds.

The following tables show the returns for the various fixed income sectors and rating categories for the first three quarters of 2020 as well as Year-To-Date:

Sector	1st Quarter 2020 Return*	2nd Quarter 2020 Return*	3rd Quarter 2020 Return*	YTD 2020 Return*
U.S. Treasuries	8.2%	0.5%	0.2%	8.9%
MBS	2.7%	0.9%	0.2%	3.9%
Inv. Grade Corporates	-3.6%	9.0%	1.5%	6.6%
High Yield	-12.7%	10.2%	4.6%	0.6%
Emerging Markets Debt	-13.4%	12.3%	2.3%	-0.5%
EMD – local currency	-15.2%	9.8%	0.6%	-6.3%

Credit Rating	1st Quarter 2020 Return*	2nd Quarter 2020 Return*	3rd Quarter 2020 Return*	YTD 2020 Return*
AAA	5.8%	0.7%	0.2%	6.8%
AA	1.5%	4.5%	0.9%	7.0%
A	-0.6%	7.0%	1.2%	7.6%
BBB	-7.4%	11.2%	2.1%	5.2%
BB	-10.2%	11.5%	4.0%	4.2%
B	-13.0%	8.6%	4.5%	-1.2%
CCC	-20.6%	9.1%	7.4%	-7.0%

Source: Bloomberg
* Returns are from Bloomberg Barclays' indices except Emerging Markets Debt, which is from JP Morgan. All figures are as of 9/30/2020.

U.S. Treasuries

Treasury prices again did not change much over the quarter after experiencing massive price increases earlier in the year due to the flight to quality. The Federal Reserve supported the Treasury market with an announcement during the quarter that adopted a new flexible average inflation target. The latest statement from the Fed said "with inflation running persistently below" the 2% longer-run inflation target, the FOMC "will aim to achieve inflation moderately above 2% for some time so that inflation averages 2% over time." To achieve this, the Fed now expects to leave the policy rate at near-zero until labor market conditions have reached levels consistent with the assessments of maximum employment and for inflation to moderately exceed 2% for some time.

In the 3rd quarter, investors continued to be focused on buying credit and equities and less on the safety of Treasuries. In the 3rd quarter, the 2-year Treasury declined by 3 bps while the yield of the 5-year declined 2 bps. The 10-year and 30-year rose 2 and 4 bps respectively. The two-year finished the quarter at 0.13% while the ten-year closed at 0.68%. So, overall, not much change in Treasury yields.

Spread Products

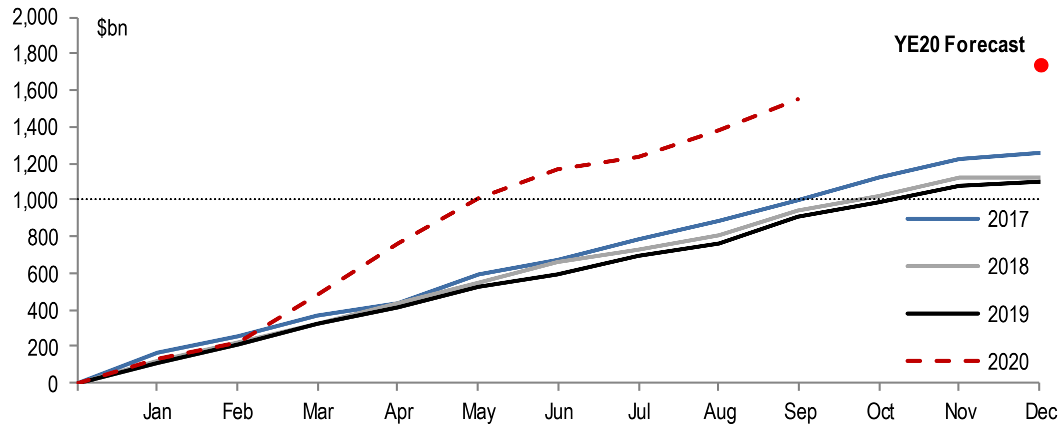
Spreads were again tighter across all of the various credit sectors during the quarter as investors continued to look for yield due to increased optimism about the economic recovery. Investment grade corporates, high yield, and EMD posted good returns. Spreads have tightened significantly for all three segments of credit but still remain above long-term historical averages. Below is a table that shows spreads for investment grade corporates, high yield, and EMD as of year-end 2018, 2019, and the end of each quarter of 2020:

Sector	12/31/2018	12/31/2019	3/31/2020	6/30/2020	9/30/2020
Investment Grade Corporates	+154	+96	+276	+150	+135
High Yield	+541	+357	+899	+626	+547
Emerging Markets Debt	+415	+291	+626	+474	+432

* 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 15 bps in the 3rd quarter and 141 over the past six months, making back much of the widening from February and March. Industrials slightly outperformed utilities and financials, while longer duration corporates had higher returns than shorter duration corporates. Corporate bond issuance slowed in July, but roared back in August and September with total year-to-date issuance exceeding $1.5 trillion as of the end of the quarter. On the next page is a chart that shows issuance over the last four years; this year has already exceeded the previous all-time record in 2017.

Corporate Bond New Issuance



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

In mortgages, Commercial Mortgages (CMBS) continued to out-perform fixed rate pass-through mortgages. Despite the 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. BBB-rated CMBS have not recovered and are trading at extremely wide levels. Asset-backed securities also performed better than pass-through mortgages.

High yield was the best performing sector within fixed income in the 3rd quarter, driven by rising equity prices and investor optimism on the economic recovery. Lower-rated high yield out-performed higher quality, with BB's returning +4% as compared to +7.4% for CCC-rated bonds. The average high yield security rose over 3 points to $99.6. High yield spreads tightened 79 bps to 547 over Treasuries. The current spread for high yield is still wider than the long-term average of 500 to 525. The yield-to-worst fell by 110 bps to 5.77%, largely due to the tighter spreads. Default activity slowed toward the end of the quarter and declined slightly from 6.2% to 5.8%. This is good news, but defaults could 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 asset class since about 12% of the high yield index is composed of energy-related companies.

U.S. Dollar Emerging Markets Debt performed well with spreads tightening by 42 bps in the quarter to close at 432 bps over Treasuries. Local currency EMD managed to gain slightly, but lagged U.S. Dollar EMD. U.S. Dollar EMD returned +2.3% while EMD local currency bonds rose +0.6%. In US Dollar EMD, higher quality countries outperformed lower-quality countries which has been the case for most of this year. Overall, yields for U.S. Dollar EMD declined by 37 basis points to 5.15%.

The Economy

Economic activity bounced back significantly after the staggering declines in March and April as states reopened and millions of workers were rehired. Retail sales rose +8.6%, +0.9%, and +0.6% respectively in June, July, and August. Amazingly, year-over-year retail sales are up +0.1%. However, retail sales are overstating the rebound in overall spending given that they don't cover much of the spending in services hardest hit by the pandemic, including health care, travel, and recreation services. It is encouraging that retail sales continued to rebound in August despite the expiration of the enhanced unemployment benefits. Manufacturing has also rebounded, but not nearly as much as consumer spending. Industrial Production is up +6.1%, +3.5%, and +0.4% over these same months and is almost -8% lower over the past year. Auto production is almost back to pre-pandemic levels, but other sectors are still struggling. The University of Michigan's measure of consumer confidence continued to rise and moved to the highest level since March. New and existing homes sales surged in July and August as record low mortgage rates and pent-up demand combined to push both housing sales up to the highest levels since December 2006.

The Federal Reserve Bank of Atlanta's GDPNow model, a running estimate of growth during the quarter, was projecting a significant rebound of +34.6% growth for the 3rd quarter as of October 1. This estimate mostly contained data from the first two months of the quarter, so it doesn't capture most of the activity in September. Many estimates for 3rd quarter growth are between +25% and +30%.

The non-farm payroll gains were weaker than expected in September at 661,000, down from an upwardly revised 1.5 million gains in August. Government employment has been volatile and was part of the reason for the weaker number mostly due to a decline in local government education employment. If you exclude government workers, payroll gains declined from 1.02 million in August to 877,000 in September. The unemployment rate peaked in April at 14.7%, declined to 11.1% in June and fell further to 7.9% in September. Despite the improvement, this is well above the recent low of 3.5% in February. Jobless claims also have declined but remain high. New unemployment claims were 837,000 during the week of September 26. This has moved down over the last few weeks, but are still extremely high on a historical basis. As a reminder, claims were running slightly above 200,000 early this year before the pandemic. Continuing claims were reported at 11.9 million which is down from the peak of about 25 million.

Inflation

Inflation moved higher due to the rebound in global economic growth and increases in prices in some of the harder hit sectors of the economy. Oil prices were stable and traded in a range between $36 and $43 a barrel. For the quarter, West Texas Crude rose by $1 dollar a barrel to $40.2. Other commodity prices mostly rose with the Bloomberg Commodity Index rising by more about 9% 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), rose, but were well below the target for both the headline and the core data (ex-food and energy) over the last three months. The CPI increased +1.3% year-over-year, up from +0.1% at the end of last quarter. Core CPI was also higher, but still only grew by +1.7% over the past year. The increase in CPI over the last few months has mostly been driven by a rise in used motor vehicle prices and secondarily by some service prices that were hard hit earlier in the year due to the pandemic. The PPI decreased by -0.2%, with Core PPI down +0.6% 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 high but remained well below the Fed's target, with an overall year-over-year increase of +1.4% and a Core PCE deflator increase of +1.6%. It is possible that this measure could move above 2% over the next six months particularly since inventories are generally low. However, as I mentioned earlier, the Fed will allow inflation to move above 2% for a period as they are now targeting a 2% average for inflation.

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 current **Mortgage** spread to 5-year treasuries of 109 bps, is near pre-COVID levels even though rate volatility has increased to 3 standard deviations above its 6-year average. This demonstrates the power of the Fed's MBS purchase program. The Fed purchased $410 billion of mortgage pools in the first three weeks of the COVID crisis. Since the beginning of May, the Fed has continued to purchase $20 to $30 billion per week. This helped move the effective 30-year fixed home mortgage rate from 4.14% to 3.20% in the past 12 months. The low mortgage rates have encouraged refinancing and strong home sales which has driven inventories to only a 3-month supply.

The Cares Act allowed homeowners to suspend their mortgage payments up to 180 days simply by asking. Fewer homeowners have requested forbearance than expected. Mortgage remittance reports showed increasing levels of delinquencies initially, but they have leveled off. Many homeowners who sought forbearance were allowed to defer this amount to their loan maturity. We have not made many changes to our mortgage portfolios this quarter and 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 during the quarter but are still slightly wider than historical averages. We believe that investment grade corporate bonds still 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 after spreads widened earlier in the year. We currently hold an overweight of close to 5% 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 and banking. Regarding ratings, we are overweight BBB-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 greatly increased our allocation due to the much more attractive spreads. We feel that the current level of spreads provides a good opportunity, but we need to be very selective. Security selection will be important due to the significant uncertainties regarding economic growth and the upcoming election 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 over the last six months and higher oil prices in the 2nd quarter. The high yield market is still slightly attractive, but we are buying cautiously since spreads tightened so quickly. Spreads could widen if equity prices decline, the economy slows down again or if oil prices fall. We continue to look to identify companies with attractive valuations including some distressed companies that could provide strong returns over the long-term. Defaults will rise and potential opportunities will be created for experienced investors.

Emerging Markets Debt continued to rebound during the quarter, particularly for hard currency. Spreads for EM 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 could 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. Overall, we bought several higher yielding countries and companies that suffered earlier in the year that we feel will perform well in the long run. We also bought 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.

The Look Forward

The significant recovery in the economy and financial markets continued in the 3rd quarter with equity prices rising and credit spreads narrowing. The speed and magnitude of the rebound has been surprising. Investment grade corporate spreads widened 180 bps in the 1st quarter and tightened 141 bps over the last six months, so close to 80% of the widening has been recovered. High yield and EMD have recovered 65% and 58% respectively. This illustrates the influence of the Federal Reserve and once again proves the saying "don't fight the Fed." The massive liquidity provided by the Fed and other central banks led to the fast and furious rebound.

Consumer spending and a very strong housing market have been drivers of the economic improvement over the last several months. The stimulus checks and additional unemployment payments helped to fuel consumption. These payments helped push the savings rate up to as high as 33% in April but has fallen to 14% in August. Although much lower, this is still above the typical savings rate and should help sustain spending, at least over the next few months. Inventories are low and this should also help contribute to growth over the next six months.

Despite the improving economic environment, there is still significant uncertainties due to the ongoing problems from the virus and the possibility of a change in administrations in the rapidly approaching U.S. Presidential election. There is also a chance that the Senate could flip to Democrat which would give that party power for the first time since 2011. The two candidates have very different plans for the economy and a change could lead to an increase in volatility.

Valuations are still slightly attractive in all fixed income credit sectors compared to Treasuries. However, the significant rebound in credit and mortgages over the last six 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 could 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 credit positions to our portfolios as we find opportunities with good long-term value.

It should be an interesting end to the year with significant uncertainty due to COVID-19 and the upcoming Presidential election. We are hoping that the virus recedes, the election process goes smoothly, and the economic recovery continues to be V-shaped. But if the first nine months are any indication, we are probably in for some surprises. Be cautious, stay safe, and get ready to "turn the page."

Summary

To summarize our outlook:

1) U.S. economic growth has recovered quicker than originally expected, but the road will be bumpy and possibly difficult at times.

2) "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 and financial markets going.

3) Interest rates are near historical lows and are expected to remain low for several years.

4) Credit valuations have rebounded quickly but remain slightly attractive. Credit should provide better returns relative to Treasuries over the long run.

5) Security selection is extremely important as downgrades and defaults will continue to rise.

6) The two U.S. Presidential candidates have very different plans for the economy and the election may result in increased volatility.

7) Caution is warranted as the virus is not going away any time soon and infections could increase over the fall and winter seasons in the U.S.

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:

Mr. William Smith, CFA
Managing Director
Business Development and Client Service
(302) 477-6083
bill.smith@dupontcapital.com

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