Fixed Income Market Review and Outlook

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Market Overview

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As David Bowie once sang in the 1970's:

Ch-ch-ch-ch-changes
Turn and face the strange
Ch-ch-changes
Don't want to be a richer man
Ch-ch-ch-ch-changes
Turn and face the strange
Ch-ch-changes
There's gonna have to be a different man
Time may change me
But I can't trace time

Ch-ch-ch-Changes…..That is what the last few months of 2020 was about. Two main events occurred during the quarter that are sparking significant changes:

1) The U.S. elected a new President in the most contentious elections in generations.
2) Two vaccines were approved in the U.S. to combat the coronavirus.

These events led to a significant change in investor sentiment, more affecting equities than fixed income. The result of these events in the 4th quarter was a massive rally in the stock market with the S&P rising by +12% and the Russell 2000 up over +30%. In fixed income, the yield curve steepened with short rates unchanged, anchored by the Fed Funds Rate, but with longer rates rising moderately. Credit continued to rally into year end, so most fixed income returns were positive outside of Treasuries.

In the 4th quarter, the Bloomberg/Barclay's Capital Aggregate Index had a return of +0.7%, driven by the high performance in investment grade corporate bonds. Lower quality securities had the highest returns with both high yield and Emerging Markets Debt both posting returns above +5% for the quarter. Treasury prices declined for intermediate and longer maturities while mortgages managed returns slightly above 0%.

The following tables show the returns for the various fixed income sectors and rating categories for each quarter of 2020 as well as Year-To-Date with the 4th quarter highlighted:

Sector	1st Quarter 2020 Return*	2nd Quarter 2020 Return*	3rd Quarter 2020 Return*	4th Quarter 2020 Return*	YTD 2020 Return*
U.S. Treasuries	8.2%	0.5%	0.2%	-0.8%	8.0%
MBS	2.7%	0.9%	0.2%	0.3%	4.2%
Inv. Grade Corporates	-3.6%	9.0%	1.5%	3.1%	9.9%
High Yield	-12.7%	10.2%	4.6%	6.5%	7.1%
Emerging Markets Debt	-13.4%	12.3%	2.3%	5.8%	5.3%
EMD – local currency	-15.2%	9.8%	0.6%	9.6%	2.7%

Source: Bloomberg
* Returns are from Bloomberg Barclays' indices except Emerging Markets Debt, which is from JP Morgan. All figures are as of 12/31/2020.

Credit Rating	1st Quarter 2020 Return*	2nd Quarter 2020 Return*	3rd Quarter 2020 Return*	4th Quarter 2020 Return*	YTD 2020 Return*
AAA	5.8%	0.7%	0.2%	-0.3%	6.4%
AA	1.5%	4.5%	0.9%	1.4%	8.5%
A	-0.6%	7.0%	1.2%	2.1%	10.0%
BBB	-7.4%	11.2%	2.1%	4.0%	9.4%
BB	-10.2%	11.5%	4.0%	5.7%	10.2%
B	-13.0%	8.6%	4.5%	5.8%	4.6%
CCC	-20.6%	9.1%	7.4%	9.9%	2.3%

Source: Bloomberg

*Returns are from Bloomberg/Barclays' indices except Emerging Markets Debt, which is from JP Morgan. All figures are as of 12/31/2020.

U.S. Treasuries

Treasury prices declined for intermediate and longer maturities over the quarter after experiencing massive price increases earlier in the year due to the flight to quality. The Federal Reserve continues to support the Treasury market and stated that "over coming months the Federal Reserve will increase its holdings of Treasury securities and agency mortgage-backed securities at least at the current pace to sustain smooth market functioning and help foster accommodative financial conditions." They also reiterated that they aim to achieve inflation moderately above 2% so that inflation averages 2% over time.

In the 4th quarter, investors continued to be focused on buying credit and equities and less on the safety of Treasuries. With the election of Joe Biden and the approval of a vaccine, investors positioned themselves for improved economic growth and higher inflation over the coming year by pricing in a steeper yield curve. In the 4th quarter, the 2-year Treasury yield was close to unchanged while the yield of the 5-year rose 8 bps. The 10-year and 30-year rose 24 and 19 bps respectively. The two-year finished the quarter at 0.13% while the ten-year closed at 0.93%. So, overall, Treasury yields mostly rose but remain at very low levels.

Spread Products

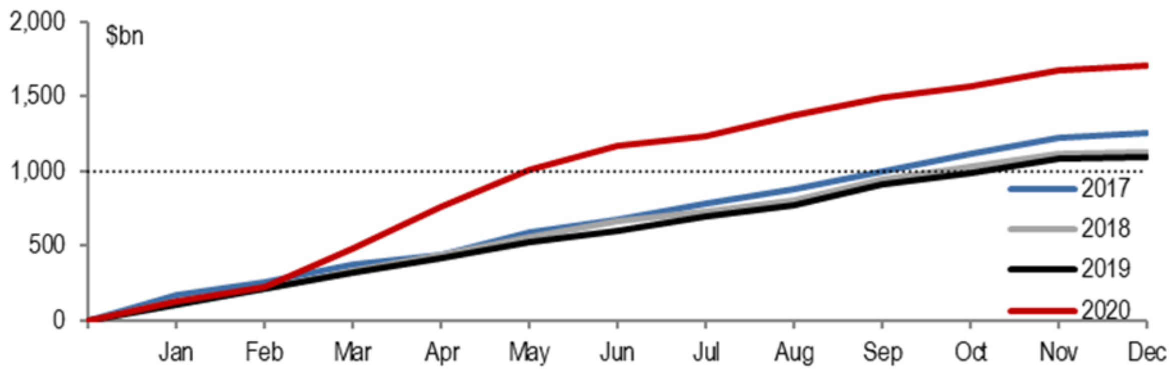
Spreads were again tighter across all of the various credit sectors during the quarter as investors continued to look for yield due to continued optimism about the vaccine and the long-term economic recovery. Investment grade corporates, high yield, and EMD posted good returns. Spreads have tightened significantly for all three segments of credit since late March and have recovered most of the widening from early in the year. Below is a table that shows spreads for investment grade corporates, high yield, and EMD as of year-end 2019, and the end of each quarter of 2020:

Sector	12/31/2019	3/31/2020	6/30/2020	9/30/2020	12/31/2020
Investment Grade Corporates	+96	+276	+150	+135	+95
High Yield	+357	+899	+626	+547	+387
Emerging Markets Debt	+291	+626	+474	+432	+352

* 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 40 bps in the 4th quarter and 181 over the past nine months, making back all of the widening from February and March. This was a staggering recovery considering the extremely poor economic environment that occurred earlier in the year and the uncertainty that still exists due to the surge in the coronavirus. Utilities slightly outperformed industrials and financials during the quarter, while longer duration corporates had higher returns than shorter duration corporates. Corporate bond issuance continued to be heavy in the 4th quarter with total 2020 issuance exceeding $1.75 trillion. Below is a chart that shows issuance over the last four years and 2020 easily set an all-time record.

Corporate Bond New Issuance



Source: JP Morgan & Dealogic
As of December 31, 2020

In mortgages, Commercial Mortgages (CMBS) continued to outperform 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. Asset-backed securities performed in-line with pass-through mortgages.

High yield was the best performing sector within U.S. fixed income in the 4th 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 +5.7% as compared to +9.9% for CCC-rated bonds. The average high yield security rose over 5 points to $105. High yield spreads tightened 160 bps to 387 over Treasuries. The current spread for high yield is now much tighter than the long-term average of 500 to 525. The yield-to-worst fell by 159 bps to an all-time low of 4.18%, due to the tighter spreads. Default activity increased in the 4th quarter and rose slightly from 5.8% to 6.2%. For the year, defaults increased significantly from the 2019 default rate of 2.6%. While this is higher than historical averages, most estimates are for defaults to decrease in 2021 as the economy recovers further after the vaccine is widely distributed. Energy prices need to be monitored as lower oil prices could cause defaults to remain high. Oil prices are important for the asset class since over 13% of the high yield index is composed of energy-related companies.

U.S. Dollar Emerging Markets Debt performed well with spreads tightening by 80 bps in the quarter to close at 352 bps over Treasuries. Local currency EMD had a quarterly return of close to 10% after lagging greatly through most of the year. In US Dollar EMD, lower quality countries outperformed higher-quality countries which was in stark contrast from the first three quarters. Overall, yields for U.S. Dollar EMD declined by 60 basis points to 4.55%.

The Economy

Economic activity continued to rebound after the staggering declines in March and April as millions of workers were rehired. Retail sales slowed in October and November as the re-imposed lockdowns in several states weighed on the ability for consumers to spend. Spending could remain sluggish at the start of 2021 until the virus gets more under control. Manufacturing continued to rebound as inventories were low. Industrial Production is up +0.4% and +0.9% over the past two months and is now about -5% lower than the pre-pandemic reading back in February. Auto production remains strong, but some sectors are still struggling. New and existing homes sales declined from the torrid pace from the summer as record low mortgage rates and pent-up demand combined to push housing sales up for several months before the recent declines. Sales remain healthy as we move into the new year.

The Federal Reserve Bank of Atlanta's GDPNow model, a running estimate of growth during the quarter, was projecting a continued strong rebound of +8.9% for the 4th quarter as of January 5. This estimate mostly contained data from the first two months of the quarter, so it doesn't capture a lot of the activity in December which could be lower due to the increased restrictions in some states. Many estimates for 4th quarter growth are between +4% and +8%.

The non-farm payroll gains were weaker than expected in November at 245,000, down from a 610,000 gain in October. The unemployment rate peaked in April at 14.7%, declined to 11.1% in June and fell further to 6.7% in November. Despite the improvement, this is well above the recent low of 3.5% in February. So far, 12.3 million of the 22 million jobs lost in the first two months of the crisis have been brought back. Jobless claims have declined but remain high. New unemployment claims were 787,000 during the week of December 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 5.2 million which is down from the peak of about 25 million in May and 11.9 million last quarter.

Inflation

Inflation did not change significantly this quarter despite the increase in global economic growth. Oil prices rose steadily during the quarter with West Texas Crude climbing by $8 dollar a barrel to $48.5. Other commodity prices mostly rose with the Bloomberg Commodity Index rising by about 10% over the past three months. Despite the rise over the last six months, commodities, including oil, mostly declined in 2020 due to the pandemic with oil prices about 20% lower from the start of last year.

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), remained well below the target for both the headline and the core data (ex-food and energy) over the last three months. The CPI increased +1.2% year-over-year, down from +1.3% at the end of last quarter. Core CPI was slightly lower and grew by +1.6% over the past year. The PPI increased by +0.8%, 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 moved lower and remained well below the Fed's target, with an overall year-over-year increase of +1.1% and a Core PCE deflator increase of +1.4%. It is very possible that this measure could move above 2% over the next six months particularly since inventories are generally low. In addition, many prices of goods and services most impacted by the pandemic, dropped earlier this year, some significantly. By the summer of 2021, prices may show a rebound and push year-over-year inflation numbers temporarily higher. 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).

Mortgage spreads finished 2020 at +98 bps over the 5-year Treasury which is near the levels they started the year. Despite this, mortgage borrowing rates fell over 100 bps to finish the year at an effective rate of 2.99% because of the decline in Treasury yields. These low rates brought on a wave of refinancing, raising the MBS refi index by 129% in 2020 which, along with higher rate volatility, made navigating the mortgage market challenging. Almost 73% of recent mortgage loan applications were for refinancing. Prepayment rates soared to 40-50% CPR range for most of the major coupons. Managing mortgages in 2020 became somewhat of a game of prepayment avoidance. Fortunately, the Fed's mortgage purchase program boosted lower coupon roll profitability which offered an avenue for avoiding prepays.

In the non-agency mortgages, higher quality issues recovered from the sharp COVID shutdown induced widening in March though wider spreads still linger for lower credit issues. In 2020, AAA rated CMBS yields fell by 129 bps with no net change in OAS. BBB rated issues finished the year with yields 92 bps higher and OAS 227 bps higher. Finding good relative opportunities is always possible in the non-agency space, but we focus on finding good absolute return opportunities which will continue to produce if the market sentiment changes. These have been more difficult to find, but we continue to seek these opportunities to add to our portfolios.

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 and are now tighter 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 6% 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 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 greatly increased our allocation due to the much more attractive spreads. With spreads back near levels from the beginning of the year, we need to be very selective on additional purchases. Security selection will be important due to the uncertainties regarding economic growth due to the virus and future policy changes from the new administration that will begin in late January.

High Yield recovered the losses from earlier in the year, supported by the rise in equity prices, massive liquidity from global Central Banks and higher oil prices. High yield spreads are now tighter than long-term averages and are slightly expensive given the uncertainties. We are buying cautiously since the market recovered so quickly and spreads could widen if equity prices decline, economic growth 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.

Emerging Markets Debt continued to rebound during the quarter, both for hard and local 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 as compared to other fixed income asset classes. 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 reduced our underweight in some of the higher quality countries in Asia and the Middle East. Overall, our main overweights are Brazil, Mexico, Argentina, Turkey, 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. High yield EMD has greatly underperformed investment grade EMD over the past year and we believe the higher yielding segment of the market will outperform over the next year.

The Look Forward

This past year was a very difficult and challenging time for everybody, mostly due to the pandemic, and sadly, the first few days of 2021 are not encouraging. I am not going to recount all of the problems, but it is safe to say we are all ready to move forward. Being an optimist, I am confident that better days are ahead.

Surprisingly, one of the few positives in 2020 was the returns in the financial markets. Global equity markets were up double-digits and fixed income returns were mostly in the 7% to 10% range. These returns came despite a significant decline in economic activity over a four-month period, higher default rates, increased rating downgrades, and much higher unemployment.

These economic challenges may continue over the first few months of 2021 as the surge in infections has led to increased restrictions on businesses in some areas of the U.S. and other countries. So, the 1st quarter of the year may see a decline in GDP growth. We do believe that this will be short-lived. As the vaccine gets more widely distributed, restrictions will be lifted, and economic growth should be strong. Consumers spending should accelerate due to the high savings rate and significant pent-up demand. People have been “trapped” at home for almost a year and will be looking to travel, eat out at restaurants, visit family and friends and get back to enjoying life. Companies that were severely impacted by the pandemic should begin to rehire employees which would push the unemployment rate down and increase personal income. In addition, the change to a new Democrat administration that will also have a majority in both houses of Congress, will most likely lead to increased government spending including a new round of stimulus checks.

Normally, strong economic growth leads to higher interest rates from the Federal Reserve. That should not be the case in 2021 as the Fed has stated that they want inflation to average 2% over the long-run so they will allow prices to increase by more than this level for a period of time without pushing rates higher. They currently forecast that the Funds Rate will remain near 0% until 2023. We are not sure if they will be able to wait that long, but we are confident that rates will not be changed this year. So, we believe that the yield curve will steepen this year as yields for intermediate and longer maturities will rise moderately while the 2-year will stay anchored by the Fed Funds Rate. With yields on Treasuries so low, we believe returns in Treasuries could be negative.

For credit, the strong economic environment later in 2021 should be positive and we expect spreads to tighten slightly during the year. We would like to be even more positive but spread levels in investment grade and high yield corporates are already tighter than long-term averages. Security and country selection will be extremely important as there are fewer opportunities than six to nine month ago. We will continue to cautiously add credit positions to our portfolios as we find opportunities with good long-term value.

Sometimes, ch-ch-ch-changes are a good thing. The approval of two vaccines certainty is a positive change and these could help reduce or eliminate the health scare and move the world back to a more normal way of life. Despite the extremely contentious political environment in the U.S., I am hopeful that the country will come together as we always have in the past. I hope for a great 2021 for everyone.

SUMMARY

To summarize our outlook:

1) Economic growth could contract in the 1st quarter, but we believe growth will be robust in the 2nd half of 2021 as the vaccine is distributed more widely and consumer spending accelerates.
2) The Federal reserve will keep the Fed Funds Rate near 0% and continue to provide liquidity by adding to their balance sheet by purchasing Treasuries and mortgages.
3) U.S. interest rate will rise moderately for intermediate and longer maturities and the yield curve will steepen.
4) With yields so low, returns for Treasuries could be negative in 2020.
5) Credit spreads will tighten slightly.
6) Security and country selection will be very important as fewer opportunities exist as compared to six to nine months ago.
7) Caution is warranted as numerous events could derail the recovery. Don't be greedy.

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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