Fixed Income Market Review and Outlook

March 31, 2021

Market Overview

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"Don't Worry, Be Happy" was a # 1 hit song in the late 1980's. It was a very annoying song, and the type that was tough to get out of your head after you heard it. Lately, this song keeps popping into my head every time I hear Federal Reserve Chairman Powell speak about inflation and the bond market. He seems to be saying that inflation will rise above their 2% target, but "Don't Worry, Be Happy" because inflation will be short-lived and go back down to target within several months. So far, the bond market is not listening to him and is worried, very worried, about inflation. Investors started to become concerned about inflation soon after President Biden was elected in November. The consensus was that Government spending would grow substantially and the economy would heat up to the point that would cause higher inflation. This caused Treasury prices to decline substantially for intermediate and longer maturities and for most fixed income sectors to post negative returns.

In the 1st quarter, the Bloomberg/Barclay's Capital Aggregate Index had a return of -3.4%, driven by the decline in Treasuries. In general, longer duration bonds, regardless of sector performed poorly including investment grade corporates and emerging markets debt (EMD). Mortgages held in better than Treasuries or corporates mostly due to their shorter duration. High yield was the lone sector that had a positive return aided by rising equity prices, higher oil prices, lower defaults and their shorter duration.

The following tables show the returns for the various fixed income sectors and rating categories for the first quarter of 2021:

Sector	1Q Return*
U.S. Treasuries	-4.3%
MBS	-1.2%
Inv. Grade Corporates	-4.7%
High Yield	0.9%
Emerging Markets Debt	-4.5%
EMD – local currency	-6.7%

Credit Rating	1Q Return*
AAA	-2.9%
AA	-4.3%
A	-4.9%
BBB	-4.3%
BB	-0.2%
B	1.2%
CCC	3.6%

Source: Bloomberg
* Returns are from Bloomberg Barclays' indices except Emerging Markets Debt, which is from JP Morgan. All figures are as of 3/31/2021.

U.S. Treasuries

As mentioned above, rising inflation expectations crushed the Treasury market. Treasury prices declined for intermediate and longer maturities while the front-end of the market was anchored by the Fed Funds rate which remained at 0% to 0.25%. Despite the rise in rates, the Federal Reserve does not seem concerned. A recent statement from the Fed said that they do not expect to change the Fed Funds Rate or reduce their bond purchases for some time. Part of the statement said that "we expect that it will be appropriate to maintain the current accommodative target range of the federal funds rate until labor market conditions have reached levels consistent with maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time."

In the 1st quarter, the 2-year Treasury yield rose by only 3 bps while the yield of the 5-year rose 56 bps. The 10-year and 30-year rose 81 and 76 bps respectively. The two-year finished the quarter at 0.16% while the ten-year closed at 1.74%. The significant move in the ten-year brings it back close to where it was trading before the pandemic. Overall, Treasury yields rose, and the yield curve steepened considerably.

Spread Products

Spreads were close to unchanged for investment grade corporates and EMD, but much tighter for high yield corporates. Returns were poor for both investment grade corporates and EMD due to the significant rise in Treasury yields as these sectors have long durations.

Below is a table that shows spreads for investment grade corporates, high yield, and EMD as of year-end 2019, the 1st quarter of 2020 after the pandemic hit, the end of 2020, and the end of the 1st quarter of 2021:

Sector	12/31/2019	3/31/2020	12/31/2020	3/31/2021
Investment Grade Corporates	+96	+276	+95	+94
High Yield	+357	+899	+387	+357
Emerging Markets Debt	+291	+626	+352	+354

* 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 2 bps in the 1st quarter and 182 over the past year, making back all of the widening caused by the pandemic. This was a staggering recovery considering the extremely poor economic environment that occurred in March through May of last year. Financials outperformed industrials and utilities during the quarter, while longer duration corporates had much weaker returns than shorter duration corporates. Corporate bond issuance continued to be very heavy in the 1st quarter despite the rise in yields.

In mortgages, fixed-rate pass-through mortgages outperformed Commercial Mortgages (CMBS). Despite the recovery, there is still 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 held in well due to their very short duration.

High yield was the best performing sector within U.S. fixed income and the only sector to post a positive return in the 1st quarter. The stronger relative performance was due to rising equity prices, lower default expectations and a lower correlation to Treasury prices. Lower-rated high yield out-performed higher quality, with BB's returning -0.2% as compared to +3.6% for CCC-rated bonds. The average high yield security declined by less than 1 point to $104.2. High yield spreads tightened 30 bps to 357 over Treasuries. The current spread for high yield is much tighter than the long-term average of 500 to 525. The yield-to-worst rose by 5 bps to 4.23%. Default activity decreased in the 1st quarter and the twelve-month default rate declined from 6.2% to 4.8%. While this is higher than historical averages, most estimates are for defaults to decrease further in 2021 as the economy recovers 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 poorly due to the decline in Treasury prices with spreads widening by 2 bps in the quarter to close at 354 bps over Treasuries. Local currency EMD also was weak and had a quarterly return of -6.7%. In US Dollar EMD, lower quality countries outperformed higher-quality countries which was in contrast from much of the last two years. Overall, yields for U.S. Dollar EMD rose by 73 basis points to 5.28%.

The Economy

Economic activity continued to rebound in the 1st quarter. The year began on a strong note, partly due to the 2nd stimulus check, but activity slowed in February as severe winter weather kept people homebound. The housing market is booming with prices rising and stories of houses being sold in days with multiple offers. Manufacturing surged with the ISM Manufacturing Index rising to 64.7, the highest level since 1983. Supply shortages are becoming more common in certain segments and could hamper growth in the near future. Air travel picked up considerably late in the quarter as more people became comfortable with travel. The ISM Service PMI rose to a record high of 63.7. Retail sales slowed in February but is expected to bounce back in March and April after the 3rd stimulus check arrives.

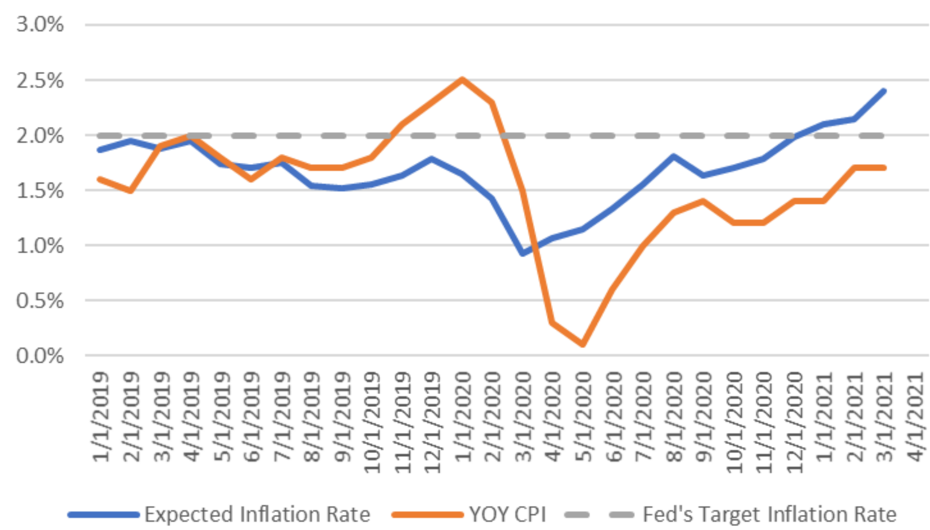
The Federal Reserve Bank of Atlanta’s GDPNow model, a running estimate of growth during the quarter, was projecting a continued strong rebound of +6.2% for the 1st quarter as of April 7. This estimate mostly contained data from the first two months of the quarter, so it doesn’t capture a lot of the activity in March. Many estimates for 1st quarter growth are between +4% and +6%.

The non-farm payroll gains were stronger than expected in March at 916,000, up from a 468,000 gain in February. Employment is still 8.4 million below the pre-pandemic level from just over a year ago. Leisure and hospitality bounced back with gains of 280,000. This was the hardest hit sector and still has over 3 million fewer people employed. The unemployment rate peaked in April at 14.7%, declined to 6.7% in December and fell further to 6.0% in March. Despite the improvement, this is well above the recent low of 3.5% in February. Jobless claims have declined but remain high. The four-week moving average for new unemployment claims was 719,000 at the end of March. This has moved down over the last few weeks but is still extremely high on a historical basis. As a reminder, claims were running slightly above 200,000 before the pandemic. Continuing claims were reported at 3.8 million which is down from the peak of about 25 million in May and 5.2 million last quarter. This is the lowest level in over a year.

For all of 2021, most estimates are for growth of between 6% and 8%, which would be the highest level since the 1980’s. Consumers have a very high savings rate and significant pent-up demand that will go a long way to drive growth. As long as the vaccine distribution continues and the virus gets contained, growth will most likely be very strong through the rest of 2021.

Inflation

As mentioned earlier in my commentary, inflation was the main topic and driver of fixed income returns this quarter. Although inflation has moved higher in 2021, the most recent data still has it much lower than the Fed's target of 2%. However, year-over-year inflation will rise over the next several months as prices in some sectors (airlines, hotels, oil, etc.) that declined last March through May due to the pandemic will become the starting point for calculations. So, it is not a matter of if inflation will rise above 2%, but how high will it go and for how long. Inflation expectations have risen above the Fed's target since late in 2020 and are currently about 2.4% based on current ten-year Treasury and TIPS yields. Below is a chart that shows both the CPI and inflation expectations since the beginning of 2019.



Source: Bloomberg

The Federal Reserve believes that the rise in inflation over the next several months will be "transitory" and will decline back to target without any actions on their part.

Oil prices rose during the quarter with West Texas Crude climbing by over $10 dollar a barrel to $59.2. Other commodity prices mostly rose with the Bloomberg Commodity Index rising by about 7% over the past three months. Although the CPI data shown above is 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 higher but remained well below the Fed's target, with an overall year-over-year increase of +1.6% and a Core PCE deflator increase of +1.4%. This measure will also most likely move well above 2% over the next six months. However, the Fed will allow inflation to move above 2% for a period as they are now targeting a 2% average for inflation.

DUPONT CAPITAL

Portfolio Positioning

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

Mortgage spreads are currently at +111 bps over the 5-year Treasury. The spread has moved around considerably between 106 and 123 this quarter as the treasury curve beyond 1-year maturities steepened considerably. Prepayments remain high even though effective 30-year mortgage rates have increased by almost 50 bps since year end. The relatively low borrowing rates have fueled a strong housing market with a 11% year-over-year price increase as depicted by the S&P CoreLogic Case-Shiller index.

New investment opportunities are challenging to find as most spread product is tight and low yielding, indicating that staying closer to the benchmark may be prudent. However, some potential strong opportunities can be found in the CMBS sector where media stories have frightened most investors away from the retail (malls), office and hotel sub-sectors. Investors can be paid handsomely providing liquidity to those selling this sector while avoiding land mines.

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 by 1 basis point during the quarter and are trading tighter than historical averages. We believe that investment grade corporate bonds still represent the best value in the investment grade fixed income market. We were not very active so far this year after increasing our allocation to corporates in 2020 after spreads widened earlier that 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 consumer non-cyclicals. Regarding ratings, we are overweight BBB and AA-rated corporates and underweight AAA-rated. In Long Duration, we had very little exposure to long corporates at the beginning of 2020 and greatly increased our allocation due to the much more attractive spreads. With spreads back to levels from the beginning of 2020, 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 Biden administration.

High Yield performed better than other fixed income sectors, supported by the rise in equity prices, massive support from global Central Banks and higher oil prices. High yield spreads are much tighter than long-term averages and are not attractive at current levels. We are very cautious in adding positions as 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 that could provide strong returns over the long-term.

Emerging Markets Debt performed poorly in the first quarter, mostly due to the rise in Treasury yields. Spreads for EM sovereigns were close to unchanged and are modestly attractive at current 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 in the spring of 2020 after spreads widened out. This past quarter, we were not very active but added small positions in Ukraine, Argentina, Pemex, and Turkey. Overall, our primary 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 two years and we believe the higher yielding segment of the market will outperform over the next year.

The Look Forward

Inflation, inflation, inflation. That is all everyone was talking about. Fixed income returns over the last few months were mostly driven by rising inflation expectations and this will most likely continue for the rest of 2021.

Economic growth will be very strong with most estimates between 6% and 8%. To put this in context, the U.S. has only had one year (1984) over the last 50 years with growth above 6% (+7.2%). This extraordinary growth will come from a combination of huge pent-up demand from the pandemic, a very high savings rate aided by three stimulus payments, low interest rates, and high government spending. Despite the slow and frustrating initial roll-out of vaccine distribution, the U.S. has greatly accelerated the pace and the majority of the country could be vaccinated by the end of May. This has already increased spending on flying, hotels, and eating out at restaurants. This will certainly grow much more as we get into the summer. Companies are hiring again as demand picks up and the unemployment rate should continue to fall throughout the year. The Biden administration passed another stimulus bill and recently announced an infrastructure plan that would increase government spending. Time will tell whether the plan gets passed, but it is likely that government spending will increase over the next several years.

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 for a period of time without pushing rates higher. They currently forecast that the Funds Rate will remain near 0% until 2023. We do not think 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 further this year, but at a slower pace, 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 rising, we believe returns in Treasuries will be negative for all of 2021.

For credit, the strong economic environment in 2021 should be positive for credit fundamentals. However, spreads are already very tight for high yield and moderately tight for investment grade. If the economy does well and inflation does not stay high, credit spreads could remain tight through year-end. Emerging markets debt looks slightly attractive relative to corporates at current spread levels. Security and country selection will be extremely important as there are fewer opportunities than twelve months ago. We will continue to cautiously add credit positions to our portfolios as we find opportunities with good long-term value.

"Don't Worry, Be Happy" is what the Federal Reserve is telling us. If the Fed is correct and inflation does not stay above 2%, financial markets should be in good shape and the fixed income markets should stabilize. That would make us happy. If inflation remains high, yields for Treasuries will rise further and financial markets, including equities, could see increased volatility and stumble. Let's hope that Fed Chairman Powell is correct.

SUMMARY

To summarize our outlook:

1) Economic growth will be robust in 2021 as the vaccine is distributed more widely and consumer spending accelerates. Growth could be in the range of 6% to 8%.
2) Inflation will be the main driver of returns until at least early next year. We believe inflation will rise above 2% and stay above the Fed's target for at least several months.
3) 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.
4) U.S. interest rate will rise moderately for intermediate and longer maturities and the yield curve will steepen.
5) Returns for Treasuries will most likely be negative for all of 2021.
6) Corporate spreads, both investment grade and high yield, are expensive but could remain near current levels for a while due to strong fundamentals.
7) Security and country selection will be very important as fewer opportunities exist as compared to twelve months ago.
8) Caution is warranted as inflation 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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