DuPont Capital

Fixed Income Market Review and Outlook

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Market Overview

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In my 1st quarter commentary, I said that Federal Reserve Chairman Jerome Powell's comments made me think of the annoying song "Don't Worry, Be Happy". His message seemed to be that inflation would be transitory so don't worry about it. I have been skeptical about this message. In the 2nd quarter, Jerome Powell and the other Fed members changed their tune to something I like much better, both from a musical standpoint and in regard to the financial markets. In 1966, the Four Tops sang "Reach Out, I'll Be There" and it was one of the best-known Motown songs of the 1960's. Part of the chorus included the lyrics:

Darling, reach out, come on girl, reach out for me
I'll be there, to love and comfort you
And I'll be there, to cherish and care for you

I think this song represents the Fed's new message. While Jerome Powell is still saying that he believes inflation will be transitory, the Federal Reserve has moved their median forecast for the next interest rate hike from 2024 to 2023. Also, seven members of the Fed think they might need to raise rates as early as next year. Finally, the Fed is also going to start talking about tapering their bond purchases soon and will announce their plans after the meetings in either late July or mid-September. Essentially the Federal Reserve is saying that "they will be there to comfort investors" if inflation runs too high for too long. This change in tune did work as suddenly the financial markets seemed to stop worrying about inflation with Treasury yields falling for most maturities and the stock market moving to new highs.

In the 2nd quarter, the Bloomberg/Barclay's Capital Aggregate Index had a return of +1.8%, driven by the rise in most Treasuries and the narrowing of credit spreads. In general, longer duration bonds, regardless of sector performed well including investment grade corporates and emerging markets debt (EMD). Mortgages had a lower return than Treasuries and corporates mostly due to their shorter duration. High yield also did well, aided by rising equity prices, higher oil prices, and lower defaults.

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

Sector	2Q Return*	YTD Return*
U.S. Treasuries	1.8%	-2.6%
MBS	0.4%	-0.7%
Inv. Grade Corporates	3.6%	-1.2%
High Yield	2.7%	3.6%
Emerging Markets Debt	4.1%	-0.7%
EMD – local currency	3.5%	-3.4%

Credit Rating	2Q Return*	YTD Return*
AAA	1.2%	-1.7%
AA	3.0%	-1.4%
A	3.2%	-1.8%
BBB	3.7%	-0.8%
BB	2.9%	2.7%
B	2.2%	3.4%
CCC	3.5%	7.2%

Source: Bloomberg
* Returns are from Bloomberg Barclays' indices except Emerging Markets Debt, which is from JP Morgan. All figures are as of 6/30/2021.

U.S. Treasuries

Moderating inflation expectations helped fuel a rally in most of the Treasury market. Treasury prices rose and yields declined for intermediate and longer maturities while the yield of the front-end of the market rose slightly as expectations on the next Fed Funds rate hike moved forward from 2024 to 2023. The most recent "dot plot" showed that the Fed Governors forecast that they will increase the Funds rate twice in 2023. In addition, some of the Fed Governors want to start talking about tapering the bond purchases and investors believe this may happen later this year.

In the 2nd quarter, the 2-year Treasury yield rose by 9 bps while the yield of the 5-year declined by 5 bps. The 10-year and 30-year fell 27 and 35 bps respectively. The two-year finished the quarter at 0.25% while the ten-year closed at 1.47%. Overall, Treasury yields declined for intermediate and longer maturities, and the yield curve flattened. For the year, yields are higher for almost all maturities.

Spread Products

Spreads were tighter across all credit sectors with high yield moving significantly tighter. Returns were also strong in credit with Emerging Markets Debt and Investment Grade Corporates leading the way, partly due to the sectors' longer duration.

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 and 2nd quarters of 2021:

Sector	12/31/2019	3/31/2020	12/31/2020	3/31/2021	6/30/2021
Investment Grade Corporates	+96	+276	+95	+93	+83
High Yield	+357	+899	+387	+357	+311
Emerging Markets Debt	+291	+626	+352	+354	+340

* 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 10 bps in the 2nd quarter to 83 over Treasuries, the tightest level since 2005. Industrials and utilities outperformed financials during the quarter, while longer duration corporates had much stronger returns than shorter duration corporates. Corporate bond issuance continued to be heavy in the 2nd quarter as corporations take advantage of the high investor demand and lower yields.

In mortgages, fixed-rate pass-through mortgages underperformed Commercial Mortgages (CMBS). The CMBS market has improved despite 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 posted a small positive return.

High yield performed well, but lagged the sectors that have longer durations, such as investment grade corporates, EMD, and Treasuries. For the year, high yield is the only fixed income sector with a positive return. The stronger performance was due to rising equity prices, lower default expectations, higher oil prices, and a lower correlation to Treasury prices. Lower-rated high yield out-performed higher quality, with BB's returning +2.9% as compared to +3.5% for CCC-rated bonds. The average high yield security rose by more than 1 point to $105.4. High yield spreads tightened 46 bps to 311 over Treasuries. The current spread for high yield is much tighter than the long-term average of about 500. The yield-to-worst declined by 48 bps to 3.75%, the lowest yield on record. Default activity decreased in the 1st half of the year and the twelve-month default rate declined from 4.8% to 1.9%. This is much lower than the historical default rate of 3.6% and most estimates are for defaults to remain low over the next year as the economy recovers.

U.S. Dollar Emerging Markets Debt performed well partly due to the rise in long Treasury prices with spreads tightening by 14 bps in the quarter to close at 340 bps over Treasuries. Local currency EMD also performed well and had a quarterly return of 3.5%. In US Dollar EMD, lower quality countries outperformed higher-quality countries which was in contrast to 2019 and 2020. Overall, yields for U.S. Dollar EMD declined by 37 basis points to 4.91%.

The Economy

The rebound in economic activity accelerated in the 2nd quarter. The vaccine distribution moved more smoothly and the spread of COVID-19 decreased significantly. More areas of the economy reopened including travel, restaurants, and other entertainment. Consumer spending soared. The housing market is booming with prices rising with stories of houses being sold in days with multiple offers. Manufacturing remained strong with the ISM Manufacturing Index staying above 60 and finished the quarter at 60.6. Supply shortages are still common in certain segments and could hamper growth in the near future. Air travel picked up considerably as people became comfortable with travel. Retail sales slowed in May after strong sales for most of the year. Retails sales grew by 11% in March and 0.9% in April before declining -0.9% in May.

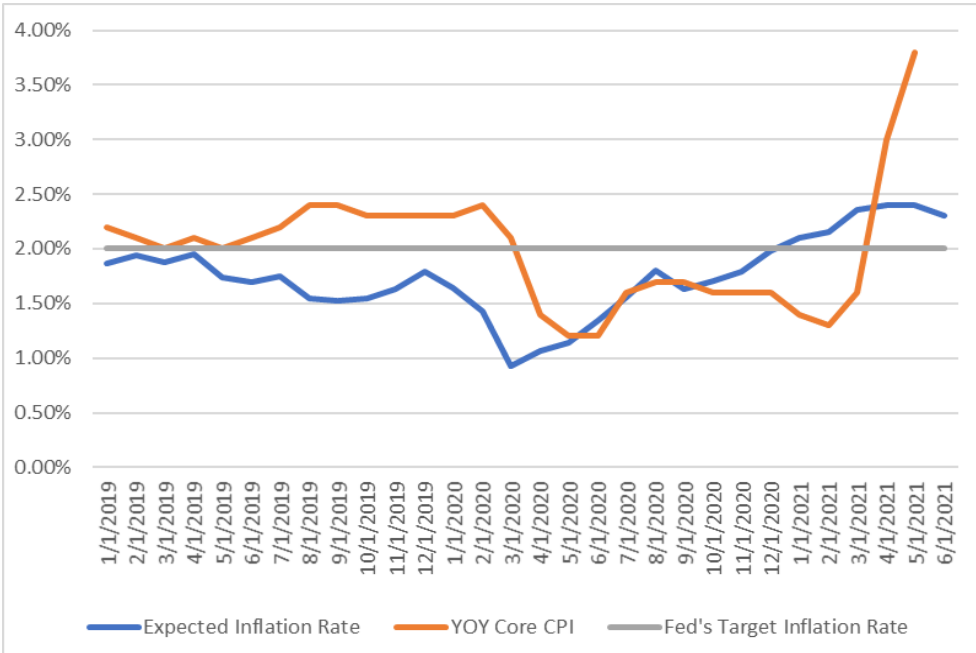
The Federal Reserve Bank of Atlanta's GDPNow model, a running estimate of growth during the quarter, was projecting a continued strong rebound of +7.8% for the 2nd quarter as of July 2. This estimate primarily contained data from the first two months of the quarter, so it doesn't capture a lot of the activity in June. Many estimates for 2nd quarter growth are between +6% and +8%.

The non-farm payroll gains were strong in June at 856,000, up from 583,000 in May and 264,000 in April. Employment is still 8.4 million below the pre-pandemic level from just over a year ago. Leisure and hospitality continued to bounce back with gains of 343,000. This was the hardest hit sector and still has over 2 million fewer people employed. The unemployment rate peaked in April of 2020 at 14.7%, declined to 6.7% in December and fell further to 5.9% in June. Despite the improvement, this is well above the low of 3.5% in February of last year. Jobless claims continue to decline. The four-week moving average for new unemployment claims was 392,750 at the end of June, the lowest since March of 2020. As a reminder, claims were running slightly above 200,000 before the pandemic. Continuing claims were reported at 3.5 million which is down from the peak of about 23 million in May of 2020 and 3.8 million last quarter. This is the lowest level in about 15 months.

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 virus stays contained, growth will most likely be strong through the rest of 2021.

Inflation

As mentioned earlier in my commentary, inflation continued to be the main topic in financial markets this quarter. Despite inflation rising to levels not seen in close to thirty years, inflation did not result in higher interest rates like last quarter. This is because inflation expectations have stabilized after rising significantly since late last year and are currently about 2.3% based on current ten-year Treasury and TIPS yields. Below is a chart that shows both the Core Consumer Price Index (Core CPI) and inflation expectations since the end of 2019.



Source: Bloomberg

The CPI has risen 5% over the past year while the Core CPI is up 3.8%. The Core CPI is the highest since 1992. The Federal Reserve believes that the increase in inflation will be "transitory" and will decline back to target without any actions on their part. Although they have been saying this for several months, they just recently moved forward their projection for the next rate hike to 2023 and will soon start talking about reducing their bond purchases. These statements have comforted investors in believing that the Fed will take action if needed to contain inflation.

Oil prices rose during the quarter with West Texas Crude climbing by over $14 dollar a barrel to $73.5. For the year, oil has risen $25 per barrel which is an increase of over 50%. Other commodity prices mostly rose with the Bloomberg Commodity Index rising by over 13% over the past three months and over 20% Y-T-D. Although the CPI data in the chart 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 has moved much higher over the last few months with an overall year-over-year increase of +3.9% and a Core PCE deflator increase of +3.4%. This will likely stay above 2% over the next several months. However, the Fed will allow inflation stay above 2% as they are now targeting a 2% average for inflation and believe the current high rate is transitory and will decline back toward the target.

Instead of focusing on the year-over-year inflation data, it is more helpful to look at how prices have changed over a two-year time frame which reduces the base effect of COVID-19. If you calculate price changes from two years ago (before COVID-19) instead of one year (during COVID-19) and annualize the data, inflation is close to 2.5% instead of 3.8% for Core CPI and 5% for overall CPI.

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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).

The current extended period of easy money has made it challenging to find opportunities in the **Mortgage** market—too much money is trying to find investments. Most of the money seems to be going to the limited number of new issue deals, most of which have unattractive spreads. We have been focusing on areas of the mortgage market where investor fears have caused capital voids, such as CMBS with retail exposure. We had been avoiding this sector over the last several years but have been selectively buying. The COVID-19 panic response to jettison retail exposure produced many opportunities during the early stages of the epidemic that have continued. While we are negative on retail in the long run, we are positive in the shorter term and see opportunity. As the COVID-19 isolation dissipates people are getting out and supporting malls and other brick and mortar retail stores. We utilize multiple factors to find opportunities with multiple levels of protection. We consider loan to value (LTV), debt service coverage ratio (DSCR), occupancy, credit enhancement, weighted average life, NOI trends, servicer advances, payment histories and other characteristics. We select bonds with shorter weighted average lives to avoid the longer-term negatives of the sector, as well as bonds paying large coupons which provide additional protection in situations where the underlying loans have difficulty refinancing and extend beyond their original maturity dates. This approach has served us well in acquiring solid investment grade bonds that are producing double digit yields in a low yielding market. We will continue to add selectively to this sector in the short-term.

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 10 basis points during the quarter and are trading at the tightest level since 2005. We believe that investment grade corporate bonds still represent the best value in the investment grade fixed income market. We have not been very active this year after increasing our allocation to corporates in 2020 after spreads widened early that year. We currently hold an overweight of 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 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. We continue to selectively make additional purchases in long corporates as we find opportunities. Security selection will be very important as there are far fewer opportunities than there were a year ago.

High Yield continued to perform well, supported by the rise in equity prices, higher corporate earnings, fewer defaults, 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 or economic growth slows. We continue to look to identify companies with attractive valuations that could provide strong returns over the long-term.

Emerging Markets Debt rebounded after performing poorly in the first quarter. The decline in long treasury yields was the driving factor but spreads also tightened. Spreads for EM sovereigns tightened by 14 basis points during the quarter. Although spreads are not cheap, they are much more attractive as compared to other segments of credit, particularly high yield. We believe EMD will provide an attractive return over the long-term as compared to other fixed income asset classes. The high yield portion of EMD significantly underperformed investment grade EMD in 2019 and 2020 and we believe the higher yielding segment of the market will outperform over the next year or two. 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 year, we have not been 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.

The Look Forward

The Fed's statements in the 2nd quarter calmed inflation fears and helped reverse some of the rise in interest rates that occurred earlier in the year. They accomplished this not by changing policy but by doing nothing except talking and releasing a new dot plot. For this, I commend them. Although the fixed income markets changed during the quarter, our overall outlook did not change meaningfully.

Although U.S. economic growth may slow from the torrid pace in the second half of 2021, growth for the year will most likely be higher than 6% and possibly over 7%. 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%). The extraordinary growth this year has and 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. greatly accelerated the pace and the majority of the country has been vaccinated with abundant additional supply. There has been a huge increase on spending on flights, hotels, and eating out at restaurants. This will most certainly grow more through the summer. Companies are hiring again and having an extremely difficult time filling open positions, even with higher pay. The unemployment rate should continue to fall over the second half of the year. The Biden administration is starting to work on a bi-partisan infrastructure plan that would increase government spending over the next few years. Time will tell whether the plan gets passed, but it is likely that government spending will increase over the next few years.

Normally, strong economic growth and higher inflation leads to higher interest rates. That was not the case in the 2nd quarter as rates fell for intermediate and longer maturities. The Federal Reserve is facilitating the higher growth and inflation by keeping the Fed Funds rate near 0% and continuing to purchase $120 billion of bonds ($80 billion Treasuries and $40 billion of mortgages) per month. They will not raise rates this year but have changed their projection to show that they forecast two rate hikes in 2023. More imminently, they will be discussing tapering their bond buying and could announce a plan to reduce purchases after one of their next two meetings in late-July or mid-September.

We believe they will begin tapering purchases but will proceed cautiously as they are well aware of the problems in the bond markets after their last big tapering plan commenced in 2013. We also think they will not be able to wait until 2023 to make a rate hike, but we are sure that rates will not be changed this year or early next year. We believe that Treasury yields will rise moderately this year and the yield curve will steepen, but at a slower pace than what we saw early in 2021. With yields on Treasuries rising further, we believe returns in Treasuries will be negative for all of 2021.

For credit, the strong economic environment in 2021 will be very positive for credit fundamentals. However, spreads are already very tight for high yield and investment grade and are pricing in the great environment. If the economy does well and inflation does not stay high, credit spreads could remain tight and possibly tighten slightly further. Emerging markets debt looks slightly attractive relative to corporates at current spread levels. In all credit markets, security and country selection will be extremely important as there are far 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.

The biggest risk to the financial markets for the second half of 2021 would be a surge in COVID-19 infections due to the variants. This could derail both the equity and credit markets and cause interest rates to decline further. This is another reason not to take on too much risk and to keep overall positioning not too far from the benchmark.

The decline in interest rates in the 2nd quarter was a welcome relief for fixed income investors. The Federal Reserve's message of "I'll Be There" did the trick to stabilize markets and reduce inflation concerns. Will the message continue to work, or will the Fed change their tune again during the second half of the year? It is hard to say, but I am confident that the Fed will err on the easier side to make sure the economic rebound continues.

SUMMARY

To summarize our outlook:

1) Economic growth will be robust for all of 2021 as consumer spending stays high and businesses more fully reopen. Growth should be in the range of 6% to 7%.

2) Inflation will continue to be one of the main focal points and will remain above the Fed's 2% target until at least early next year. Supply constrains should ease later this year, but wages may continue to rise in the service sector until jobs get filled.

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. However, we believe they will announce a plan to taper purchases no later than September.

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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