Fixed Income Market Review and Outlook

September 30, 2021

Market Overview

Mark Foust
Senior Portfolio Specialist

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

I wish I could say that I enjoyed reading Shakespeare in my high school English class. But, alas, it is not true. Shakespeare's works were challenging to understand, and I always found it helpful to have the teacher explain what happened in the story. One of his comedies was "Much Ado About Nothing." Although I don't remember much about it, the title is a good description of the fixed income markets over the 3rd quarter. There was a lot going on in the 3rd quarter and the news headlines included: a surge in the Delta variant in the U.S., the withdrawal of troops from Afghanistan, the significant financial problems of a very large Chinese property developer, Evergrande, the potential breech of the debt ceiling, ongoing Congressional negotiations over the two large spending programs, and discussions about the beginning of the tapering of the Federal Reserve's bond purchase program. Despite all of this, nothing really changed much for the fixed income markets over the course of the quarter. Despite some volatility, interest rates were close to unchanged with just a small rise in rates, credit spreads also did not change much with a small widening in all sectors, and returns were close to 0%. It was "Much Ado About Nothing."

In the 3rd quarter, the Bloomberg Aggregate Index had a return of +0.05%. You can't get much closer to 0%. All other fixed income sectors were within +/-1% of 0%. Treasuries, Mortgages and investment grade corporates were all basically flat while high yield led the way at +0.9% while EMD lagged and declined slightly with a return of -0.7%. Even most of the rating categories had returns close to 0%.

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

Sector	3Q Return*	YTD Return*
U.S. Treasuries	0.1%	-2.5%
MBS	0.1%	-0.7%
Inv. Grade Corporates	0.0%	-1.3%
High Yield	0.9%	4.5%
Emerging Markets Debt	-0.7%	-1.4%

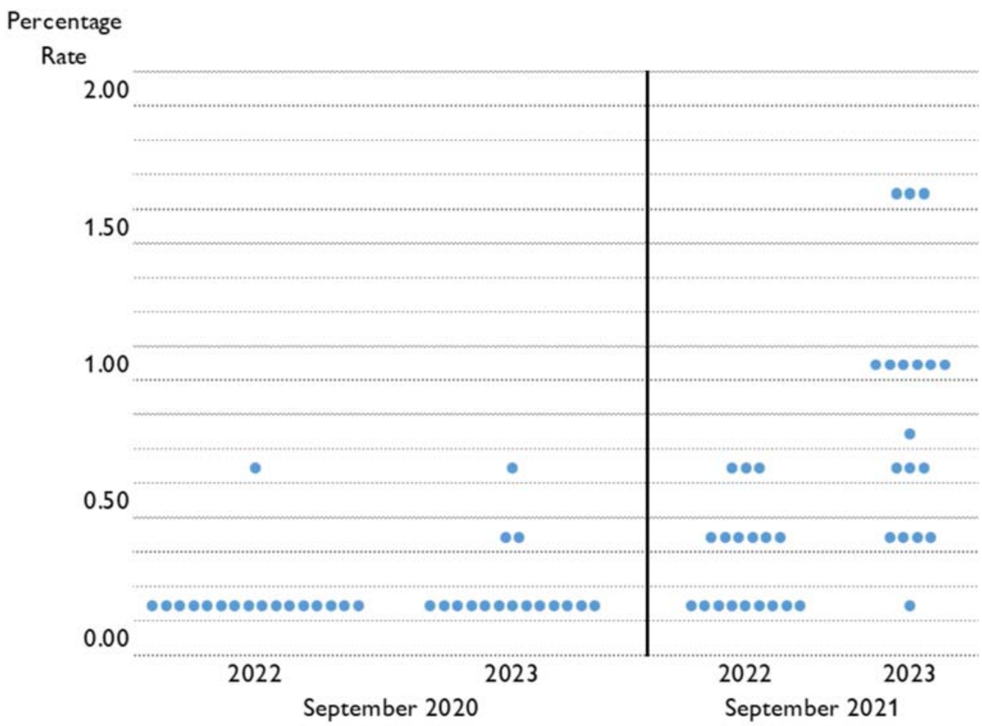
Credit Rating	3Q Return*	YTD Return*
AAA	0.1%	-1.7%
AA	0.0%	-1.4%
A	-0.1%	-2.0%
BBB	0.0%	-0.7%
BB	1.1%	3.8%
B	0.6%	4.0%
CCC	0.8%	8.0%

Source: Bloomberg
* Returns are from Bloomberg indices except Emerging Markets Debt, which is from JP Morgan. All figures are as of 9/30/2021.

U.S. Treasuries

As mentioned, Treasury yields did not change much during the 3rd quarter. Continued confidence in the Federal Reserve and moderating economic growth kept investors calm. Treasury yields rose slightly for all maturities with the middle of the curve rising more than the front and back-ends of the curve. This came despite the Fed continuing to slowly move their forecast for rate hikes sooner. The most recent "dot plot" showed that the Fed Governors' forecast will increase the Funds rate once in 2022 and at least twice in 2023. Below is a chart of the dot plot that shows how Fed officials have shifted their forecast from September of 2020 to their most recent meeting in September of 2021.

Fed Dot Plot



Source: Federal Reserve Federal Open Market Committee, September 22, 2021

Note: Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. One participant did not submit longer-run projections for the federal funds rate.

In addition, the Fed most likely will announce, at the next meeting in November, that they will begin to taper their bond purchase program. In the 3rd quarter, the 2-year Treasury yield rose by 4 bps while the yield of the 5-year rose by 12 bps. The 10-year and 30-year rose 9 and 2 bps respectively. The 2-year finished the quarter at 0.29%, while the 10-year closed at 1.53%. For the year, yields are higher for all maturities and the yield curve is much steeper.

Spread Products

Spreads were slightly wider across all credit sectors. Returns were close to 0% in most sectors with high yield leading on the upside and EMD positing the lowest return. On the next page is a table that shows spreads for investment grade corporates, high yield, and EMD as of year-end 2019 (pre-COVID), the 1st quarter of 2020 after the pandemic hit, the end of 2020, and the end of the 2nd and 3rd quarters of 2021:

DuPont Capital

Sector	12/31/2019	3/31/2020	12/31/2020	3/31/2021	6/30/2021	9/30/2021
Investment Grade Corporates	+96	+276	+95	+93	+83	+87
High Yield	+357	+899	+387	+357	+311	+332
Emerging Markets Debt	+291	+626	+352	+354	+340	+357

* Spread data are from the Bloomberg U.S. Corporate Index for IG Corporates, Bloomberg U.S. High Yield Index for high yield and from the JP Morgan EMBI Global Diversified Index for Emerging Markets Debt.

Investment grade corporates widened by 4 bps in the 3rd quarter to 87 over Treasuries, still close to the tightest level since 2005. Utilities very slightly outperformed industrials and financials during the quarter, while longer duration corporates had slightly weaker returns than shorter duration corporates. Corporate bond issuance was heavy in September as corporations continue to take advantage of the high investor demand and lower yields. Issuance for all of 2021 will likely be the second highest year of all-time, only behind 2020.

In mortgages, fixed-rate pass-through mortgages outperformed Commercial Mortgages (CMBS). The CMBS market has greatly improved over the past year despite uncertainty in some areas of CMBS due to the current problems in areas such as retail and the unknown future implications of the success of employees working from home. Asset-backed securities posted a small positive return.

High yield managed only a small positive return of close to 1%, but this was better than other sectors of fixed income. For the year, high yield is the only fixed income sector with a positive return. The stronger performance was due to rising equity prices, much lower defaults, higher oil prices, and a lower correlation to Treasury prices. Higher-rated high yield out-performed lower quality, with BB's returning +1.1% as compared to +0.8% for CCC-rated bonds. The average high yield security declined by less than 1 point to $104.6. High yield spreads widened 21 bps to 332 over Treasuries, but are still about 70 tighter for the year. The current spread for high yield remains tighter than the long-term average of about 500. The yield-to-worst rose 29 bps from an all-time low of 3.75% to 4.04%. Default activity decreased again and the twelve-month default rate declined from 1.9% to 1.0%. 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.

Evergrande was the big story in emerging markets this quarter. Although the company has not officially defaulted yet, they have not made payments on several U.S. dollar issues. The Chinese property sector is having significant problems and other property companies are also having difficulties paying their debts. U.S. Dollar Emerging Markets Debt declined slightly mostly due to spreads widening by 17 bps in the quarter to close at 357 bps over Treasuries. Local currency EMD declined more and had a quarterly return of -3.1%. In U.S. Dollar EMD, lower quality countries underperformed higher-quality countries. Overall, yields for U.S. Dollar EMD rose by 22 basis points to 5.13%.

The Economy

Economic activity continued to be positive but at a slower and more uneven pace compared to the first six months of 2021. The Delta variant caused a slowdown in certain sectors and areas of the country. Travel related sectors, including air travel and hotels saw their recoveries slow as some people delayed or cancelled plans due to the virus. In addition, supply shortages, including semiconductors, are also leading to lower economic growth. Auto manufacturing, consumer electronics, and appliance manufacturing have all slowed due to the chip shortage.

Manufacturing activity was mixed as supply shortages have dampened some activity. The ISM Manufacturing Index rose slightly during the quarter from 59.9 to 61.1, but this probably overstates activity. Durable goods orders remained strong with gains of 0.5% in July and 1.8% in August. Consumer spending has been very erratic over the last few months after soaring earlier in the year. Retail sales were up +0.7% in August after declining -1.1% in July. The housing market has leveled off after booming late in 2020 and the first half of 2021. Housing prices moved up at a record pace over the past year. The S&P Case-Shiller national home price index posted a 19.7% annual gain in July, the fourth straight month with a record gain.

The Federal Reserve Bank of Atlanta's GDPNow model, a running estimate of growth during the quarter, was projecting growth of only +1.3% for the 3rd quarter as of October 8. This estimate was running over 4% earlier in the quarter but slowed significantly over the last month and doesn't capture most of the activity in September. Many estimates for 3rd quarter growth were around +3%.

The non-farm payroll gains were lower than expected in August and September after a very strong July. The total gain in September was only 194,000 compared to forecasts of 500,000. However, private payrolls expanded by 317,000 including gains in leisure and hospitality (+74,000) and retail (+56,000). The weaker total number was partly caused by a decline of -144,000 in local government education. This was mostly due to a combination of seasonal adjustment factors and complications from COVID. In the September data release, July and August employment numbers were revised 169,000 higher. The unemployment rate declined from 5.9% to 4.8% over the quarter, but is still above the rate of 3.5% pre-COVID. The four-week moving average for new unemployment claims was 344,000 in early October, close to the lowest since March of 2020. As a reminder, claims were running slightly above 200,000 before the pandemic. Continuing claims were reported at 2.7 million, which is down from the peak of about 23 million in May of 2020 and 3.5 million last quarter. This is the lowest level in about 18 months. Regardless of what the unemployment numbers are, there are widespread labor shortages across numerous industries and job openings over the last few months have been at record highs.

Inflation

Inflation continued to be a focal point for bond investors. But, despite inflation rising to levels not seen in close to thirty years, inflation did not drive interest rates higher like during the 1st quarter. This is because inflation expectations have stabilized after rising significantly since late last year and are currently about 2.5% based on current ten-year Treasury and TIPS yields.

The CPI has risen 5.4% over the past year while the Core CPI is up 4.0%. The Core CPI is the highest since 1992 but has leveled off over the past two months. The Federal Reserve believes that the increase in inflation will be "transitory" and will decline closer to target sometime next year. Although they have been saying this since early this year, they continue to move forward their projection for their first rate hike to 2022 and will soon start talking about reducing their bond purchases. These statements have comforted investors into believing that the Fed will take action if needed to contain inflation.

Oil prices rose during the quarter with West Texas Crude climbing by $1.5 dollars a barrel to $75. For the year, oil has risen $26.5 per barrel which is an increase of about 55%. Other commodity prices mostly rose, with the Bloomberg Commodity Index rising by over 6% over the past three months and over 29% YTD. Although CPI data 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 slightly higher since the 2nd quarter, but has leveled out over the last two months with an overall year-over-year increase of +4.3% and a Core PCE deflator increase of +3.6%. This will likely stay above 3% over the next six months and possibly longer. However, the Fed will allow inflation to stay above 2%, as they are now targeting a 2% average for inflation and believe the current high rate will decline back toward the target.

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).

In the **Mortgage** sector, the third quarter proved to be quite uneventful led by a Treasury yield whose net movement remained within a narrow range. The ten-year realized treasury volatility increased to 48% in the 3rd quarter from 40% in the 2nd that was caused mostly from the debate over the anticipated tapering of Treasury and mortgage securities. This resulted in mortgage spreads widening slightly by 6 bps during the quarter which finished at 100 bps as measured relative to the 5-year treasury rate. The 30-year effective mortgage rate also showed little net movement and decreased by 8 bps to 3.24%.

Ample market liquidity has provided few market opportunities during the quarter causing us to place additional investments near our benchmark. Typically, we seize opportunities during periods of market distress by providing liquidity. We maintain our CMBS overweight, a majority of which consists of the profit opportunities that arose from the COVID induced market stress. As these opportunities are realized our outperformance could grow.

Our **Investment Grade Corporate** strategy focuses on companies with the potential to outperform the benchmark on a risk-adjusted basis. Investment grade corporate spreads widened by 4 basis points during the quarter and are trading close to the tightest level since 2005. We believe that investment grade corporate bonds are not cheap, but 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 7% 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. 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 performed well compared to other fixed income sectors, supported by good 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 declined slightly after performing well in the 2nd quarter. Spreads for EM sovereigns widened by 17 basis points during the quarter and are close to unchanged for the year. Although spreads are not cheap, they are more attractive as compared to other segments of credit, particularly high yield. We believe that EMD will provide an attractive return over the long-term as compared to other fixed income asset classes. The high yield portion of EMD greatly 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 earlier in the year. 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

Although U.S. economic growth has slowed from the torrid pace of the previous twelve months, growth should remain healthy over the next year. Growth slowed due to various headwinds including the Delta variant, supply chain issues, labor shortages, and higher inflation. These problems will take time to resolve and will continue to hamper growth until at least early next year. Companies are having an extremely difficult time filling open positions, even with higher pay, and the expiration of additional unemployment compensation did not incentivize people enough to look for a job. Despite these headwinds, the unemployment rate should continue to fall over the next year. The Biden administration and Congress continue to negotiate on spending plans 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.

Inflation is at the highest level in almost 30 years. Although we expect inflation to come down over the next several months, prices will most likely stay well above 2% for most of 2022. Wages have increased 4.6% over the past year and price increases are widespread across the economy. Oil prices have risen significantly and could remain high as energy companies have decreased capital spending due to pressure from climate change advocates.

Focus is squarely on the Federal Reserve. We believe the Federal Reserve will announce the tapering of the bond purchases in November but will proceed cautiously as they are well aware of the problems that occurred after their last big tapering plan commenced in 2013. We also think they will not be able to wait until 2023 to make their first rate hike, but we are confident that rates will not be changed until late next year. We believe that Treasury yields will rise moderately over the next year and the yield curve will steepen slightly, but at a much slower pace than what we saw early in 2021.

For credit, the strong economic environment has been very positive for credit fundamentals. However, spreads are very tight for high yield and investment grade and there is not much upside at current levels. If the economy remains healthy and inflation moderates, credit spreads could remain tight for some time. 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 in 2020. We will continue to cautiously add credit positions to our portfolios as we find opportunities with good long-term value.

The 3rd quarter was “Much Ado About Nothing.” This environment could last a little longer, but the question is, will the next few quarters be more like Shakespeare’s “All’s Well That Ends Well” or “The Tempest”? It is hard to say, but with valuations where they are in fixed income, caution is warranted.

Summary

To summarize our outlook:

1) Economic growth has slowed from the robust pace of the first half of the year due to various headwinds including the Delta variant, supply-chain shortages, and labor shortages. Although these headwinds may continue for some time, growth should remain healthy over the next year.
2) Inflation will continue to be one of the main focal points and will remain above the Fed's 2% target until at least late in 2022 and possibly longer. Supply constraints will remain, and 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% until at least late in 2022. However, we believe they will announce a plan to taper bond purchases in November.
4) U.S. interest rates will rise modestly for all maturities and the yield curve may steepen slightly.
5) Returns for fixed income will be low over the next year as rates rise moderately and coupons don't provide enough cushion.
6) Corporate spreads, both investment grade and high yield, don't have much upside 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 last year.
8) Caution is warranted as several 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

For additional information please contact:

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

DuPont Capital