# FIXED INCOME MARKET REVIEW AND OUTLOOK

## DECEMBER 31, 2021

## MARKET OVERVIEW

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The party had to end sometime. The Federal Reserve pulled out all stops in 2020 to jumpstart the economy after the pandemic decimated global economic activity. They initiated a large bond purchase program that, for the first time, even included corporate bonds. They cut the Fed Funds Rate to close to 0%, and they put in place many other initiatives all designed to get the economy going despite widespread shutdowns due to COVID-19. This "party" of liquidity started in March of 2020 and mostly continued until the 4th quarter of 2021 when the Fed started tapering their bond purchases. It is safe to say that the Federal Reserve achieved their goals of strong economic growth and full (or close to full) employment. These actions also led to a massive rally in financial markets, particularly in U.S. equities. But, as is the case with some large parties, there was a downside. Inflation has soared to levels not seen since the early 1980's. Until recently, the Fed thought the price increases would be "transitory", a phrase they would use over and over until finally abandoning the word late in 2021. The party began winding down in the 4th quarter and it appears that the lights will come on and the party will end in the 1st quarter of 2022. Rates rose in the front-end of the curve at the end of 2021 as investors began pricing in multiple rate hikes by the Federal Reserve.

In the 4th quarter, the Bloomberg Aggregate Index had a return of +0.01%. You can't get much closer to 0%. All other fixed income sectors were within +/-1% of 0%. High yield led the way at +0.7% while Emerging Markets Debt (EMD) and mortgages lagged and declined slightly with a return of -0.4%. 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 4th quarter and YTD for 2021:

| Sector | 4Q Return* | YTD Return* |
|---|---|---|
| U.S. Treasuries | 0.2% | -2.3% |
| MBS | -0.4% | -1.0% |
| Inv. Grade Corporates | 0.2% | -1.0% |
| High Yield | 0.7% | 5.3% |
| Emerging Markets Debt | -0.4% | -1.8% |

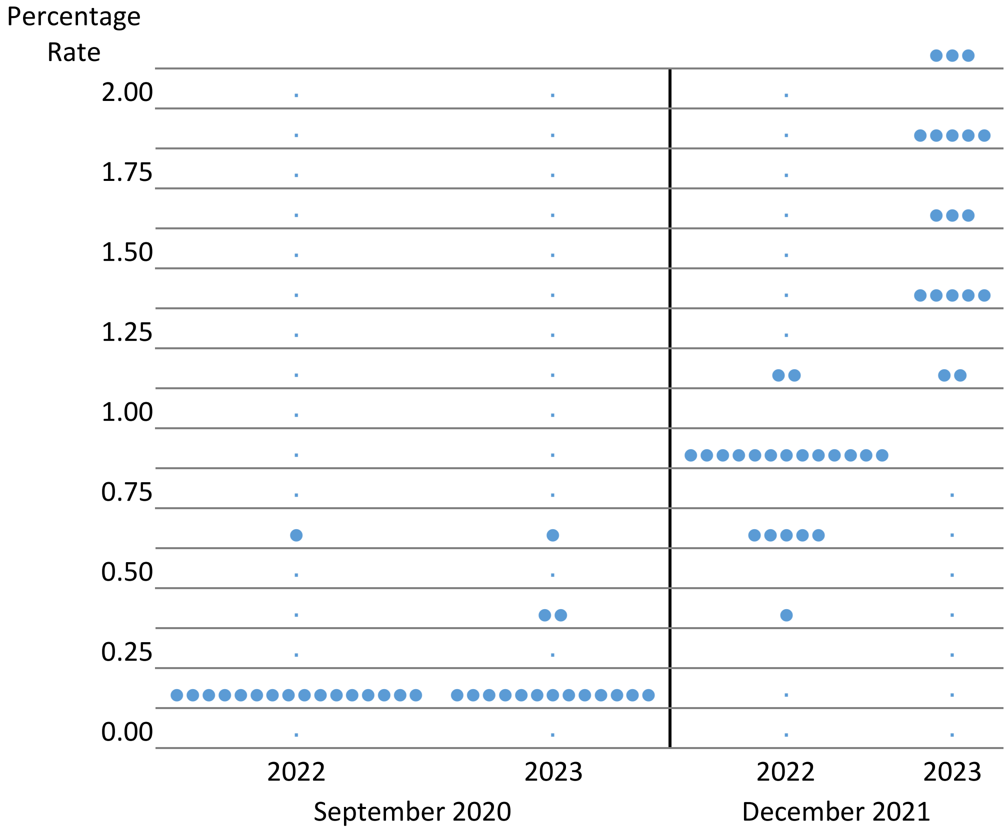
| Credit Rating | 4Q Return* | YTD Return* |
|---|---|---|
| AAA | -0.1% | -1.8% |
| AA | 0.2% | -1.2% |
| A | 0.1% | -1.8% |
| BBB | 0.3% | -0.4% |
| BB | 0.8% | 4.6% |
| B | 0.8% | 4.9% |
| CCC | 0.5% | 8.6% |

Source: Bloomberg
* Returns are from Bloomberg indices except Emerging Markets Debt, which is from JP Morgan. All figures are as of 12/31/2021.

## U.S. Treasuries

As mentioned, Treasury yields rose significantly for shorter maturities and declined slightly for longer maturities in the 4th quarter. Investors began to price in more rate hikes in 2022 as the Federal Reserve changed to a much more hawkish stance. The most recent "dot plot" showed that the Fed Governors' median forecast is for three hikes in 2022 and three more 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 December of 2021.

### Fed Dot Plot




Source: Federal Reserve Federal Open Market Committee, December 15, 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.

The Fed began to taper their bond purchase program in the 4th quarter and it is currently scheduled to end in March. The Fed could begin to hike rates as early as March after the program concludes. St. Louis Fed President James Bullard was quoted in early January and his comments were very telling. "It makes sense to get going sooner rather than later so I think March would be a definite possibility based on data that we have today," Bullard told reporters after a talk at the CFA Society of St. Louis. "This is not a situation where a particular price will go back to the pre-pandemic level and we won't have to worry about this. This is an issue where Fed policy will have to influence where inflation goes." He added that "credibility is more at risk today than at any time" in his 30 years at the Fed. The Fed, he said, "is in good position to take additional steps as necessary to control inflation, including allowing passive balance sheet runoff, increasing the policy rate, and adjusting the timing and pace of subsequent policy rate increases."

In the 4th quarter, the 2-year Treasury yield rose by 45 bps while the yield of the 5-year rose by 30 bps. The 10-year was close to unchanged and the 30-year declined by 13 bps. The 2-year finished the quarter at 0.73%, while the 10-year closed at 1.51%. For the year, yields are higher for all maturities with the 2-year up by 61 bps and the 10-year by 59.

### Spread Products

Spreads were mixed during the quarter with investment grade corporates wider, while high yield was tighter. Returns were close to 0% in most sectors with high yield leading on the upside and EMD posting the lowest return. Below 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 3rd and 4th quarters of 2021:

| Sector | 12/31/2019 | 3/31/2020 | 12/31/2020 | 9/30/2021 | 12/31/2021 |
|---|---|---|---|---|---|
| Investment Grade Corporates | +96 | +276 | +95 | +87 | +96 |
| High Yield | +357 | +899 | +387 | +332 | +321 |
| Emerging Markets Debt | +291 | +626 | +352 | +357 | +369 |

* 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 9 bps in the 4th quarter to 96 over Treasuries, still much tighter than historical averages. For the year, spreads were close to unchanged. Utilities and industrials outperformed financials during the quarter, while longer duration corporates had much better returns than shorter duration corporates. Corporate bond issuance was heavy before the holidays as corporations continue to take advantage of the high investor demand and lower yields. Issuance for all of 2021 will be the second highest year of all-time, only behind 2020.

In mortgages, fixed-rate pass-through mortgages slightly 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 also declined slightly.

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 slightly out-performed lower quality, with BB's returning +0.8% as compared to +0.5% for CCC-rated bonds. High yield spreads tightened 11 bps to 321 over Treasuries, and are 66 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 17 bps from 4.04% to 4.21%. Default activity continued to be low and the twelve-month default rate declined from 1.0% to 0.3%. This is at an all-time low and much lower than the historical default rate of 3.6%. Most estimates are for defaults to remain very low in 2022 as the economy continues to grow and oil prices remain high.

U.S. Dollar Emerging Markets Debt declined slightly mostly due to spreads widening by 12 bps in the quarter to close at 369 bps over Treasuries. Local currency EMD declined much more and had a quarterly return of -2.5%. In U.S. Dollar EMD, lower quality countries greatly underperformed higher-quality countries. Overall, yields for U.S. Dollar EMD rose by 16 basis points to 5.29%.

## The Economy

Economic activity in the U.S. came roaring back in the 4th quarter after slower growth in the 3rd. Consumers continued to spend and various sectors including travel and leisure did well. Supply shortages, including semiconductors, remained a challenge to the economy. 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 declined slightly during the quarter from 61.1 to 58.7, but this probably still overstates activity. Durable goods orders (ex-transportation) remained strong with gains of 0.7%, 0.3%, and 0.8% over the last three months. Consumer spending has been good but erratic over the last few months after soaring earlier in the year. Retail sales were up just +0.3% in November after rising 1.8% in October. 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 19.1% annual gain in October.

The Federal Reserve Bank of Atlanta's GDPNow model, a running estimate of growth during the quarter, was projecting growth of +7.4% for the 4th quarter as of January 4. This mostly includes data from October and November so it could change significantly before the first official release at the end of January.

The non-farm payroll gains were lower than expected in November and December after a very strong October. The total gain in December was only 199,000 compared to forecasts of over 400,000. Total jobs are running about 3.6 million below levels from two years ago. The unemployment rate declined from 4.7% to 3.9% over the quarter, and is only slightly above the pre-pandemic rate of 3.5%. Wage gains have been strong with average hourly earnings rising by 4.7% year-over-year. The four-week moving average for new unemployment claims was 204,500 in early January, down from over 300,000 last quarter. As a reminder, claims were running at about 215,000 before the pandemic. 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 rise and be a focal point for bond investors. But, despite inflation rising to levels not seen in almost forty 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 in 2020.

The CPI has risen 7.0% over the past year while the Core CPI is up 5.5%. The Core CPI is the highest since June of 1982. As mentioned earlier, the Fed has stopped using the word "transitory" and has begun taking steps to bring inflation down.

Oil prices did not change much during the quarter with West Texas Crude closing at $75. For the year, oil rose over $26 per barrel which is an increase of about 55%. Other commodity prices were mixed, with the Bloomberg Commodity Index declining by over 1% over the past three months while rising 27% for all of 2021. 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 much higher this year with an overall year-over-year increase of +5.7% and a Core PCE deflator increase of +4.7%. This will likely stay above 3% over the next six months to a year and possibly longer.

## 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, mortgage refinance applications continued their downward trend as the refi wave starting in 2019 declined as rates headed higher. The 30-year mortgage effective rate, which began the fourth quarter at 3.20%, now stands at 3.47%. The biggest headwinds facing mortgages is the reduction of Fed security purchases as the Fed quickly tapers their bond purchase program.

We currently see few opportunities worth departing from our benchmark. However, the few opportunities we have acted on over the past year have worked well so far. These have been in the CMBS sector where investors have been shunning retail exposure. We have filled the void providing liquidity, where others have not, resulting in our CMBS portfolio yielding over 9% versus the 1.8% in our CMBS benchmark. The positions we have been purchasing have had short weighted average lives of less than 1.5 years. This will allow us to avoid the pain of rising rates and put us in a good position to redeploy our capital at higher yields as these shorter positions paydown.

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, very few 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 both in the 4th quarter and for the year. Spreads for EM sovereigns widened by 12 basis points during the quarter and 19 for the year. Although spreads are not very 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. Currently 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

U.S. economic growth ended the year on a high note due to higher activity by consumers and manufacturing. However, growth will slow in early 2022 due to the Omicron variant. We expect activity will pick up again in the spring and summer as infections slow (hopefully), the service sector improves, and supply shortages ease. The unemployment rate should continue to fall in 2022 and may move lower than the pre-pandemic level of 3.5%. The Biden administration and Congress will 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 the mid-term elections are later this year.

Inflation is at the highest level in almost 40 years. Although we expect inflation to come down this year, prices will stay well above 2% for all of 2022. Wages have increased 4.7% 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. The Federal Reserve announced the tapering of the bond purchases and will probably conclude the program in March. They could start hiking rates as early as March and we believe they will make 3 or 4 rate hikes this year. Don't be surprised if one of the hikes is by 50 bps. We believe that Treasury yields will rise moderately over the next year.

For corporate bonds, the strong economic environment has been very positive for credit fundamentals. However, spreads are 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 and 2021. We will continue to cautiously add credit positions to our portfolios as we find opportunities with good long-term value.

The "party" looks like it is over. The Fed will finish their bond buying program in the 1st quarter and may begin to increase the Funds Rate as early as March. Soon, the phrase "don't fight the Fed" might have a different meaning from the last few years. Fortunately, even a few rate hikes by the Fed will still leave rates at relatively low levels and will most likely slow the economy down without significant damage.

## Summary

**To summarize our outlook:**

1) Economic growth was robust in the 4th quarter, but will slow at the beginning of 2022, partially due to the Omicron variant. We expect growth to be healthy for all of 2022 and will most likely be above 3%. Supply chain problems should mostly be resolved as the year progresses and employment should continue to be strong.

2) Inflation will remain well above the Fed's 2% target until at least late in 2022 and possibly longer. Although supply constraints should ease, wages will continue to rise and many industries will pass on price increases to their customers.

3) The Federal Reserve will hike the Fed Funds Rate as early as March. We are looking for 3 or 4 hikes this year and don't be surprised if one of the hikes is for 50 bps.

4) U.S. interest rates will rise modestly for all maturities.

5) Returns for fixed income will be very low in 2022 as rates rise moderately and coupons don't provide much 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 the last two years.

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:

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