DuPont Capital

Fixed Income Market Review and Outlook

March 31, 2022

Market Overview

Mark Foust
Senior Portfolio Specialist

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

"No place to hide". That phrase sounds like it could be a title for a James Bond movie similar to "No Time to Die", "Never Say Never Again", "You Only Live Twice", or "Live and Let Die". Well, it is not a James Bond title, but the phrase "No place to hide" does capture what happened in the financial markets in the first quarter of 2022. Inflation moved higher, the Federal Reserve turned more hawkish, volatility increased, and Russia started a war with neighboring Ukraine. The lofty valuations in the equity and fixed income markets came tumbling down from January through about mid-March before a rally during the last two weeks of the quarter. Treasury yields rose for all maturities, the yield curve flattened, and spreads widened across all credit sectors. Oil prices soared, as did many other commodity prices, causing inflation to rise. Outside of commodities, cash was definitely king, even with a yield close to 0%. So far this year, there has been "No place to hide".

In the 1st quarter, the Bloomberg Aggregate Index had a return of -5.9%. The other sectors of fixed income didn't fare much better with high yield down -4.8% and investment grade corporates down almost -8%. It was the worst quarter for fixed income in more than 40 years. There was truly no place to hide in fixed income regardless of sector, maturity, or credit rating.

The following tables show the returns for the various fixed income sectors and rating categories for the 1st quarter:

Sector	1Q Return*
U.S. Treasuries	-5.6%
MBS	-5.0%
Inv. Grade Corporates	-7.7%
High Yield	-4.8%
Emerging Markets Debt	-10.0%

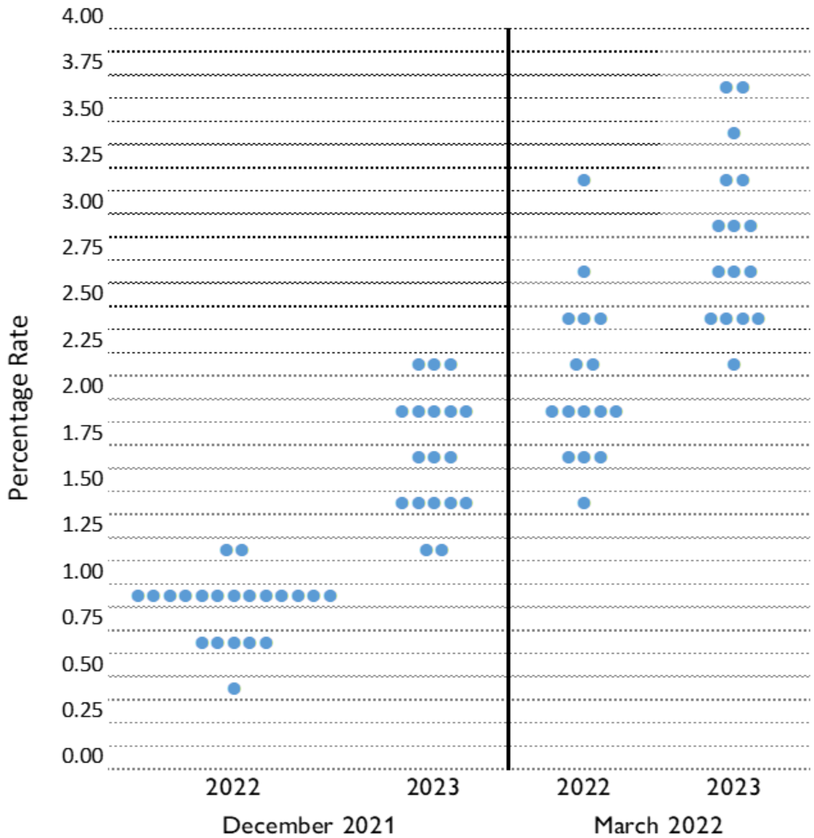
Credit Rating	1Q Return*
AAA	-5.3%
AA	-7.0%
A	-7.3%
BBB	-7.9%
BB	-5.9%
B	-3.5%
CCC	-3.9%

Source: Bloomberg
* Returns are from Bloomberg indices except Emerging Markets Debt, which is from JP Morgan. All figures are as of 3/31/2022.

U.S. Treasuries

As mentioned, Treasury yields rose significantly for all maturities and the yield curve flattened in the 1st quarter. Investors began to price in numerous rate hikes in 2022 and 2023 as inflation rose and the Federal Reserve changed to a much more hawkish stance. The Fed's "dot plot" drastically changed over the three-month period between December and mid-March. In December, the Fed Governors' median forecast was for three hikes in 2022 and three more in 2023, bringing the Funds Rate up to around 1.50%. In March, the forecast moved much higher and is now priced for seven 25 bp hikes in 2022 and three or four more in 2023 for a Funds Rate close to 2.75%. Below is a chart of the dot plots from December of 2021 and March of 2022.

Fed Dot Plot



Source: Federal Reserve Federal Open Market Committee, March 31, 2022

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.

Despite this very hawkish stance, the Federal Reserve only moved rates higher by 25 bps in March. The 25 bps move was what I was expecting, but that doesn't mean I agreed with the decision. The Fed is so far behind in tightening that they should have moved the Funds Rate up by 50 bps in both March and May to help them catch up. Within days of their first rate hike in three years, several Fed officials stated that they may want to move by 50 bps when they meet next in May. Why wait?

In the 1st quarter, the 2-year Treasury yield rose by a staggering 155 bps while the yield of the 5-year rose by 116 bps. The 10-year rose by 81 and the 30-year went only 54 bps higher. The 2-year finished the quarter at 2.28%, while the 10-year closed at 2.32%. The yield curve is close to flat across the yield spectrum from 2-years out to 30-years with some inversion along the way.

Spread Products

Spreads widened significantly from the beginning of the year until mid-March. Spreads tightened over the last two weeks but were still wider over the past three months. Returns were very poor across all credit sectors with high yield declining the least and EMD posting the largest declines. 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 COVID hit), the end of 2020, 2021, and the end of the 1st quarter of 2022:

Sector	12/31/2019	3/31/2020	12/31/2020	12/31/2021	3/31/2022
Investment Grade Corporates	+96	+276	+95	+96	+122
High Yield	+357	+899	+387	+321	+366
Emerging Markets Debt	+291	+626	+352	+369	+400

* 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 26 bps in the 1st quarter to 122 over Treasuries, close to historical averages. Spreads had gotten to 151 in mid-March before a rally over the last two weeks of the quarter. Financials outperformed utilities and industrials during the quarter, while longer duration corporates had much lower returns than shorter duration corporates. Corporate bond issuance was up 5% over the beginning of last year despite rising yields.

In mortgages, fixed-rate pass-through mortgages slightly outperformed Commercial Mortgages (CMBS). The CMBS market has greatly improved over the past two years despite some uncertainty in areas of CMBS due to the problems in retail and office space. Asset-backed securities also declined slightly.

High yield declined by -4.8%, but this was a smaller decline than other sectors of fixed income. Fundamentals remained positive with historically low defaults, high oil prices, and good corporate earnings. Higher-rated high yield underperformed lower quality, with BB's returning -5.9% as compared to -3.9% for CCC-rated bonds. High yield spreads widened by 45 bps to 366 over Treasuries. The current spread for high yield remains much tighter than the long-term average of about 500. The yield-to-worst rose 197 bps from the extremely low level of 4.04% to 6.01%. Default activity continued to be very low, but the twelve-month default rate increased slightly from 0.3% to 0.4%. This is close to 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 significantly due to the rise in interest rates and with spreads widening. Of note, Russia and Belarus were removed from the EMD indices on the last day of the quarter, which led to spreads tightening by 39 basis points on 3/31 since both countries were trading at very distressed levels. In total, spreads widened by 31 bps over the quarter and closed at 400 bps over Treasuries. Lower quality countries greatly outperformed (declined less) higher-quality countries. Overall, yields for U.S. Dollar EMD rose by 115 basis points to 6.44%. Local currency EMD declined less than US Dollar sovereigns with a quarterly return of -6.5%.

The Economy

Economic activity slowed in the 1st quarter after a very strong end of the year. Consumers continued to spend, but at a slower pace partly due to rising prices. Manufacturing activity was mixed as supply shortages continue to dampen some activity. The ISM Manufacturing Index declined slightly during the quarter from 58.7 to 57.1, but this might still overstate activity. Durable goods orders (ex-transportation) were volatile with a gain of 0.8% in January, followed by a decline of -0.6% in February. Consumer spending is starting to be hampered by rising prices. Retail sales were up just +0.3% in February after rising 4.9% in January. Sales at gas stations were up over 5% due to high gasoline prices and this distorted overall sales. 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 19.2% annual gain in January.

The Federal Reserve Bank of Atlanta's GDPNow model, a running estimate of growth during the quarter, was projecting growth of +1.5% for the 1st quarter as of April 1. This mostly includes January and February data so it could change significantly before the first official release at the end of April.

The non-farm payroll gains were very strong through the quarter. A total of over 1.6 million jobs was added over the quarter, meaning the average monthly increase was 562,000. The gains over the rest of this year will most likely decline as most of the jobs lost during the pandemic have been recovered. The unemployment rate declined from 3.9% to 3.6% over the quarter and is only 0.1% above the pre-pandemic rate of 3.5%. It is safe to say that the U.S. is at full employment. Wage gains have remained strong with average hourly earnings rising by 5.6% year-over-year. The four-week moving average for new unemployment claims was 208,500 in late March, close to unchanged from last quarter. As a reminder, claims were running about 215,000 before the pandemic. There continues to be labor shortages across numerous industries and job openings remain near the record high set in December of last year.

Inflation

Inflation continued to rise and be a focal point for bond investors. The Consumer Price Index (CPI) has risen 7.9% over the past year while the Core CPI is up 6.4%. Both of these are the highest inflation the U.S. has seen since 1982. The Producer Price Index (PPI) rose 10% year-over-year. Oil prices rose significantly, partly due to the war initiated by Russia. West Texas Crude rose by $25 a barrel to $100. Other commodity prices were also much higher, with the Bloomberg Commodity Index rising by over 25% over the past three months after 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 higher this year with an overall year-over-year increase of +6.4% and a Core PCE deflator increase of +5.4%. This will likely stay at 3% or higher for 2022 and possibly longer which would be well above the Fed's targeted rate of 2%.

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 first quarter has brought sharply higher rates and a flatter curve. This has moved the current coupon 30yr mortgage yield to 3.55%, considerably higher from 2.07% at the start of the year. Mortgage refinance applications have fallen to levels from before the sharp drop in rates caused by COVID-19. This dynamic, coupled with the Fed's reduction in MBS purchases, has put pressure on lower coupon MBS and greatly diminished TBA roll profitability. In response to these market dynamics, we have been moving our coupon positioning up the coupon stack from 2.5% to 3.5%. There have been limited opportunities in the structured RMBS and CMBS sectors. The panicked selling during COVID has transitioned into a wait and see atmosphere with very few attractive bonds available. Our largest overweight in this area is in non-agency CMBS followed by prime RMBS. We believe we are well positioned as our current holdings are out yielding the RMBS benchmark by 170 bps and the CMBS benchmark by over 900 bps. Our CMBS positioning is on the very short end of the yield curve, and this could put us in good shape to reinvest at higher yields from the rising rates. We will take what the market gives us.

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 26 basis points during the quarter and are now trading close to historical averages. We believe that investment grade corporate bonds are not cheap but represent the best value in the investment grade fixed income market. We currently hold an overweight of 7% to corporates in our Core Fixed Income portfolios. We favor the basic industry, insurance, communications, energy, and electric utility sectors. The portfolios are underweight technology. Regarding ratings, we are overweight BBB-rated corporates. 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 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 in 2020 and earlier 2021.

High Yield declined but held in better than other fixed income sectors, mostly because high yield has a shorter duration, particularly compared to investment grade. Despite spreads widening during the quarter, they are much tighter than long-term averages. We have been very cautious over the past year and had positioned the portfolio more defensively. We are selectively finding some opportunities and continue to look to identify companies with attractive valuations that could provide strong returns over the long-term.

Emerging Markets Debt declined significantly in the 1st quarter due to higher interest rates, the war in Ukraine, and the risk-off investment environment. Spreads for EM sovereigns widened by 31 basis points during the quarter. The war in Ukraine had major implications for EMD. Russia and Belarus were taken out of the JP Morgan EMD indices at the end of March due to the sanctions levied by the U.S. and other countries. These securities had declined significantly since the war started in late February and were removed from the indices at $0. Most of the other Eastern European countries also declined more than the index due to their reliance on energy and agricultural products from Russia and Ukraine. EMD will most likely remain volatile in the short-term due to the significant uncertainties caused by the war. It is prudent to be cautious, but opportunities exist due to the wider, more attractive spreads. 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, and Turkey. 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, South Africa, and Poland.

The Look Forward

In the 1st quarter, there was no place to hide in the financial markets to avoid negative returns. The combination of higher inflation, the Fed's hawkish stance, the war in Ukraine, and slower economic growth combined to crush both the equity and fixed income markets, especially over the first 2 ½ months of the year.

U.S. economic growth ended 2021 on a high note due to higher activity by consumers and manufacturing. However, growth has slowed in early 2022 due to higher inflation, continued supply chain problems, the Omicron variant, and the conflict in Ukraine. We expect U.S. growth for all of 2022 to be much slower than last year and will chug along at a moderate pace. Higher prices, particularly energy, and continued supply chain issues in some industries will dampen growth while the very strong labor market will keep activity moving forward.

Inflation is at the highest level in 40 years. Although we expect inflation to come down later this year, prices will stay well above 2% for all of 2022 and possibly 2023. We expect inflation to be above 3% for this year with a decent chance of it being closer to 4%. Wages have increased 5.6% 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. The war in Ukraine and sanctions against Russia increases the chance for energy prices to stay high for a longer period of time.

Focus is squarely on the Federal Reserve. The Federal Reserve will continue to hike rates this year with a higher probability of one or more 50 bp moves. However, the Federal Reserve may move slower than expected later in the year which could surprise the markets. Rates have moved up considerably this year, but we believe that Treasury yields will continue to rise but at a slower pace over the rest of the year.

For investment grade corporate bonds, spreads have widened over the past quarter and are now close to historical averages. The strong economic environment has been very positive for credit fundamentals and should help to drive capital to corporate bonds. High yield spreads are not as attractive as investment grade, so some caution is needed. We believe volatility could remain high in credit and that spreads may end the year close to where they are currently trading. In all credit markets, security and country selection will be extremely important as there are far fewer opportunities than in 2020 and early 2021. We will continue to cautiously add credit positions to our portfolios as we find opportunities with good long-term value.

Fortunately, valuations in fixed income, across all sectors, are cheaper than they were at year-end. While that is good news, the rise in interest rates could continue over the course of 2022. Inflation needs to be tamed and that will take time and a much higher Fed Funds Rate. We are hopeful that much of the damage in fixed income has already occurred and that rates will move up more moderately going forward. We will continue to be cautious with duration and selectively buy credit as we find opportunities.

SUMMARY

<u>To summarize our outlook:</u>

1) Economic growth was robust in 2021, but will be much more moderate in 2022. We do not expect a recession in the U.S. this year as the strong labor market will drive growth despite higher prices and supply chain issues. A recession in the U.S. is possible in 2023, but we will have to see how things develop later in 2022. Europe could experience a mild recession later this year.
2) Inflation will remain well above the Fed's 2% target until later in 2023 and possibly longer. We expect inflation to be at least 3% for all of 2022 and probably closer to 4%. 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 to at least 1.50% this year. Don't be surprised if one or more of the hikes is for 50 bps. However, the Fed may raise rates slower than expected later this year.
4) U.S. interest rates will rise modestly for all maturities.
5) Returns for fixed income will most likely be negative for all of 2022 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 due to strong fundamentals.
7) Security and country selection will be very important as fewer opportunities exist as compared to 2020 and early 2021.
8) Caution is warranted as high inflation, rising interest rates, and geopolitical 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