Fixed Income Market Review and Outlook

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Market Overview

Bad to the Bone
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Bad to the Bone

George Thorogood could have been singing about the fixed income markets in 2022 in his iconic song "Bad to the Bone" from 1982. The fixed income markets have just gone through one of the worst six-months periods ever. Most sectors had double-digit or close to double-digit losses for the first six months of 2022. Long duration or short duration, Treasuries, corporates, or mortgages, high quality, or low quality. It didn't matter. There was no place to hide in the fixed income markets in 2022 and returns were truly "Bad to the Bone."

Inflation moved higher, the Federal Reserve turned more hawkish, volatility increased, and the war continued in Ukraine. Treasury yields rose for all maturities, the yield curve remained flat, and spreads widened across all credit sectors. Cash was definitely king, even with a yield not too much above 0%. The Federal Reserve moved the Funds Rate 75 bps higher in June, the largest increase in nearly three decades.

In the 2nd quarter, the Bloomberg Aggregate Index had a return of -4.7% and -10.4% for the year. Many other sectors of fixed income fared even worse in the 2Q with high yield down -9.8% and investment grade corporates down -7.3%. Treasuries and mortgages were the best performers but still posted losses of down almost -4% in the quarter and -9% for the year.

The following tables show the returns for the various fixed income sectors and rating categories for the 2nd quarter and YTD:

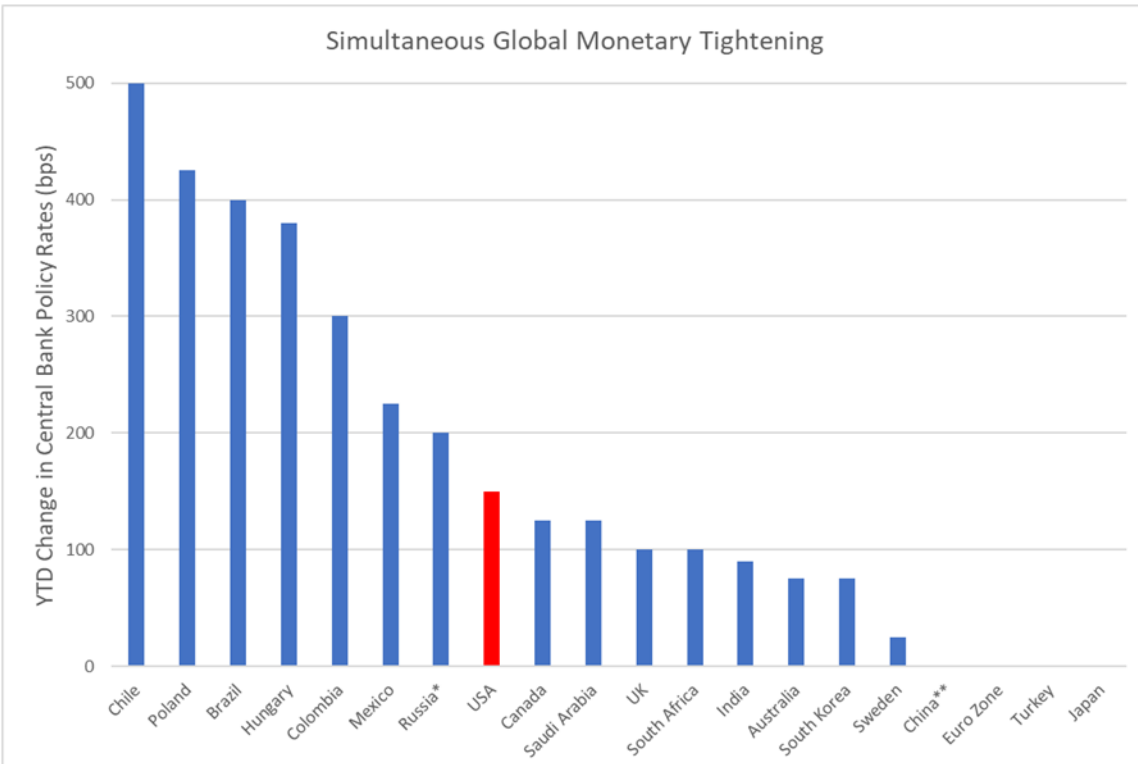
Sector	2Q Return*	YTD Return
U.S. Treasuries	-3.8%	-9.1%
MBS	-3.9%	-8.7%
Inv. Grade Corporates	-7.3%	-14.4%
High Yield	-9.8%	-14.2%
Emerging Markets Debt	-11.4%	-20.3%

Credit Rating	2Q Return*	YTD Return
AAA	-3.8%	-8.9%
AA	-5.6%	-12.3%
A	-6.5%	-13.3%
BBB	-7.9%	-15.2%
BB	-8.4%	-13.9%
B	-10.8%	-13.9%
CCC	-13.0%	-16.4%

Source: Bloomberg
* Returns are from Bloomberg indices except Emerging Markets Debt, which is from JP Morgan. All figures are as of 6/30/2022.

U.S. Treasuries

As mentioned earlier, Treasury yields rose significantly for all maturities in the 2nd quarter. Not only did interest rates rise in the U.S. but rates have also gone much higher in many countries across the world. The rise in rates has mostly been caused by the simultaneous global monetary tightening that has been done by Central Banks around the globe. Below is a chart that shows the year-to-date change in Central Bank Policy Rates in twenty major countries in various regions. As you can see, 16 of the 20 countries have increased rates this year with 12 of them hiking rates by 100 bps points or more. And the rate hikes are not done yet. For example, the U.S. has raised the Federal Funds Rate by 150 bps so far in 2022 and the Fed is expected by make another 50 or 75 bp hike later in July with additional hikes expected later in the year. The Eurozone, which has not raised rates this year, has already announced that they will make its first rate hike later in July with more to come. It will be interesting to see what this chart looks like at year-end.



As of June 30, 2022

Source: Bloomberg and FactSet

In the 2nd quarter, the 2-year and the 10-year Treasury yield rose by 65 bps. Yields across all maturities are trading in a narrow range with the 2-year at 2.93% and the 10-year at 2.97%. For the year, the 2-year has risen by 220 bps with the 10-year up by about 145.

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Spread Products

Spreads widened significantly in the 2nd quarter across all segments of fixed income. Returns were very poor for all credit sectors with EMD and high yield declining by -10% or more. 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 and 2nd quarters of 2022 :

Sector	12/31/2019	3/31/2020	12/31/2020	12/31/2021	3/31/2022	6/30/2022
Investment Grade Corporates	+96	+276	+95	+96	+122	+166
High Yield	+357	+899	+387	+321	+366	+587
Emerging Markets Debt	+291	+626	+352	+369	+400	+542

* 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 44 bps in the 2nd quarter to 166 over Treasuries, much wider than the historical average of about +120. Financials outperformed utilities and industrials during the quarter, while longer duration corporates had much worse returns than shorter duration corporates. Corporate bond issuance declined later in the quarter as spreads widened. The issuance in the first six months of 2022 was down 5% as compared to 2021.

In mortgages, fixed-rate pass-through mortgages underperformed 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 declined slightly but held in better due to the shorter duration.

High yield was hit hard, driven by a declining stock market and increased fears of a recession in the U.S. Spreads widened by 221 bps and ended the quarter at +587 which is wider than the historical average of about +500. The yield of the index has risen from an all-time low of 3.75% at the end of June in 2021 to 8.89% just 12 months later. Higher-rated high yield outperformed lower quality, with BB's returning -8.4% as compared to -13.0% for CCC-rated bonds. Default activity continued to be low, but the twelve-month default rate increased to 1.1%. This remains well below the historical default rate of 3.6%.

U.S. Dollar Emerging Markets Debt declined significantly due to weaker global economic growth, the rise in interest rates, and concerns about a U.S. recession. Spreads widened by 142 bps over the quarter and closed at 542 bps over Treasuries. Higher quality countries greatly outperformed (declined less) lower-quality countries. Overall, yields for U.S. Dollar EMD rose by 213 basis points to 8.57%. Local currency EMD declined less than US Dollar sovereigns with a quarterly return of -8.6%.

The Economy

Economic activity remained sluggish in the 2nd quarter after contracting by -1.6% in the 1st quarter. Consumers continued to spend, but at a slower pace partly due to rising prices. Manufacturing activity was mixed with some data showing growth and other data weaker. The ISM Manufacturing Index declined slightly during the quarter from 57.1 to 53.0, a 2-year low. Durable goods orders posted gains for the last three months including a gain of +0.7% in May. Consumer spending has been hampered by rising prices. Retail sales were down -0.3% in May after rising 1.2% and 0.7% in March and April. The housing market has leveled off after booming late in 2020 and the first half of 2021. Despite some weakness, housing prices continued to move up at a record pace over the past year. The S&P Case-Shiller national home price index continued to move higher with a 20.6% annual gain as of March.

The Federal Reserve Bank of Atlanta's GDPNow model, a running estimate of growth during the quarter, was projecting another decline in growth of -1.2% for the 2nd quarter as of July 8. This mostly includes data from April and May so it could change significantly before the first official release at the end of July.

The non-farm payroll gains were very strong through the quarter. June saw a stronger than expected gain of 372,000 resulting in a 3-month average gain of 375,000. 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 was unchanged at 3.6% over the quarter and is only 0.1% above the pre-pandemic rate of 3.5%. Wage gains have declined slightly but remained strong with average hourly earnings rising by 5.1% year-over-year. The four-week moving average for new unemployment claims was 232,500 in late June, up by over 20,000 from last quarter. As a reminder, claims were running slightly above 215,000 before the pandemic.

Inflation

Inflation continued to rise and be a focal point for bond investors. The Consumer Price Index (CPI) has risen 8.6% over the past year, the largest 12-month increase since December of 1981. Core CPI rose at a lower rate over the past three months and is now up 6.0% over the past year. Oil prices declined over the last few weeks of the quarter but still rose for the quarter. West Texas Crude rose by $5 a barrel to $105. Overall, other commodity prices declined, with the Bloomberg Commodity Index falling by -5% over the past three months, but has risen by 25% for the year. 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 remained high over the last few months with an overall year-over-year increase of +6.3% and a Core PCE deflator increase of +4.7%. The core deflator has come down from 5.3% over the past three months. 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 in-line with the benchmark. We had been positioned shorter than the benchmark for over a year but recently moved close to the benchmark after interest rates moved much higher this year. 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 significant move higher in interest rates was more than enough to push the 30-year mortgage rate almost 100 bps higher in the 2nd quarter to 5.92%. The higher rates drastically slowed refinance applications by 55% in the quarter. Only once in the past 20 years (12/28/18) has the refinance application index been lower than the current level. The current coupon mortgage rate now stands at 4.30%, 80 bps higher than at the start of the quarter. The Fed continued to slow its MBS purchases, moving from $9.6 billion a week to a $2.7 billion rate in the quarter. This decline in demand continued to push mortgage spreads wider. The mortgage basis began 2022 at 80 bps and currently stands at 140 bps. Further widening will be determined on whether the market can find a new buyer to replace the Fed's prior purchases. Recently, the higher rates and the MBS spread widening have caused less liquid product sectors such as non-agency structured product to lag the rest of the market. This lag should dissipate as the market settles into more stable operating regimes. Market volatility causes stress in the mortgage market, but also can provide investing opportunities.

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 44 basis points during the quarter and are now trading wider than historical averages. We believe that investment grade corporate bonds represent the best value in the investment grade fixed income market. We currently hold an overweight of close to 10% to corporates in our Core Fixed Income portfolios. We favor the basic industry, insurance, communications, energy, and electric utility sectors. 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.

High Yield finally suffered after holding in much better than other sectors of fixed income over the past year. Spreads widened significantly during the quarter and are wider 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 again in the 2nd quarter due to higher interest rates, weaker economic growth in many countries, and the risk-off investment environment. Spreads for EM sovereigns widened by 142 basis points during the quarter. The war in Ukraine has had major implications for EMD, including the removal of Russia and Belarus from the index and much higher prices in energy and food. 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

For the first half of 2022, 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. Returns were "Bad to the Bone."

U.S. economic growth slowed significantly in the first half of 2022 caused by very high inflation, much higher global interest rates, continued supply chain problems, the Omicron variant, and the conflict in Ukraine. We expect U.S. growth to continue to be sluggish in the second half of the year. The same headwinds mentioned above will mostly remain in place over the balance of the year. However, the strong labor market will keep activity moving forward and help the U.S. avoid a moderate or deep recession.

Inflation is at the highest level in 40 years. We expect inflation to come down later this year but will have difficulty getting much below 4%. Wages have increased 5.1% over the past year and price increases are widespread across the economy. Oil and other commodity prices have come down over the last few weeks of the quarter mostly due to increased fears of a recession.

Focus remains squarely on the Federal Reserve. The Federal Reserve will continue to hike the Funds Rate this year with a high probability of another 75 bp move later in July. However, the Federal Reserve may discontinue rate hikes earlier than expected later in the year which could surprise the markets. Interest rates have moved up considerably this year and are pricing in numerous future rate hikes. We believe that Treasury yields are close to fair value and may not move much higher between now and year end.

For investment grade corporate bonds, spreads have widened significantly over the six months and are now wider than historical averages. High yield spreads also have moved much wider and both markets reflect the weaker economic environment. We believe volatility could remain high in credit and that spreads could widen further if the economy weakens more than expected. In all credit markets, security and country selection will be extremely important due to the increased volatility and uncertainty. We will continue to add credit positions to our portfolios as we find opportunities with good long-term value.

Fortunately, valuations in fixed income, across all sectors, are much cheaper than they were at year-end. While that is good news, the future course of interest rates and credit spreads is very uncertain. Inflation needs to be tamed and that will take time and a higher Fed Funds Rate. The Fed waited far too long before they started hiking rates but are making up for its earlier mistake by hiking more aggressively. We are hopeful that much of the pain in fixed income is over and that rates and spreads may not get much higher over the next few months. We will continue to keep duration close to the benchmark and will selectively buy credit as we find opportunities.

SUMMARY

To summarize our outlook:

1) Economic growth was robust in 2021, but has slowed considerably in 2022. We do not expect a moderate or deep recession in the U.S. this year as the strong labor market will prop up growth despite high prices and supply chain issues. Europe will most likely experience a mild recession later this year.
2) Inflation will start to mover lower over the next few months. We expect inflation to come down to 3.5% to 4.5% by year-end. This is still well above the Fed's 2% target, but could be low enough for the Fed to slow additional rate hikes
3) The Federal reserve will hike the Fed Funds Rate to at least 3.0% later this year. However, the Fed may discontinue rate hikes sooner than expected.
4) U.S. Treasury yields have risen significantly this year and already reflect additional rate hikes. Yields are currently close to fair value.
5) Returns for fixed income have been horrible so far in 2022, but most of the pain may be over.
6) Corporate spreads have widened significantly and are much more attractive than earlier in the year. Spreads could widen further if economic activity declines in the second half of the year.
7) Caution is warranted as high inflation, sluggish economic activity, and geopolitical events could cause continued poor returns.
8) Fixed income should be able to resume its traditional role of being a hedge against weaker economic growth or a recession.

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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