DuPont CAPITAL

Fixed Income Market Review and Outlook

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Market Overview

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I don't like rollercoasters. I didn't ride on them much as a child, but as a father of four, I had to ride on my fair share when we took our children to Disney and other amusement parks. The one I disliked the most was the Aerosmith Rock 'n' Roller Coaster at Disney. It travelled at a very high speed and had many significant up and down moves. Fixed income investors don't like rollercoasters either but that is what we went through in the 1st quarter of 2023. The 2-year Treasury, in particular, had a wild ride. It started the year with a yield of 4.43%, moved lower to 4.08% in mid-January as markets priced in future rate cuts by the Federal Reserve. This seemed like a stretch as the labor market was expanding and inflation was still very high. Then, up we went on the coaster with the yield soaring to 5.07% on March 8 after a very strong employment report and worse than expected inflation data. This was the peak of the roller coaster before the big, unexpected finish. It was on March 10 that news came out about the significant problems at Silicon Valley Bank (SVB). This led the 2-year to fall from 5.07% to 4.03% in just three trading days. That move might be a steeper drop than anything on the Disney ride. Volatility remained high for the next two weeks before slowing as the quarter ended with the 2-year at 4.04%. Whew. I was glad to get off that ride.

In the 1st quarter, the Bloomberg Aggregate Index had a return of +3.0% driven by the decline in interest rates. Credit sectors did very well too with High Yield up +3.6% and Investment Grade Corporates up +3.5. Emerging Markets Debt lagged due to wider spreads but was still up +1.9%.

The following tables show the returns for the various fixed income sectors and rating categories for the 1st quarter of 2023:

Sector	1Q Return*
U.S. Treasuries	3.0%
MBS	2.5%
Inv. Grade Corporates	3.5%
High Yield	3.6%
Emerging Markets Debt	1.9%

Credit Rating	1Q Return*
AAA	2.8%
AA	3.5%
A	3.3%
BBB	3.6%
BB	3.4%
B	3.5%
CCC	5.0%

Source: Bloomberg
* Returns are from Bloomberg indices except Emerging Markets Debt, which is from JP Morgan. All figures are as of 3/31/2023.

U.S. Treasuries

As I mentioned, Treasuries were volatile during the quarter, particularly in the front-end of the curve. Yields declined in the first half of January but moved higher in February and early March as investors moved more bearish as the economy showed strength, and inflation did not come down as much as expected. The yield curve steepened further. The 2-year peaked at 5.07% on March 8th with the 10-year at 3.97%, an inversion of 110 bps. This was the highest yield for the 2-year since 2006. Shortly after, Silicon Valley Bank began to have problems and Treasuries rallied. The 2-year moved down by 104 bps in four trading days to 4.03%. For the entire quarter, the 2-year and 10-year yields declined by 39 bps and finished at 4.04% and 3.49% respectively.

The Federal Reserve moved the Fed Funds Rate higher by 50 bps in the 1st quarter, bringing it up to a range of 4.75% to 5.0% at the end of the quarter. The market is pricing in one more 25 bps hike before pausing in June and cutting rates before the summer is over.

Spread Products

Credit spreads were mixed in the 1st quarter. Investment grade spreads widened slightly while high yield spreads tightened. Returns in the quarter were positive driven by the decline in Treasury yields and coupon income. 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 2021, the end of 2022 and the end of the 1st quarter for 2023:

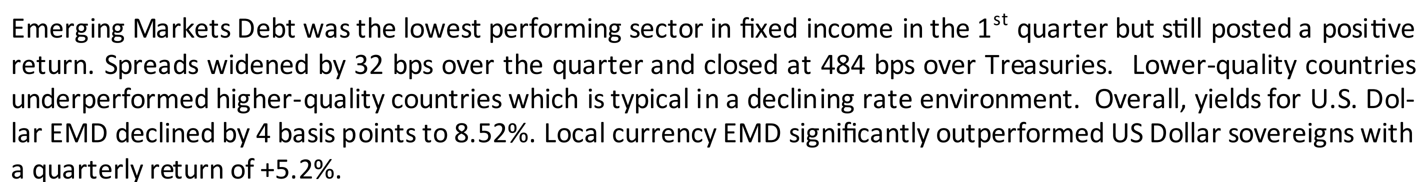
Sector	12/31/2019	3/31/2020	12/31/2021	12/31/2022	3/31/2023
Investment Grade Corporates	96	276	96	138	146
High Yield	357	899	321	489	478
Emerging Markets Debt	291	626	369	453	484

*Spread data are from Bloomberg indices for IG Corporates and High Yield and from JP Morgan for Emerging Markets Debt.

Investment grade corporates widened by 8 bps in the 1st quarter to 146 over Treasuries, wider than the historical average of about +120. Industrials and utilities outperformed financials during the quarter, while longer duration corporates had higher returns than shorter duration corporates. Corporate bond issuance was strong in January and February before slowing down dramatically in March. The total issuance for the quarter was down 5% from the average of the last five years.

In mortgages, fixed-rate pass-through mortgages outperformed Commercial Mortgages (CMBS) and ABS. CMBS had a positive return despite some concerns and Asset-backed securities lagged due to the shorter duration.

High yield did very well, aided by the rise in equity prices. Spreads tightened by 11 bps and ended the quarter at +478 which is lower than the historical average of about +500. The yield of the index moved from 8.96% down to 8.52%. Higher-rated high yield underperformed lower quality, with BB's returning +3.4% as compared to +5.0% for CCC-rated bonds. Default activity continued to be low, with the twelve-month default rate (including distressed exchanges) rising 0.2% to 1.9%. This remains well below the historical default rate of 3.2%, but most forecast show defaults rising closer to 3% this year.



Emerging Markets Debt was the lowest performing sector in fixed income in the 1st quarter but still posted a positive return. Spreads widened by 32 bps over the quarter and closed at 484 bps over Treasuries. Lower-quality countries underperformed higher-quality countries which is typical in a declining rate environment. Overall, yields for U.S. Dollar EMD declined by 4 basis points to 8.52%. Local currency EMD significantly outperformed US Dollar sovereigns with a quarterly return of +5.2%.

The Economy

Economic activity was robust early in the year before slowing as the quarter progressed. Consumer spending has slowed from the pace early last year partly due to rising prices. Retail sales were down in three of the last four months, but the month of January was very strong. Manufacturing activity has been weak with Durable Goods Orders falling -5% in January and -1% in February. The ISM Manufacturing Index declined during the quarter from 48.4 to 46.3, the lowest level since the beginning of the pandemic. The index was above 57 a little over a year ago. Overall, the demand for services has been healthy although the ISM Services Index declined from 55.1 to 51.2 over the last month. The economy could be in trouble if demand for services declines. The housing market has shown a little life as mortgage rates have come down, but overall is still weak. Home prices have moved lower in many areas of the country. The S&P Case-Shiller national home price index has moved lower over the last seven consecutive months and prices are now only up 3.8% higher over the past year.

The Federal Reserve Bank of Atlanta's GDPNow model, a running estimate of growth during the quarter, was projecting growth of +2.2% for the 1st quarter as of April 10. This mostly includes data from January and February so it could change significantly before the first official release at the end of April.

The non-farm payroll gains remained healthy but declined in March. March saw an increase of 236,000 after gains of 326,000 in February and 477,000 in March. The unemployment rate remained the same at 3.5% which matches a 50-year low and is the same as the pre-pandemic rate. Wages were up +0.3% in March bringing the average hourly earnings to 4.2%, down from 4.6% year-over-year. The four-week moving average for new unemployment claims was 237,750 at the end of March, up by over 20,000 from last quarter. As a reminder, claims were running about 215,000 before the pandemic. It looks like the labor market is slowing from the torrid pace of the last year.

Inflation

Year-over-year inflation declined but remained high and is still the main focus for the Federal Reserve. The Consumer Price Index (CPI) has risen 5.0% over the past year, which is down from 6.5% three months ago. Core CPI rose by +0.4% in March and is now up 5.6% over the past year. Progress has been made but inflation has a long way to go. Oil prices declined over the quarter. West Texas Crude fell by 6% to $75, down from a peak of over $120 last year. However, OPEC agreed to a surprise production cut with the hopes of stabilizing prices. Overall, other commodity prices declined, with the Bloomberg Commodity Index falling by -5% over the past three months. 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 come down but remained high over the last few months with an overall year-over-year increase of +5.0% and a Core PCE deflator increase of +4.6%. The core deflator has only come down from 4.7% over the past three months.

PORTFOLIO POSITIONING

In the **Government** sector, our Core and Core Plus portfolios have durations that are in-line with the benchmark. We were positioned shorter than the benchmark for over a year but moved close to the benchmark after interest rates moved much higher earlier in 2022. We continue to have a large 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 rates have come down from their peak, but remain well above what they were a year ago. Not only are homeowners finding it more difficult to transition to different homes because of higher mortgage rates, their home equity is not rising as fast as year-over-year home price appreciation has fallen over the last seven months. The higher rates have caused mortgage securities to extend as shown by the Bloomberg Aggregate Mortgage Index duration moving from 4.6 early last year to 5.8 years in April. Our overall mortgage exposure is positioned on the shorter side in terms of duration, and we have taken advantage of security structures that have provided higher yields while still maintaining credit risk protection. Most of this activity has been in the CMBS sector which is somewhat less sensitive to interest rate volatility.

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 8 basis points during the quarter and are trading wider than historical averages. We currently hold an overweight of 6% to corporates in our Core Fixed Income portfolios. We favor the utility, insurance, communications, energy, and consumer cyclicals sectors. Regarding ratings, we are overweight BBB-rated corporates. We continue to make additional purchases in corporates as we find opportunities, but we are much more selective because of the potential for a weaker economy.

High Yield performed well over the last two quarters as the equity market rose. Spreads tightened slightly this year and are tighter than long-term averages. We are selectively finding opportunities and continue to look to identify companies with attractive valuations that could provide strong returns over the long-term.

Emerging Markets Debt posted a good return in the 1st quarter due to falling interest rates. Spreads for EM sovereigns widened by 32 basis points during the quarter. 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, and Argentina. 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

March was quite the ride in fixed income. Twists, turns and an unexpected finish. What is next?

Economic activity started to decline in mid-February after a strong start to the year. March looked to be even worse in some segments of the economy. The problems with a few regional banks have hurt confidence and will most likely lead to tighter lending standards. Investors are trying to determine:

Would the Fed stop raising rates and start injecting liquidity into the market?
Will other regional banks have problems and how much will lending standards tighten?
Will consumer confidence erode and help push the U.S. into a recession?

These are tough questions to answer right now. As far as the Fed, its focus was squarely on inflation before the problems with SVB. Now, it will have to be split more to watch the health of the banking system and the declining economy. The Federal Reserve may move the Fed Funds Rate higher by 25 in May but could pause if data continues to be slow. This would bring the Funds Rate over 5% for the first time since 2007.

U.S. economic growth started the year strong due to warmer weather and much higher Social Security payments. Growth has started to soften, and we expect U.S. growth to continue to be sluggish over the rest of the year. High interest rates will weigh on spending, both by consumers and businesses. Although the labor market is still strong with only 3.5% unemployment, job growth should slow over the coming months with layoffs in more industries.

Inflation was at the highest level in 40 years just a few months ago. Some prices have started to stabilize and should continue to moderate over the rest of 2023. We expect inflation to continue coming down and get closer to 3% by year-end. It could go lower if the service side of the economy weakens. This would help keep the Fed at bay.

Treasury yields have been volatile and declined in the first quarter and are now pricing in easing later this year. There are a lot of uncertainties, and we believe it is best to keep duration closer to the benchmark. In our Core Fixed Income portfolio, our duration is slightly shorter than the benchmark.

For investment grade corporate bonds, spreads widened over the past year and are slightly wider than historical averages. We believe volatility could remain high in credit and that spreads could widen further if the economy heads into a recession. However, yields are much higher in all credit segments with investment grade at 5.2% and high yield and EMD at 8.5%. 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.

As I mentioned earlier, I was glad to get off the ride that we had in March. I don't like the sudden movements and certainly not at the speed we saw after March 8. Unfortunately, there is a significant amount of uncertainty in the economy and financial markets, so the ride probably isn't over. All we can do is buckle in, be careful, and don't take significant risks.

SUMMARY

To summarize our outlook:

1) The U.S. economy is entering a sluggish phase that may turn into a recession due to high interest rates, tighter lending standards, eroding consumer confidence, and a weakening labor market.

2) The Federal Reserve will increase the Funds Rate by an additional 25 bps in May but is likely to pause after that.

3) Inflation will decline as the year progresses and we expect core inflation to be closer to 3% for all of 2023.

4) U.S. Treasury yields have come down this year. With the increased uncertainty, it is best to keep durations close to the benchmark.

5) Credit spreads have attractive yields and investment grade spreads are slightly attractive. Although spreads could widen if economic growth declines, we are overweight IG corporates due to relatively good fundamentals and the improved valuations.

6) Fixed income could provide an attractive return over the next few years due to the higher yields.

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, and scientists. We believe their global expertise creates a portfolio implementation edge that benefits our clients.

Fixed Income Team Summary

- 6 Portfolio Managers
- 3 Research Analysts/Traders

Fixed Income Capabilities

- Core Fixed Income
- Emerging Markets Debt

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