DUCENTA SQUARED
ASSET MANAGEMENT

Economic and Sector Summary & Outlook

Second Quarter 2020

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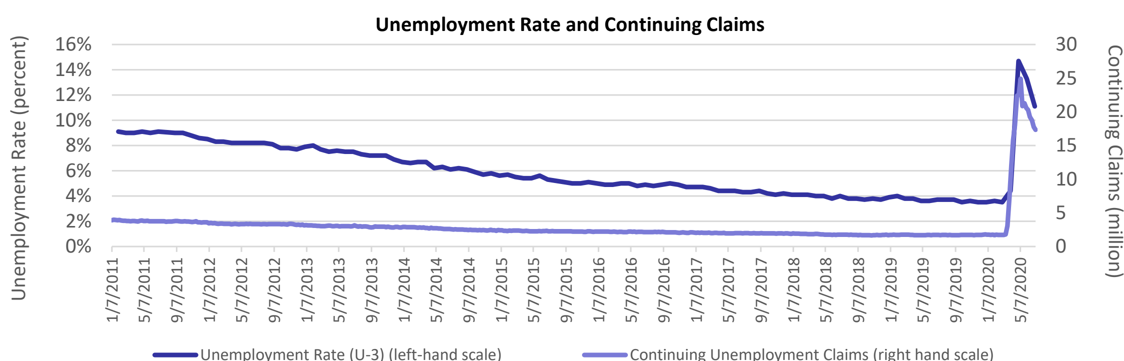
US Economy

Summary

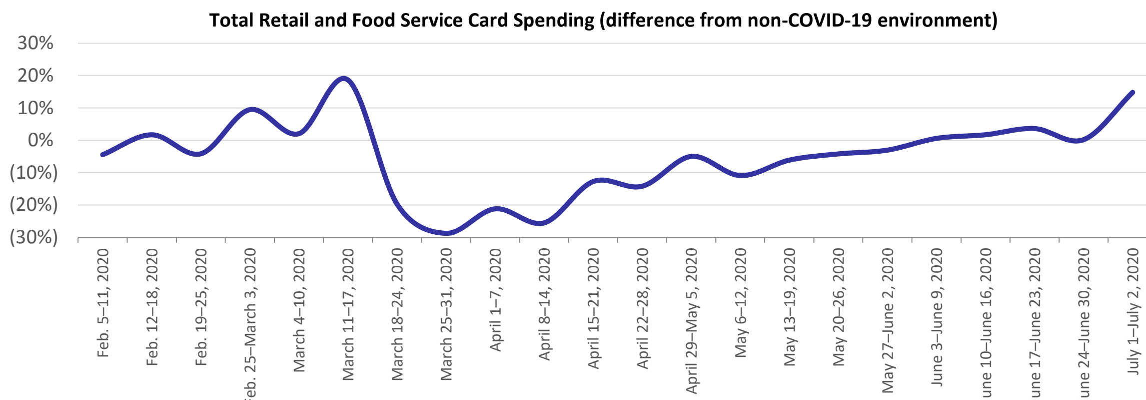
In the second quarter of 2020, the US and global economy rebounded from the initial spread of the COVID-19 virus. In the US, the economy responded quickly to the swift and forceful stimulus from the Federal Reserve and Congress.

With many states reopening in May 2020, economic data in the US generally trended better than expected in the last few weeks of the second quarter, leading to optimistic forecasts for a potential V-shaped recovery. Although US GDP could fall a staggering 35% in the second quarter, the trough in economic activity probably occurred in April. Labor markets quickly rebounded, adding 4.2 million jobs in June, and the unemployment rate fell from a record high of 14.7% in April 2020 to 11.1% in June 2020. Regardless of the strong recent retracement, the jobs market has a long way to full recovery, as approximately 15 million remain unemployed and the level of continuing jobless claims exceeds 18 million.



Source: Bloomberg

Consumer spending comprised a significant driver of the recent strong economic retracement. Importantly, while retail sales increased 17.4% sequentially in May, the absolute level of activity remains 6.1% below the prior year period. A similar retracement occurred in new home sales, durable goods orders, industrial production and the ISM Manufacturing Index. During May and June, many of the high frequency economic indicators such as consumer credit and debit card spending (see chart, below), airline bookings, and mobility indices also showed sharp increases on a sequential weekly / monthly basis as states began lifting stay-at-home orders and loosening restrictions on business activities.



Source: Bloomberg

Unfortunately, just as momentum was building for an economic recovery, the number of new COVID-19 positive tests and hospitalizations also began to reaccelerate late in the second quarter of 2020 (see chart, below). New

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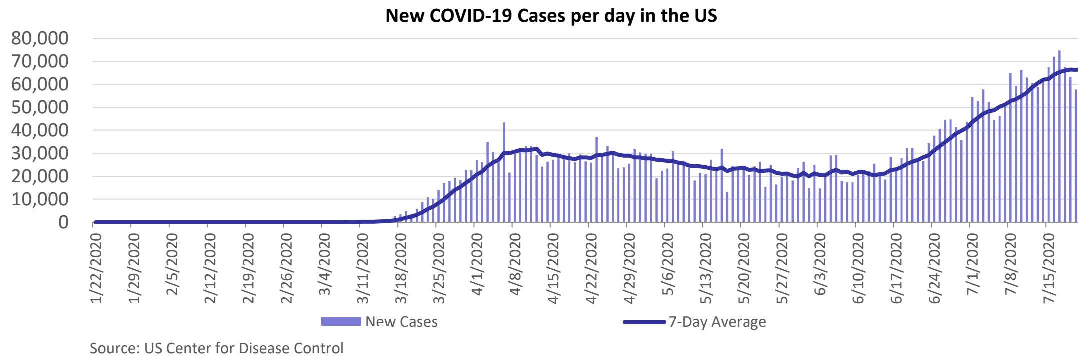
cases in California, Arizona, Florida, and Texas increased rapidly to new record highs at the end of the second quarter, raising concerns about a potential pause or reversal in the fledgling post-COVID-19 economic recovery.



In addition, the effect of recent economic stimulus prescribed by the Federal Reserve, through its market liquidity facilities, and Congress, through the CARES Act (which extended unemployment benefits) and its Paycheck Protection Program, will likely wane in coming weeks. The increased unemployment benefits expire at the end of July and the assistance from the Payroll Protection Plan will roll off in July and August. Consequently, the economy may require additional fiscal and monetary stimulus. The Federal Reserve indicated it is ready to deploy its growing policy toolbox, but Congress remains in gridlock on a phase four stimulus bill.

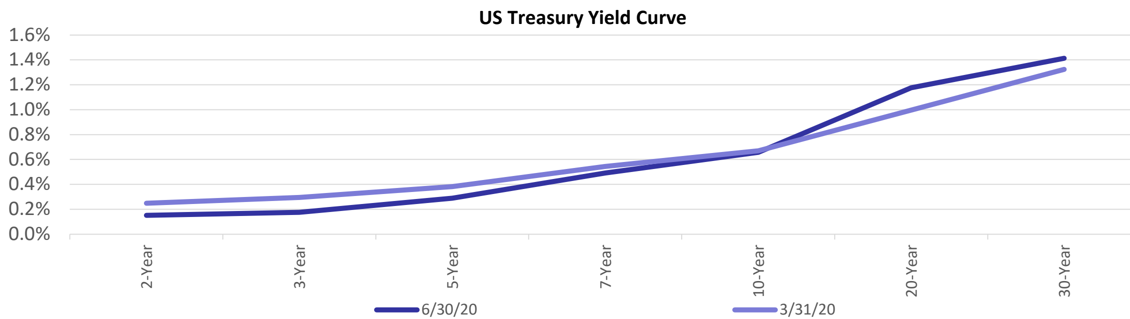
Outlook

The outlook for the US economy remains very uncertain and highly interdependent with the outcome of the COVID-19 pandemic. We believe Congress will authorize additional stimulus and view the prospects for a vaccine as promising; however, we continue to expect a slow and uneven recovery in economic growth rather than a sharp V-shaped rebound.

Sector Analysis

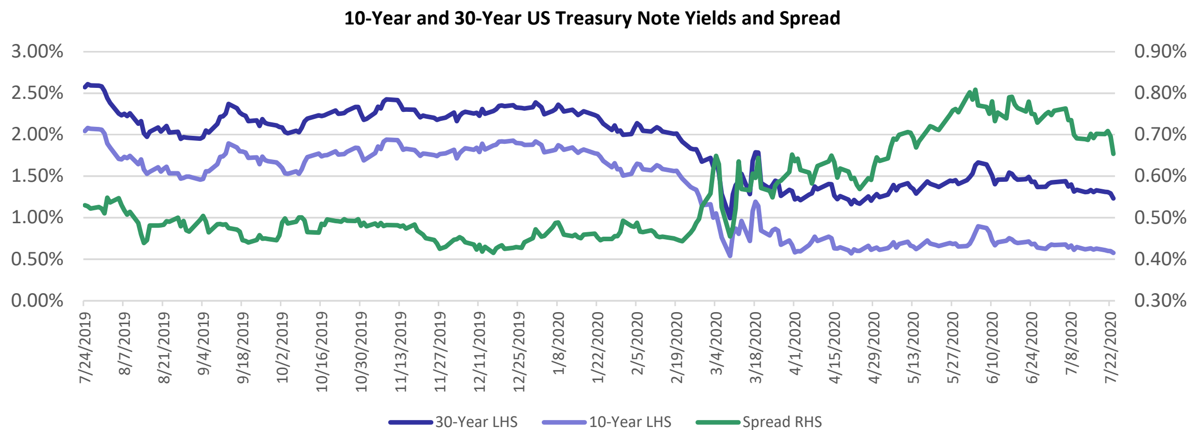
U.S. Interest Rates

Heading into the second quarter of 2020, the Federal Reserve signaled that short-term rates would be anchored at essentially zero for the foreseeable future. In addition, the Federal Reserve announced quantitative easing would be aggressively brought back to the forefront to maintain market liquidity and it announced several programs which authorized purchase of a range of assets, including US Treasuries, mortgage backed securities and corporate debt. In addition, Congress passed the CARES Act to support the economy in the near term. With these programs in place, volatility in US Treasury rates receded and yields largely traded within a range throughout the second quarter of 2020.



The U.S. yield curve steepened during the second quarter of 2020. The yield difference between the 2-year and 10-year US Treasury notes increased by 8 basis points while the 10-year versus 30-year yield spread increased 10 basis points (see chart, below). With the Federal Reserve locking down the front end of the yield curve by

maintaining a federal funds target rate range of 0% to 0.25%, we expect the yield curve will continue to steepen over the longer term, despite the flattening trend that occurred in late June and July. As the world works through the COVID-19 pandemic, economic growth should accelerate, and the rate of growth will influence the steepness of the yield curve. A quick, V-shaped recovery (not our base case) could cause the yield curve to steepen rather quickly assuming short rates hold near zero, while a long, slow recovery could delay any curve steepening, at least in the near term.



Source: Bloomberg

In the second quarter of 2020, the US Treasury increased issuance of notes to fund the massive stimulus spending authorized by the CARES Act and other programs. Investors anticipated that supply could overwhelm demand, resulting in higher interest rates. However, markets readily absorbed the larger US Treasury supply, and investors currently appear receptive to further increased US Treasury notes issuance. Investor initially thought the Treasury would target issuance at the short end of the curve but later explained it would balance new supply along the curve; nevertheless, regardless of the tenure, the massive amount of expected Treasury issuance should eventually lead to higher rates on the long end of the yield curve.

Securitized Products

The securitized markets rebounded strongly from the COVID-19 selloff in the first quarter. Both the ABS and CMBS sectors responded positively to the unprecedented fiscal and monetary stimulus and to signs that the US economy had reached a bottom in April. The ABS sector outperformed comparable US Treasuries by 3.5% for the quarter, driven by better than expected collateral performance and strong investor demand for yield. The rally in ABS pushed many benchmark, high quality auto and credit card issues back to pre-COVID valuation levels. Similarly, CMBS outperformed Treasuries by 4.15%, despite headwinds from deteriorating commercial real estate fundamentals. Delinquencies increased significantly for hospitality and retail properties. The ABS and CMBS sectors also benefited from expectations that new issue supply will fall dramatically in the second half of 2020.

Agency mortgages, which were the best performing asset class in the first quarter, lagged the strong rally in ABS, CMBS, and the credit markets. While Mortgages modestly outperformed Treasuries by 67 basis points, the sector faced concerns over rising refinancing risk and investor preference for credit investments. The Federal Reserve continues to buy agency mortgages in support of the housing market.

Our securitized investment strategy remained largely unchanged during the second quarter of 2020. We remain neutral the agency MBS sector, but anticipate increasing allocations as relative value versus the credit markets has improved. Even with the strong recent performance in the ABS sector, we still find the sector an attractive source of high quality yield in excess of U.S. Treasuries. With regard to CMBS, we would expect to reduce the risk in the sector by lowering portfolio allocations and improving quality in the second half of 2020. The COVID-19 virus has negatively affected the near term performance of commercial real estate and potentially changed longer-term space utilization across the various property types.

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Credit Spotlight

On a collision course? A weakened economy, unprecedented government stimulus, increased US Treasury issuance, and future interest rates.

The COVID-19 pandemic upset prevailing social, political, economic and financial trends. Some changes, such as closed businesses and public protests, played out prominently in the second quarter of 2020. Others changes continue to build slowly out of the sight of mainstream media. Among the potential latent trends, we harbor some concern that increased government spending on a nearly unprecedented scale could require future US Treasury issuance in quantities that surpass investor demand, forcing US Treasury rates higher and further increasing deficit spending.

Unprecedented US government stimulus

To date, Congress has spent roughly $2.8 trillion, or approximately 13% of GDP, on stimulus related to the COVID-19 pandemic, while the Federal Reserve increased its balance sheet by $7.1 trillion. While the efforts of both organizations supported the economy during the critical period as COVID-19 first emerged, the resulting surge in government spending will increase the federal deficit.

Breakdown of fiscal stimulus	
Transfer to individuals	23%
Stimulus checks	12%
UI benefits	11%
Other transfers to individuals	2%
Government consumption through direct federal purchases of goods and services	24%
Transfers to state and local governments	12%
Grants and uncovered loans to businesses PPP	29%
60-75% used on wages	
25% used on nonpayroll income	
Tax provisions	11%
Reduce individual taxes	1%
Cut business taxes	10%
Other	0%

Source: BofA, CRFB, San Francisco Federal Reserve Bank

The level of stimulus enacted to date totals $4.5 trillion for 2020 and an additional $2.5 trillion in 2021. Alarmingly, economists expect the US budget deficit to reach $1.103 trillion in 2020. A sustained second wave of COVID-19 cases in the US, as suggested by the trend of test results as of mid-July, will likely increase headwinds to economic growth and raise the potential for additional fiscal stimulus, such as infrastructure spending or a cut in payroll taxes. A ballooning deficit can crowd out private borrowing, decrease net exports, and could lead to higher taxes, interest rates and inflation.

Admittedly, it's currently difficult to criticize recent stimulus efforts and lecture from the "deficits are bad" soapbox, as the COVID-19 pandemic called for an unprecedented government response. Deficits rightly took a back seat to the immediate need to reduce the spread of the virus, support key industries and the welfare of large numbers of unemployed. Indeed, governments world wide continue to focus now on providing broad economic support, leaving the issue of confronting ever-increasing deficits to a date when COVID-19 has passed and economies have stabilized.

Increased Government Stimulus and Deficit Spending Require Increased Treasury Issuance

Some economists expect US Treasury net debt issuance to total $2.87 trillion in 2021. As the US Treasury increases its issuance of debt to fund a growing federal deficit, investors may continue to seek the safety of US Treasuries, especially if the economic recovery follows a U-shaped pattern. However, and especially if the recovery is quick (V-shaped, which is not our base case) and risk assets gain favor, investor demand for an increasing supply of US Treasury debt could wane.

Many economists argue that the expected large increase in Treasury borrowing will conveniently occur during today's environment of extremely low interest rates, even at the long end of the curve. While recent US Treasury auctions don't reflect any supply and demand imbalance, we note that the Federal Reserve was effectively supporting the market by buying large quantities of US Treasury debt in late March and early April 2020 and as the COVID-19 pandemic unfolded. The Federal Reserve began tapering its purchases of US Treasury debt in mid-April, so markets may soon reflect a more natural interaction between supply and demand.

The Federal Reserve took kit may be inadequate to respond to increasing rates caused by unprecedented stimulus and significantly increased US Treasury issuance. Notably, Jay Powell has rejected the prospect of negative interest rates. However, he has not ruled out the possibility of yield curve control ("YCC") and its potential to target specific rate levels along the US Treasury curve. To exercise YCC, the Federal Reserve would announce a longer-term rate target, and then buy or sell as many US Treasury notes necessary to achieve the targeted rate. While it hasn't been used in the US, Japan's experience with YCC appears mixed.

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Investment Grade Credit

In the second quarter of 2020, investment grade credit experienced a partial recovery from the sell-off triggered by the COVID-19 pandemic, as spreads on the Bloomberg-Barclays US Credit Index (the "Credit Index") tightened 112 basis points during the quarter and the Credit Index generated 771 basis points of excess returns over similar duration U.S. Treasuries.

Despite the severe economic slowdown, the initial stay-at-home orders, and the corporate earnings shock brought on by the COVID-19 global pandemic, the emergency actions taken by Congress and the Federal Reserve to provide at least a temporary backstop to individuals and businesses proved effective. The CARES Act, passed by Congress and signed into law in March 2020, softened the hit to the economy and bridged some corporate solvency concerns while the Federal Reserve's extensive asset purchase facilities, which now include corporate bonds, ensured market liquidity. As a result, investment grade bond issuers raised an unprecedented amount of cash in the new issue corporate bond market during the quarter in order to both refinance maturing debt as well as plug any potential cash flow gap for many quarters to come. Further adding to the rebound within the corporate bond markets were the OPEC oil supply cut, a slowdown in growth of COVID-19 deaths, progress on COVID-19 treatments and vaccines, and some improving economic data as economies slowly reopen. In turn, credit curves normalized after being inverted heading into the second quarter and credit spreads across most industries recovered a significant portion of their spread widening experienced in the preceding period. The best performing industries and sub-segments of the Credit Index, on a spread basis, included energy, lodging, automotive, gaming, and finance companies. The worst performing industries and sub-segments during the quarter included the non-corporate portion of the Credit Index, cable, pharmaceuticals, aerospace / defense, and property and casualty insurance.

In early May, we increased our investment grade credit allocation to overweight from neutral due to extremely robust demand technicals and attractive valuations, partially offset by weakening credit fundamentals. From a fundamental perspective, corporate revenues and EBITDA have declined substantially for many issuers and industries as a result of the severe economic shock, temporary government mandated business shutdowns, and supply chain disruptions related to COVID-19. At the same time, corporate balance sheet leverage, which was near a post-crisis peak heading into the year, has increased and will continue to increase in the near term as a result of declining EBITDA and increasing debt balances. As a result, credit rating downgrades have increased for those companies managing the weakest balance sheets and / or experiencing the most significant operational impact from COVID-19. However, from a liquidity and solvency perspective, the Federal Reserve backstop of the investment grade corporate bond market as well as record low US Treasury rates have allowed companies to issue record amounts of debt to plug any solvency gap; at least for now. Furthermore, corporations reduced share repurchases, dividends and CAPX in order to weather the storm. It is important to note that the current market crisis has a varying effect on industries and issuers, with some experiencing only modest or no negative financial impact.

Investment grade corporate bond demand technicals comprised the driving force behind the credit spread tightening over the quarter. The Federal Reserve's newly announced Secondary Market Corporate Credit Facility propelled demand, by enabling it to purchase substantial amounts of investment grade corporate bonds with a maturity of five years or less, as well as investment grade corporate bond ETFs. In addition, the substantial decline in foreign currency hedging costs as a result of lower US short-term rates provided one of the most attractive relative investment opportunities over the last five years for many foreign investors on a currency hedged basis. Further, retail fund flows reversed, resulting in substantial inflows for much of the quarter. The large supply of negative yielding debt globally combined with unprecedented global central bank balance sheet expansion continues to crowd investors into non-government bonds. On the technical supply front, corporate bond issuance reached an all-time record during the quarter as companies scrambled to issue debt and build cash reserves sufficient to to weather their worst-case near-term projection scenarios. We expect this strong pace of issuance to slow going forward given the massive liquidity war chest already raised and the looming US presidential election in November, which could increase policy uncertainty.

From a valuation perspective, the investment grade corporate bond index ended the quarter at a spread of 150 basis points, 223 basis points tighter than the March 23rd pandemic period peak, yet still 57 basis points wider

year to date. Short-maturity credit as well as single A and higher rated credit retraced much of the spread widening year to date relative to the Credit Index and relative to longer maturity and BBB rated credit.

In the near term, we expect some dismal corporate earnings reports, slowing corporate new issuance, and range-bound credit spreads. While the Federal Reserve's monetary policy bazooka should soften the blow to the economy and provide some backstop to market liquidity should the pandemic worsen, material spread tightening from current levels appears unlikely until a vaccine begins to emerge. Further, as we approach the US presidential election, additional potential headwinds may arise within certain industries. Given the extremely robust techicals supply and demand outlook as well as decent valuations, we remain modestly overweight investment grade corporate credit with an intense focus on industry allocation and issuer selection.

High Yield

In the second quarter of 2020, the US high yield bond market, as measured by the Bloomberg-Barclays US Corporate High Yield Index (the "High Yield Index"), rebounded strongly to produce a 10.2% total return versus the 12.7% loss generated in the first quarter. The high yield market's second quarter performance represents its strongest quarterly return in over a decade. From the cyclical wide level of 1,100 basis points on March 23, 2020 (the highest level since 2009), high yield bond spreads tightened approximately 475 basis points to 626 basis points on June 30, 2020, still well off the 315 basis point pre-COVID year-to-date tight achieved in mid-January 2020. The High Yield Index finished the period with a 6.87% yield to worst, down from the recent peak of 11.69% attained on March 23, 2020. While lower-rated tiers of the high yield market performed worst in the first quarter of 2020 (i.e., CCCs returned -20.6%), better-rated credits led the market higher in the second quarter (BBs returned +11.5%, Bs +8.6%, and CCCs +9.1%), as investors remain cautious regarding the economic recovery and credit fundamentals. Additionally, high yield investors eagerly purchased recent fallen angels (including Ford Motor Company and Occidental Petroleum, now the two largest High Yield Index constituents), due in part to the Federal Reserve's decision to include those issuers in its bond-buying program that is largely targeting the investment grade market.

At a sector level, the energy industry rebounded from a dismal first quarter to post a 40% total return in the second quarter, as oil climbed back toward $40 per barrel, while consumer cyclical sectors also posted strong returns (lodging +14.0%, autos +13.2%, and gaming +11.8%). Transportation represented the only sector to end the second quarter underwater (returning -5.7%), driven by airlines (-14.9%), which continue to burn significant amounts of cash.

Technicals proved extremely positive during the second quarter rebound, with record quarterly retail inflows totaling $47.3 billion enabling issuers to tap the high yield market to put more cash on their balance sheets to bolster liquidity. A record $145 billion of new deals priced in the quarter, bringing the year-to-date figure to $218 billion (up 55% year-over-year). In contrast, high yield fundamentals remain challenged, with the default rate spiking to 6.19% in June (representing a 10-year high) and credit metrics deteriorating quickly. Average high yield leverage climbed to 4.5x in the first quarter 2020 (latest available), the highest figure since the fourth quarter of 2016, and will surely jump more following second quarter 2020 earnings reports. As a result of fundamental challenges likely still ahead, particularly in light of the recent spike in COVID-19 cases, we currently prefer the higher-quality tiers and noncyclical sectors of the high yield market, particularly as valuations for BBs look relatively attractive compared to the BBB segment of the investment grade market.

Leveraged Loans

Like the high yield market, leveraged loans experienced a sharp gain in the second quarter of 2020, returning 9.7% (Credit Suisse Leveraged Loan Index) in a partial recovery of the pummeling incurred in the first quarter (-13.2% total return). After plunging as much as 20 points at one point in the first quarter (to the mid-70s), average prices gained nearly 7 points in the second quarter of 2020 to finish just under 90 as of June 30, 2020, still well below the 96.5 level at year-end 2019. Spreads, as measured by the 3-year discount margin, retraced approximately 200 basis points during the second quarter (far less than then the recovery in high yield bond spreads) to end June at 624 basis points, while yields declined over 300 basis points to 7.25% due to the contribution of falling LIBOR (down 115 basis points during the second quarter, to approximately 0.30%) to the all-in yield calculation. In contrast to the high yield market, lower-rated loans outperformed in the second quarter, with split-Bs / CCCs leading the way (+13.8% total return), followed by CCCs and Bs (+11.5% for both), while BBs lagged (+6.1%). At the

sector level, return themes proved similar to the high yield market, as energy significantly outperformed (+26.4% total return), followed by other cyclical sectors (such as metals and mining (+13.8%) and autos (+12.5%)) while more stable sectors such as cable (+3.7%), wireless telecom (+5.1%), and consumer durables (+6.4%) underperformed.

With continued retail outflows, no direct Federal Reserve support, and limited resumption of CLO primary issuance, loan market technicals remain somewhat challenged, which has limited primary issuance and persuaded issuers to instead utilize the high yield bond market for funding (particularly for secured bonds). Retail loan funds experienced twenty-one consecutive months of outflows through June 2020, representing a total outflow of $79 billion. During the second quarter, new CLO issuance totaled $18.1 billion, and while up slightly from the first quarter, the pace trails recent years meaningfully. As a result of tepid demand, new loan issuance is down 30% year-over-year through June (excluding refinancings). The leveraged loan default rate essentially doubled during the second quarter to end June at just under 4%, with retail industry issuers particularly hard hit (the retail sector default rate is nearing 20%). Additionally, the recent downgrade wave has lowered the average credit quality of loan market, with a third of the market now either rated low-B or CCC. This represents a particular problem for CLOs subject to limits on CCC holdings. We remain concerned that default and downgrade trends will not recede in the near-term. Many recently-issued deals underwritten with high leverage and other weak credit fundamentals will likely be tested in the next few quarters as the economy struggles to emerge from the COVID-19 shutdown.

Within the leveraged loan space, our preference remains for higher-rated credits that exhibit adequate liquidity and manageable leverage profiles which don't require aggressive EBITDA growth assumptions to meet pro forma leverage metrics. We expect more opportunities to selectively add risk as the market continues to digest the depth and duration of economic downturn. Lastly, we continue to prefer the high yield market over loans, given the Federal Reserve's inclusion of certain fallen angel bonds in its purchase plans.

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