DUCENTA SQUARED
ASSET MANAGEMENT

Economic and Sector Summary & Outlook

Third Quarter 2021

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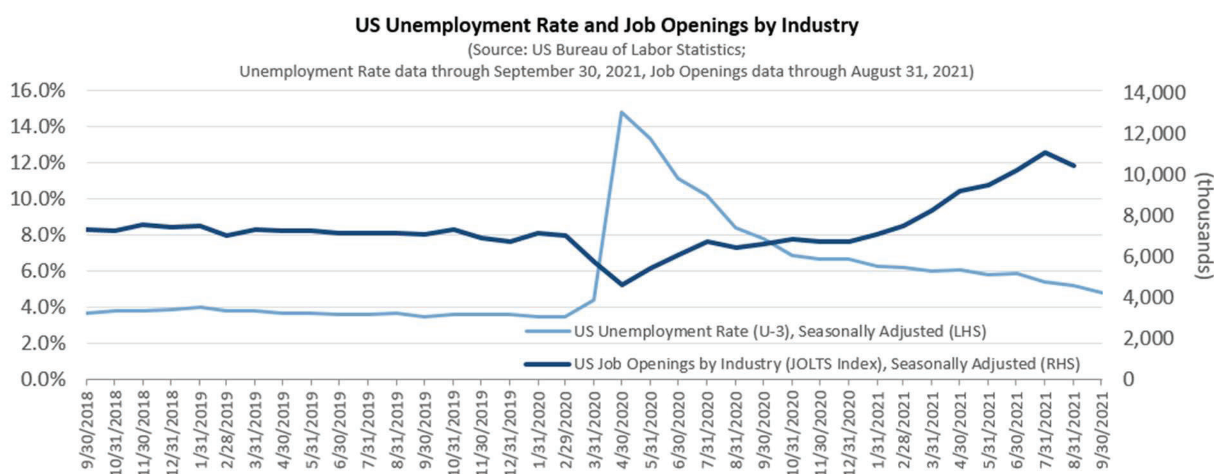
US Economy

Summary

Recent US economic data suggests that third quarter 2021 GDP growth will be solid but sharply reduced from the robust growth rates of 6.3% and 6.7% in the first and second quarters, respectively, as rising COVID-19 Delta variant cases and supply chain disruptions contributed to slower economic activity. Additionally, the pace of consumer spending declined from the pandemic reopening frenzy and continues to shift away from goods expenditures towards services. Nevertheless, robust household savings, augmented by government transfers, should support consumer spending through the holiday season.

Labor markets improved during the third quarter of 2021, but the pace of job creation underperformed expectations. Demand for labor as measured by the JOLTS Index (see chart) reached record highs in the period but labor shortages persist, despite the expiration of generous pandemic unemployment benefits and the return to classrooms. A decline in the unemployment rate during the quarter from 5.9% to 4.8% represents a positive development, although total employment remains approximately five million jobs below pre-pandemic levels.



Strong demand, rising wages, high transportation and raw material costs, and persistent supply chain disruptions have combined to push inflation higher. The Core CPI Index, which excludes volatile food and energy prices, finished the quarter at a 4.0% annualized pace. Rising shelter and energy prices offset a moderation in price increases for pandemic reopening items such as used cars, airfares, and lodging.

The Federal Reserve is cautiously inching towards unwinding its highly accommodative monetary policy while pursuing a dual mandate of low average inflation and full employment. In the September Federal Open Market Committee ("FOMC") meeting, Chairman Powell indicated the Federal Reserve will likely begin reducing its $120 billion in monthly bond purchases as soon as November. The Federal Reserve's latest economic projections acknowledged that inflation was running hotter and economic growth was weaker than previously expected. The Federal Reserve's dot plot, which depicts the outlook for the path of interest rates, surprised the markets by suggesting an earlier-than-expected and sharper pace of interest rate hikes.

Outlook

The US economy faces a difficult transition heading into the final quarter of 2021. US economic growth remains strong but is slowing, monetary policy is accommodative but shifting to a more restrictive stance, and inflation has likely peaked but is proving less transitory than previously expected. In addition, fiscal policy, which aided the swift recovery from the pandemic, will be less stimulative in the coming year even if the US Congress can agree on a compromise spending plan.

Despite these uncertainties, we maintain our positive outlook for the US economy. Consumer spending remains supported by healthy fundamentals, including high household savings, strong job demand, and net worth gains

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from housing and equity markets. Corporate profits continue to track a level which should translate into increased business investment, inventory rebuilding, and hiring. The supply bottlenecks and shortages, including those in labor markets, have taken longer to resolve than we had initially expected; but we continue to believe inflation will decline back to the Federal Reserve's target of 2.0% by the second half of 2022. Currently, we view the biggest risk on the horizon as being the Federal Reserve's ability to successfully navigate an economic soft landing while also avoiding uncomfortably high inflation and asset prices.

Sector Analysis

US Interest Rates

For much of the third quarter of 2021, US Treasury yields declined on weaker payroll reports and subdued inflation data. The ten-year US Treasury Note yield began the quarter at 1.46% and rallied to as low as 1.12% on August 4, and the 30-year US Treasury Note yield declined to 1.80% on September 22 after beginning the quarter at 2.08%.

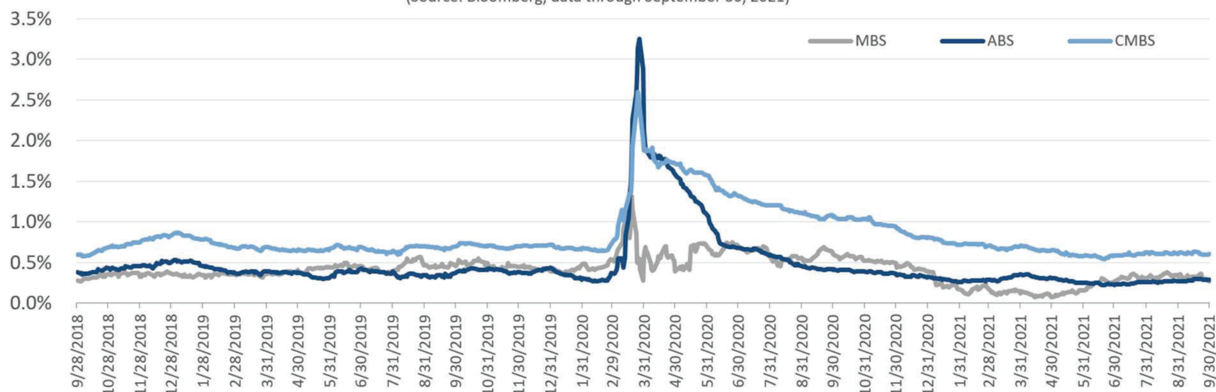
Bonds reversed course after the Federal Reserve clarified on September 22 that it would complete tapering of its open market bond and mortgage purchases by the middle of 2022. That clarification reinforced market expectations that the Federal Reserve would announce its tapering plan in November and begin reducing purchases early in the first quarter of 2022.

Investors reacted to the Federal Reserve's September 22 clarification regarding tapering by selling Treasury Notes, as evidenced by a backup in yields that resulted in the 10-year US Treasury yield ending the quarter at 1.48%, an increase of 32 basis points from the 1.17% low reached during the quarter and the 30-year US Treasury ending the quarter at 2.04%, an increase of 27 basis points from the 1.80% low it registered during the period. In addition, the spread between the yield on 5-year and 30-year US Treasury Notes flattened to just over 107 basis points as of September 30, 2021.

We expect a gradual increase in rates in the near term as the Federal Reserve begins the taper process; however, the move higher may be limited as the economic recovery is decelerating and the labor market remains under pressure.

Securitized Products

The third quarter of 2021 proved particularly uneventful in the securitized products space, despite the continuation of the bond market rally that started in the second quarter and drove 10-year US Treasury Note yields to a low of 1.12% in early August. The MOVE Index, an indicator of implied volatility in the fixed income markets, remained well contained. The spread of the COVID-19 Delta variant dominated headlines and increased restrictions on the broad economy over the course of the quarter. Notably, on July 18, 2021, Los Angeles County reintroduced an indoor mask mandate for everyone.



In the third quarter of 2021, the MBS market dealt with both the rally in rates and the approaching tapering of the Federal Reserve's mortgage securities purchase program. Interest rate directionality dominated performance as

MBS spreads widened during the rate rally and then recovered as rates backed up into quarter end. The MBS Index option adjusted spread ("OAS") made a full round trip beginning the quarter at +27 basis points, reaching a high of +38 basis points in August and then closing the quarter at +25 basis points. This ultimately amounted to a modest +3 basis points of excess return versus duration-matched Treasuries. Not unexpectedly, in his press conference following the September Federal Reserve meeting, Chairman Jay Powell made it all but certain that the details of the upcoming taper process would soon be announced. However, he surprised some investors by indicating that he anticipates the taper to be complete by mid-year 2022. This was more accelerated than the market had assumed and caused spreads to widen modestly, but the widening proved temporary as the general expectation of a tapering of purchases has been well priced in.

ABS performance continues to be challenged as spreads remain extremely tight. The OAS on the ABS Index began the quarter at +23 basis points and finished the period at +29 basis points. Income offset this modest widening and the sector ultimately returned +3 basis points of excess return versus Treasuries. ABS supply remains heavy as year-to-date issuance now totals $231.8 billion, or 46% higher than the comparable 2019 period. This heavy supply has been met with equally strong demand which has kept spreads stable to marginally tighter.

The CLO market continues to originate record volumes of new issuance. In the third quarter of 2021, JPMorgan data suggests that a near-record $35 billion in new issue broadly syndicated loan CLO debt securities priced. Nevertheless, as was the case in ABS, very strong demand for loans persisted and spreads in the sector remained stable. CLO debt securities traded in a narrow range during the period (at a discount margin of +101 basis points to +104 basis points for AAA classes and +314 basis points to +318 basis points for BBB classes).

The CMBS Index also performed in-line with other securitized sectors, as its OAS varied within a 4 basis point range during the period, trading between +59 basis points and +63 basis points. For the quarter, CMBS underperformed duration-matched Treasuries by 3 basis points. Conduit supply remains very muted, lending strong technical support to the sector. Year-to-date supply totals an underwhelming $23.3 billion. As the economy moves past the depths of the pandemic, underlying CMBS fundamentals continue to improve, especially for non-business focused hospitality securities.

We remain underweight MBS versus index weightings. While off their absolute tights in spread, MBS appear historically tight. Money managers have been underweighting the sector most of the year. Despite the lack of demand from money managers, the Federal Reserve continues to add $40 billion in MBS to its balance sheet and banks have been strong buyers on the recent back-up in rates. Federal Reserve and bank demand has kept spreads tight and unattractive to total return buyers. We plan to wait for some meaningful cheapening of the sector before we begin adding exposure to MBS. The outlook for spreads in both CMBS and ABS is for more of the same. Spreads are tight, but the supply / demand balance leans toward excess demand which will likely keep spreads compressed. In addition, fundamentals lend a helping tailwind to both CMBS and ABS. We will continue to monitor both sectors closely and opportunistically take advantage of any idiosyncratic situations that present themselves. We continue to see good relative value in the CLO sector due to adequate current yield, stable overall loan market dynamics and supportive issuer fundamentals backing these deals.

Credit Spotlight

Stagflation – Back to the 70s?

The past 18 months have presented a number of unprecedented economic and financial market challenges to decipher, so maybe it is no surprise that investors are now facing a potential predicament unseen in over four decades – stagflation. Stagflation refers to an economic environment characterized by high inflation accompanied by slow economic growth and high unemployment. Stagflation presents a challenge to central bankers because attempts to reduce inflation may exacerbate already high levels of unemployment. A quick look at recent US economic trends highlights the causes for concern. US economic growth appears to be slowing quickly from the robust recovery in the first half of the year, when GDP expanded at an annualized rate of nearly 6.5%. In the past few weeks, economists have quickly cut their forecasts for third quarter GDP growth, as the COVID-19 Delta variant, supply chain constraints, and a slower-than-expected recovery in the labor market appear to be reducing economic activity. As of October 8, 2021, The Federal Reserve Bank of Atlanta's "GDP Now" forecast, a real-time estimate of the current quarter's growth rate, reflects a sharp deceleration in third quarter growth to an annualized rate of just 1.3%, down from a reading of as high as 6.3% in early August. At the same time, inflation appears to be increasing, with the Core PCE Index climbing to 3.6%, the highest reading since the early 1990s. The combination of these two economic trends (i.e., slowing economic growth and rising inflation) has led to a renewed focus on stagflation among some investors, analysts, economists and the media.

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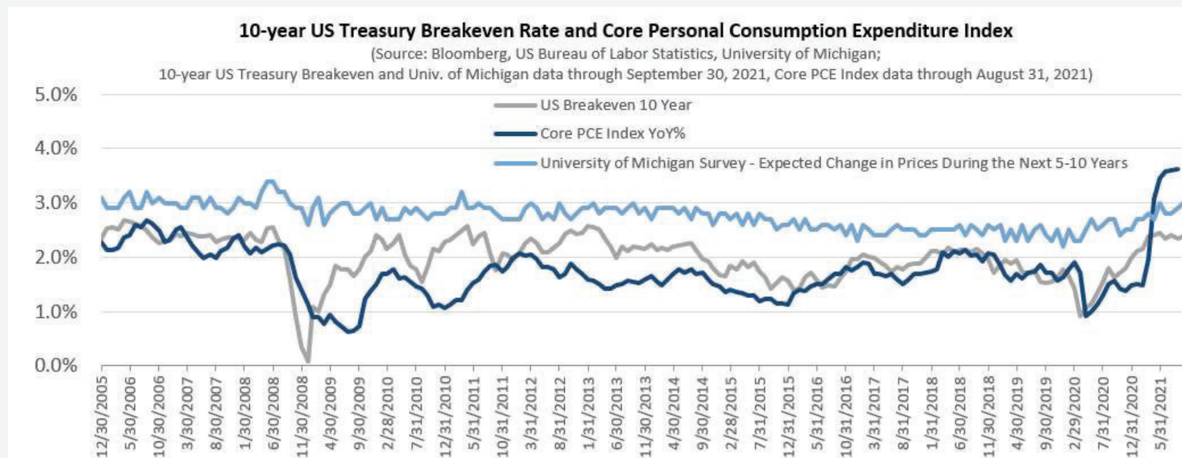
Credit Spotlight (continued)

Not only does stagflation – or the potential for stagflation – represent a challenge for investors, but it presents a key risk for the Federal Reserve to consider as it plans to reverse its asset purchase program and ultimately raise its target for short-term interest rates. Recent inflation readings have persuaded some FOMC members that rate increases should start next year as indicated by the FOMC's "dot plot", and federal funds futures show that the bond market is beginning to agree. Yet more dovish members of the FOMC, including Chairman Jay Powell, continue to argue that the recent jump in inflation is transitory and will recede once supply chain bottlenecks clear. Furthermore, they argue, monetary policy is not equipped to deal with supply-side shocks, so raising rates to slow the economy would not be appropriate. Under the Federal Reserve's new "higher for longer" inflation framework, we expect the FOMC to remain reluctant to pull forward rate hikes to address a potentially transitory increase in inflation. We observe that longer-term inflation expectations – as measured by market-implied readings such as the 10-year "breakeven" rate or by survey data such as The University of Michigan's Consumer Confidence report (in particular, the question of expected change in prices during the next 5-10 years) – haven't yet confirmed a range significantly above the Federal Reserve's 2% long-run inflation target. FOMC members likely feel comfortable with the current 10-year breakeven rate hovering just inside 2.5% (see chart).



Over the next several months, investors will be watching closely to see whether companies can find ways to relieve supply bottlenecks, labor shortages, and rising input costs, particularly as headline-grabbing commodity prices push higher. The third quarter earnings season will likely feature management commentary highlighting margin pressures, which will translate to weaker earnings (a risk for equity and risk markets in general) and / or rising prices (more inflation). While stories of semiconductor shortages and pictures of containerships waiting off the coast of Los Angeles are sure to persist, there are reasons to be optimistic that we will not see a repeat of the 1970s. First, the global economy continues to reopen from the pandemic, which implies that a lot of the current supply constraints and inflation is demand driven, so while growth is certainly slowing, we do not see it turning negative in the short run due largely to pent-up spending. In addition, high levels of unemployment, the third leg to the stagflation stool, aren't currently a factor, as unemployment has been declining and currently resides at 4.8%. Furthermore, the US economy is structurally much different than it was in the 1970s; today, the globalization of the economy and the reduced number of unionized workers reduce the potential for the transmission of supply-side inflation directly to higher wages. That being said, it may take several more quarters for supply chains and inflation to normalize. In the meantime, we expect investors to challenge the FOMC's definition of transitory as the stagflation narrative intensifies.

Investment Grade Credit

In the third quarter of 2021, the Bloomberg-Barclays US Corporate Bond Index generated -15 basis points of excess return over similar duration US Treasuries, as spreads widened 4 basis points during the period. The quarter began with US Treasury yields declining sharply in July before reversing course in August and September. Despite starting off the quarter strong, total return performance ended the third quarter flat as gains early in the period were quickly erased by the end of September. Investment grade corporate spreads remained fairly stable, widening just 4 basis points during the quarter. Current headwinds for investment grade corporate credit include US Treasury rate volatility, geopolitical uncertainties, slowing US economic growth and inflationary pressures stemming from increasing labor costs, higher energy prices and supply chain disruptions.

The best-performing industries and sub-segments of the Bloomberg-Barclays US Credit Index on an excess return basis comprised airlines, packaging, finance companies, life insurance and retail REITs. Gaming, sovereigns, transportation services, metals & mining and telecommunication ranked among the worst performing industries and sub-segments during the quarter.

We remain market weight in investment grade credit due to tight valuations and near record-low all-in yields. The OAS on the Bloomberg-Barclays US Corporate Bond Index ended the second quarter at +84 basis points, 289 basis points tighter from the pandemic period peak and 12 basis points tighter than the beginning of the year. Although corporate fundamentals continue to reflect year-over-year improvement, demand technicals have softened so far in the second half of the year but remain supportive to corporate spreads. We believe corporate spreads will remain within a relatively tight range through year end given the continuing fundamental and technical tailwinds.

High Yield

While the third quarter of 2021 certainly provided numerous headlines for credit investors to ponder (the surge of the “delta” strain, timing of Federal Reserve tapering, rate volatility, supply-side strains and inflation, and Chinese property defaults, to name a few), US high yield returns suggest a relatively quiet period. The Bloomberg-Barclays US Corporate High Yield Bond Index (the “High Yield Index”) returned +0.89% in the period, pushing year-to-date 2021 gains to +4.53%. High yield bond spreads hit a new 14-year low of +262 basis points early in July, experienced a little late-summer volatility in August (peaking at +314 basis points), and then retraced some lost ground as post-Labor Day supply underwhelmed, finishing September at +289 basis points (21 basis points wider versus June 30, 2021). The combination of higher spreads and a back-up in rates left the yield on the High Yield Index 29 basis points higher (versus June 30, 2021) at 4.04%, nearly 50 basis point higher than the record low of 3.53% set in early July.

Across high yield ratings buckets, US Treasury rate moves drove most of the return differential within the quarter. In July, as rates moved sharply lower, BBs outperformed (returning +0.74% versus -0.27% for CCCs), while the reverse occurred in September as rates climbed again (CCCs returned 0.52% versus -0.21% for BBs). For the quarter, return dispersion was minimal, with BBs leading the way at +1.09% whiles Bs lagged at +0.61% (+0.74% for CCCs). Similarly, sector returns were tightly dispersed around the High Yield Index, with energy posting the strongest quarterly return (+1.7%) while gaming lagged (-0.1%) as news of more intense Chinese regulation hit Macau-centric casino credits.

High yield credit fundamentals are recovering faster than anticipated, as second quarter earnings largely beat lofty expectations. For high yield issuers, revenues increased 9% sequentially in the second quarter of 2021 (versus +1% in the first quarter), and a record high 38% on a year-over-year basis; and EBITDA jumped 18% sequentially and 80% year-over-year, also a quarterly record. Leverage continued to decline, dropping to 5.1x in the second quarter from 5.9x in the preceding quarter and 6.1x in the fourth quarter of 2020 (the highest level recorded since at least the financial crisis). At 5.1x, leverage resides at its lowest level since the first quarter of 2020 but well above the six-year low of 4.0x recorded in the fourth quarter of 2018. With a strong earnings recovery, default activity in the third quarter was the lightest since the fourth quarter of 2013. As such, the high yield default rate continued its sharp downward trajectory, ending September at 0.92%, the lowest rate since March 2014 and down 525 basis points year-to-date. Rising stars total $27 billion year-to-date, outpacing $12 billion of fallen angels. Looking forward, while we do not anticipate material deterioration in credit fundamentals, there is a risk that third quarter earnings and forward guidance will disappoint versus expectations, as rising input costs and supply chain disruptions threaten margins that have been strong thus far in the recovery.

The third quarter supported the thesis that high yield technicals remain sound as cash balances built in anticipation of a heavy post-Labor Day new issue calendar were quickly put to work when the supply picture disappointed. New issue volumes totaled $108.5 billion in the third quarter, down 18% year-over-year and meaningfully lower than the $158.8 billion and $142.5 billion issued in the first and second quarters, respectively. High yield retail fund flows returned to positive territory in the third quarter, registering a modest +$1.7 billion, the first quarterly inflow since the fourth quarter of 2020. We expect the volume of new issue over the last few months of 2021 to remain consistent with the recent pace, with a tilt to more M&A and LBO financing transactions and fewer of the refinancings that have dominated issuance in the last few quarters.

With spreads still inside +300 basis points, we maintain a cautious near-term view on the high yield market, as third quarter earnings announcements may include important information regarding emerging fundamental trends. Supply chain constraints, labor shortages, and rising costs for certain inputs all feature prominently in recent news flow, and we anticipate that some sectors and companies will temper earnings outlooks, which could push spreads wider. We also expect management teams to discuss how they might use the cash reserves built during the pandemic, with share repurchases and / or dividends representing potential negatives for bondholders. The Federal Reserve's expected tapering path, as well as the recent back-up in Treasury rates, also cloud the outlook somewhat. Nevertheless, healthy credit fundamentals and technicals will likely limit the downside to high yield bond prices, and we would view the market at wider levels more constructively.

Leveraged Loans

Against a backdrop of a rates market round trip (i.e., rates initially rallied and then sold off during the period) and the impending Federal Reserve asset purchase taper, the US leveraged loan market provided a steady, coupon-like return of +1.13% in the third quarter of 2021, as measured by the Credit Suisse Leveraged Loan Index (the "CSLLI"). Through the end of September, the CSLLI returned +4.65% year-to-date, slightly outpacing the high yield market's +4.53% gain. While the down-in-quality trade faltered in the high yield market, lower-rated loans continued to outperform in the third quarter, with CCCs returning +2.8% versus +1.2% for Bs and +0.8% for BBs. For the second consecutive quarter, commodity sectors outperformed, led by metals (+3.4% total return) and energy (+1.9%), while gaming & leisure (+0.7%) and cable / wireless (+0.6%) lagged. Average loan prices climbed approximately one-half point to nearly $98.50 at the end of September, the highest level in three years. Loans spreads (3-year discount margin) remained relatively unchanged during the quarter, tightening 5 basis points to +438 basis points after a similar move (6 bps tighter) in the second quarter. Whereas high yield spreads reside near 14-year tights reached back in July, loan spreads remain approximately 60 basis points wide of post-crisis tights reached back in the spring of 2018. With 3-month Libor still hovering around 15 basis points, the average loan yield (assuming a 3-year average maturity) was virtually unchanged at 4.79% in the third quarter.

With a sharp rebound in earnings in the first half of 2021, loan market credit fundamentals are quickly returning to pre-pandemic levels. Loan issuer revenues jumped 37% year-over-year in the second quarter, while EBITDA more than double from the prior-year period. As a result, average leverage declined more than a full turn to 7.4x, down from the pandemic peak of 8.8x in the fourth quarter of 2020 but still above the 5.2x registered in the fourth quarter of 2019. Despite recent headlines regarding rising labor and input costs, as of the second quarter, loan issuer EBITDA margins exceed those achieved the fourth quarter of 2019. The earnings recovery has also paused a wave of defaults that started in 2020; only four loan issuers defaulted so far this year, including two in the third quarter. The loan market default rate now resides at just 0.71%, down from 1.11% at the end of June and 3.95% at the end of 2020. Reflecting improving fundamentals, loan rating upgrades outweighed downgrades 2.2 to 1 in the third quarter, pushing the year-to-date upgrade-to-downgrade ratio to 2.1x, which compares to a record low 0.3x in 2020. Although inflationary cost pressures and supply chain stress may pressure the margin recovery, we expect the upgrade trend to continue and believe default rates will remain near record-low levels.

Although flows into retail loan funds continued to slow in the third quarter, loan market technicals remain firm. Inflows totaled just over $7 billion in the third quarter of 2020, down from $14.1 billion and $13.6 billion in the first and second quarters, respectively. While retail loan demand has tapered off, JPMorgan data suggests that CLO issuance continued at a near-record pace in the third quarter, as $35 billion in new deals priced (excluding refinancings and resets), which represents only a modest deceleration from the $38 billion and $42 billion priced in the first and second quarters, respectively. The loan primary market also slowed from its near-record pace in the first half of 2021, with $161 billion of deals pricing in the third quarter versus $194 billion in the second quarter and $301 billion in the first quarter. As the Federal Reserve begins tapering its asset purchases in coming periods, and the market turns its attention to potential timing of rate increases, loan market technicals will likely remain dominated by the overall US interest rate environment over the next few quarters.

With the loan market still offering a marginally better yield than high yield bonds, we maintain our preference for loans over high yield for the remainder of 2021. We believe that coupon carry will remain the dominant driver of fixed income returns in coming quarters, and that environment favors loans, particularly as market participants focus on the potential for tighter monetary policy in the near future. While the earnings growth outlook appears

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slightly less favorable in coming quarters, we still believe that solid fundamental credit trends support investment in lower-rated tiers of the loan market at this juncture.

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The MOVE Index is a measure of US interest rate volatility that tracks the movement in US Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries.

The Bloomberg-Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

The Bloomberg-Barclays US Credit Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

The Bloomberg-Barclays US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

The Bloomberg-Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1 / BB+ / BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

The Credit Suisse Leveraged Loan Index tracks the investable market of the US dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's / S&P ratings of Baa1 / BB+ or Ba1 / BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.