DUCENTA SQUARED
ASSET MANAGEMENT

Economic and Sector Summary & Outlook

Second Quarter 2021

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US Economy

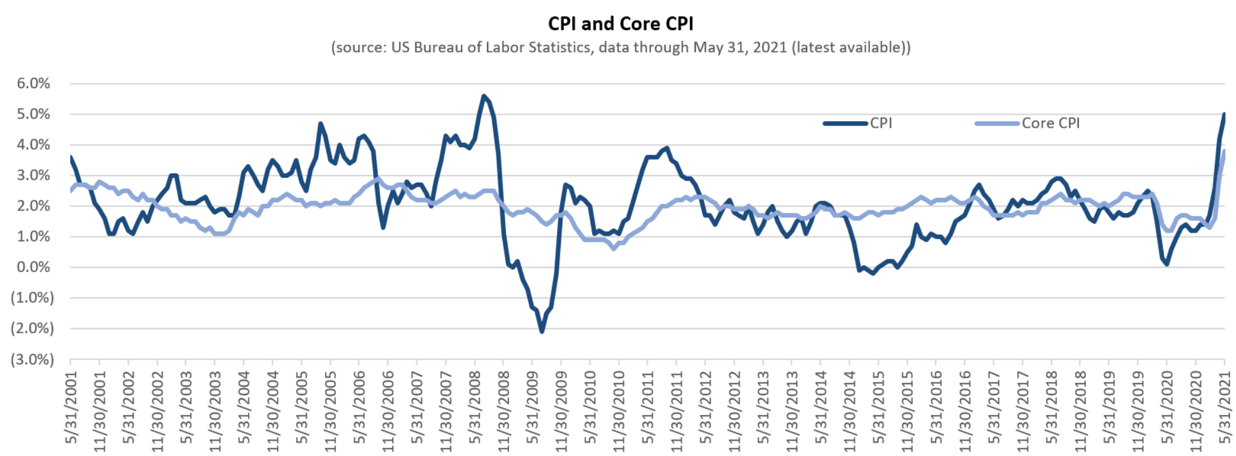
Summary

The US economy appears in good shape to begin the second half of 2021. Analysts expect that GDP growth in the second quarter of 2021 will exceed the robust 6.4% growth rate achieved in the first quarter, despite supply chain bottlenecks and labor shortages created by the post-pandemic economic reopening.

The consumer represents a source of strength for the US economy, benefiting from elevated savings, net worth gains from home price and stock market appreciation, a rebound in the labor markets, and pent-up demand as the economy repens. Spending remains strong as consumers shift from goods purchases to spending on services such as air travel, restaurants, and hotels. The health of the consumer is reflected in the sharp rise in the Conference Board Consumer Confidence Index which increased from a pandemic low of 85.7 in April 2020 to 127.3 at the end of June 2021.

The labor markets continued to improve, registering 567,000 net new jobs per month on average in the second quarter of 2021. Demand for labor resides at record highs with over nine million job openings, but generous unemployment benefits, health considerations, and school closures have temporarily limited the supply of available workers. Despite the recent improvement in net new job creations, ample slack remains in the labor markets. The labor force participation rate reached 61.6% in June 2021 compared to 63.3% prior to the pandemic, and as of June 2021, total employment remained 6.7 million jobs below pre-pandemic levels.

Inflation fears increased significantly in the second quarter, driven by strong demand, supply shortages, and the base effects of low inflation readings recorded during the early pandemic period rolling off the annualized figures. Headline CPI rose from 2.6% in March 2021 to 5.0% in May 2021; and Core CPI, which excludes food and energy, climbed from 1.6% in March 2021 to 3.8% in May 2021, the highest level since April 1992. The increase in prices surpassed expectations and surprised investors. However, the most significant contributors to the recent increase in prices appear confined to a narrow range of volatile categories impacted by supply and demand imbalances such as used car prices, lodging, airfares, and rental cars. For now, price pressures appear transitory, but investors nevertheless face some risk of a more permanent upward shift in long-term inflation expectations.



Another surprise in the second quarter was the Federal Reserve's hawkish shift in its June 2021 meeting. In its Summary of Economic Projections report, the Federal Reserve raised 2021 US GDP growth estimates from 6.5% to 7.0% and Core PCE inflation from 2.2% to 3.0%. More importantly, the "dot plot", which maps the Federal Reserve's outlook for future interest rates, moved from no interest rate hikes in 2023 to a mean estimate of two increases, and seven members forecasted a rate hike beginning as early as 2022. Chairman Powell also stated that the Federal Reserve needed to make more progress towards its goals of stable 2% inflation and maximum employment and that it would likely begin discussing plans to taper asset purchases in upcoming meetings.

Outlook

The good news should continue for the US economy in the second half of the year, but risks exist. We expect that strong consumer fundamentals will produce continued robust spending and healthy corporate profits should translate into increased business investment and inventory rebuilding. We believe that labor market headwinds will subside by the fall as enhanced employment benefits roll off and schools reopen. In addition, the economy could benefit from the bipartisan $1.2 trillion infrastructure agreement reached in late June 2021; however, the plan must still pass votes in the House of Representatives and Senate. The biggest risk on the horizon is the uncertainty regarding the transitory nature of recent inflation data. In our view, the supply and demand imbalances will gradually normalize as bottlenecks clear. The economy also still retains ample slack, especially in the labor markets, which should return core inflation to approximately 2.0% in 2022. Finally, as the Federal Reserve inches towards tighter policy, we recognize the challenge of successfully navigating an economic soft landing while simultaneously avoiding uncomfortably high inflation and asset prices.

Sector Analysis

US Interest Rates

During the second quarter of 2021, inflation increased sharply and uncertainty regarding fiscal and monetary policies persisted. As a result, during the second quarter of 2021, the 10-year US Treasury Note yield declined 27 basis points to 1.469% and the 30-year US Treasury Bond yield declined 33 basis points to 2.087%. Short-term rates remained anchored at near zero by Federal Reserve policy and the 2-year US Treasury Note yield increased 10 basis points during the period to end the quarter at 0.25%. The US Treasury yield curve, specifically the 10-year yield versus the 30-year yield differential flattened by 5 basis points while the 2-year note versus the 10-year note yield differential flattened 35 basis points.

Real yields also declined during the second quarter, falling 24 basis points as measured by the yield on 10-year US Treasury Inflation Protected Notes.

With the unprecedented fiscal stimulus enacted and the Federal Reserve signaling a willingness to tolerate higher inflation, we expect bond yields to increase in the second half of 2021. In addition, recent economic data has not changed our view that the Federal Reserve's first step toward any monetary policy adjustment will be a September 2021 announcement signaling a tapering of asset purchases at the start of 2022.

Securitized Products

The second quarter of 2021 represented the one-year anniversary of the COVID lockdowns and economic data regarding the period reflects the deepest and most exaggerated year-over-year comparison. Chief among these are measures of inflation. The Federal Open Market Committee ("FOMC") and Chairman Powell have repeatedly expressed expectations regarding a spike in inflation data and their view that any such trend will likely be transitory and not figure into policy. Nevertheless, market participants were skeptical of that thesis and sold Treasuries, pushing yields higher throughout the first quarter. Since then, FOMC members have repeatedly restated their view that inflation will be transitory, and markets responded accordingly by buying Treasuries and pushing yields back down.

The decline in Treasury rates and the flattening of the yield curve proved too much for the mortgage market to overcome. Additional headwinds emanated from increased discussion surrounding the tapering of Federal Reserve MBS purchases in the coming months. Currently, the Federal Reserve and banks comprise the two largest buyers of mortgages. When the Federal Reserve begins to taper its $40 billion per month in MBS purchases, which we expect to occur in early 2022, a next-best buyer will need to step in to maintain market pricing. Prior to the 2007-2008 Financial Crisis, GSEs represented the MBS buyer of last resort. Currently, money managers appear to be the most influential potential MBS buyer and market stabilizer, but given current MBS valuations it appears unlikely they will exhibit strong demand. As a result, MBS spreads began to widen during the quarter to levels that will ultimately look attractive to money managers. Consequently, MBS underperformed duration equivalent Treasuries by -61 basis points in the second quarter to provide a 27 basis point OAS at quarter end from a period tight of 7bps on April 30, 2021.

The second quarter of 2021 represented a rather uneventful period for the ABS sector. Fundamentally, strong underlying collateral performance reflected healthy consumer balance sheets buoyed by continued federal aid and an improving employment market. Corporate asset-backed deals also exhibited strong fundamentals as economic data confirmed a general recovery while COVID restrictions continued to fade into the past. Notably, during the second quarter, investors signaled significant demand for the Hertz Global Holdings rental car securitization, one of the largest ABS deals of the past twelve months; the transaction was ultimately upsized to $4 billion from an initial ask of $2 billion. Overall, ABS supply in the second quarter tracked at its highest level in the last five years, totaling $150.3 billion as reported by Bloomberg. However, investors easily digested the high level of supply and the ABS index OAS finished the period at its year to date tight of +22 basis points. For the quarter, ABS provided +24 basis points of excess return versus equivalent duration weighted Treasuries.

CLO fundamentals remain strong as loan defaults declined and the upgrade-to-downgrade ratio continues to improve. However, CLO supply appears on track to set an annual record as first half new issue supply totaled $81.1 billion, and sector supply and demand technicals began to exhibit some strain. Despite an expanding investor base of traditional credit buyers, the increased supply appears to be pressuring yields, as we observed softness in both new issue and secondary spreads over the last few weeks. This dynamic can be seen in spread moves. AAA-rated CLO spreads moved modest 15 basis points tighter year-to-date, with all of that tightening coming in the first quarter, and BBB spreads moved ten basis points tighter for the year, even after widening 20 basis points during the month of June 2021.

CMBS performed well in the second quarter as the OAS of the CMBS Index declined from +71bps to +59bps during the period. The move in spreads produced positive excess returns of +82 basis points versus duration equivalent Treasuries. CMBS sector fundamentals, especially within the hospitality and retail sectors, continue to improve as the economy reopens. Technically, supply appears very manageable as year-to-date conduit issuance totals only $13.6 billion. Analysts expect that year 2021 issuance will total between $25 billion and $30 billion, versus $49.3 billion of issuance in 2019.

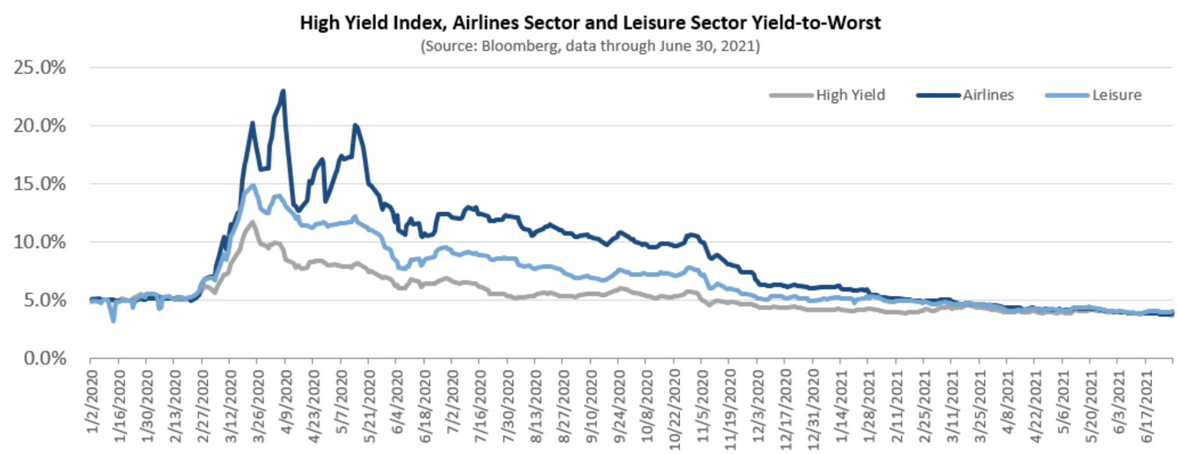
We maintain a mixed outlook for the securitized markets in the coming months. We believe that ABS and CMBS fundamentals and technicals will remain favorable. Additionally, we expect that strong demand for high quality assets will persist and be met with only moderate supply, while the post-COVID economic recovery will provide a tailwind for fundamentals. However, rich valuations in both sectors remain a challenge and will likely limit performance. We expect the greatest opportunity in some of the more esoteric corners of the ABS sector. Within the CMBS sector, opportunities will likely be more tactical and tied to idiosyncratic widening of spreads within the space. Investors appear to expect a continuingly attractive CLO market underpinned by solid positive carry opportunities, but the potential for spread tightening appears limited. Mortgage pass-through securities remain the one sector we continue to view negatively, despite the spread widening and underperformance in the second quarter. We believe MBS spreads need to widen before the sector appears attractive on a total return basis. Remember, non-total return buyers (i.e., the Federal Reserve and banks) currently dominate the MBS space and have driven valuations to unattractive levels from the perspective of money managers. We will likely remain underweight MBS for the foreseeable future.

Credit Spotlight

Does the Post-COVID Reopening Trade Still Offer Value?

The US high yield market has demonstrated a remarkable recovery from the depths of the COVID pandemic in March 2020. From its low on March 23, 2020, the average Bloomberg Barclays US Corporate High Yield Index bond price has rallied over 25 points, from just under $80 to over $105; on a yield basis that translates to a peak of 11.69% recovering to 3.75% as of June 30, 2021. Industries such as airlines and leisure (cruise lines, movie theatre chains, and amusement parks) experienced a more dramatic recovery. The airline sector yielded as much as 23% in March 2020 but now yields less than 4%. Leisure sector yields peaked at nearly 15% and now reside at slightly over 4%. Investors overweight these "recovery trade" sectors in recent periods clearly outperformed; but given the dramatic recovery, we consider whether room for further tightening exists.

Credit Spotlight (continued)



To illustrate the reopening phenomenon in the high yield market, we highlight Carnival Corporation and Delta Air Lines; both companies rank as industry leaders and fallen angels (i.e., they carried investment grade ratings prior to the COVID pandemic). Early in the pandemic, both Carnival Corporation and Delta Air Lines tapped the debt markets to shore up liquidity as travel restrictions and shelter-in-place orders effectively shut down their businesses.

In early April 2020, Carnival Corporation issued $4 billion of 11.5% First-Priority Senior Secured Notes due 2023. Agencies rated the notes Baa2 / BBB- rating on the issue date but began lowering the ratings as soon as May 18, 2021 (Moody's) and June 23, 2020 (Standard & Poor's). The ratings currently stand at Ba2 (negative) / BB- (negative). With its operations shuttered for the better part of a year, Carnival Corporation accessed the bond market five more times to fund its significant cash burn rate. As of the end of May 2021, Carnival Corporation held approximately $9.3 billion of cash. On July 6, 2021, with cruise lines gradually returning to service, Carnival Corporation announced a tender for half of the $4 billion notes issue at a dollar price of $114.25 (equivalent to a 1.5% yield-to-worst).

Delta Air Lines also tapped the bond market in April 2020, issuing $3.5 billion of 7% Senior Secured Notes due 2025 (secured by certain routes and takeoff and landing slots and gate leaseholds in the US, UK, Europe, and Latin America.) Delta returned to the bond market two more times in 2020, including on September 23, 2020 to issue a dual-tranche structure (i.e., maturities of 2025 and 2028) secured by the company's SkyMiles loyalty program. Like Carnival Corporation, with operations returning to normal, on July 15, 2021, Delta Air Lines announced a tender for the 7% Senior Secured Notes due 2025 at $118.125 (equivalent to a 2.0% yield-to-worst.) Both the Carnival Corporation and Delta Air Lines tender offer prices exceeded the notes' market prices in the days preceding the announcements.

Currently, regarding a post-COVID reopening investment thesis, we believe investors should be more selective when it comes to both sector and issuer selection. As we highlighted above, the yield pick-up earned by owning COVID-impacted sectors appears minimal (i.e., approximately 20 basis points for airlines and 35 basis points for leisure.) Although these sectors trade through the High Yield Index at times, we believe it may take several quarters, if not years, for some issuers to generate the earnings and cash flow needed to repay the debt accumulated during the COVID pandemic.

American Airlines may represent the best example of this challenge, as its debt balance ballooned to $48.0 billion at the end of the first quarter from $33.4 billion at the end of 2019. On July 14, 2021, the company announced that its quarterly daily cash build rate turned positive in the second quarter of 2021 for the first time during the pandemic, after burning $100 million per day during part of 2020. The sector may not return to its historical level of profitability until international and business travel recovers to pre-pandemic levels, which is not likely until 2022 at the earliest. Likewise, cruise line schedules also appear likely to remain below pre-pandemic levels until next year. Some leisure sectors, such as movie theatres, may never fully recover, as the pandemic accelerated secular trends favoring home viewing options.

With the high yield market offering record-low yields, and recovery trade valuations reflecting very little differentiation, we believe investors should maintain a selective attitude regarding sector and issuer selection going forward.

Investment Grade Credit

In the second quarter of 2021, the Bloomberg-Barclays US Corporate Bond Index generated +112 basis points of excess return versus similar duration US Treasuries, as spreads tightened 10 basis points during the period. Total return performance in investment grade corporate credit rebounded substantially from a challenging first quarter, as spreads compressed alongside a decline in US Treasury note yields. Expected US Treasury rate volatility from inflationary pressures, negative total returns, tight corporate spreads and record low all-in yields remain current headwinds for investment grade credit. Offsetting these challenges are improving corporate fundamentals, accommodating global central bank policies, favorable hedging costs coupled with attractive yield advantages for US dollar denominated corporate bonds and a modestly light new issue calendar going into the second half of the year.

The best-performing industries and sub-segments of the Bloomberg-Barclays US Credit Index on an excess return basis comprised gaming, independent energy, pipelines, oil field services, refining and REITs. Foreign agency, health insurance, sovereigns, supranationals and tobacco ranked among the worst-performing industries and sub-segments during the quarter.

We remain market weight in investment grade credit, as tight valuations for high grade corporate spreads continue to offset an improving corporate fundamentals outlook. The OAS on the Bloomberg-Barclays US Corporate Bond Index ended the second quarter at 80 basis points, 293 basis points tighter from the pandemic period peak and 16 basis points tighter than the beginning of the year. Demand technicals softened slightly in the second quarter; however, corporate fundamentals continue to improve and remain supportive of high grade corporate credit. Despite positive technicals and fundamentals, valuations remain stretched as investment grade corporate spreads remain near their record-level tights together with record low all-in yields.

High Yield

The continued strength of the economic reopening coupled with the stabilization of interest rates provided a favorable backdrop for the US high yield bond market in the second quarter. The Bloomberg-Barclays US Corporate High Yield Bond Index (the "High Yield Index") returned +2.75% in the period, pushing year-to-date 2021 gains to +3.62%. High yield bond spreads moved tighter in the quarter, ending the period at 268 basis points, a 14-year low (at the time) and 42 basis points tighter from the end of March 2021 (bringing the year-to-date tightening to 92 basis points). On a yield basis, the High Yield Index tightened a similar 48 basis points to 3.75% (a record low at the time) during the second quarter.

As was the case in the first quarter, CCC-rated bonds led the rally in the second quarter, gaining +3.5% (+7.2% year-to-date), thanks to improving credit fundamentals and willingness by investors to move down in quality in search of additional yield. The second quarter rate rally helped the higher-quality segment of the market, with BBs returning +2.9% (+2.7% year-to-date), followed by Bs at +2.2% (+3.4% year-to-date). Investors continued to favor cyclical, commodity and "reopening" sectors during the quarter, with energy (+6.1% total return), food & beverage (+3.5%), metals & mining (+3.1%), retail (+3.0%) and autos (+3.0%) leading the market during the second quarter; pharmaceuticals (-1.0%) lagged and comprised the only sector to post a negative total return.

Earnings fundamentals appear to be recovering faster than anticipated. In the second quarter of 2021, analysts expect that S&P 500 earnings will increase over 60% on a year-over-year basis. In the first quarter of 2021, S&P 500 earnings increased 54% year-over-year, surpassing the 25% rate of growth expected by analysts. For high yield issuers, revenues increased 7% year-over-year in the first quarter, marking the first year-over-year gain since the second quarter of 2019, while EBITDA expanded 23% year-over-year, the largest quarterly year-over-year gain since 2010. EBITDA growth contributed to a decline in average leverage reported by high yield issuers for the first time in seven quarters, as debt-to-EBITDA dropped to 5.8x from 6.1x at the end of the first quarter. As such, leverage remains well above the six-year low of 4.0x recorded in the fourth quarter of 2018. The high yield default rate also improved markedly during the second quarter, declining from 2.6% and 4.8% at the end of December 2019 and March 2021, respectively, to 1.6% at the end of June 2021. Credit rating agencies quickly recognized the improved fundamental trend, and the upgrade to downgrade ratio jumped to 2.4x in the second quarter. On a year-to-date basis, rising stars totaled $19.5 billion, outpacing $2.6B of fallen angels. We continue to expect these fundamental measures to improve in the second half of 2021.

High yield retail fund outflows continued in the second quarter, albeit at a slower pace than the preceding period. Retail funds experienced withdrawals of $4.1 billion in the three months ended June 2021, down from a $10.6 billion outflow in the first quarter. Nevertheless, high yield technicals remain sound as fixed income investors persistently hunt for incremental yield. New issue volumes totaled $140.5 billion in the second quarter of 2021, the third most active period on record, just behind a record $158.6 billion in the first quarter of 2021 and $145.5 billion in the second quarter of 2020. Refinancing volume, which comprised approximately two-thirds of year-to-date new supply, continues to dilute the weight of heavy supply. Although companies may continue to issue to lower their cost of capital and push out maturities, net new issuance is likely to remain low for the remainder of the year, with M&A related financing posing a potential wildcard.

Although issuer fundamentals will likely remain supportive of the high yield market in the second half of 2021, spreads currently reside near the tights of 2007, suggesting that investors assume a successful vaccine rollout, further stimulus spending, and a relatively benign Federal Reserve tapering environment. The continued outperformance of the compression trade in the second quarter, and generally stretched valuations, leave us inclined to gradually rotate back toward BBs, which still appear to provide value relative to the investment grade market. We also see fewer relative value opportunities in the re-opening sectors and will selectively look to take profits as the economic trends normalize.

Leveraged Loans

The leveraged loan market continued to provide steady performance, as measured by the Credit Suisse Leveraged Loan Index (the "CSLLI") which generated a +1.44% total return in the second quarter, pushing the year-to-date return through June to +3.48%, a level just shy of the high yield market's +3.62% year-to-date return. Similar to the high yield market, lower-rated loans outperformed the broader market, with CCCs returning +4.3% versus +1.5% for Bs and +0.8% for BBs. Commodity sectors performed well, led by metals (+3.5% total return) and energy (+2.9%), while utilities (-0.5%) lagged. Average loan prices climbed approximately one-half point to nearly $98.00 at the end of June, the highest month-end level since October 2018. After tightening 37 basis points in the first quarter, loan spreads (3-year discount margin) tightened just 6 basis points in the second quarter of 2021 to 443 basis points, which is still wide of post-crisis tights. Loan yields, assuming a 3-year average maturity, declined 7 basis points in the period to 4.80% as of June 30, 2021.

The loan market's solid year-to-date performance reflects, in part, improving fundamentals. For the second consecutive quarter, only one loan issuer defaulted, resulting in a 1.11% default rate over the past 12 months, versus 3.3% at the end of March 2021. Based on earnings reports for the first quarter of 2021, loan issuer credit metrics continued to recover, albeit a slower pace than for high yield issuers. First quarter revenues came in essentially flat versus the prior quarter and down 0.7% on a year-over-year basis, while EBITDA increased approximately 21% sequentially and 3% year-over-year. Leverage remained steady at a very elevated 9.0x. Rating agencies recognized improved fundamentals by upgrading loan issuers at a rapid pace; the year-to-date upgrade-to-downgrade ratio stands at 1.9x as of the year ended May 31, 2021 (latest data available), which compares to a record low 0.3x in the year ended December 31, 2020. We expect fundamentals will continue to improve meaningfully in the next few quarters and the default rate to remain very low.

Loan market technicals remained favorable during the second quarter as retail fund inflows totaled $12.7 billion, down slightly from $14.1 billion of inflows during the very robust pace recorded in the first quarter of 2021. The loan primary market slowed from its frenetic pace, as new issuance totaled $172 billion in the second quarter, down from $301 billion in the first quarter. Excluding repricings, $152 billion of loans priced in the second quarter, down from $168 billion in the preceding period. Additionally, CLO issuance continued at a near-record pace, as $44.0 billion in new loans (excluding refinancings and resets) priced in the second quarter, up from $38.1 billion in the prior year period and only $92.1 billion in all of 2020. Loan market technicals will likely remain dominated by the overall US interest rate environment and expected Federal Reserve policy in the second half of 2021.

The yield gap between high yield bonds and leveraged loans has recently peaked, as leveraged loan yields and spreads remain relatively steady while the yield on the High Yield Index set a new all-time low of approximately 3.5% (yield-to-worst), driven in part by the rally in US interest rates. We therefore maintain our preference for loans over high yield bonds at this juncture. Our base case remains that much of the returns in fixed income in the second half of 2021 will come from coupon carry, an environment well-suited for loans, particularly as potential Federal Reserve policy shifts become more scrutinized in the fall.

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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.