DUCENTA SQUARED
ASSET MANAGEMENT

Economic and Sector Summary & Outlook

Fourth Quarter 2020

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US Economy

Summary

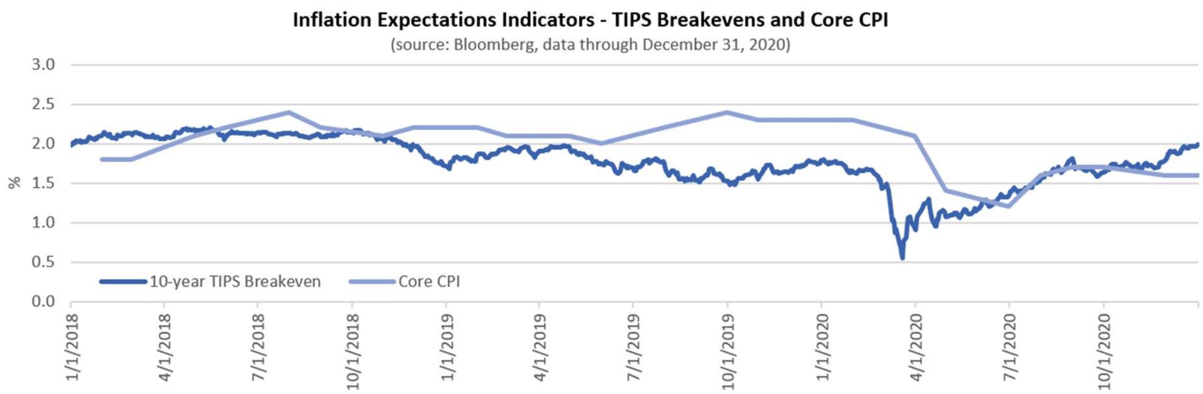
Fiscal stimulus, Federal Reserve policy, inflation, and the path of COVID-19 highlight the final chapter to a very eventful year for the US economy and remain positioned to significantly influence trends in 2021.

The surprisingly quick economic recovery from the COVID-19 pandemic ran into headwinds in the fourth quarter of 2020. Momentum slowed as viral infections reaccelerated, economic lockdowns increased, and benefits from the CARES Act waned. Fourth quarter data revealed a notable slowing in the labor markets as December's non-farm payrolls dropped 140,000, representing the first decline since April. Improvement in the unemployment rate also stalled during the quarter at 6.7%. Employment in COVID-impacted service sectors such as leisure and hospitality declined sharply in December. Initial jobless claims also weakened and ended the year at 965,000 compared to pre-COVID levels of around 200,0000. Even with the improvement earlier in the year, employment remains approximately ten million below pre-COVID levels in February 2020.

Consumer spending, which had been resilient, also waned in the fourth quarter with declines in both November and December. Spending on goods slowed after a strong recovery and service spending, which relies more on in-person contact, remains well below year ago levels. Consumers, while still supported by a high savings rate, increases in net worth, and strong balance sheets, appear in need of additional support until widespread vaccinations reduce COVID-19 infection rates and deaths.

The housing market continues to benefit from low interest rates and pent-up demand. Housing starts and building permits reside above year ago levels, but new and existing home sales declined from record highs primarily due to scarce inventory.

Inflation fears, predicated on easy monetary policy, additional fiscal stimulus, and an eventual economic reopening, dominated investor concerns in the fourth quarter of 2020. Inflation expectations as measured by the TIPS breakeven surged 36 basis points to end the year at 1.99% (see chart). Actual inflation, however, remained modest with the Core CPI and Core PCE ending the year slightly lower at 1.6% and 1.4% respectively. Medical care and housing rents represent the most significant detractors to the overall price indices over the past six months.



Congress finally passed a $900 billion aid package in December 2020, which should support the economic recovery until vaccines become widely distributed. President-elect Biden unveiled his $1.9 trillion "American Rescue Plan" which will face obstacles getting passed given the size and composition of the package. Taken together, the proposed and previously passed stimulus combine to a staggering 23% of overall US GDP.

During the fourth quarter of 2020, the Federal Reserve maintained its easy monetary policy stance, keeping short rates low and continuing the pace of asset purchases at $120 billion a month. A reduction in asset purchases will figure prominently in 2021, raising potential "taper tantrum" concerns. The Federal Reserve's recent commitment to an average inflation targeting policy may also face a test this year, if inflation moves beyond the 2% target as the economy reopens.

Outlook

The outlook for the US economy has improved with the prospect for effective vaccines, additional fiscal policy stimulus, easy monetary policy, and pent-up demand on a reopening. The roll-out of vaccines thus far has been frustratingly slow, but we still expect wide distribution to hit mid-year targets. Fiscal stimulus provided an important bridge during the economic shutdowns caused by the virus. The additional $900 billion recovery bill passed in December and our expectations for another bill of similar size to begin the year should support and lengthen the bridge to a recovery by mid-year. We expect the Federal Reserve to maintain its current accommodative policy stance and believe tapering of purchases and rate hikes will not occur until 2022 and 2023, respectively. We will be monitoring price indicators closely but expect inflation to end the year below the Federal Reserve's 2% target due to ample slack in the economy. We thankfully turn the page on a dreadful 2020, and believe the outlook for 2021 points to a strong rebound for the US economy.

Sector Analysis

US Interest Rates

US unemployment continued to improve during most of the fourth quarter of 2020 and pharmaceutical companies announced successful COVID-19 vaccination trials in December. As a result, 'risk-on' best describes the overwhelming investment markets theme for the quarter, even as COVID-19 cases climbed. Global central banks maintained accommodative monetary policies by committing to keep interest rates low and, in some cases, increasing their balance sheet holdings through various purchase programs and lending facilities. In turn, longer-term interest rates rose rapidly and the yield curve steepened.

During the fourth quarter of 2020, the yield on the 10-year US Treasury Note rose 23 basis points to finish the period at 0.91%, a level not seen since mid-March 2020, while the yield on the 30-year US Treasury Note rose 19 basis points to finish the quarter at 1.64%. With short-term rates remaining low (i.e., the yield on the 2-year US Treasury Note finished the quarter at 0.12%), the US yield curve (as defined by the spread between the 2-year and 10-year US Treasury Notes) steepened more than 23 basis points, ending the quarter at 79 basis points.

We believe that US interest rates on the short end of the curve will remain low for the foreseeable future. Intermediate and long interest rates increased considerably during the fourth quarter of 2020 and will remain higher if the vaccination rollout proves successful and economy returns to a semblance of normalcy. With the short end of the yield curve remaining low, the yield curve should remain steep.

Securitized Products

The US Presidential Election dominated news flow in the fourth quarter of 2020. Prior to the election, issuers rushed supply to the market in order to complete transactions prior to any potential election-related market turmoil. After November 3rd, despite election result uncertainty, markets functioned quite smoothly. We noted last quarter that extremely low volatility in the rates market benefitted MBS performance. The fourth quarter saw a slight increase in volatility, as measured by the MOVE Index, but mortgages looked through this as market participants remained confident in the Federal Reserve's forward guidance of lower rates for longer. Interestingly, the MOVE Index spiked in the weeks prior to the election and then quickly receded immediately afterward.

During the quarter, interest rates rose and the yield curve steepened, to the benefit of mortgages. In the fourth quarter of 2020, MBS provided 24 basis points of excess return over US Treasuries as the MBS Index OAS tightened from 61 basis points to 39 basis points. The Federal Reserve's continuing monthly purchases of $40 billion in MBS significantly affected performance across the coupon stack, particularly in new production coupons where it concentrates its purchases. We have been steadily moving down in coupon anticipating this performance disparity and this benefited portfolios. Thirty-year 1.5%, 2% and 2.5% coupons significantly outperformed the +34 basis points MBS Index excess return by providing +70 basis points, +105 basis points and +83 basis points of excess returns, respectively.

The ABS sector benefitted from tremendous demand from investors for paper, so despite very healthy issuance, the ABS sector OAS tightened 8 basis points to +33 basis points to generate 34 basis points of excess return versus comparable US Treasuries. A stretch for yield by going down the credit stack and giving up liquidity aptly describes the main theme followed by ABS investors during the fourth quarter of 2020. Triple-B and single-A classes outperformed the double-A and triple-A classes. We also observed spread tightening in out-of-favor and less liquid sectors such as rental car and aircraft bonds. The CLO sector also experienced further recovery in spreads as the loan market continued to improve. Our exposure to CLOs benefited accounts where guidelines permitted holdings in the asset category.

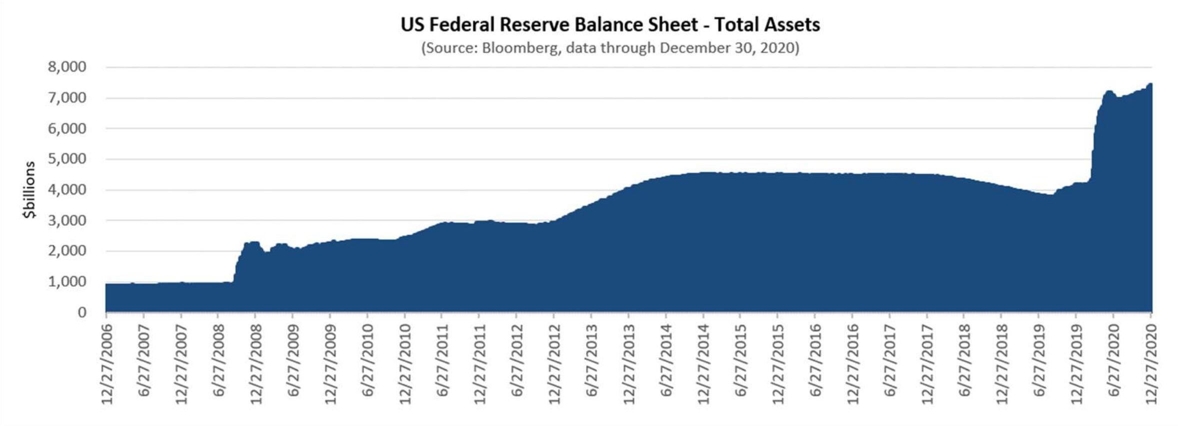
The CMBS sector performed particularly well over the course of the quarter by providing +150 basis points of excess return versus US Treasuries as the CMBS Index OAS tightened 25 basis points to +81 basis points. As we mentioned last quarter, CMBS fundamentals face headwinds as COVID-19 lock downs significantly affected fundamentals in both the retail and lodging sectors. However, the CMBS sector's positive correlation with the investment grade credit sector dominated any concerns regarding fundamentals. The sector's positive momentum stoked investor demand and, combined with diminished supply, drove spreads tighter across the board.

Our outlook for the securitized products sector is for continued positive returns performance. ABS spreads have recovered to new post-2008 tights, while spreads on both MBS and CMBS reside very close to their tights. Despite tight spreads, demand should remain strong as investors continue to search for yield. Although some opportunity exists for further spread compression, we anticipate that most performance will come from interest rate carry. In MBS, this means a focus on a down-in-coupon strategy, to avoid very fast prepayments and to follow the Federal Reserve's purchasing lead. In ABS and CMBS we plan to be more selective. We continue to like the CLO sector as it provides some of the widest spreads available given the ratings. In CMBS, a continued lack of supply will provide very favorable technicals, so despite the headwind of poor fundamentals we expect the sector to continue to provide adequate returns. Opportunities will likely emanate from new issue single-asset single-borrower deals and seasoned secondary offerings where analyzing underlying loans will be paramount.

Credit Spotlight

Federal Reserve Balance Sheet Policy - 2021

The Federal Reserve's balance sheet policy will be a critical factor for the fixed income markets in 2021. With the current federal funds rate at essentially zero and an unwillingness to move to negative rates, the Federal Reserve's balance sheet is its primary monetary policy tool. In support of its dual mandate of price stability and maximum employment, the Federal Reserve is currently purchasing $80 billion in US Treasuries and $40 billion in MBS each month, as well as reinvesting all paydowns. It increased its balance sheet by $3 trillion to a total of $7.4 trillion in 2020, following the economic downturn from the COVID-19 pandemic. For the moment, the Federal Reserve seems comfortable with the current level of policy accommodation, but that could change with the prospect of improved economic growth in the coming year. Below, we consider some key questions regarding the Federal Reserve's balance sheet for 2021.



What could trigger a tapering of quantitative easing / asset purchases?

Chairman Powell recently reiterated that changes to the Federal Reserve's balance sheet policy are tied to "substantial further progress" towards the committee's goals of stable 2% inflation and maximum employment. Clearly, more progress is needed because the 1.4% Core PCE inflation rate is running below the target and the 6.7% unemployment rate remains well above the pre-COVID level of 3.5%. Additionally, in accordance with its new "flexible form of average inflation targeting" policy (announced August 2020), the Federal Reserve could allow inflation to exceed the 2% target for a period of time to compensate for the past periods of below target inflation. The employment side of the dual mandate seems unlikely to generate concern this year, especially with the Federal Reserve's renewed focus on improving income inequality.

Will the Federal Reserve fight a rise in long-term interest rates?

The answer to this question depends on the cause of the rise in interest rates. The Federal Reserve would be unlikely to intervene if rates increased due to "healthy" reasons, such as an improvement in economic growth and inflation expectations. It would, however, fight a rise in interest rates caused by a policy error like the taper tantrum, a liquidity event like the March 2020 pandemic reaction, or perhaps if US Treasury supply overwhelmed the market.

Can the Federal Reserve prevent another taper tantrum?

The announcement of any reduction in balance sheet purchases will represent a significant communication challenge for the Federal Reserve. The infamous taper tantrum in 2013 resulted in a dramatic rise in US Treasury yields when the Federal Reserve rattled the markets by announcing it would reduce asset purchases at some future date. Chairman Powell's carefully worded statement that "we will communicate very clearly to the public and well in advance of active consideration of beginning a gradual taper of asset purchases" highlights the caution and concern over a potential policy error. Regardless of how carefully the Federal Reserve plans its exit strategy, we expect that the news will likely push rates higher given the current market dependence on its purchases.

Can the Federal Reserve reduce its assets purchases in the face of growing Treasury supply?

The interplay between the Federal Reserve's asset purchase program and the projected increase in the supply of US Treasury Notes represents another conundrum facing the central bank. The US government budget deficit has expanded rapidly and will likely increase as officials pass additional stimulus programs. US Treasury supply is expected to continue to increase to fund the growing deficits. Given the Federal Reserve's standing as the largest buyer of US Treasuries (it currently holds 27% of all outstanding US Treasury debt), it is not clear that the private sector or foreign buyers possess the resources to absorb the expected additional supply. Consequently, some investors suspect that the Federal Reserve may maintain a permanent presence in the US Treasury market.

Credit Spotlight (continued)

When will the Federal Reserve begin to taper its asset purchases?

The market is very focused on the timing of the Federal Reserve taper, especially given its potential link to the timing of the first rate hike. We share the market optimism regarding the economic recovery, but believe the Federal Reserve will delay a reduction in its asset purchases until the first half of 2022 for two main reasons. Firstly, we expect inflation pressures to build this year due to the additional fiscal stimulus and the eventual reopening of the economy. Some of the increase in inflation will represent the base effects of negative inflation readings in March and April of 2020 rolling off the annual rate and some will represent pent-up demand for services like airlines and lodging. Despite these gains, we believe the Federal Reserve will look through the transitory noise in inflation and wait for a sustainable rise above the target. Given the high levels of slack in the economy, especially in the labor markets, we do not expect a sustainable rise in inflation occurring in 2021. Secondly, we recognize the game changing shift in Federal Reserve policy toward average inflation targeting. Prior to adopting that policy in August 2020, the Federal Reserve would lean against the first signs of inflation; and under the new policy is now appears poised to let the economy run “hot” to promote a sustainable rise above the 2% target. We believe the Federal Reserve will hold true to the new “average inflation targeting” commitment and act with caution before beginning the tapering process.

Investment Grade Credit

The fourth quarter of 2020 provided solid excess returns for risk assets as OAS spreads on the Bloomberg-Barclays US Credit Index (the Credit Index) finished a highly volatile and uncertain year only slightly wider from where they started the year. With the elections firmly behind us, the focus has shifted to the incoming administration, vaccinations and subsequent reopening of the economy. The investment grade credit market has been extremely resilient, shrugging off a tense situation in Washington DC, the expiration of the Federal Reserve’s corporate bond purchasing program, ongoing economic shutdowns, and a relatively high domestic unemployment rate. Despite these negative headlines, spreads in the Credit Index finished the quarter 36 basis points tighter while generating 380 basis points of excess returns over similar duration US Treasuries.

The best performing industries and sub-segments of the Credit Index, on an excess return basis, comprised aerospace and defense, airlines, independent energy, metals and mining, and pipelines. The worst performing industries and sub-segments during the quarter included the non-corporate portion of the Credit Index, domestic banks, building materials and home construction, environmental, consumer products, and technology.

We reduced our overweight to investment grade credit down to market weight primarily due to the hovering of corporate spreads close to the tight end of the range along with near record low all-in yields. In terms of valuation, the Bloomberg-Barclays US Corporate Bond Index OAS closed out 2020 at 96 basis points, 277 basis points tighter from the peak during the pandemic and just three basis points wider from the beginning of the year. Although demand technicals remain favorable and supportive to high grade corporate credit, we beleive upside potential is limited at current valuations and expect corporate spreads to be range bound going into the new year.

High Yield

The US high yield bond market finished 2020 on a strong note, buoyed by hopeful vaccine news and expectations for a 2021 cyclical rebound, posting a +6.5% return on the Bloomberg-Barclays US Corporate High Yield Bond Index (the High Yield Index). This proved to be the second strongest quarterly return of 2020 (behind the +10.2% total return in the second quarter, the strongest quarterly return in over a decade) and pushed the full-year 2020 return to +7.1%, a remarkable outcome given the -12.7% return in the first quarter.

High yield bond spreads gapped 157 basis points tighter during the fourth quarter, ending 2020 at 360 basis points, just 24 basis points wide from year-end 2019. During 2020, spreads ranged from pre-COVID tights of 315 basis points in mid-January to the cyclical wide level of 1,100 basis points on March 23, 2020 (the widest since 2009). The High Yield Index finished approximately 160 basis points tighter during the fourth quarter to yield 4.18%, a new record low and approximately 100 basis points lower than year-end 2019.

Investors appear increasingly comfortable with the trajectory of the economic recovery in 2021, which would support high yield credit fundamentals. Lower-rated tiers of the market continued to outperform in the fourth quarter, with CCCs posting a +9.9% return, followed by Bs at +5.8%, and BBs at +5.7%. For 2020, BBs held their lead against the rest of the market, returning +10.2%, while Bs (+4.6%) and CCCs (+2.3%) trailed. At an industry sector level, positive news regarding vaccine development led "reopening" sectors to outperform again in the fourth quarter, including airlines (+15.9%), energy (+13.3%), aerospace / defense (+10.4%), and leisure (+8.2%). Returns generated by higher rated, less cyclical sectors, including wireless (+3.4%), packaging (+3.5%), and cable / satellite (+3.0%) lagged during the fourth quarter.

Positive technicals continued into year-end 2020, as retail flows remained positive ($7.7 billion in the fourth quarter of 2020, bringing the annual total to +$43.6 billion) and fallen angel trends slowed ($20.1 billion in the fourth quarter of 2020, resulting in a record $237.5 billion in 2020). This backdrop proved favorable for the high yield bond primary market, as another $99.6 billion of new deals priced in the fourth quarter of 2020, bringing the full-year total to a record $450 billion. With the exception of M&A related financing, which is a bit of wildcard in the coming year, we expect new issuance to decline in 2021 as many companies have already refinanced upcoming maturities.

Although high yield issuer fundamentals remain challenged, third quarter 2020 earnings trends were improved from the prior quarter, with sales and EBITDA jumping sharply on a sequential basis. However, average leverage reported by high yield issuers climbed to 5.8x, up from 5.6x in the second quarter of 2020 and 4.2x in the fourth quarter of 2019, exceeding the 5.2x at the peak of the financial crisis of 2007-2008. The default rate has plateaued around 6% (6.2% at December 31, 2020), but this figure is likely to trend down as earnings continue to improve in 2021.

Although valuations are certainly appearing stretched, our expectations for further stimulus spending, a successful vaccine rollout, and continued quantitative easing from the Federal Reserve suggest a favorable environment for high yield bond performance in 2021. We continue to focus on rotating into sectors that will benefit as the economy normalizes, with a particular focus on higher-coupon bonds that are not likely to get called soon. While BBs remain attractive relative to BBBs, we currently prefer lower-rated tiers of the high yield market that still have room to compress as investors seek yield in a low-rate environment.

Leveraged Loans

The leveraged loan market posted a +3.6% total return in the fourth quarter of 2020, as measured by the Credit Suisse Leveraged Loan Index, pushing the full-year return into positive territory (+2.8%). Average loan prices climbed another three points in the fourth quarter to finish 2020 at $95.73, less than a point short of the year-end 2019 level ($96.50) and almost 20 points above the March low ($76.48). During the fourth quarter of 2020, spreads (3-year discount margin) retraced nearly 100 basis points to end the year at 486 basis points, while yields declined 92 basis points to 5.10% as LIBOR held steady at approximately 0.23% during the quarter. As was the case in the high yield bond market, lower-rated leveraged loans outperformed in the fourth quarter, with CCCs returning +9.5% and split-Bs +6.8%, whereas BBs and split-BBBs gained +2.4% and +2.0%, respectively. COVID-impacted sectors generated the best gains in the final quarter of 2020, led by aerospace (+7.3%), energy (+6.6%), and gaming / leisure (+6.2%).

Loan market technicals continued to improve in the fourth quarter of 2020, with retail loan funds drawing their first inflow in December following 26 consecutive months of outflows (outflows for 2020 totaled -$26.9 billion). CLO issuance gained steam as nearly $32 billion in new deals priced in the fourth quarter, up from $22 billion in the prior period. To meet stronger demand, primary loan issuance jumped to nearly $109 billion in the fourth quarter of 2020 from $68 billion in the third quarter. For the year as a whole, 2020 net primary loan volumes totaled $312 billion, nearly catching up to the 2019 level ($331 billion). The leveraged loan default rate finished 2020 just under 4%, down from 4.25% at the end of the third quarter but still up more than 2% from the end of 2019. We expect the default rate to trend back down during 2021 as earnings and credit metrics continue to recover.

With high yield and leveraged loan spreads now almost fully back to where they started 2020, and much of the high yield market trading above call prices, we prefer loans over high yield bonds at this juncture. Our base case is that much of 2021 returns in fixed income will come from coupon carry, an environment well-suited for loans, particularly if interest rates do see upward pressure. At the sector level, we continue to target opportunities that should benefit as the economy reopens, targeting credits that possess adequate liquidity to manage through what is likely to be a bumpy start to 2021.

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Past performance is no guarantee of future results.

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.