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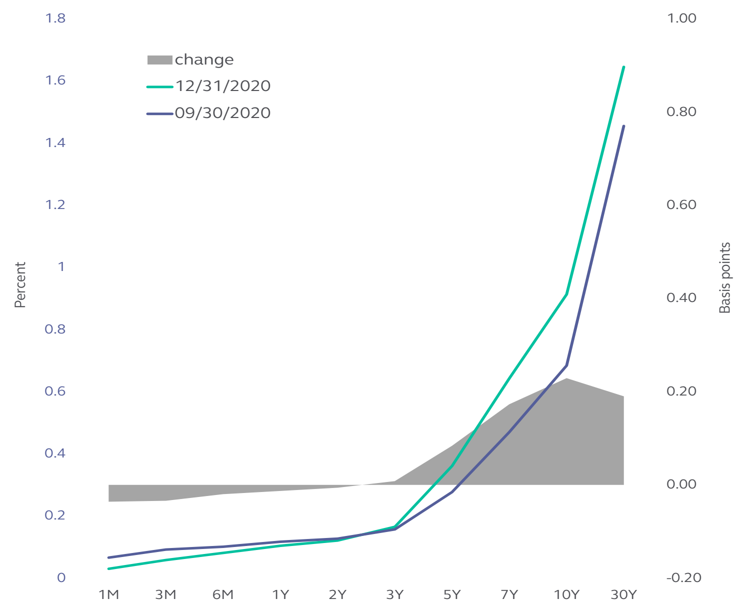
Highlights

Throughout the 4th quarter the uncertainty surrounding mostly political events made for higher interest rate volatility. The heightened market anxiety took place against a backdrop of steadily rising rates that became more pronounced further out the term structure resulting in a steepening of the yield curve. Markets were seeking a level consistent with a second wave of Covid-19 spread and the approval of new vaccines to reign it in just as a second large wave of infections threatened further shutdown and slowing of the pace of economic recovery. Politics and elections seemed to get in the way of Congress' ability to provide additional fiscal support. The Presidential election shaped up as being a close race which favored a change of administration, while at the same time the majority make-up of the Senate was highly uncertain. Daily developments kept markets on edge throughout the early stages of the quarter and into the elections. The Federal Reserve may have provided the most clarity to markets by assuring that accommodative monetary policy will remain in place until full employment is reached and longer-term inflation expectations of 2% are achieved.

Rates on the United States Treasury Note (USTN) bellwether 10-year rose from 0.68% at the beginning of the quarter to a high of 0.96%, before closing out the period at 0.92%. Shorter rates such as the USTN 2 year exhibited a modestly similar pattern, but remain anchored by the relative certainty of accommodative Fed policy finishing the quarter a basis point lower over the period at 0.12%.

US Treasury Yield Curve



Source: Bloomberg

Mark Kummerer, CFA
Portfolio Manager

Outlook

As we enter the first stanza of the new year it is still the ability to control and live with the coronavirus that will drive markets. The roll out of vaccines was slow out of the blocks but can be expected to gain momentum. The near-term rise in cases will cause economic momentum to slow but not contract. Continued fiscal spending initiatives should also be effective in maintaining the recovery's momentum. Fiscal initiatives may get further support given the 50-50 split of the Senate, but it is unlikely that the new administration will have its way entirely. With the Fed having called for additional fiscal measures to support already accommodative monetary measures, they can be expected to maintain that policy until the recovery brings unemployment to a level that they believe is resulting in undesirable levels of inflation. Seemingly, we are far from those conditions. However, the massive sizes of stimulus expectations and the implications for supply of U.S. Treasury issues should continue the pressure on longer yields and the continued steepening of the curve.

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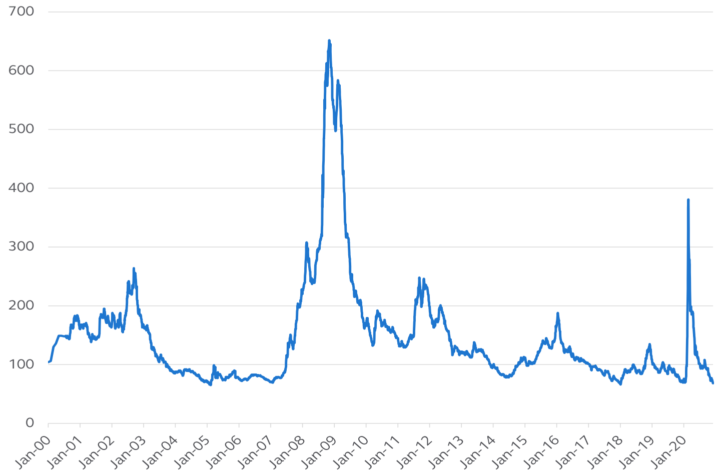
Please see Disclosures for important information.

Highlights

The Bloomberg Barclays U.S. Intermediate Corporate index ended 2020 on a strong note as 4th quarter total and excess returns were 1.76% and 2.08%, respectively. After a weak September, the 4th quarter experienced a strong risk-on performance as the U.S. election tail risk did not materialize and two vaccine candidates released better than expected results. During December, Congress was able to pass a $900 billion fiscal stimulus bill that should help mitigate the economic weakness associated with a record rise in Covid-19 cases.

The quarter capped a tumultuous year where index spreads gapped as wide as 381bps in March but ended the year near all-time tights. Aided by extremely supportive policies by the Federal Reserve and significant fiscal support, full year total returns were 7.47% while excess return were 1.17%. During 2020, investment grade companies raised a record $1,827B in the primary market (+64% yoy) due to the success of the Federal Reserve actions and policies.

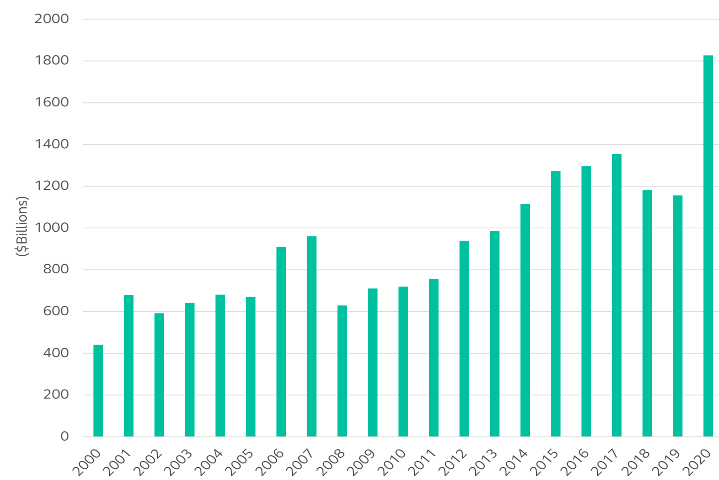


Source: Bloomberg

Outlook

We enter 2021 with a positive view on the macroeconomic landscape but have modest expectations for excess return. Last year, we saw tremendous divergence in the fortunes of Wall Street vs. Main Street. As markets swiftly rebounded and the S&P500 reached record highs, the economic and human tolls were still significant. For 2021, we expect the wide vaccine distribution to reduce the high costs of Covid-19 and further normalize human and economic activity. However, the markets may have already anticipated this. As we ended the year, Corporate spreads were at all time low historical levels and therefore some of this year's performance may have been pulled forward.

With our expectations for a continued strong macro recovery and outlook, we will be questioning our two main assumptions that underpin our strategy. First, when will the Fed pivot away from its extremely dovish policy? The Fed actions have suppressed volatility and created an insatiable need for yield. We could see an uptick in volatility as the Fed begins to lift off and step away from the markets. Second, we would expect company managements to begin to address their balance sheets and maintain a debt-holder friendly strategy. However, a more optimistic outlook and generous financing markets may motivate management to shift to a more aggressive strategy. We have already started to see an uptick in M&A activity and therefore will monitor any resumptions of animal spirits from the C-suite.



Source: Bloomberg

Dan Kang, CFA
Portfolio Manager

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Highlights

The Bloomberg Barclays U.S. Agency MBS Index posted total and excess returns of 0.24% and 0.34%, respectively, during the fourth quarter, bringing full year 2020 returns to 3.87% and -0.17%. The 15 year sector outperformed longer maturities, posting positive excess returns for the year. Strong Q4 performance across spread sectors was supported by positive vaccine developments, clarity around the November elections, passage of a second pandemic relief bill and a strong commitment of support by the Federal Reserve.

At their December policy meeting the FOMC unveiled qualitative guidance around their QE purchase timeline, committing to net (of paydowns) purchases at least $40B/month in MBS until "substantial further progress" has been made towards maximum employment and price stability goals. Rates volatility declined post-election and the Fed projected policy rates would remain near 0% through 2023. Mortgage rates were much less volatile than Treasuries, buffered by primary/secondary spread compression, which drove 30-year primary rates to a record low 2.67% by year-end even as the 10-year Treasury yield rose.

Historically low mortgage rates and expanding mortgage servicer capacity/efficiency drove fast prepayments and record MBS supply. Gross issuance surpassed $1T in Q4 and reached $3.16T for the full year. Net 2020 issuance was $513B, led by a surge in 15 year supply, while Ginnie Mae MBS outstanding contracted. Prepay and supply headwinds were offset by QE4 purchases totaling $362B in Q4 and $1.47T since the onset of QE4 in March. Coupon performance was highly correlated with the size of Fed purchases, driving roll specialness in production coupons, which outperformed the rest of the stack as investors "followed the Fed". Domestic banks provided another significant source of MBS demand as record deposit growth and subdued loan demand during the pandemic drove outsized MBS purchases.

Outlook

After a strong finish to the year MBS valuations offer less cushion against a number of potential headwinds this year. First, the outlook for the economy has brightened considerably given vaccine rollouts and additional fiscal support under a Democratic administration. This risk-on environment favors credit-sensitive sectors over MBS. Second, mortgage rates aren't likely to move higher with Treasury yields until primary/secondary spreads normalize, leaving over 70% of loans outstanding in-the-money. This along with industry capacity adds and processing efficiencies honed during the pandemic should extend the current refi wave. Third, MBS supply is expected to remain elevated this year, with a steeper yield curve boosting supply in shorter maturity segments. Meanwhile, bank demand for MBS is unlikely to match the lofty levels seen in 2020 as loan demand improves as the economic recovery unfolds. Finally, the Fed could signal a taper later this year if inflation and employment measures strengthen meaningfully, although we expect them to communicate this well in advance in order to avoid a repeat of the 2012-13 "taper tantrum".

The trajectory of the pandemic remains the biggest unknown on the road to economic recovery, with vaccine acceptance and rollout plus virus mutations having surfaced as key risks to the otherwise positive outlook. We expect accommodative monetary policy throughout 2021 as aftershocks from the pandemic continue this year. Therefore, we believe the Fed will remain the predominant driver of MBS performance, likely continuing to buy $40B/month outright and $100-$130B/month inclusive of paydown reinvestments. By the time they taper the Fed will own approximately 30% of the MBS market, a far larger share than in past QE programs. This should cap basis volatility and support carry-type returns for the sector for the foreseeable future, making MBS an attractive high-quality alternative to Treasuries.

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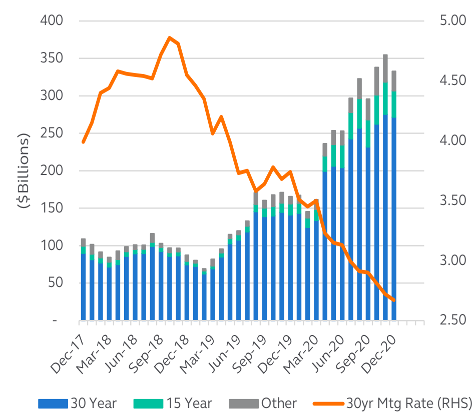
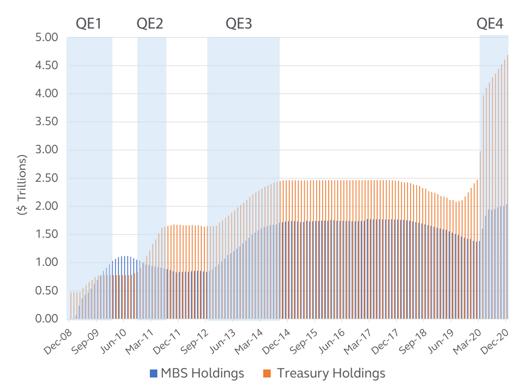
MBS Supply & Mortgage Rates



Source: BoA Securities, Bloomberg

Fed Balance Sheet



Source: Bloomberg, Federal Reserve Bank of New York

Perpetua Phillips
Portfolio Manager

Please see Disclosures for important information.

Asset-Backed Securities (ABS)

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Highlights

The Bloomberg Barclays AAA Asset Backed Securities (ABS) Index posted total and excess returns of 0.29% and 0.27%, respectively. Risk assets rallied during the fourth quarter due to several positive developments, most notably the approvals of two COVID-19 vaccines in the U.S., and more working their way through the process. Other favorable news included much better than expected corporate earnings results and the United Kingdom and the European Union reached a trade deal just days prior to the UK's exit from the EU. The Federal Reserve (Fed) continues to support financial markets through purchases of U.S. Treasury securities, mortgage-backed securities, and corporate bonds. These positive events were enough to overcome the negativity from increasing virus infections, hospitalizations, and renewed lockdown measures throughout the world.

The total number of Americans on government unemployment benefits ended 2020 just above 10 million. On December 21, 2020 Congress passed a $900 billion pandemic relief package as part of a broader $1.4 trillion government funding bill. Two critical federal unemployment programs: PUA & PEUC (Pandemic Unemployment Assistance & Pandemic Emergency Unemployment Compensation) were extended to March 14, 2021 and the FPUC (Federal Pandemic Unemployment Compensation) was restarted. The FPUC provides an additional $300 in benefits for each week of unemployment between December 26, 2020 and March 14, 2021.

The Fed re-introduced TALF in the first quarter (Term Asset-Backed Securities Lending Facility) which lent to investors for purchases of select AAA-rated securities. TALF activity in ABS was very limited and the program was allowed to expire on December 31. The final total of TALF usage was only $5 billion in requests of $100 billion in loans available. Total usage was for: small business (58%), CMBS (24%), leveraged loans (10%), student loans (6%) and premium finance (2%).

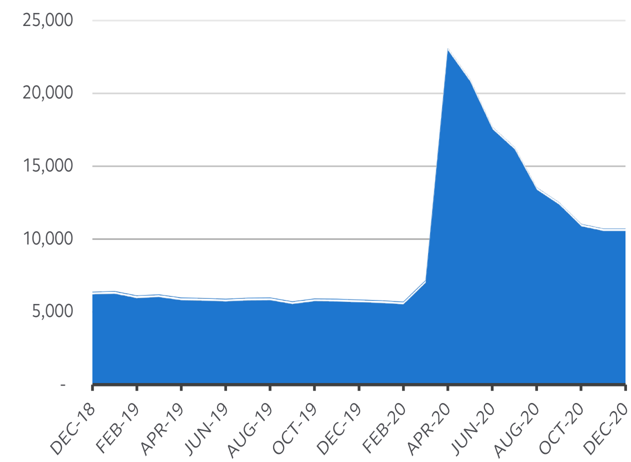
As the Presidential election results came and went, the ABS market carried on with business as usual. Spreads continued to move to tighter levels this quarter with senior tranches of three-year prime auto loan ABS moving 13bp tighter, three-year credit card ABS moving 5bp tighter and three-year equipment ABS moving 14 bp points tighter.

Outlook

Global economic activity is expected to gradually recover throughout 2021. The housing market remains robust and is supported by all-time low mortgage rates. U.S. consumers are further supported by continued fiscal stimulus measures, and a high savings rate suggests that consumer spending may further improve throughout 2021 due to pent-up demand.

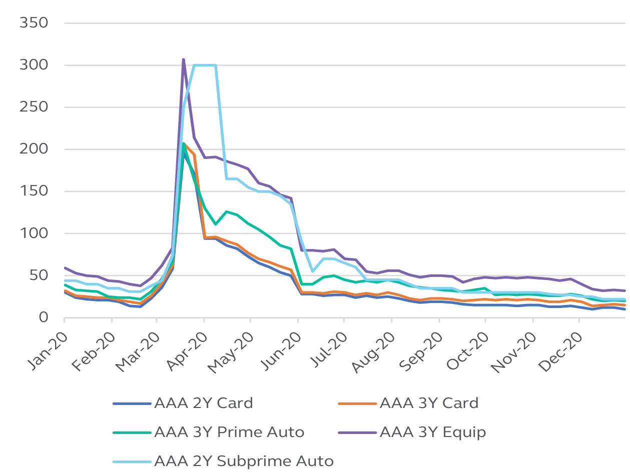
2020 ABS new issue supply was $175bn versus $229bn in 2019. However net issuance in 2020 was -$40bn. Projected supply for 2021 is $220bn, +$10bn net issuance. ABS fundamentals remain strong with delinquency rates at very low levels. Investor demand for ABS remains robust. Valuations appear attractive when compared to U.S. Treasuries and other short duration alternatives.

U.S. Unemployed Workers



Source: Bureau of Labor Statistics

AAA ABS Index Option Adjusted Spreads



Source: JP Morgan

Perpetua Phillips
Portfolio Manager

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Highlights

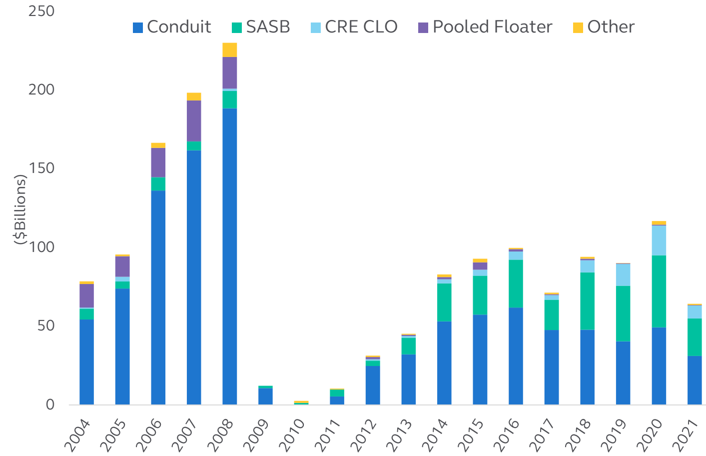
The Bloomberg Barclays AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of 0.73% and 1.17%, respectively, during the fourth quarter, bringing full year 2020 returns to 8.33% and 0.90%.

The CMBS market continued to show signs of recovery from the initial deterioration of the outlook for real estate fundamentals and commercial real estate pricing. Improving economic activity, recovering real estate fundamentals and favorable supply and demand in the CMBS market along with performance of risk assets generally, led to the sector's solid performance results. Spreads on the AAA part of the CMBS stack finished the year having mostly recovered from the spread widening during the first quarter.

The initial economic shutdown post-Covid across the United States in mid-March has impacted all commercial real estate property types led by hotels and retail, but loan delinquencies have leveled off. While the conservative underwriting standards originally assumed on CMBS loans has the potential to help mitigate defaults and losses on problem loans, the market is expecting cumulative losses to more than double from pre-Covid expectations.

New issue activity remained light, though fourth quarter issuance was heavier than the second and third quarters. Private label issuance was $20.7B compared to nearly $44B during the same quarter of 2019. Issuance for the year of $64.1B compares to $116.9B from the preceding year. Demand remained strong for the limited issuance driving spreads tighter and bringing secondary market levels along with it resulting in the solid total returns from the sector.

Full Year Issuance



Source: JP Morgan

Mark Kummerer, CFA
Portfolio Manager

Outlook

The outlook for CMBS will continue to be driven by how quickly economic activity can recover as states allow businesses to reopen and employees choose to return to work. Further government stimulus packages continue to be discussed in support of the recovery and vaccine roll outs, while progressing more slowly than had been hoped, hold the promise of progress toward a broader opening of economic and social activity. While multifamily properties have performed solidly throughout the Covid-19 emergency, the pandemics longer term impact on travel and hospitality properties, changes in retail trends and the uncertainty as to what the future holds for office use are still to be determined. However, we expect that the favorable supply and demand dynamics will continue to be supportive of CMBS valuations and structural protections and conservative underwriting will continue to protect from a credit perspective.

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Index descriptions:

The Bloomberg Barclays US Corporate Investment Grade Index is a component of the Bloomberg Barclays US Credit Index which includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements within the Bloomberg Barclays U.S. Aggregate Index.

The Bloomberg Barclays US Agency MBS Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Bloomberg Barclays AAA ABS Index represents the asset-backed securities within the Bloomberg Barclays US Aggregate Index.

The Bloomberg Barclays AAA CMBS Index represents the commercial mortgage-backed securities within the Bloomberg Barclays US Aggregate Index.

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