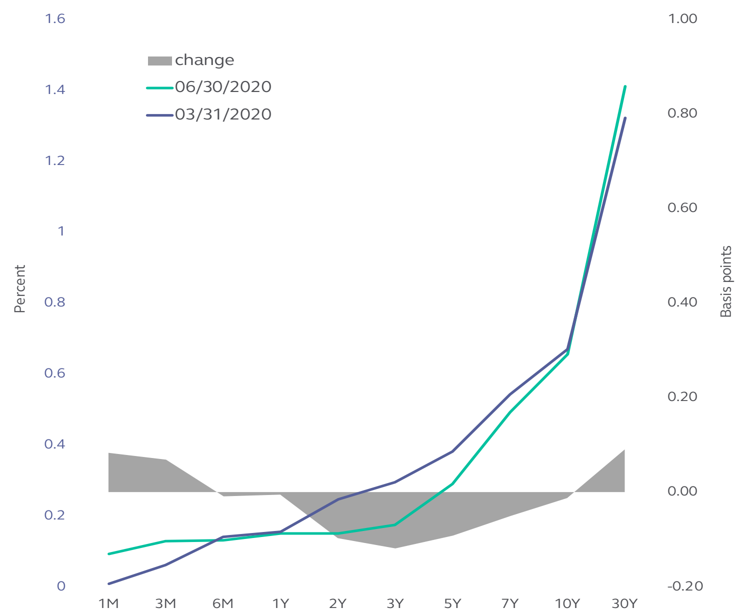
## Highlights

As the second quarter of 2020 began it was Dickensian 'worst of times' as the U.S. was just a few weeks into a massive shutdown bringing economic activity to a sudden stop. The Federal Reserve Open Market Committee had already used the Fed Funds tool to return rate policy to effectively zero. The U.S. Treasury market had long before made a move of similar magnitude and dropped yields to historic lows. The Federal Reserve (Fed) debunked any thought that they would consider negative rates a desirable tool but did provide assurance that highly accommodative monetary policy was likely to be the norm for an extended period. That left little room for rates to move and so the quarter over quarter change was muted. Yields on shorter cohorts moved a mere 10 basis points lower, trading in a very narrow range, while the 10 year bellwether was unchanged.

## Outlook

The Fed is very much the story for rates for the foreseeable future and the picture is and should remain very clear: as much as it takes for as long as it takes. Given the ongoing challenges with containing COVID-19 and the current state of the economy we should anticipate policy rates at the lower bound for a couple of years. The Fed has also committed to the current pace of asset purchases of U.S. Treasuries, Agency MBS and, to a much lesser extent, Agency CMBS, providing support to these markets. Further, we can expect the Fed to provide more open policy guidance going forward in an effort to enhance policy effectiveness by giving markets a greater degree of certainty. With policy goals of full employment well below the natural rate and inflation targets of less concern it is very hard to imagine any change from the current highly accommodative policy. That paints a picture of more of the same, low volatility for rates for the foreseeable future.

US Treasury Yield Curve




Source: Bloomberg

**Mark Kummerer, CFA**
Portfolio Manager

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## Highlights

The Bloomberg Barclays U.S. Intermediate Corporate index posted total and excess returns of 7.63% and 7.02%, respectively for the second quarter of 2020. Risk assets saw a quick reversal from the first quarter sell-off aided by unprecedented monetary stimulus, a significant fiscal response and better than expected economic recovery once states began to open. During the quarter we saw positive headlines on more effective treatments for COVID-19 and encouraging early data on vaccine candidates. Market sentiment vacillated from the falling case count in the early part of quarter to the accelerating rise of cases post Memorial Day holiday weekend.

With the support by the Federal Reserve, credit markets were wide open for issuers during this period. The record pace of new issuance allowed corporations to shore up liquidity, pay down their revolvers and address near term maturities. For the first half of 2020, investment grade new issuance totaled $1.2T which surpassed the totals for all of 2019.

## Outlook

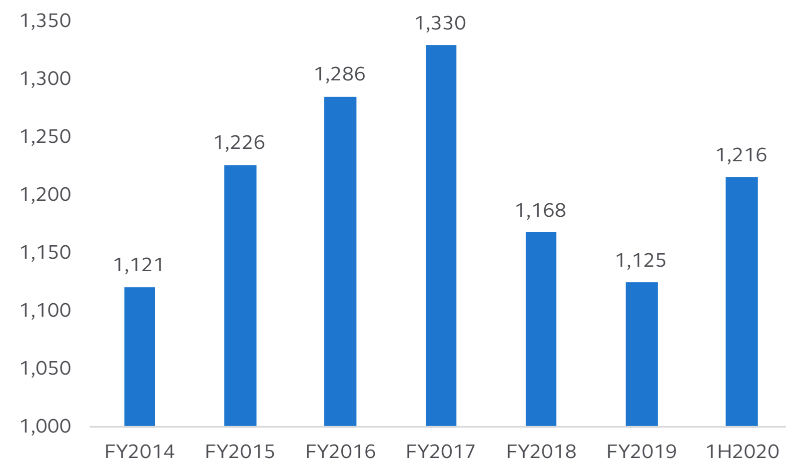
We continue to have a positive view of the second half of the year. However, our risk adjusted return expectation has been muted due to the sharp retracement in spreads during the quarter and an expected pick up in volatility as we head into the fourth quarter. By June 30th, Corporate Intermediate spreads had re-traced 84% of the widening from its all-time tights. However, numerous higher quality non-financials have reached their pre-Covid levels and any further tightening within the sector will be more dependent on higher beta and Covid-impacted credits. We could see higher volatility as we head into Fall due to a potential second wave of the virus and increased uncertainty with upcoming elections.

Going forward, we believe credit spreads will be buoyed by several factors. First, the technical picture continues to be supportive as supply is expected to diminish significantly from the first half record pace. Conversely, solid demand from both retail investors and foreign investors should continue with Fed accommodative policies. Second, we would expect economic data to remain consistent with an economic recovery. Third, we should see positive headlines around several vaccine candidates entering Phase 3 trials and more effective pharmacological treatments which mitigate the record number of cases the U.S. is facing.

Citigroup Economic Surprise Index


Source: Bloomberg

Primary New Issuance ($Billions)




Source: Morgan Stanley

**Dan Kang, CFA**
Portfolio Manager

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## Mortgage-Backed Securities (MBS)

**Perpetua Phillips**
Portfolio Manager

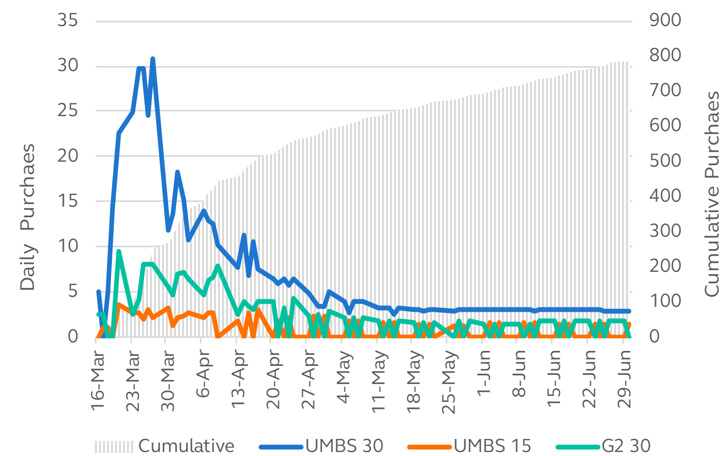
### Highlights

The Bloomberg Barclay's U.S. agency MBS Index posted total and excess returns of 0.67% and 0.38%, respectively, in the second quarter as an arsenal of fiscal and monetary policy measures launched late in the first quarter provided liquidity and helped stabilize the economy and financial markets.

The Federal Reserve upsized their fourth round of Quantitative Easing (QE4) to unlimited purchases of MBS and Treasuries on March 23rd. Gross MBS purchases (outright plus paydown reinvestment) totaled nearly $300B in April, driving MBS outperformance of 0.48% for the month. Purchases were scaled back to around $100B in May and June as markets stabilized, while monthly gross issuance surpassed $250B. This combined with rising prepayment risk and reallocations into corporate bonds caused the basis to give back 0.10% in relative performance in the final two months of the quarter. Nevertheless, strong Fed support helped drive MBS option-adjusted spreads 15 bps tighter over the full quarter.

Mortgage rates hit record lows during the period with the 30-year rate approaching 3.0%. Prepayments surprised to the upside as anticipated refinancing frictions arising from forbearance measures and servicer capacity constraints failed to fully materialize. Prepay speeds on TBA pools surged to over 65% CPR in certain cohorts, driving prepay-protected specific pool payups to new highs.

Fed QE4 MBS Purchases ($Billions)



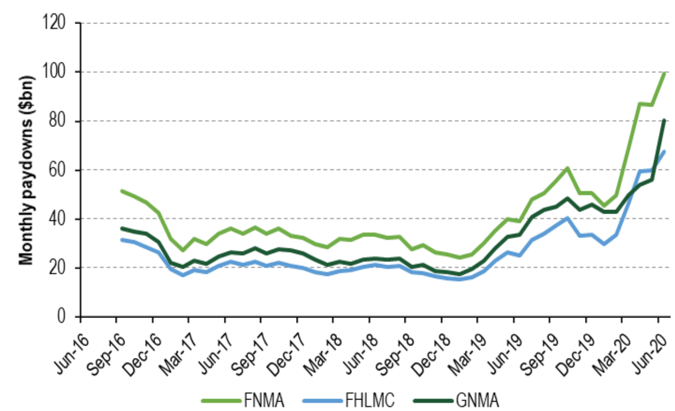

Source: Federal Reserve

### Outlook

The Fed's QE4 program had an outsized impact on the MBS market over the past quarter and continues to dominate the outlook for the sector in the months ahead. Although MBS net issuance is expected to surge above $300B for 2020, Fed purchases of $40B/month will likely take down most of this supply, causing spreads to tighten further, as seen in prior QE periods. In addition to outright purchases, the Fed's paydown reinvestment ($50B/month in the near term) improves the convexity characteristics and roll specialness of TBA collateral, improving expected returns. There are costs associated with these stimulus measures, however. The sharp and sustained decline in rates brought about by QE4 has left most of the MBS market susceptible to elevated prepayment risk at a time when much of the sector is trading above $105 dollar prices. Furthermore, prepayment model risk is elevated due to ongoing policy uncertainty around loan forbearance and buyouts.

The path out of this pandemic will be challenging and not without significant costs to the economy. This underscores the MBS sector's appeal as a high quality defensive alternative to Treasuries. However, the QE-driven tightening in OAS over the past quarter combined with elevated refinancing risks make security selection particularly important as fast speeds are driving negative yields within certain segments of the market. We expect continued strong demand for prepayment protection in specified pools to support payups near current record high levels, while Fed purchases in production coupons should support spreads and roll specialness until QE4 purchases are scaled back, possibly next year. CMOs look attractive relative to pools as they remain outside the scope of the Fed's purchase program.

Agency MBS Paydowns




Source: BoA Merrill Lynch

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Morley Capital Management

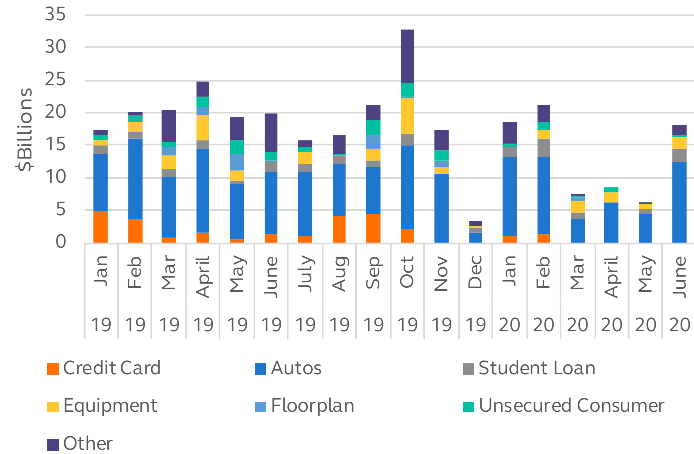
## Highlights

The Bloomberg Barclays AAA Asset Backed Securities (ABS) Index posted total and excess returns of 3.31% and 3.02%, respectively, for the quarter when compared to similar duration U.S. Treasury securities. Throughout the second quarter AAA rated ABS spreads recovered 90% of COVID-19 induced widening. Subordinate spreads are lagging the spread recovery and offer the best relative value but a small opportunity set (difficult to scale). Risk assets rebounded sharply in the second quarter, bolstered by unprecedented levels of monetary and fiscal support. Markets were further encouraged by progress towards vaccine candidates and evidence of improving economic indicators as communities began to emerge from lockdown. The Fed re-introduced TALF in the first quarter (Term Asset-Backed Securities Lending Facility) which will lend investors to purchase select AAA-rated securities. TALF activity has been very limited to date and opportunities are disappearing across securitized products as spreads grind tighter.

## Outlook

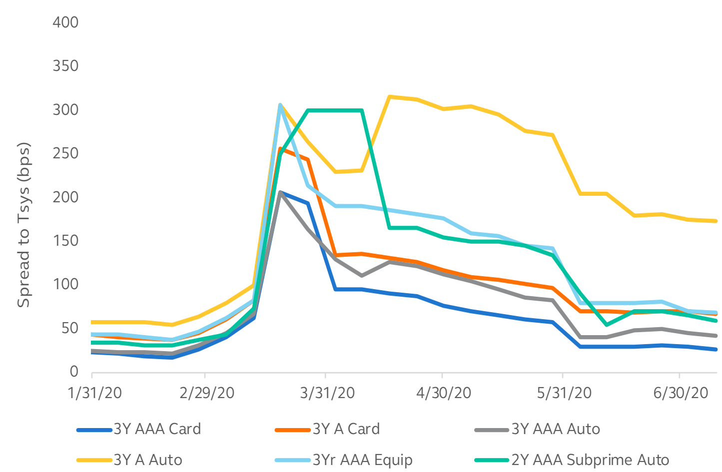
Global economic activity is expected to gradually recover throughout the remainder of 2020 and into 2021 although the path to recovery remains uncertain and is highly dependent on the success of containing the virus. However, monetary and fiscal support serve as a powerful market backstop. ABS fundamentals are supported by the fiscal stimulus measures of the U.S. government. The $2 trillion Cares Act provides support to consumers, and by extension the ABS market, through expanded unemployment benefits and direct cash relief to the most at-risk individuals. Throughout the quarter Primary and Secondary market volume has been low. These favorable technicals are expected to continue for the rest of 2020 as new supply is down 35% vs 2019 and net supply will be negative. Investor demand has returned to the ABS market and spreads have nearly retraced all the pandemic induced widening. Valuations appear attractive when compared to U.S. Treasuries and other short duration alternatives.

ABS Monthly Issuance




Source: JP Morgan

AAA ABS Index Option Adjusted Spreads




Source: JP Morgan

**Perpetua Phillips**
Portfolio Manager

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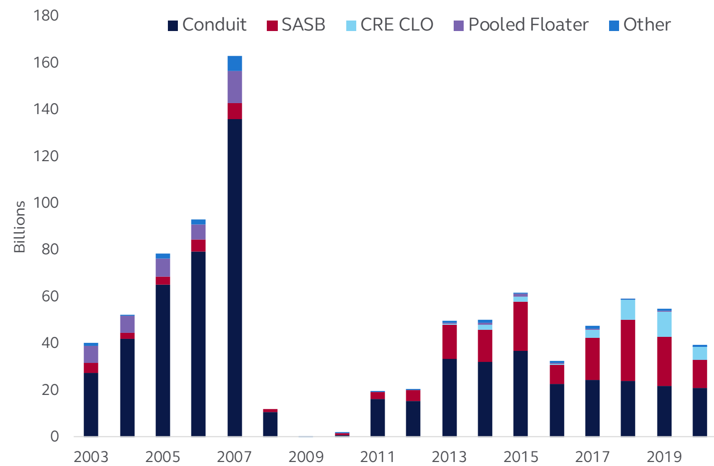
# Commercial Mortgage-Backed Securities (CMBS)

Morley
Capital Management

## Highlights

The Bloomberg Barclays AAA Commercial Mortgage-Backed Securities (CMBS) Index posted a total return of 4.12% and excess return of 3.40% for the quarter. The deterioration of the outlook for real estate fundamentals and commercial real estate pricing post the Covid-19 nationwide shelter-in-place orders and shut down of the U.S. economy was reflected in CMBS pricing at the beginning of the quarter. While AAA spreads largely recovered from the late March wide levels, CMBS credit that was more deeply discounted in March and April was slower to recover. AAA spreads tightened in anticipation of and the eventual inclusion of previously issued super-senior AAA's in the Fed's bond-buying program under TALF. The delinquency rate on loans originated after the Great Financial Crisis spiked higher during the quarter as more borrowers requested relief from debt service requirements as a result of the economic shutdown.

The economic slowdown impacted all commercial real estate property types led by hotels and retail. By June remittance, the delinquency rate on all loans was 8.5%. The conservative underwriting standards originally assumed on the loans have the potential to help mitigate defaults and losses on problem loans. Total private label CMBS issuance ended a Covid-19 impacted second quarter at \$8.0B and Agency CMBS was \$16.5B compared to \$11.6B and \$28.3B respectively at the end of the first quarter.




Source: JP Morgan

**Mark Kummerer, CFA**
Portfolio Manager

## Outlook

The outlook for CMBS will be driven by how quickly economic activity can recover as states allow businesses to reopen and employees choose to return to work. The success of the government sponsored rescue packages to support business and property owners through this period of stress will be important in determining the ultimate impact the slowdown in economic activity will have on the commercial real estate market.

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# Disclosures

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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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