Highlights

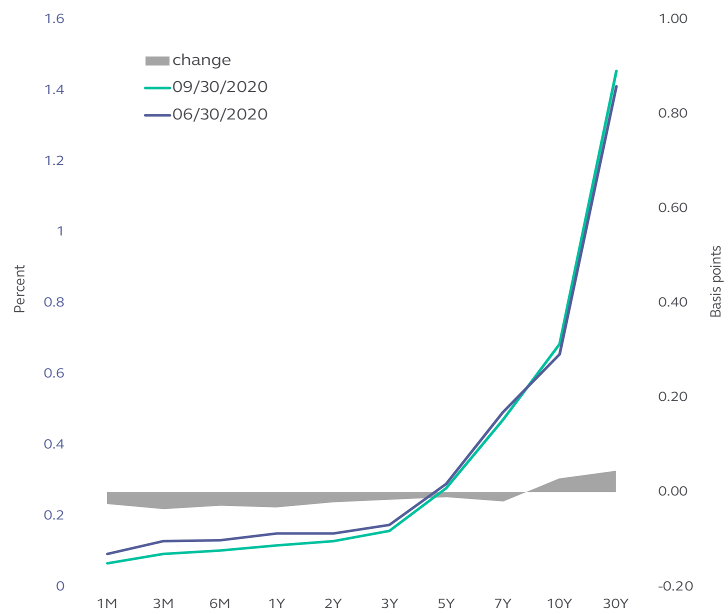
Rates volatility was muted during the third quarter as markets continued to gauge the pace of economic recovery as the employment picture continued to improve, but other facets of the economy remained sluggish. Rates were little changed during the third quarter, with short rates having dropped a couple of basis points and longer rates 3-4 basis point higher, providing the yield curve with a slightly steeper slope. Intra-quarter the 10-year Treasury yield reached a high of 0.75% and a low of 0.50%. The term structure changed directionally, flattening as rates fell and steepening into selloffs.

Record U.S. Treasury issuance was coupled with the Federal Reserve's (Fed) resolve to keep buying Treasuries. The Fed instituted a change to their policy framework that seeks to achieve a 2% average inflation rate, suggesting that inflation would be allowed to run higher than target following periods, like the current one, where inflation is well below the target. That in turn means future policy will be less sensitive to continued economic growth even as inflation approaches the target. The end result is likely lower rates for longer as reflected in the Federal Open Market Committee (FOMC) dot plot which forecasts policy rates to remain at the current zero bound until at least 2023.

Outlook

Nearly everyone seems to agree that another round of fiscal spending to boost the economy is the next step. However, as of this writing negotiations for an additional fiscal spending bill remain in limbo as parties seem far apart in both size, content, and will to compromise. Markets are following the negotiations closely responding to every turn. It is, however, expected that some form of spending bill will be agreed upon at some point though pre-election political dynamics make it unlikely until after the election. Added to that is the increasing possibility of a Democratic Party sweep in the upcoming election. The risk of not getting any follow-on fiscal stimulus would be elevated with a Biden victory and a continued split congress. Further trillion-dollar plus bills will require large add-ons to already record U.S. Treasury issuance. All that money also raises the specter of the rising inflation the Fed desires, but to which long rates remain sensitive. Looking further out as markets tend to do, the steady improvement in testing and treatment of Covid-19 and the prospects for a vaccine provide the vision that at some not too distant point we may be living in a closer to normal world and with that a better economic environment. That could present the Fed with the first test of the new policy regime.

US Treasury Yield Curve



Source: Bloomberg

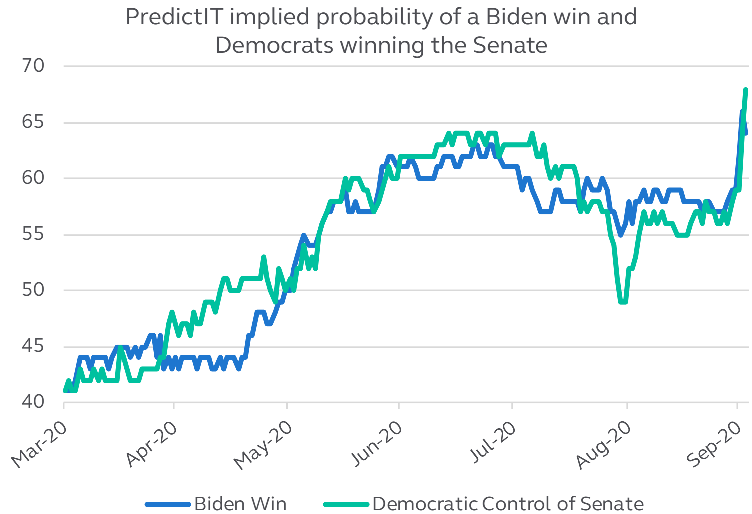
Mark Kummerer, CFA
Portfolio Manager

The financial market outlook is based on current market conditions. There is no assurance that such events or projections will occur and actual conditions may be significantly different than that shown here. The potential for profit is accompanied by the possibility of loss.

Highlights

The Bloomberg Barclays U.S. Intermediate Corporate index had total and excess returns of 1.33% and 1.11%, respectively for the 3rd quarter of 2020. Spreads continued to tighten at the start of the quarter but settled into a trading range for the remaining period. During September, spreads began to leak wider due to diminished fiscal stimulus prospects, contested U.S. presidential election fears, increased Covid-19 case counts in the U.S. and Europe and a heavy new issuance calendar.

Second quarter earnings came in better than expected, but still significantly lower than the prior year. With the help of the Federal Reserve and management conservatism (reduced share buybacks and capex), corporations have accumulated a cash war chest to face the uncertain fundamental outlook. According to Barclay's, cash balances for non-financials increased by almost $450B to reach a record high. As the world begins to normalize, we would expect management teams to utilize the massive cash pile to reduce debt and repair their balance sheets.



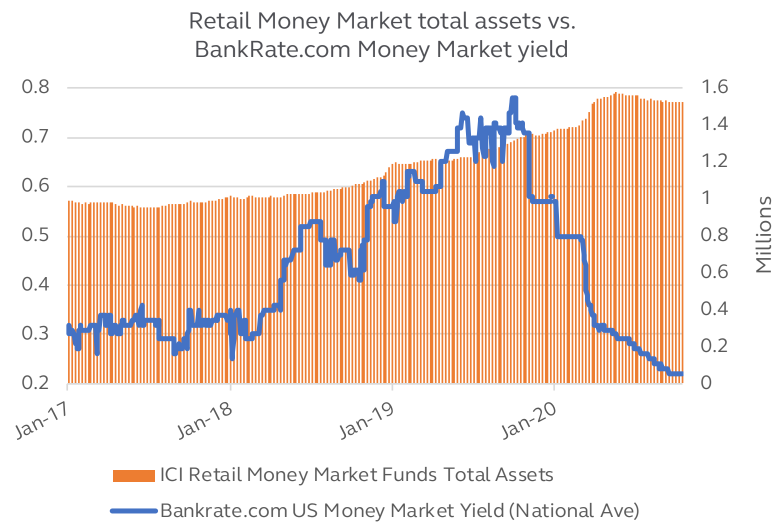
Source: Bloomberg, PredictIT

Dan Kang, CFA
Portfolio Manager

Outlook

As we enter 4Q20, we maintain our near-term cautious view on spreads while maintaining our positive assessment medium term. Rising Covid-19 cases/ hospitalizations and upcoming election risks still loom over risk sentiment. We believe near term volatility could spike, not only in a blue sweep scenario, but also if Republicans retain the Senate. With a split Congress, we would expect gridlock to continue and the prospects of a substantial fiscal stimulus package diminished.

We reiterate our stance that any spread widening would be limited in magnitude due to continued Fed support, the strong need for yield and lower primary new issuance. Besides the $15T in negatively yielding global debt, there is $1.5T in retail money market funds currently earning essentially zero yield. We believe that investors will continue to re-allocate towards positive yielding, high quality assets such as investment grade corporates.



Source: Bloomberg, Bankrate

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Perpetua Phillips
Portfolio Manager

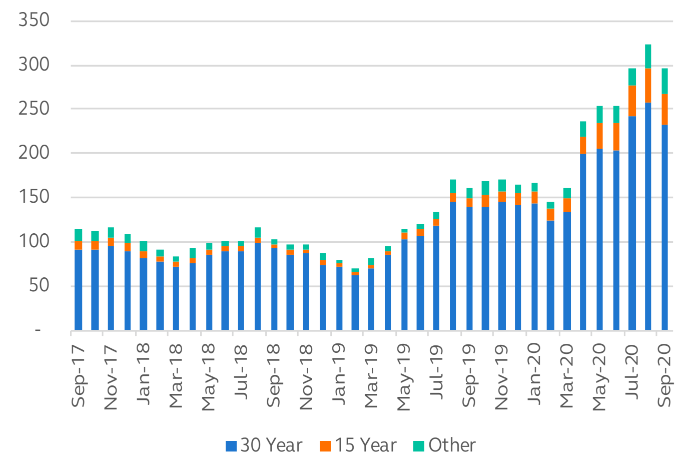
Highlights

The Bloomberg Barclay's U.S. agency MBS Index posted total and excess returns of 0.11% and -0.07%, respectively, in the third quarter as investor risk appetite favored credit sectors while mounting MBS supply and prepayment concerns offset continued QE4 support from the Federal Reserve. Notably, Ginnie Mae MBS sharply underperformed UMBS due to elevated buyout-related prepayment risk and a relatively lower share of Fed purchases.

The FOMC moved to a new average (2%) inflation framework at their September policy meeting and forecast the Federal Funds rate to remain near 0% through 2023, which drove rates volatility to new lows during the quarter. They also reiterated their commitment to purchase MBS "at least at the current pace" of $40B per month, net of paydowns, which have exceeded $60B/month. The Fed's purchases benefited certain segments of the market over others given their greater focus on production coupons (2.0-2.5%) and conventional MBS over Ginnie Mae.

Mortgage rates reached new lows during the quarter, remaining at or below 3% on 30-years for most of the period. This created challenges for the sector as surging mortgage purchase and refinancing demand drove MBS supply to $916B in Q3'20, nearly double that of Q3'19. Aggregate 15-year speeds most recently printed at 23% CPR while 30-years paid at 33% CPR and certain cohorts exceeded 60% CPR. Demand for prepayment protection intensified and lifted specified pool payups to new highs.

MBS Supply ($Billions)



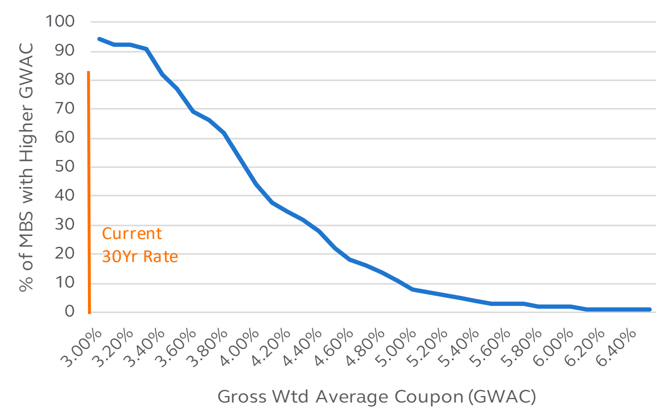
Source: BoA Securities

Outlook

The outlook for the economy and markets remains murky given uncertainty around the length and breadth of the pandemic as well as the November elections. The Fed's commitment to maintaining accommodative financial conditions through this challenging period is expected to prolong the current refi wave. In addition, mortgage companies have been increasing capacity and efficiency via increased staffing and digitization of origination and servicing processes, which should keep MBS supply and prepayments elevated. Furthermore, forbearance-related buyouts could increase in Q4 as September marks the 6-month point since initial COVID forbearance requests were submitted under the CARES Act.

While short rates are expected to remain anchored near 0% over the next year or more, longer term rates could face upward pressure over the next few quarters if significant progress is made on therapeutics/vaccines or passage of a large stimulus bill. In this scenario we would expect lower coupons and 30-year MBS to underperform as extension risks resurface and the timeline for QE tapering shortens. We would also expect specified pool payups to come under significant pressure in a sustained rates selloff. While we expect Fed purchases to support spreads and roll specialness in TBA production coupons over the next few quarters, performance of higher coupons and specified pools face more rate-dependent outcomes. Given the uncertain outlook for rates and a potential resurgence in volatility we believe CMOs and shorter maturity (15-year and 20-year) segments of the market offer the best risk-reward opportunities for our stable value portfolios.

30-Yr MBS Rate Distribution



Source: BoA Securities

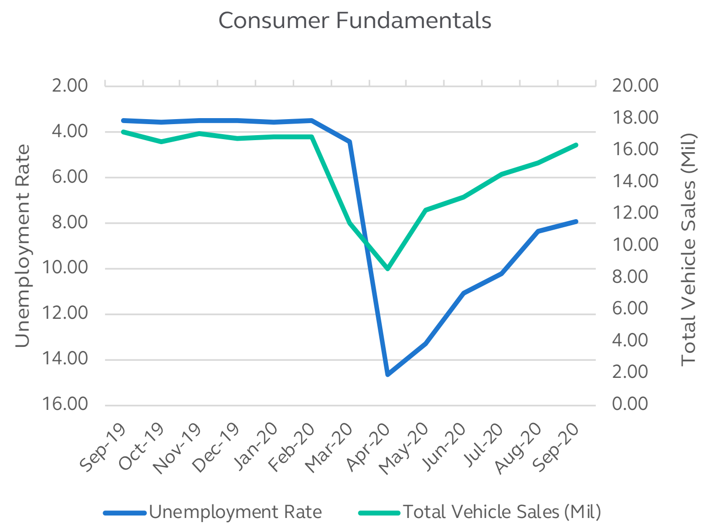
Asset-Backed Securities (ABS)

Morley
Capital Management

Highlights

The Bloomberg Barclays AAA Asset Backed Securities (ABS) Index outperformed the Bloomberg Barclays U.S. Aggregate Index with total and excess returns of 0.60% and 0.46%, respectively. Several positive developments supported risk assets during the third quarter. Economic data continues to trend in a positive direction and quarterly earnings results surprised to the upside. The Federal Reserve (Fed) continues to support financial markets through purchases of U.S. Treasury securities, mortgage-backed securities, and corporate bonds. However, further economic recovery in consumer and labor markets appears tenuous without further fiscal stimulus measures.

Spreads continued to move to tighter levels this quarter with senior tranches of prime auto loan ABS moving 18bp tighter, credit card ABS moving 13bp tighter and equipment moving 40 basis points tighter. As the Presidential election draws nearer, broader market volatility may pressure spreads, though we think benchmark sectors should benefit from any flight to quality in the market relative to higher-yielding ABS sectors.

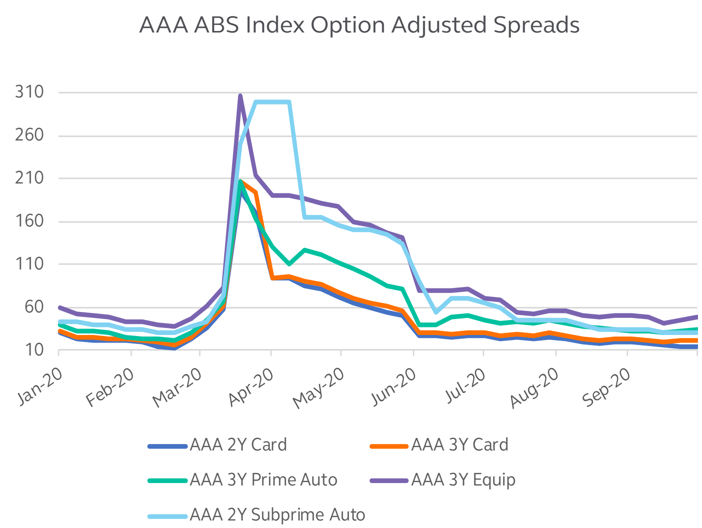


Source: Bureau of Labor Statistics, Ward's Automotive Group

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 successful virus control and vaccine development. ABS fundamentals remain strong with delinquency rates at very low levels. However, due to the expiration of expanded unemployment benefits, delinquency rates may increase somewhat. 2020 ABS full-year new issue supply is on target to reach $185bn after a surge of $26bn in September. For comparison, the full-year issuance in 2019 was $229bn. Investor demand for ABS remains robust. Valuations appear attractive when compared to U.S. Treasuries and other short duration alternatives.

The Fed re-introduced TALF in the first quarter (Term Asset-Backed Securities Lending Facility) which lends to investors for purchases of select AAA-rated securities. TALF activity in ABS has been very limited and we believe requests for TALF loans to finance ABS (auto, card, equipment, floorplan, premium finance and private student loan ABS) will remain low as current spread levels for those sectors result in negative TALF yields.



Source: JP Morgan

Perpetua Phillips
Portfolio Manager

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Please see Disclosures for important information.

Commercial Mortgage-Backed Securities (CMBS)

Highlights

The Bloomberg Barclays AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of 1.32% and 1.09%, respectively. 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 post the Covid-19 nationwide shelter-in-place orders and shut down of the U.S. economy in March and April. While AAA spreads largely recovered from the late March wide levels during the 2nd quarter, CMBS credit that was more deeply discounted in March and April showed a stronger recovery during the 3rd quarter as demand for yield and the broader recovery in economic numbers helped improve investor confidence. Since the peak in CMBS spreads in late March, AAA spreads have recovered 97% of the widening, AA- spreads 95%, A- spreads 83% and BBB- spreads 85%. Investor sentiment was also improved as the delinquency rate on 2.0 CMBS loans (bonds issued post 2009) leveled off during the quarter as fewer borrowers required debt relief and more loans were resolved through borrowers bringing loans current or through forbearance.

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. The September remittance confirmed, however, that the trend for loan delinquencies has leveled off since peaking in June at 8.5%. 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. The market disruption has also impacted new issue activity. Third quarter 2020 total private label CMBS issuance was $11.2B compared to $23.6B third quarter 2019. Year-to-date, private label issuance ended the third quarter at $47.5B compared to $72.9B during the same period in 2019.

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 being available 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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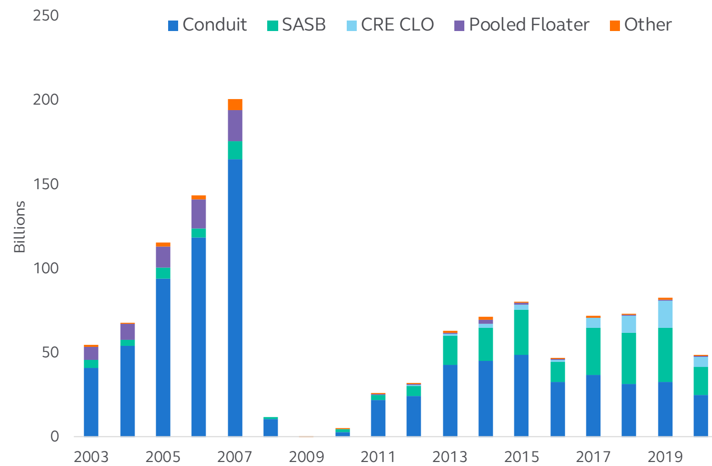
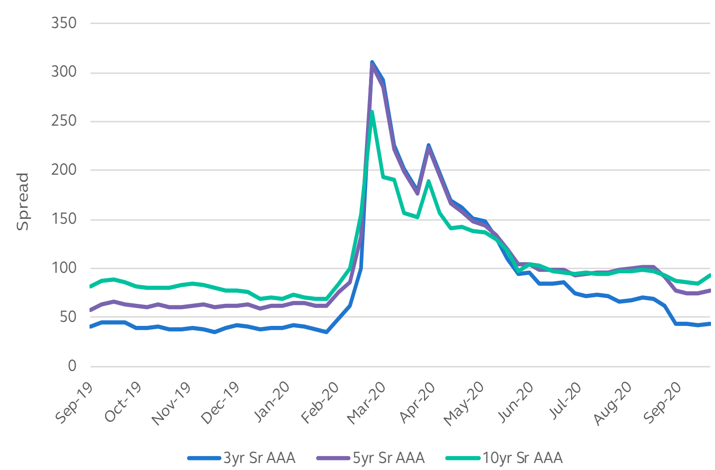
Full Year Issuance



Source: JP Morgan

AAA CMBS Spreads to US Treasuries



Source: J.P. Morgan, Pricing Direct

Mark Kummerer, CFA
Portfolio Manager

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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