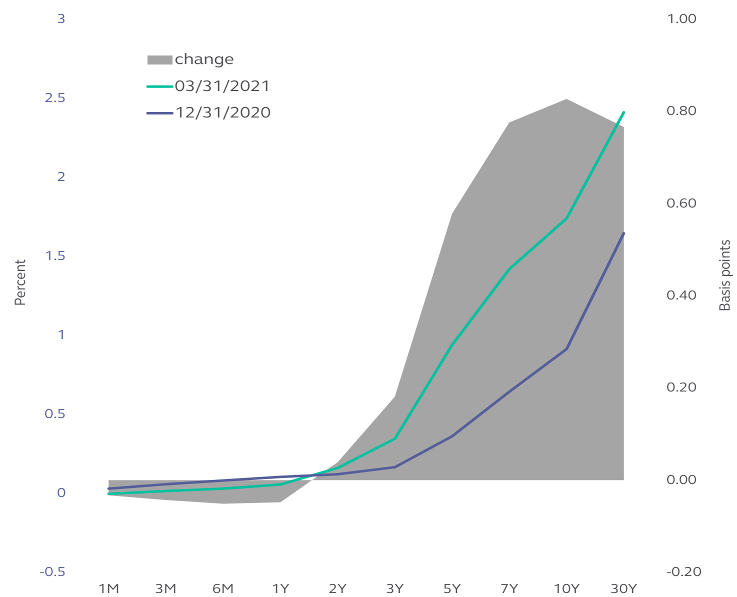
Interest Rate Strategy

Highlights

Large fiscal stimulus packages and accommodative monetary policy continues to produce good news on the economic front. Markets continue to follow the news regarding COVID-19, its current impact and the emerging prospects for future economic growth. With continued progress on vaccinations accelerating throughout the 1st quarter in step with stronger spending and the passing of yet more fiscal stimulus, the reflation trade dominated rates action in the first quarter.

Yield increased sharply from the 5yr tenor of the yield curve on out producing a marked steepening. Five-year USTN's increased 58 bp in yield while long maturities increased 75-85 basis points. Yields on the short end of the curve changed only marginally as the zero policy rate targets provide and anchor for those maturities. Rising rates and a steepening of the curve are typical of market expectations for stronger economic growth and higher inflation in the future. This quarter's increase in rates was accompanied by some increase in market inflation expectations as implied by the break-even rates on U.S. TIPS but also by an increase in the real rate. At the end of the period the implied inflation rate stood at 2.37%.

U.S. Treasury Yield Curve



Source: Bloomberg

Outlook

We expect the U.S. economy to maintain above trend growth for 2021/22 releasing a significant amount of pent-up demand as the population gets vaccinated. With an unemployment rate of 6.2% and 9.5 million jobs below the pre-COVID level, the economy has a long way to go to full recovery. We expect the Fed will maintain their new policy framework of allowing inflation to run above its target as it pursues the objective of full employment. We would expect policy to remain in that mode with a shift to tapering of asset purchases in early 2022 but maintaining zero interest rates through 2023. It is possible, though, that we could hear some discussion around the framework for tapering purchases sometime later this year. That policy should continue to anchor the short end of the curve but anticipation of reduced buying further out should result in further steepening. Federal Reserve Chairman Powell has been adamant in downplaying the risk of sustained inflation and that price increases from a 'burst of spending' as the economy recovers are likely to be transitory.

Mark Kummerer, CFA
Portfolio Manager

Highlights

The Bloomberg Barclays U.S. Intermediate Corporate index generated total and excess returns of -2.19% and +.03%, respectively. The significant increase in rate volatility during the period and the heavier than expected primary issuance contributed to the mixed performance for credit. Treasury rates sold off and curves steepened as the passage of the $1.9T American Rescue Plan and improving Covid trends (cases and vaccination) upgraded expectations of growth and inflation. As markets contemplated a potential multi-trillion infrastructure bill and an earlier removal of Federal Reserve accommodation, rates gapped higher.

Retail demand was surprisingly resilient despite the total negative returns for investment grade indices. YTD retail IG fund inflows were $112B with short and intermediate strategies benefiting while longer strategies experienced outflows. The primary market saw an active start as issuers took advantage of the wide-open financing markets. For the quarter, investment grade supply totaled $454B which represents the 3rd highest of all-time after the record quarters in 2020.

Fund Flows by Asset Class - Through 03/31/21

	YTD	YTD % AUM
Short	33,648	3.7%
Intermediate	75,452	3.9%
Long	(17,440)	-11.5%
Total Return	21,175	2.8%
Total IG	**112,835**	**3.0%**
Total HY	(1,293)	-0.3%
Leverage Loans	12,692	13.8%
Money Markets	197,044	3.8%
Equities	129,109	1.0%

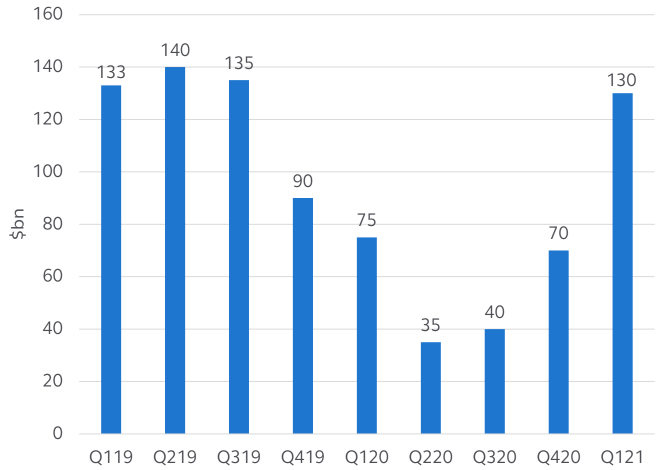
Source: EPFR

Dan Kang, CFA
Portfolio Manager

Outlook

The events of the quarter re-affirmed our view that fundamental outlooks continue to be robust during our investment horizon, but excess returns may be more challenged. An influx of strong economic data requiring a forecast upgrade, an earning season continuing to surprise to the upside and regular fiscal stimulus all support credit fundamentals. However, as confidence in the recovery take hold, we have seen more M&A activity and related financing needs. We would expect this trend to continue as confidence remains high and financing markets are open. Also exhibited in this past quarter, rate volatility can bleed into spread volatility. Therefore, we are still concerned about the market's reaction to the expected withdrawal of Fed support in both tapering and rate hikes. We believe the Fed wants to establish an extremely gradual glide path in reduction of monetary accommodation, but the actual data might disrupt those plans. Finally, despite the recent volatility, corporate spreads are still at or near historical tights. Therefore, a fair amount of the positive news is already incorporated into current valuations.

Increasing M&A Supply



Source: Deutsche Bank

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.

Please see Disclosures for important information.

Highlights

The Bloomberg Barclay's U.S. agency MBS Index posted total and excess returns of -1.10% and 0.15%, respectively, for the quarter. Fifteen-year MBS outperformed 30-years on a total return basis as longer maturity Treasury yields rose sharply and the yield curve steepened by 80 bps. The selloff in rates has been more orderly than the 2013 taper tantrum, with volatility tempered by dovish Fed forward guidance. This coupled with a firm technical backdrop supported MBS performance, while vaccine rollouts and additional fiscal support measures kept the economic recovery on track and supported risk assets overall.

The Federal Reserve revised their economic projections markedly at their March 17th meeting. The committee projected sharply higher GDP growth (6.5%) and lower unemployment (4.5%) for 2021 but expected only modestly higher inflation (2.2%). Consequently, the median dot was unchanged and continued to indicate no rate hikes through 2023. Regarding tapering Chair Powell stated that the economy is a long way from their employment and inflation goals and "substantial further progress" is needed. Until those criteria have been met, they intend to continue MBS purchases at a pace of $40B/month.

MBS supply-demand technicals were exceptionally strong during the quarter. While gross and net MBS issuance surged to $978B and $185B (compared to $475B and $56B in the year-ago quarter), this was easily absorbed by demand from the Fed and domestic banks. Fed MBS purchases (net of paydowns) totaled $134B while domestic banks added an estimated $150B, easily eclipsing net supply and providing a strong tailwind for performance.

After lagging the moves higher in Treasury rates through much of 2020 mortgage rates finally began to rise meaningfully, increasing by over 50 bps from an all-time low of 2.65% in early January to close the quarter at 3.17%. This reduced the refinanceable universe of MBS from around 75% to under 60% and provided a more positive prepayment outlook for the coming months.

Outlook

The combination of vaccine rollouts, fiscal stimulus measures and extremely dovish global central banks is providing a supportive backdrop to the economic recovery. While this is generally positive for risk assets, it is expected to be less favorable for MBS as it will likely culminate in a taper announcement later this year. This would reduce the primary source of MBS demand that has supported rich valuations and absorbed the most negatively convex new issue supply. We expect the Fed to remain conservative in assessing their "substantial further progress" metric and don't anticipate a taper announcement until the third or fourth quarter of this year, with actual asset purchase reductions beginning in Q1'22 and likely declining at a very gradual pace ($5B/month). Until this time the near-term technicals for the sector remain powerful as supply and prepayment pressures are being tempered by rising rates, while Fed demand continues to absorb the bulk of net supply.

We expect that any Treasury rates selloff or basis widening this cycle will be more orderly than the 2013-14 taper tantrum, which the Fed is keen on avoiding. However, we see the risk that they could potentially shift QE purchases away from MBS towards Treasuries if supply-demand imbalances become problematic. This "technical taper" could result in a more disruptive basis widening, with Fed-targeted production coupons bearing the brunt of selling pressure. We believe near-term carry will remain positive and still find pockets of opportunity in non-Fed sectors but are more cautious on the longer-term outlook for the basis.

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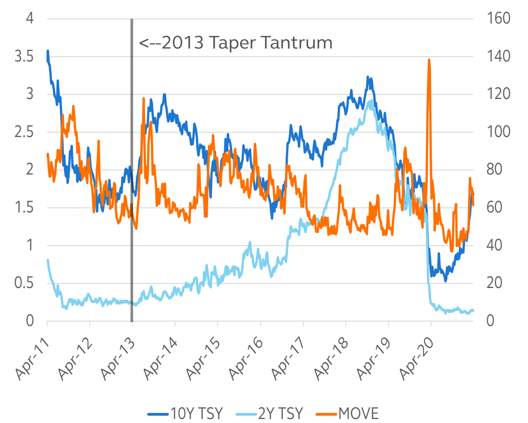
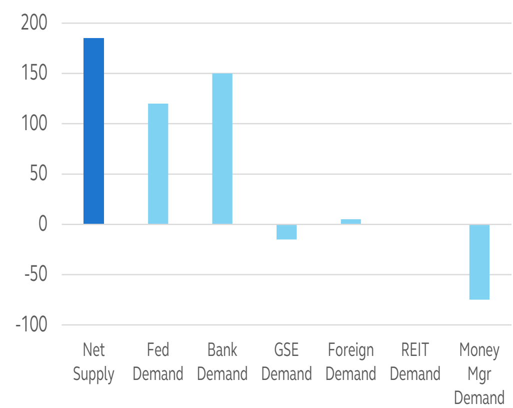
Rates Volatility



Source: Bloomberg

Supply-Demand Technicals



Source: Nomura

Perpetua Phillips
Portfolio Manager

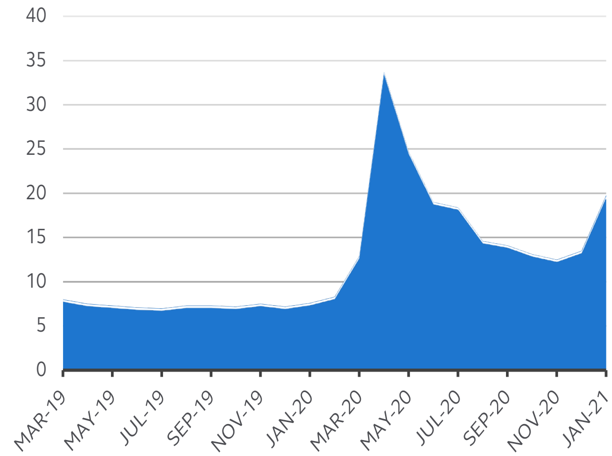
Morley Capital Management

Highlights

The Bloomberg Barclays AAA Asset Backed Securities (ABS) Index posted total and excess returns of -0.25% and 0.08%, respectively. The Bloomberg Barclays U.S. Aggregate Index, a proxy for the overall fixed income market, had an excess return of 0.35% for the quarter when compared to similar duration U.S. Treasury securities. The Bloomberg Barclays AAA Asset Backed Securities Index outperformed similar duration U.S. Treasury securities but underperformed the Bloomberg Barclays U.S. Aggregate Index with an excess return of 0.08%. Spread movements in the ABS market were mixed with senior tranches of three-year credit card ABS moving 1 bp tighter but senior tranches of three-year prime auto loan and equipment ABS moving 5 bp wider.

On March 11, 2021 President Biden signed into law a $1.9 trillion economic stimulus bill (the American Rescue Plan Act of 2021). Key elements of the law were: extending the duration of expanded unemployment benefits with a $300 weekly supplement through Labor Day and $1,400 direct payments to individuals. A large percentage of stimulus checks have been saved and the consumer is positioned to drive growth as more people are vaccinated and unemployment levels normalize. The U.S. unemployment rate improved to 6.0% in March and will likely continue to steadily improve as the economy gains momentum. However, there are still approximately 9.5 million fewer people employed as compared to prior to the start of the pandemic. And, with participation rates and employment to population percentages still significantly lower, the labor market has a long road to full recovery.

Savings Rate % of Disposable Income



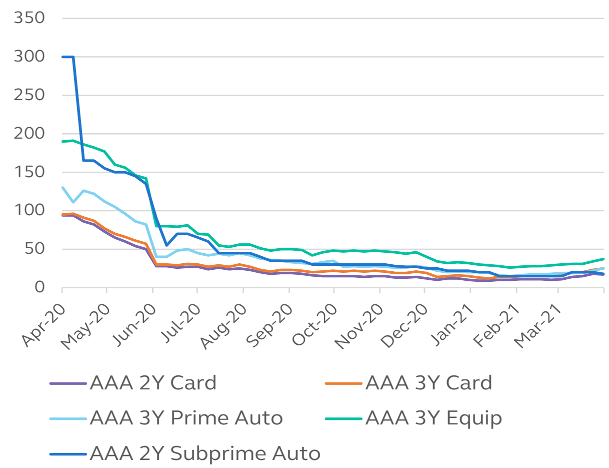
Source: Bureau of Economic Analysis

Perpetua Phillips
Portfolio Manager

Outlook

Vaccinations are moving the world toward normalcy and global central bank accommodation continues to spur risk-taking. Economic data shows a strong recovery is underway. ABS fundamentals are supported by continued fiscal stimulus measures and strong consumer balance sheets. Consumer balance sheets are extremely healthy with debt service ratios near 40-year lows. A high savings rate suggests that consumer spending may further improve throughout 2021 due to pent-up demand. Delinquency rates remain at very low levels and investor demand for ABS remains robust. Year-to-date ABS supply stands at $60 bn, which is higher than the $47bn at the same point last year, but on-pace with YTD issuance during pre-COVID years. Valuations appear attractive when compared to U.S. Treasuries and other short duration alternatives.

AAA ABS Index Option Adjusted Spreads



Source: JP Morgan

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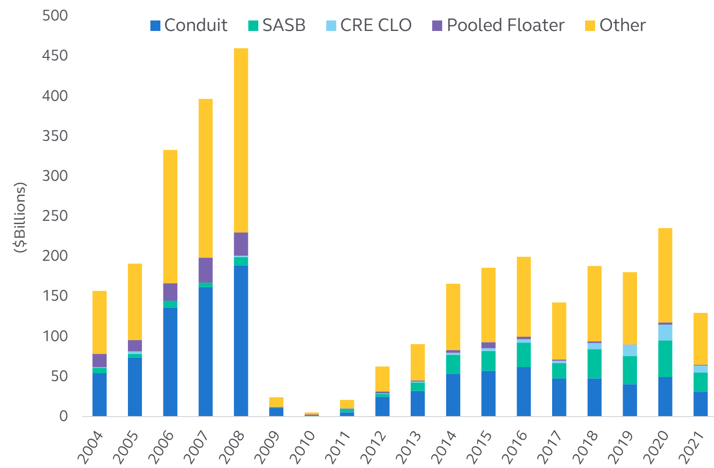
Highlights

The Bloomberg Barclays AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of -2.51% and 0.27%, respectively, for the quarter. CMBS market fundamentals continued to recover from the initial deterioration 12-months ago as the pace of new delinquencies has slowed, and more loans are being resolved either through forbearance or loan modifications which are resulting in more positive outcomes than expected. Improving economic activity, recovering real estate fundamentals and favorable supply and demand in the CMBS market along with performance of risk assets generally were constructive for CMBS spreads helped keep spreads firm to slightly wider during the quarter. The movement in Treasury rates, with the 10-year ending the quarter 83 bps higher, put some pressure on risk assets and impacted fund flows with money moving out of fixed income during the sell-off in Treasuries. Spreads on short duration AAA CMBS were 1-3 bps tighter and long duration AAA bonds were 3-5bps wider.

New issue activity remained light as issuers looked to shore up pipelines as CMBS spreads have more than fully recovered from the COVID induced wides from a year ago. Private label conduit issuance during the first quarter was $5.94B compared to nearly $11.6B during the first quarter of 2020. Demand remained strong for the limited issuance which kept spreads in a relatively tight range even with the headwinds of higher rates and negative fund flows during the quarter.

Full Year Issuance



Source: JP Morgan

Mark Kummerer, CFA
Portfolio Manager

Outlook

The outlook for CMBS fundamentals 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. The rollout of the vaccine during the first quarter has improved that outlook. Inflation expectations and the impact on ten-year Treasuries has gotten the market's attention but the Fed is expected to keep the long end from gapping out as it manages the short end. While multifamily and industrial properties have performed solidly throughout the Covid-19 crisis, 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 provide protection from a credit perspective.

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Morley
Capital Management

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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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