1Q 2021 Market Outlook – Fed and Markets Expect Modest Increase in Inflation

- Emerging signs of economic recovery, an expanding vaccine rollout, and new fiscal stimulus drove U.S. Treasury yields sharply higher in a move reminiscent of the "taper tantrum" of 2013. The 10-Year rose as high as 1.7%, in a return to January 2020 levels. With the front end of the curve anchored by the Fed, the U.S. yield curve between the 2-Year and 10-Year hit the steepest level since 2015, generating losses across fixed income assets.

- While Fed officials have attributed the rise in yields to optimism about growth and thus did not take additional policy action, market concerns about inflation are also a contributing factor to higher long-end rates. Inflation expectations have risen since the start of the year, with the market's main measure, the 5-year forward rate of the 5-year breakeven inflation rate, rising to 2.2%, up over 112 bps from the lows of March 2020.

- Divergent views about growth and inflation have put the market and Fed at odds about the path of monetary policy. The Fed tried to quell concerns, noting that they expected a temporary jump in core PCE to 2.4% in 2021 before declining to 2.1% in 2023, with rate hikes unlikely before 2024. However, market pricing of expected rate hikes reflects a potentially overheating economy and pulls forward the first hike into 2022, with three additional hikes by the end of 2023.

- Rapidly rising rates drove bouts of market volatility, with risk-assets retreating at various points this quarter. However, signs of excesses remain abundant as policy support continues to bolster the markets with equity markets hitting new highs, SPACs taking over the IPO market, retail equity trading surging, and credit market spreads historically tight, despite maintaining extreme levels of leverage and record low yield compensation.

Our View: As the market prices in higher growth and inflation, longer-term rates are expected to move modestly higher. Even so, we do not expect rampant inflation as deflationary pressures are still at play and inflation risk is generally low for the near-term, limiting a potential upward move in rates. Nevertheless, there is a growing risk that massive stimulus in the face of a recovering economy accelerates growth and inflation more quickly than expected, forcing the Fed to react sooner than currently anticipated.

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1Q 2021 Economic Outlook – Recovery Gaining Some Momentum

- The economic outlook brightened as the recovery from the pandemic accelerated with vaccine availability increasing and cases declining. Further adding fuel to the fire, Congress approved a $1.9 trillion stimulus package, providing additional support to households, companies, and state and local governments. Improvements in the outlook were captured by the Fed's median estimates for 2021 real GDP growth, which were revised upward to 6.5% from 4.2%.

- Despite a more supportive economic backdrop, the employment picture is much more challenging than the 6.5% unemployment rate alone suggests. The economy is still over 8 million jobs below its pre-pandemic level, the labor force participation rate at 61% (down significantly from 63% at the end of 2020) has seen a substantial rise for months, and broader measures of unemployment highlight myriad stresses.

- Other economic data painted a mixed picture, as the combination of remaining pandemic restrictions and severe weather weighed on activity. Producers faced headwinds from rising costs, labor disruptions, and increased shipping rates and overall services activity declined to a nine-month low. Meanwhile, manufacturing activity expanded in February at the fastest pace in three years, with the ISM manufacturing index hitting 60.8.

- Though consumer spending has seen a recovery, retail sales have been volatile. February's tally fell short of consensus expectations, with the headline print down 3%, the largest decline since April 2020. On the other hand, January's headline reading was revised upward to 7.6% from 5.3%. Looking forward, a further boost to aggregate spending data is expected due to the recent stimulus, which has disbursed over $325 billion in March.

Our view: The stage looks set for strong growth this year, though that depends critically on aggressive stimulus, expanding vaccine distribution, and declining COVID-19 cases. Despite that growth, the economy has undergone a fundamental transformation due to the pandemic and associated shutdown. While we are seeing the positive side of the emergence from that shutdown now, we have yet to really see the negative side of the shutdown given the massive influx of support from the Fed and the Treasury. Once that support subsides, solvency problems that have been masked by stimulus payments will begin to appear.

1Q 2021 Global Outlook: Stimulus Makes the World Go Round

- The recovery in global growth continued this quarter, bolstered by U.S. fiscal support and sizable global monetary policy accommodation. At the current pace, global growth is forecast to reach nearly 6.5% this year and 4.7% in 2022, though further progress on advancing the vaccine will be key to realizing this outlook. With COVID-19 cases rising in Europe and Latin America, fears of a third wave should not be fully discounted.

- Global manufacturing activity accelerated, as evidenced by the rise in the manufacturing PMI to 55.0 in February from 54.2 in January. Improvements reflected a broad-based recovery across countries supporting global trade volumes, which have steadily improved. At the same time, pandemic-related challenges continue to disrupt supply chains, leading to inventory shortages, and higher prices.

- China's economic recovery continues to provide a boost to global growth, as the country largely exceeded its pre-pandemic growth levels at the end of last year. As a result, Chinese authorities have begun to withdraw COVID-19 related stimulus by cutting the fiscal spending target by 0.4% this year, reducing the quota for local government special bonds, and utilizing open-market operations to drain liquidity from the banking sector.

- In contrast, Europe is still seeing an uneven recovery, as manufacturing has rebounded yet services sectors are recovering much more slowly, weighed down by COVID-19 lockdowns. Rising COVID-19 cases in Germany, France, and Italy also raise considerable concerns about additional economic gains, especially given the delayed roll-out of vaccines. Against this backdrop, the ECB in March said it would accelerate bond purchases under its pandemic emergency purchase program.

Our View: Growth in the U.S. and China will help propel the global economy this year, though there is substantial uncertainty around the outlook. On the one hand, vaccination deployment is uneven and rising cases heighten the risk of a third wave in certain regions. On the other hand, an unexpected surge in growth due to significant policy stimulus comes with the potential for higher rates, which could derail the recovery. Investors will be caught in a tug-of-war for the foreseeable future and should be positioned with ample levels of liquidity to respond to rapidly changing market valuations.

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1Q 2021 Corporate Outlook: Can Credit Resilience Continue in the Face of Higher Rates?

- The U.S. Treasury sell-off spilled into corporate bonds, causing credit yields to rise, driving borrowing costs higher. The average yield across investment grade corporates hit 2.3%, up 50 bps so far this year (coming off all-time lows at year-end) though remaining quite low by historical standards. The rise in yields, which corresponds to a fall in prices, produced negative total returns of nearly 5%, the worst first quarter performance since 1980.

- Despite negative returns, fund flows and gross issuance are on track to exceed last year's record. Demand for yield and the concern that the pace of issuance will slow later this year, has given a technical boost to the sector. Gross investment grade supply volume hit a record high in February and totals $466 billion so far this year, an 11% increase over 2020. Demand kept pace, with over $50 billion flowing into investment grade credit so far this year.

- At the same time, issuers have capitalized on record low funding costs to term out debt, extending the duration of the Bloomberg Barclays Investment Grade Credit Index to record levels. At over 8.5 years, the duration significantly exceeds the 6.4-year average of the past several decades. With low yields and spread levels of 91 bps over duration-equivalent Treasuries, investors have little cushion to withstand even a modest increase in rates or spreads.

- High yield bonds managed to deliver slight positive total returns during the quarter, despite the headwinds from higher interest rates. Investor demand outweighed any fundamental concerns, as lower-rated CCC credits handily outpaced BB- and B-rated issues. In addition, only *seven* bonds in the high yield universe trade below $50. With discounts evaporating from the marketplace, prices do not reflect potential risks and prospective returns are vulnerable to adverse shocks.

Our view: The global economy has bounced back quickly due to unprecedented monetary and fiscal stimulus. The outlook for vaccine development and distribution is also positive, which should continue to support consumer and business sentiment in the short-term. However, the pandemic has led to a significant deterioration of public and private sector balance sheets, which should warrant caution among investors.

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1Q 2021 Securitized Outlook: Pockets of Risk and Opportunities

- The repercussions of COVID-19 still weigh on underlying commercial properties backing conduit CMBS deals. While the number of CMBS loans that are 60+ days delinquent or are in special servicing have declined, these aggregate figures mask stresses in hotel and retail, sectors which still account for 85% of all loans in forbearance.

- Hotel and retail properties have seen the largest appraisal reductions of any sector, with reductions in the range of 28% to 41% since March 2020. CMBS loans are re-appraised when certain events occur, such as a missed coupon payment or prolonged time in special servicing. The appraisal reduction amount represents the portion of the loan that will likely realize a loss.

- Substantial policy support has kept the consumer afloat, translating to improving delinquencies and loss rates in many parts of the consumer ABS market. Sub-prime auto ABS delinquencies fell to 3.7% in March from nearly 6% in Jan 2020, bolstered by this trend along with the rapid increase in used car prices, which also provided sizable support to the market.

- Agency MBS struggled this quarter as yield spreads widened sharply alongside the Treasury rate sell-off. The concurrent upswing in mortgage rates and extension in mortgage duration also contributed to the underperformance of the longer duration, lower coupon cohort vs higher coupon securities. While realizing 1.1% in losses this quarter, agency MBS managed to slightly outperform duration-matched Treasuries by 15 bps.

Our view: Despite recent weakness, the Fed's sizable purchases provide a significant tailwind to agency MBS, supporting our conviction for current coupon TBAs. The legacy non-agency MBS market is also attractive from a collateral perspective with the added benefit of having largely floating rate coupons if rates continue to rise. Growing stresses in CMBS have not yet translated into significant purchases, though we expect numerous opportunities in the quarters ahead while minimal yield compensation across most ABS sectors is not sufficient given potential risks once policy stimulus fades.

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1Q 2021 – Core and Core Plus Fixed Income Positioning Summary

Given historically tight spreads and abundant risks, portfolios have returned to a more defensive position, with ample levels of liquidity to respond to potential volatility.

Characteristic	Positioning	Comments
Duration	Ended the quarter modestly short versus the benchmark	Remain shorter than the index with yields still historically low, with a propensity to add duration faster on a rate backup than to reduce it on a fall in rates
Curve	Underweight intermediate and longer maturities	The curve is likely to steepen as the Fed anchors short-intermediate rates, while longer rates drift higher on increased Treasury funding needs and potential longer term inflation risks
Governments	Neutral, with an emphasis on on-the-run securities	• On-the-run Treasury securities provide much greater liquidity • No exposure in TIPS given relatively wide and unattractive breakeven inflation rates
MBS	• Agency MBS – overweight • Non-Agency MBS – maintain allocation, with bias to add on pricing dislocations	• Preference for current coupon agency MBS TBAs which remain attractive given relatively high carry of TBAs versus specified pools • Maintain emphasis on higher quality, shorter duration, currently amortizing non-agency MBS bonds • Look to add exposure in heavily discounted senior legacy non-agency MBS bonds with solid fundamentals
ABS	Small Overweight	• Prefer AAA CLOs given better liquidity, robust structures and reasonable spreads • Maintain modest position in select FFELP student loan ABS
CMBS	Neutral	• Emphasis on non-agency CMBS holdings, in particular super senior single asset single borrower deals, but beginning to look down the capital structure for opportunities
Credit	Underweight	• Remain underweight given very low yield premiums • Positioning remains concentrated in high conviction names and defensive sectors like communications and non-cyclicals, particularly healthcare, and food & beverage • Avoid cyclical credit sectors and non-corporate credit
High Yield	Small allocation, with a bias to add selectively	• Anticipate further opportunities to add more substantially to high yield exposures if and when volatility picks up • Emphasize defensive credits and select, high conviction idiosyncratic issuers
International	Small allocation, with a bias to add high quality names on weakness	Like high yield, expectations are for an uneven pandemic recovery to create more attractive entry points in the future for higher quality issuers

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