3Q 2021: Economic Data Sending Mixed Signals

- Pandemic related distortions are causing economic indicators to paint very different pictures of the health of the US economy making it difficult to determine exactly where in the business cycle we are.

- On the positive side, GDP growth has been north of 6% for 2 consecutive quarters and expectations are for a similar jump in the 3rd quarter, implying we are early in the cycle and experiencing a robust recovery, though some data series show a recent softening of the positive trends as stimulus wane.

- The overall unemployment rate is 5.2%, well above the 3.5% level seen pre-COVID, while the labor force participation rate, at 61.7%, is a full 1.5 percentage points lower than the peak levels seen early in 2020, both suggesting ample slack in the labor force to meet the growing demand for workers.

- Despite those positives, classic end of cycle indicators are also flashing red with core CPI consistently above 4% and headline CPI well above 5% throughout the 3rd quarter.

- Supply chain issues are well documented, with global factory shutdowns, backlogged ports, and parts scarcity driving prices higher, though there are expectations that these challenges will remediate as global economies emerge from COVID disruptions and the impact of more widespread vaccine distribution is felt.

- A closer look at the labor market reveals a different picture, with many more job openings available than is typical at the same level of overall unemployment (the Beveridge Curve), pointing to an environment in which many people are unwilling or unable to go back to work likely due to a variety of factors including child care responsibilities, health fears, or favorable unemployment benefits. While some of those limitations are expected to fade over time, there is a risk that the labor force of today is fundamentally different than the labor force of even two years ago, potentially suggesting that the labor market is much tighter than current unemployment statistics indicate.

Our View: The most likely outcome is that, as the Fed predicts, the temporary factors pushing inflation higher dissipate and inflation returns to a more benign level of 2-3% over time. However, there is a growing risk that "temporary" inflation gets ingrained in behaviors and expectations, and what started as temporary can quickly become permanent. Wages are one of the key factors we will be watching to determine the future path of inflation, and given the Beveridge Curve data (high levels of both unemployment and job openings), it is certainly possible that we see wage inflation at much higher levels of unemployment than we have in the past.

3Q 2021: Policy Response Shifting From Early to Mid Cycle

- While monetary policy remains highly accommodative today, the Fed is broadly expected to announce a tapering of asset purchases later this quarter, with the actual implementation scheduled to start potentially in December or January, with new purchases ended around the middle of next year. That schedule then sets the stage for interest rate hikes late in 2022 or early in 2023, with current expectations for three hikes by the end of 2023 and two more in 2024.

- As the Fed begins to unwind monetary policy accommodation, the fiscal side is also likely to see a drop in stimulus efforts. Though Congress is currently debating an additional sizable infrastructure package, passage of the legislation is uncertain, and it may end up being significantly smaller than indicated. Regardless, peak fiscal stimulus is behind us, adding another drag on growth.

- Further clouding the future is a regime of generally greater regulation and higher taxes, which will also tend to slow growth.

- The Fed will have to manage the disparate effects of all of those factors as they attempt to guide the economy to a low inflation, positive growth outcome. That becomes increasingly challenging with so many forces in motion at the same time, requiring the Fed to "thread the needle" and avoid removing accommodation too slowly and risking elevated inflation, or removing it too quickly and causing a double dip recession, exacerbated by the massive debt overhang that currently exists.

Our View: The Fed has a very difficult job in front of them as they try to manage the simultaneous withdrawal of fiscal and monetary stimulus. While the timeline described above is reasonable, assuming everything plays out as forecasted, there are many unknowns between now and 2023, and the Fed will be quick to adjust course as necessary. Our expectation is that the Fed (even with a potential new chairman) will continue to lean in a dovish direction, as high inflation, while painful, is a problem with known solutions, while deflation is an outcome with far greater uncertainty. All of this suggests to us an environment where the extreme outcomes become more likely and the potential for volatility goes up.

3Q 2021: Corporate and Consumer Indicators Also Mixed

- Corporations have been resilient through the pandemic recovery with S&P500 companies showing EBITDA growth of almost 30% year to date, and free cash flow growth of 12.4% over the same period. Similarly, EBITDA margins have improved from less than 17% to over 20%, as companies have been able to wring costs out of operations.

- However, there are anecdotal signs of stress on the horizon, potentially foreshadowed by FedEx's weaker than expected results, citing increasing costs for labor, with total operating expenses up by 28%.

- Corporate balance sheets also are more typical of late cycle levels, with high yield leverage at all-time highs, while leverage in the investment grade sector is still significantly elevated, though off the historic highs seen in mid-2020 as companies issued massive amounts of debt to shore up liquidity profiles in an era of profound uncertainty.

- Consumers, too, are flush with cash, beneficiaries of generous transfer payments from the federal government efforts to forestall the effects of the pandemic lockdowns. As a result, markets have seen auto loan delinquency and loss rates drop dramatically, with similar outcomes in credit cards, mortgage loans, and other consumer lending categories.

Our View: It is difficult to disentangle the effect of fiscal stimulus in particular from the strong results we have seen and to predict the outcome of potentially rising costs on corporate earnings. Ultimately, the disparate indicators will need to be reconciled, and while it is hard to know exactly how that reconciliation will happen, it seems likely to us that it won't be a perfectly smooth process, suggesting that volatility will be a characteristic of markets going forward.

3Q 2021: Financial Markets Pegged at the Limit

- While corporate fundamentals are a mixed bag, corporate bond prices point clearly at "late cycle." With corporate yield spreads narrower than they were in 2007 on a nominal basis, and arguably skinnier than they were at their lowest level in 1997 on a risk adjusted basis, the corporate bond market is indisputably expensive across virtually every sector.

- Equities are similarly expensive, with the S&P500 and NASDAQ indexes almost doubling since the lows in March of 2020. At the same time, the price to earnings ratio of the S&P500 index is at 21.3, somewhat lower than the peaks seen earlier this year, but still at levels not seen since the dotcom era of the early 2000s.

- The meteoric rise of other speculative investments like NFTs (non-fungible tokens), meme stocks, and cryptocurrencies like Bitcoin suggest an abundance of optimism and a lack of discipline on the part of many market participants, all hallmarks of a market cycle in its very late stages.

Our View: Market pricing appears to afford no margin for error, despite the potential for meaningful volatility due to a mistake by the Fed, higher inflation, slowing growth, the effects of elevated leverage, a change in the course of the COVID virus, or myriad other factors. Financial markets across the board are priced for perfection and as value driven fixed income investors, we are generally going to be underweight perfection, and would suggest that caution in these times is warranted.

3Q 2021: Corporate Review and Outlook

- Despite abundant supply in the 3rd quarter, spreads remained tight over the quarter with very little movement during the period. Relentless technical support propped up the market despite negative headlines and higher rates as the investment grade corporate market remains one of the few places in the world where investors can earn a positive yield from a reasonably high quality asset.

- With the constant demand for corporate credit, new issue concessions have generally been small and pricing of new issues typically ends up significantly tighter than initially proposed. In this environment, liquidity has been very good, and while it can be challenging to source bonds to buy, anyone looking to sell is generally able to execute at attractive levels.

- High yield spreads are similarly tight, ending the quarter at 281 basis points over comparable Treasuries, despite the fact that loss rates for defaulted bonds remains high at over 70%.

- Like investment grade, the new issue market remains wide open for below investment grade issuers, and marginal high yield borrowers have taken advantage. The percentage of issuers rated CCC surged to a high near 70% early in 2021 and remains elevated as underwriting continues to be aggressive and investors show little discipline.

Our View: Corporate credit across the ratings spectrum provides scant compensation for taking what amounts to a sizable amount of credit risk. Further, with all-in yields less than 4% for high yield and only about 2% for investment grade, the potential for income is modest and the cost to being underweight is low. Given that, although there are pockets of reasonable relative value available, investors should be defensive overall.

3Q 2021: Securitized Review and Outlook

- Like corporate credit, securitized sectors are generally trading tight relative to history, however, fundamentals are also better, making the valuations more balanced.

- Agency mortgage TBAs in particular continue to benefit from significant purchases by the Fed, as evidenced by their ongoing "specialness", which represents the additional yield an investor receives by holding TBAs versus specific mortgage pools. Even as the Fed starts to reduce purchases next year, history suggests that the specialness will persist (at a somewhat lower level) for at least as long as the Fed continues to reinvest paydowns from their existing holdings.

- Rapidly rising home prices have also been beneficial to non-agency mortgages, with the median LTV of legacy i.e. pre-GFC non-agency loans down to less than 50%. With LTVs that low, default risks are lower and the potential for a loss even in the event of default are dramatically reduced.

- Underwriting standards in the mortgage origination arena have also stayed robust. The recent rise in home prices hasn't been driven by the easy availability of specialty loans with cheap teaser rates, negative amortization terms, 105% LTV loans and the like. Rather it has been driven by increasing demand due to the pandemic and the desire for space and a chronic underbuilding of homes over the last decade, leading to a structural shortage.

Our View: Given the better underwriting and strong underlying fundamentals, securitized products represent better relative value than corporate credit. While caution is still warranted given the potential for volatility, the variety of structures and collateral profiles create specific opportunities that allow a skilled investor to pick up additional yield by moving down the capital structure in select issues. We will continue to look to take advantage of those opportunities being mindful of the give up in liquidity and the need to be well protected through difficult periods.

3Q 2021: Global Review and Outlook

- News out of China dominated the quarter with the pending collapse of property developer Evergrande, perceived as a possible Lehman Brothers moment for the Chinese markets. Rhetoric out of government officials suggest they will take steps to limit the losses to consumer property holders, but investors, especially those offshore, aren't likely to fare as well.

- Additional emphasis on the common prosperity theme combined with recent pressure on technology billionaires and their companies along with curbs on manufacturing to limit negative environmental impacts has reinforced the idea that China is no longer pursuing growth at all costs, but rather is looking to reestablish the pre-eminence of the state with lower growth and a more evenly distributed economic outcome for its citizens.

- Elsewhere around the world, central banks have already begun the tightening process as individual countries look to control rising inflation. Markets have already priced in roughly 3 hikes by the Bank of England by the end of next year, while the central banks of Norway and the Czech Republic raised rates in September, representing the beginnings of the next global tightening cycle.

- While higher rates threaten growth down the road, rampant gas and power prices in Europe create more immediate concerns for policymakers. Substantially higher prices not only risk choking off the nascent recovery in Europe by limiting production capacity, but also creating inflationary pressures that magnify the supply chain driven stresses that already exist.

Our View: Structurally slower growth from China and Europe largely offsets the positive impact of re-opening their economies and creates additional complexity for the Fed and other global central banks as they try to navigate the turbulent waters between inflation and growth. However, divergent monetary policy around the world may set the stage for opportunities in foreign exchange markets, even if global rates markets remain predominantly negative.

3Q 2021 Core and Core Plus Fixed Income Positioning Summary

Defensive positioning overall given historically tight spreads and abundant risks, while an ample level of liquidity is maintained to respond to potential volatility.

Characteristic	Positioning	Comments
Duration	Ended the quarter approximately 0.4 years short versus the benchmark	Remain shorter than the Index with yields still relatively low, but added modestly to the duration position late in the 3rd quarter as rates rose.
Curve	Underweight intermediate and longer maturities	The curve is likely to steepen as the Fed anchors short-intermediate rates for the foreseeable future, 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 • Added a small position in long TIPS as breakeven inflation rates narrowed in the quarter
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 and AA rated 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
Investment Grade Credit	Underweight	• Remain underweight given historically low yield premiums • Positioning remains concentrated in high conviction names, intermediate banks, and defensive sectors like communications and non-cyclicals, particularly healthcare • Minimal exposure to cyclical credit sectors and non-corporate credit
High Yield	Small allocation	Emphasize defensive credits and select, high conviction idiosyncratic issuers
International	Small allocation	Potentially rising rates and risks of slowing growth make relative value unattractive in most cases

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