September 30, 2021

PUBLIC FIXED INCOME

Short & Intermediate Duration

Q3 2021 Recap, Portfolio Actions & Outlook

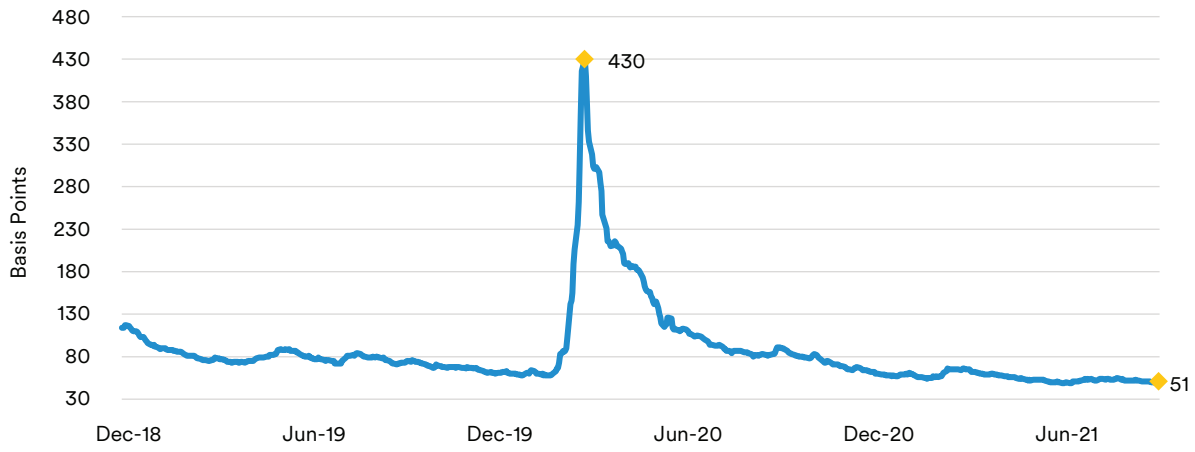
MetLife Investment Management

Investment Grade Credit

Recap: In the third quarter we saw credit spreads remain in a fairly tight range, ending two basis points wider from where they began the quarter and not far above historic lows for the broad credit indices. Despite negative developments with the delta variant, weakness in equities, potential for higher corporate tax rates, growing signs of margin pressures, surprisingly strong new issue activity and the likelihood the Federal Reserve will look to conclude tapering by the middle of next year, the investment grade credit market maintained its resilience as technicals remain strong. By the end of August, the Federal Reserve wrapped up selling all of its remaining bond and ETF holdings in the Secondary Market Corporate Credit Facility, which was introduced at the height of the market meltdown in March 2020, with no discernible impact on spreads. Credit spreads held in well despite the arguably less favorable macro backdrop due to a number of factors in our view. We believe the U.S. market remains a preferred destination for global investors given our market's attractive all-in yield, liquidity and breadth to foster diversification.

ICE BofA Corporate 1-5 Year Index

(as of September 30, 2021)



Source: ICE Data Services

As well, some corporate fundamentals continue to improve as leverage declined from the pandemic-driven peak reached last year coupled with strong top-line and earnings growth helped by easy comparisons vs. stressed 2020 levels. There are however some causes for concern cropping up as supply chain issues and input cost increases have extended well beyond the semiconductor chip shortage that became evident early in the year. Specifically, higher costs in terms of energy, shipping/distribution, raw materials, and labor have all been apparent across much of the business landscape and have seeped into management commentary with the soon-to-begin third-quarter earnings season set to offer more clarity on the degree to which companies have been able to pass along higher costs to customers and how much margins will be affected going forward. Certainly, as far as broad gauges of price pressures at the consumer or producer level are concerned, year-over-year inflation indicators remain elevated and have not yet shown signs of significantly rolling over to follow the transitory inflation narrative espoused by the Federal Reserve and other central banks. Thus, while consumer balance sheets remain in good shape, especially after the huge amount of fiscal stimulus to cushion the impact of the coronavirus, consumer confidence has fallen off its highs in recent months while retail sales have been a bit choppy, perhaps skewed by fears over the spread of the delta variant, which unquestionably weighed on consumer behavior and economic activity over

the back half of the third quarter. Further progress on the vaccination front and anticipated rollout of booster shots in addition to the recent slide in new virus cases should help sustain the unfolding recovery, but it seems like the second half of the year will see a downshift in the pace of economic growth compared to the first half. With many companies as well as their employees adapting to a more hybrid work arrangement and many large corporations' return-to-office plans pushed off until the beginning of next year, we continue to be in an environment subject to distortions as consumer and commuter behaviors differ from pre-pandemic norms. The key service segment of the U.S. economy in particular remains subject to heightened uncertainty as it struggles with labor shortages and uneven demand in certain areas. Overall, the tremendous amount of central bank-supplied liquidity and fiscal pumped into markets has led to distortions with the result being skewed valuations as complacent investors have reached for yield, leaving risks a bit asymmetric.

Portfolio Actions & Outlook: Our bellwether front-end 1-5 year investment grade corporate index closed the third quarter at an option-adjusted spread (OAS) of 51 basis points, 2 basis points above where it ended the second quarter. Although corporate credit fundamentals seem to be moving in the right direction, a number of factors support maintaining a more defensive, up-in-quality bias across strategies. Looking at subsector excess returns (see table below) in the front-end credit space over the third quarter, we also do not see much excess return dispersion across subsectors, which says to us much of the excess return or outperformance in higher-beta or higher spread subsectors has already been squeezed out.

Excess Return 1-5 Year Credit[1]

1-5 Year Credit Sector	QTD Excess Return (in bps)
Banking	11
Financial Services	17
Insurance	20
Capital Goods	11
Basic Industry	12
Healthcare	9
Utility	14
Energy	17
Transportation	22
Total Index Excess Return	12

Source:BofA
[1] As of September30, 2021

Corporate leverage metrics in aggregate, although having declined from recent pandemic-driven highs, remain elevated from a historical standpoint as evidence of margin pressures builds across the business landscape due to some of the aforementioned reasons related to supply constraints and rising input costs. Further, valuations remain a bit stretched given credit spreads are not too far above record tights, leaving diminished room for spread compression. Consequently, we expect to retain a lower risk budget for the investment grade credit sector or spread duration profile until valuations or spreads reset to more attractive levels. In such a scenario, we would expect to alter our risk profile by lifting our sector weighting and/or moving out the maturity or ratings spectrum in terms of our corporate sector holdings.

Drilling into third-quarter trading activity, despite the extremely active corporate new issue calendar, especially in September, we continued to maintain our disciplined and selective approach across strategies, chiefly focusing on higher-quality issuers in our favored, more defensive subsectors like banking, insurance, consumer non-cyclicals, technology and electric utilities. In our shorter strategies' portfolios where we generally held our sector weightings steady during the quarter, highlighted purchases included several callable new issues: a BBB-rated technology company's three-year, fixed-

rate bond to help capitalize its being spun off from its parent and simultaneous parent dividend as well as a health insurance company's two-year, fixed-rate issue. In addition, we bought a life insurer's secured funding agreement-backed three-year, SOFR-linked floating-rate issue and a nearly identical structure from another life insurer/annuity provider making its bond market debut. In term of sales, we sold some short-dated 2021 maturity bonds with a notable trade being the September selling of a communications company's three-year, SOFR-linked floating-rate issue at a very attractive level after the September 2 announcement of a tender and exchange offer and subsequent spread tightening given the security's special appeal to other investors looking to tender and exchange the securities into ten-year instruments.

In our 1-3 year portfolios, we were similarly selective in participating in new issues where we also added the above noted technology company's three-year, fixed-rate callable bond, an insurance company's three-year, secured funding agreement-backed fixed-rate bond, and a Canadian midstream energy pipeline issuer's two-year, fixed-rate bond. For the few portfolios where bank loans are permissible, we also found several opportunities to add exposure in this sector where their attractive yields and anticipated short holding periods justified their slightly less liquid profile. We sold a handful of securities, primarily inside of two years whose spread compression and all-in yields made them attractive sale candidates to redeploy in more desirable securities. Lastly, we also sold some three-year, fixed-rate bonds of the communications company involved with the tender and exchange mentioned previously at a level that was materially better than where they had been trading prior to the announced tender offer.

In our 1-5 year portfolios, it was a similar story in terms of being very discriminating in the face of a surfeit of new issue supply, much of which we deemed less appealing given their spread levels and lack of new issue concessions in many cases. That said, we purchased the BBB-rated technology company's three-year, fixed-rate callable bond, the aforementioned insurance company's three-year, secured funding agreement-backed fixed-rate bond, and the Canadian midstream energy pipeline issuer's two-year, fixed-rate bond. In a number of portfolios, we also purchased an international protein processor's high-coupon, callable five-year crossover security rated BBB- by one rating agency whose improving credit profile should enable the issuer to call the bond early next year. Sales included securities we determined to have reached our spread objectives as well as selected opportunities to reduce our portfolios' spread duration or spread risk where appropriate. We also took advantage of the situation involving the communications company's bond tender and exchange by selling their five-year, fixed-rate bonds at an attractive level.

In terms of what we see lying ahead and where we see value in the investment grade corporate sector, our appetite for credit or desire to change our risk profile is colored by our less favorable view of valuations at current spread levels. We continue to see valuations somewhat disconnected from companies' credit fundamentals, which we acknowledge are much better than last year's pandemic-ruined first half, but the grind tighter in spreads over the first half of 2021 was outstripped by the more positive economic landscape and better operating environment and financial improvement for issuers. Time will tell whether the eventual winding down of the central bank-driven liquidity fest, pumping up markets since last year, will reset valuations in pushing spreads wider or perhaps anticipated rate hikes, which could begin in 2022, will do so. In the meantime, we will remain patient and nimble in maintaining a more defensive orientation, adjusting our credit weighting and seek to

> We continue to see valuations somewhat disconnected from companies' credit fundamentals…

capture well-protected carry or spread above comparable Treasuries to generate returns. We will alter sector exposure to capitalize on temporary spread backups or market mispricings, primarily in our preferred up-in-quality subsectors and issuers within banking, insurance, consumer non-cyclicals, communications, and electric utilities. After the recent move in Treasury yields and yield curve reshaping, we favor building and maintaining more of a barbell posture finding attractive floating-rate securities, most often SOFR-linked instruments in the front end, and generally higher-quality bonds further out the maturity spectrum to serve as the other end of the barbell.

Performance: The investment grade credit sector was a positive contributor to relative performance across all of our strategies in the third quarter. While credit spreads were little changed overall, our overweights in the Banking, Insurance, Wirelines, Automotive, and Technology subsectors were the main drivers of sector positive excess returns as we benefited from security selection and carry or yield as a component of total and relative return.

Treasuries / Agencies

Recap: The third quarter began with a decidedly bullish trend in Treasuries as delta-variant concerns called into question the speed with which the new normal would truly get underway. The reality that return-to-office timelines would be delayed pushed 10-year yields as low as 1.12% by early August, before the market spent the latter part of the quarter in a very definable range and eventually steepening to higher yields. Economically, delta variant concerns translated to a somewhat lackluster pace of hiring in the third quarter while inflation remained in elevated territory, as some, like us, continued to doubt the "transitory" nature of inflation the Federal Reserve wants the markets to believe. At both the July and September FOMC meetings, the Fed effectively laid the groundwork for tapering to likely proceed by year end with Chairman Powell expressing his preference for the process in its entirety to conclude by mid-2022. At Jackson Hole, Chairman Powell made a clear effort to delineate between taper timing and interest rate liftoff, but also noteworthy, the Chairman did not push back against the most recent dot plot showing half the FOMC (9 of 18 members) forecasting a rate liftoff in 2022.

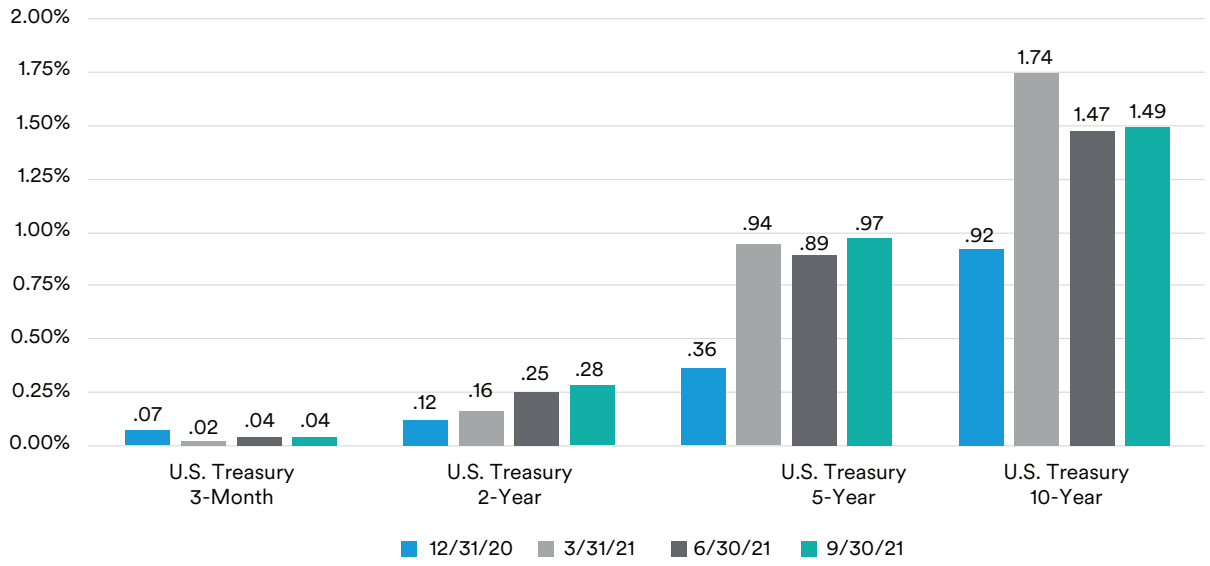
> As some, like us, continued to doubt the "transitory" nature of inflation the Federal Reserve wants the markets to believe.

These mildly hawkish shifts by the FOMC were a bit of a surprise in terms of timing and may have pulled forward investor expectations regarding interest rate increases. In September, Treasury yields across the curve broke out of their ranges and moved higher (five-year as high as 1.04% and ten-year as high as 1.56%). The move higher in rates was driven by a combination of both inflation expectations and real yields moving higher. Five-year inflation breakeven rates spent much of the quarter between 2.40% and 2.60%, ending the quarter closer to the high end of the range while five-year real yields traded as low as -2% in early August before ending the quarter at -1.61%. The yield on the three-month Treasury-bill lost a fraction of a basis point, closing the quarter at 0.03%. The two-year Treasury yield rose 3 basis points to finish the quarter at 0.28% and the five-year Treasury yield increased 8 basis points to end the quarter at 0.97%. The yield on the ten-year Treasury rose only 2 basis points to close the quarter at 1.49%, as the spread between the three-month T-bill/ten-year Treasury note climbed 3 basis points, ending the quarter at a spread of 146 basis points. In the very front end of the curve, the use of the Fed's Reverse Repo facility (RRP)

averaged well above $1 trillion towards the end of the quarter as liquidity remained abundant and money funds searched to find a home for their cash. Net negative Treasury bill issuance continued to put downward pressure on short rates, and with Secretary Yellen saying the Treasury will be out of cash by mid-October, default worries started to distort the Treasury bill curve by late September. Front-end Government-Sponsored Enterprise (GSE) debt spreads moved lower over the quarter as the option-adjusted spread (OAS) of the ICE BofA 1-5 Year U.S. Bullet (fixed maturity) Agency Index ended the third quarter at zero, a basis point tighter from second quarter's sequential close. GSE spreads were well supported by technicals as supply was virtually nonexistent. On the other hand, in the SSA subsector, U.S. dollar-denominated fixed-maturity securities' saw spreads widen a basis point as issuance continued and subsequently finished the quarter, on average, at 17 basis points over comparable-maturity Treasuries.

U.S. Treasury Yields

(as of September 30, 2021)

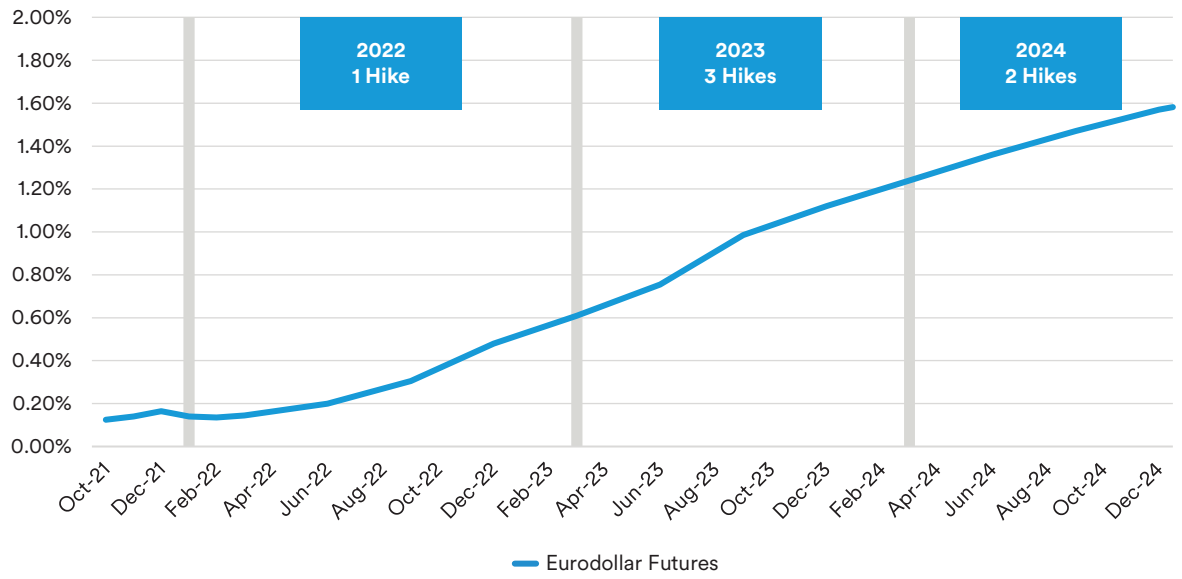


Source: Bloomberg

Portfolio Actions & Outlook: Over the quarter we increased our allocation to nominal U.S. Treasuries while continuing to sell select spread product across various sectors that had, in our opinion, limited upside potential. In addition, to further increasing liquidity, we were able to decrease our spread duration risk profile across strategies prior to the subsequent volatility pickup. We broadly maintained our sector underweights in the Agency sector while letting some strategies naturally lower their weights as some of our short maturity Agency holdings were called.

As we enter the fourth quarter, market expectations are for the Fed to begin to taper its balance sheet Treasury and mortgage purchases by the end of the year. With tapering starting and the possibility of 2022 rate hikes, we believe front end rates will slowly move higher as we get closer to those Fed actions. While we don't expect a significant repricing of yields in the very front end of the Treasury curve in Q4, the bias, given elevated inflation, is towards higher yields. Regarding the TIPS market, any increase in nominal Treasury rates should be largely driven by an increase in real yields with TIPS potentially underperforming nominal Treasuries. With five-year and ten-year real yields still well below pre-pandemic levels, we believe they have room to move higher.

Anticipated Fed Rate Increases
(as of September 30, 2021)



Looking forward, we expect GSE supply to continue to decrease across the board running into year-end as their funding needs continue to remain low with cash and other investments still at historically elevated levels. We expect the backdrop of fixed-maturity bullet issuance to be net negative, although positive net issuance in callables is likely to persist. Although supply dynamics should help support tight spreads, we think there is a risk towards spreads moving wider if Treasury yields rise over the balance of the year given investors are not being adequately compensated for lower Agency liquidity. Given valuations and the current environment, we will remain underweight the Agency sector. Turning to the SSA space, we expect robust issuance to continue as top tier issuers concentrate funding in the 5-year part of the yield curve as historical patterns suggest. Over the remainder of the year, we look for modestly wider SSA spreads on the back of elevated issuance. At current levels, SSA debt continues to offer a positive spread pickup to US Agencies, with valuations still somewhat cheaper relative to recent averages and may present an opportunity in the fourth quarter.

Performance: Our yield curve positioning detracted from performance amongst our strategies due to the steepening of the front-end and our positioning relative to our more bulleted benchmark indices. Our slightly short duration posture more than offset our curve positioning however and was additive to performance across strategies over the quarter as yields continued to rise. The Agency sector was mixed as our shorter strategies saw positive excess returns as spreads tightened across the most Agency sub-subsectors while our longer strategies underperformed as spreads on some of our SSA holdings, further out the yield curve, widened.

ABS

Recap: Spreads on short-tenor ABS tranches moved wider relative to like-duration Treasuries over the course of the third quarter in the face of high new issue supply volumes. Spreads on two-year, fixed-rate AAA-rated credit card, prime auto, and subprime auto tranches moved 2, 6 and 9 basis points wider to end the quarter at 12, 18 and 27 basis points over Treasuries, respectively. Three-year, floating-rate FFELP student loan tranches were unchanged on the quarter at a spread of 37

basis points over LIBOR. In our view, the relative outperformance of FFELP tranches likely reflects investor demand for floating-rate assets in anticipation of rising interest rates. ABS issuance overall was robust with $71 billion of new deals coming to market, the heaviest quarterly volume since the onset of the pandemic. In comparison, the second quarter saw $69 billion of primary issuance and last year's third quarter saw only $60 billion of new issuance. As usual, the auto sector led the way with over $36.7 billion of new deals coming to the market in the third quarter. This was followed by $8.5 billion of issuance in the "other ABS" subsector (which includes collateral like cell phone payment plans, timeshares, mortgage servicer advances, insurance premiums, aircraft leases, etc.) and $7.5 billion of new credit card ABS issuance.

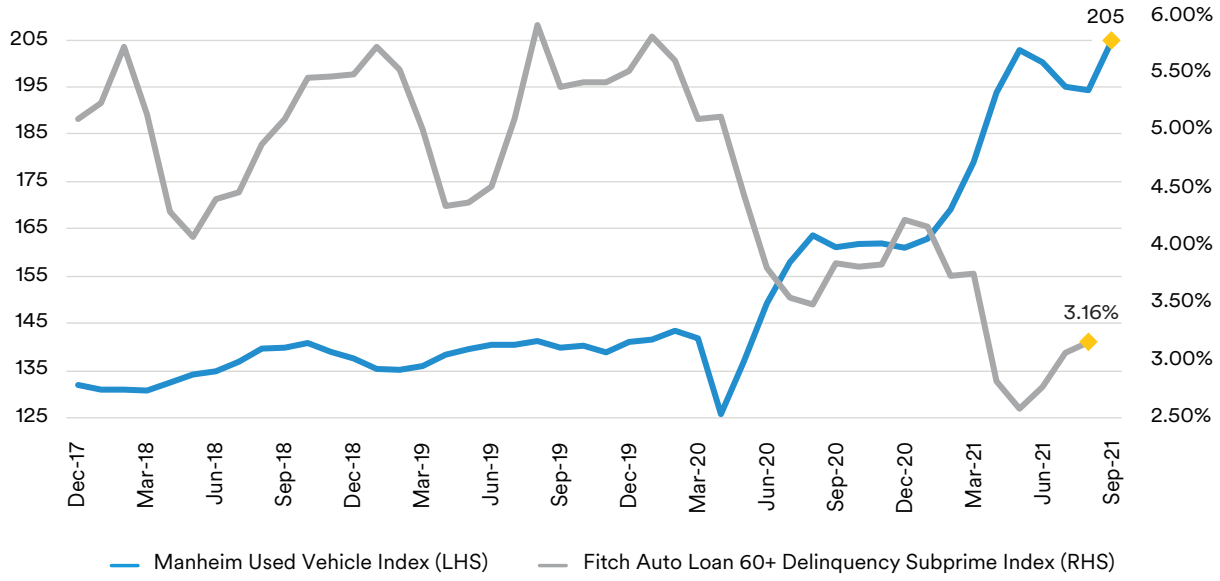
Notably, in credit cards, while the volume of traditional bank credit card ABS outstanding continues to shrink, the sector is seeing the emergence of new sponsors focusing on nonprime credit cards. In contrast to bank cards, which are heavily concentrated in prime and super-prime receivables, these new deals are backed by both private-label retail and general charge cards collateralized with near prime and subprime revolving accounts. At present, this subsector of the credit card ABS market is very small as non-prime ABS issuance totaled $1.8 billion year-to-date, $762 million last year and only $263 million in 2019 compared to the over $58 billion outstanding in traditional credit card ABS. We have avoided investing in these emerging card programs due to concerns about sponsor risk, collateral credit quality and overall liquidity in these new names. However, we are monitoring the subsector and may participate in the future should we find deals that have compelling collateral and structure. Overall, credit card trust performance metrics continue to show strength. Data from the September remittance reporting period and aggregated in the JP Morgan credit card performance indices showed charge-offs and delinquencies on credit card master trusts remain at or below pre-pandemic levels while payment rates and excess spread remain healthy, bolstering ABS trust performance. As we have noted in prior commentaries, we anticipate deterioration in these metrics going forward as pandemic-related government stimulus programs are wound down. However, we do not anticipate any material impact on our AAA-rated credit card tranches due to their levels of credit enhancement.

New vehicle sales numbers continued to slide over the course of the third quarter. Sales numbers printed at 18.5 million SAAR (seasonally-adjusted annualized rate) in April, a 16-year high but have declined every month since then. Sales printed at 14.7 million SAAR in July, 13.1 million in August and 12.2 million in September. We believe that while the consumer is in good financial condition and demand for vehicles remains strong, limited supply is constraining the numbers. The computer chip shortage has been hampering new vehicle production while new purchase customer incentives are non-existent, average selling prices are higher and dealer inventories remain extremely tight. Cox Automotive estimated that September inventories are running at historical lows, with new vehicle supply down about 1.4 million units from the same time in 2020 and more than 2.5 million below 2019's levels. Benefiting from low new vehicle production volumes, used car prices remain elevated with the Manheim Used Vehicle Index reaching an all-time high of 204.8 in September, up 5.3% on the month and 27.1% year-over-year.

With the auto market on firm ground, ABS auto trust performance metrics continue to show strength. As of August's, data, the 60+-day delinquency rates on the Fitch Auto ABS indices were 0.15% for the prime index and 3.16% for the subprime index, numbers which reflect declines of 7 basis points and 33 basis points, respectively, from last year's levels. Similarly, annualized net loss rates for the indices stand at 0.13% for the prime index and 3.05% for the subprime index, 16 basis points, and 45 basis points lower, year-over-year, respectively. We do not expect these kinds of performance numbers to persist and expect to see deterioration in auto credit metrics once government stimulus payments and various borrower forbearance programs are wound down.

We, however, remain confident that our short-tenor auto ABS holdings have ample credit support to weather any deterioration and do not expect any worsening in collateral performance to have a material impact on our holdings.

Manheim Used Vehicle Index & Fitch Auto Loan 60+ Delinquency Subprime Index
(as of September 30, 2021)



Source: Bloomberg

Portfolio Actions and Outlook: Over the course of the third quarter, we modestly reduced our ABS exposure across all strategies. As we sought to remain defensive and reduce portfolio spread duration, we sold several private student loan securitizations and CLO positions. Likewise, we continued to reduce our subprime auto exposure by abstaining from participation in new issue deals and allowed prepayments to reduce the outstanding balances of our portfolio holdings. In notable new issue activity, we purchased the AAA-rated, 1.2-year average life tranche of a new issue consumer loan securitization sponsored by an online persoanl finance company.

> As we seek to reduce overall portfolio spread duration, we are unlikely to materially increase exposure to more spread duration sensitive sectors.

In our view, much like in the second quarter, current spreads on most benchmark short-tenor ABS tranches offer little upside. We expect to maintain our ABS exposure by reinvesting the proceeds of paydowns on our holdings but do not anticipate materially adding to the sector. Also, as we seek to reduce overall portfolio spread duration, we are unlikely to materially increase exposure to more spread duration sensitive sectors like private student loans. We are also comfortable with our current levels of CLO exposure although we may look to add very short tenor tranches opportunistically. Overall, we are content to wait for wider spreads before seeking to broadly increase ABS exposure across the portfolios.

Performance: In the face of softer benchmark spreads, over the quarter our ABS holdings still generated positive performance across all strategies after adjusting for their duration and yield curve exposure. All subsectors were positive, with our fixed-rate student loan and CLO holdings generally the top performers. Our fixed-rate auto positions were modestly positive while our floating-rate auto and student loan holdings were our weakest performers although they were still positive contributors overall.

CMBS

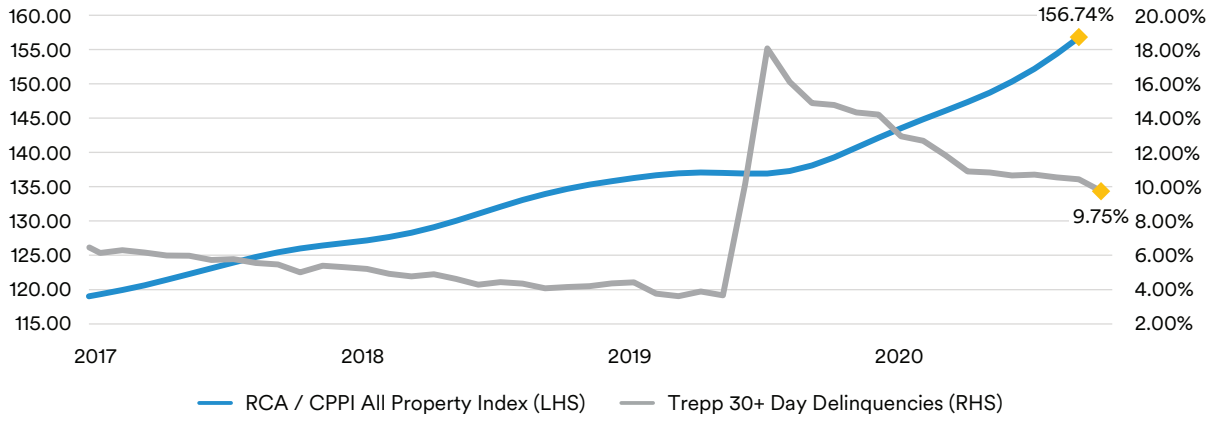
Recap: In comparison with like-duration Treasuries, the third-quarter performance of short-tenor CMBS securities was mixed. At the end of the quarter, spreads on three-year AAA-rated conduit tranches stood at 37 basis points over Treasuries (4 basis points wider) and spreads on five-year AAA-rated conduit tranches stood at 52 basis points over Treasuries (3 basis points wider). However, three-year Freddie Mac "K-bond" agency CMBS tranches moved 4 basis points tighter to end the month at a spread of 25 basis points over comparable Treasuries. We attribute the relative outperformance of three-year agency tranches to strong bank demand for shorter tenor, government-backed instruments. Over the course of the quarter almost $78 billion of new issue CMBS came to the market, well ahead of the $60 billion seen in the third quarter of 2020 when the market was amid the pandemic. The increase was driven primarily by the non-agency sector as agency issuance volumes declined relative to last year. Over the quarter, $36 billion of new non-agency deals priced, compared to only $11.5 billion last year. In contrast, third quarter agency issuance totaled almost $42 billion compared to almost $49 billion in 2020. Within non-agencies, the increase was driven by both the single-asset, single-borrower ("SASB") subsector and the "Other" subsector (a catchall subsector that includes CRE CLOs).

CMBS delinquencies continued to decline over the third quarter, capped by a sharp 39 basis point drop in September to end the quarter 90 basis points lower at 5.25%. Delinquencies have now declined for 15 consecutive months after the onset of the pandemic caused two large increases in May and June 2020 to a peak of 10.32% (just below the all-time high of 10.34% seen in July 2012). Lodging properties saw the largest improvement in delinquencies as increased vaccination rates encouraged the resumption of travel. Lodging delinquencies fell 282 basis points over the quarter to 11.45%. On a year-over-year basis, lodging delinquencies have declined 1,149 basis points. Despite this huge decline, lodging still remains the worst performing CMBS subsector. Retail properties, the second worst performing subsector, saw delinquencies decline by 96 basis points over the quarter and 501 basis points year-over-year, to 9.75%. Industrial properties remain the best performing subsector, with delinquencies dropping 4 basis points over the quarter and 48 basis points, year-over-year, to 0.59%.

Commercial property prices continued to climb higher over the third quarter with the September release of the RCA CPPI National All-Property Composite Index showing prices rose 13.5% year-over-year through August to 156.7. RCA noted that all four major property segments (apartment, office, industrial and retail) posted year-over-year growth rates over 11% with apartment prices rising at a 14.7% year-over-year pace, the fastest rate seen since the Great Financial Crisis. Industrial property prices rose 13.6% year-over-year, the fastest rate seen in that sector since 2006 and the seventh consecutive month of double-digit gains. Even the struggling retail sector saw prices rise 12.1% year-over-year, reflecting six consecutive months of accelerating gains. Office properties saw a 11.2% year-over-year price gains, led by suburban office properties which grew at 14.8% year-over-year, in comparison to Central Business District (CBD) office prices which fell 0.1% over the quarter and are now down 3.7% year-over-year. Prices for CBD office properties started to fall in late 2020. In our view, the work-from-home dynamic will continue to create headwinds for CBD office properties for the foreseeable future. For all property types in urban areas, not just office, growth has been healthy. RCA noted that the 6 Major Metros (Boston, Chicago, Los Angeles, New York, San Francisco and

Washington, D.C.) ended the quarter at a 9.9% year-over-year growth rate, a strong rebound from sub-2% growth rates seen late last year. However, the Non-Major Metros continued to outpace the 6 Major Metros with prices in the Non-Majors rising 13.9% year-over-year.

RCA / CPPI All Property Index & Trepp 30+ Day Delinquencies
(as of September 30, 2021)



Source: RCA CPPI

The current release of the Fed Senior Loan Officer Survey, reflecting sentiment as of July, showed banks having eased standards and terms on C&I loans to firms of all sizes. The Fed noted that banks eased all queried lending terms on loans to large and middle-market firms and eased most lending terms on loans to small firms. Banks have not generally reported easing lending terms since 2015 and, in our view, the survey results are another indication that the reopening of the economy is generating increased demand for commercial real estate loans which should be supportive of the CMBS market.

Portfolio Actions & Outlook: During the quarter we increased exposure to CMBS in our shorter strategies and reduced our exposure in our three-year and longer strategies. In both instances, these changes were implemented via the SASB subsector. In our shorter strategies we added shorter-tenor floating-rate SASB exposure while we reduced longer-tenor exposure in our longer duration strategies. The reduction in floating-rate SASB in the longer portfolios reflected our desire to reduce overall spread duration across the portfolios. We generally maintained our weightings in fixed-rate conduit tranches and agency CMBS. In notable new issue activity, despite our overall wariness around retail properties, we participated in a floating-rate SASB transaction collateralized by a super-regional mall. This transaction was a refinancing of an existing portfolio holding and reflects the type of top-tier collateral we prefer in retail tranches. We purchased the AAA-rated tranche of the deal for our three-year and shorter strategies.

Going forward, we do not anticipate materially increasing CMBS exposure in the portfolios. We will likely look to replace paydowns and maturities on our existing holdings with investments in the fixed-rate conduit subsector. At current spreads we find AAA-rated scheduled balance “ASB” tranches to have good value relative to other short-tenor conduit tranches and agency CMBS. In our view, ASB tranches are defensive and offer generally stable average life profiles across a broad range of collateral prepayment and default scenarios. In some ways, we consider ASB tranches similar to well-structured PAC CMOs in residential MBS. Overall, we continue to avoid most tranches with heavy exposure to retail and lodging properties, a bias we expect to persist for the foreseeable future.

Performance: Despite generally wider benchmark spreads over the quarter, our CMBS holdings added to performance across all strategies after adjusting for duration and yield curve exposure. Our non-agency positions generally outperformed our agency CMBS holdings although both sectors contributed positively over the quarter. Within non-agencies, our floating-rate SASB holdings showed the best returns with our AA-rated holdings outperforming our AAA-rated holdings which is to be expected given their incremental coupon income advantage.

RMBS

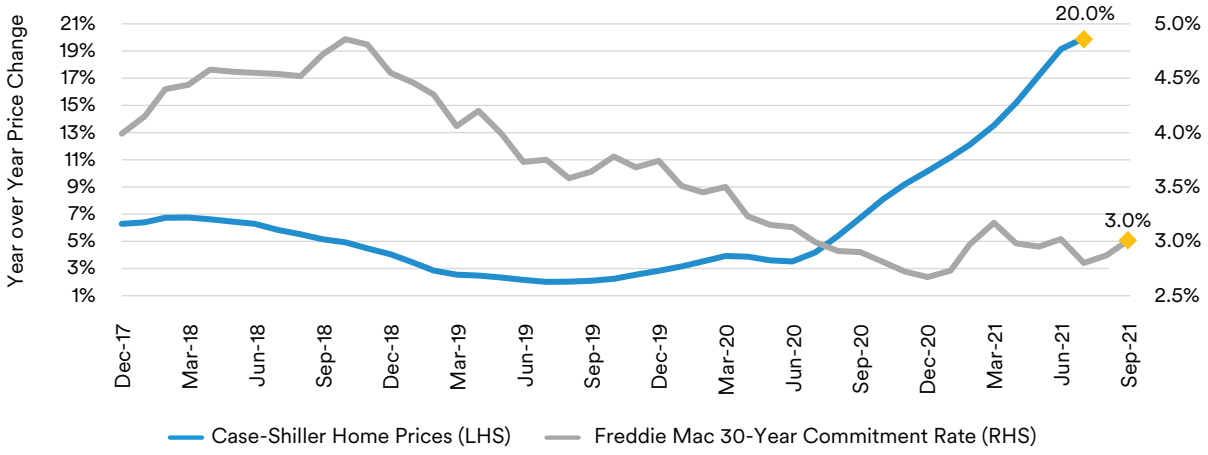
Recap: Residential mortgage-backed securities exhibited mixed performance over the third quarter as the market grappled with rising interest rates, increasing geopolitical tensions with China and the continuing impact of the Delta variant. Short duration generic 15-year collateral ended the quarter at a spread of 31 basis points over five-year Treasuries (3 basis points tighter) while longer duration 30-year collateral ended the quarter at a spread of 48 basis points over ten-year Treasuries (12 basis points wider). We attribute the underperformance of 30-year collateral to a combination of investors' preference to hold shorter duration assets in an environment of rising rates and continuing fears that the commencement of Fed tapering its QE RMBS purchases program will have a more severe impact upon 30-year performance as 30-year collateral comprises the bulk of the Fed's portfolio. Non-agencies were wider in spread with prime, jumbo front cashflow tranches ending September at a spread of 144 basis points over Treasuries (20 basis points wider than levels seen at the end of June).

Mortgage rates drifted slightly higher over the quarter with the Freddie Mac 30-year mortgage commitment rate ending September at 3.01%, 3 basis points higher than their level at the end of June and now up 34 basis points compared to the 2.67% rate quoted at the start of the year. With mortgage rates fairly range-bound over the quarter, prepayment rates have stabilized in the low to mid-20s range for 30-year collateral and high-teen to low-20s CPR range for 15-year collateral. With rates biased to move higher, we expect prepayments to trend toward the lower end of their current range over the next few months. Despite the increasing challenges of affordability, home prices continue to rise with growth rates hitting record levels throughout the quarter. The latest release of the S&P CoreLogic Case-Shiller 20-City Home Price Index showed home prices surged 19.9% in July, the largest year-over-year gain seen in available data going back to 1988. On a national level, Case-Shiller's data showed prices rose 19.7% year-over-year, the largest increase in over 30 years and the 14th consecutive month of accelerating price gains. With inventories limited, mortgage rates still relatively low by historical standards and the pandemic fueling the demand for suburban homes, housing price gains have been very strong. Going forward, we anticipate the affordability challenges of higher prices and rising mortgage rates will constrain further price gains and the pace of growth is likely to moderate. However, with mortgage underwriting standards remaining relatively conservative, we discern no catalyst for large scale housing price declines in the foreseeable future.

Following the declines seen in the first and second quarter, existing home sales numbers rebounded over the third quarter with sales numbers bouncing around a 6 million annualized pace. September's release showed home sales coming in at a 5.88 million annualized pace in August, down from the 6.0 million pace seen in July and roughly flat to June's 5.87 million rate. Inventories stood at 1.3 million homes, down 13.4% from year ago levels. At the current pace, it would take only 2.6 months to clear inventories at the current sales pace, compared with an average of about 4 months' supply before the pandemic. Realtors consider anything below five months of supply as indicative of a tight market. New home sales increased over the course of the quarter and reached a four-month high with September's report showing August new home sales increasing 1.5% on the month to a 740,000 annualized pace (and above economists' projections of a 715,000 rate). With new home inventories constrained by transportation bottlenecks, labor shortages and elevated input costs and buyers facing affordability challenges from higher prices and rising mortgage rates we expect housing sales to moderate going forward.

Case-Shiller Home Prices & Freddie Mac 30-Year Mortgage Commitment Rate

(as of September 30, 2021)



Source: Bloomberg

In September, the FHi HFA and Treasury Department jointly announced a suspension of certain provisions of the Fannie and Freddie Preferred Stock Purchase Agreements. The "PSPAs" were issued when the agencies went into conservatorship in September 2008 during the financial crisis and imposed various constraints on their activities as a consequence of receiving federal support. The suspension included removing caps on the agencies' issuance perceived riskier loans collateralized by second home and investor properties. In our view, the suspension is likely to reduce the volume on investor properties flowing into the non-agency market and reduce the premium relative to generic collateral that investor property specified pools command in the market.

Portfolio Actions & Outlook: Over the course of the quarter, we continued our strategy of reducing RMBS exposure across all strategies in anticipation of negative technical pressures emerging when the Fed eventually announces the tapering of its mortgage purchase activity. The largest decline was a reduction in our specified pool exposure. With our specified pool positions generally showing some of the longest durations of our RMBS positions, these sales also contributed to our strategy of reducing overall portfolio spread duration.

Going forward we do not anticipate increasing our exposure to the RMBS sector prior to more clarity on the timing of the Fed's tapering program. We anticipate generally allowing prepayments to gradually reduce our RMBS holdings and do not expect to engage in further sales absent a compelling market rationale. We continue to anticipate opportunistic purchases of short-tenor, high-quality non-agency tranches. As always, in non-agencies we seek to acquire tranches that we feel offer sufficient spread and structure to compensate for any negative convexity effects.

Performance: Our RMBS holdings produced mixed performance across our strategies in the third quarter. In our three-year and shorter strategies, performance was slightly positive while in our five-year and longer strategies it was slightly negative. With our specified pool and agency CMO holdings either flat or modestly negative across all strategies, the divergence was driven by our non-agency positions. In the shorter strategies our non-agency holdings were positive contributors to performance while in our longer strategies they were negative. This was the result of a higher weighting to prime collateral non-agencies in the longer strategies compared to near-prime and reperforming collateral. Although in-line with our overall expectations, the convexity impact of heighted prepayments on prime jumbo mortgages (among the most negatively convex mortgage collateral) drove the underperformance.

Municipals

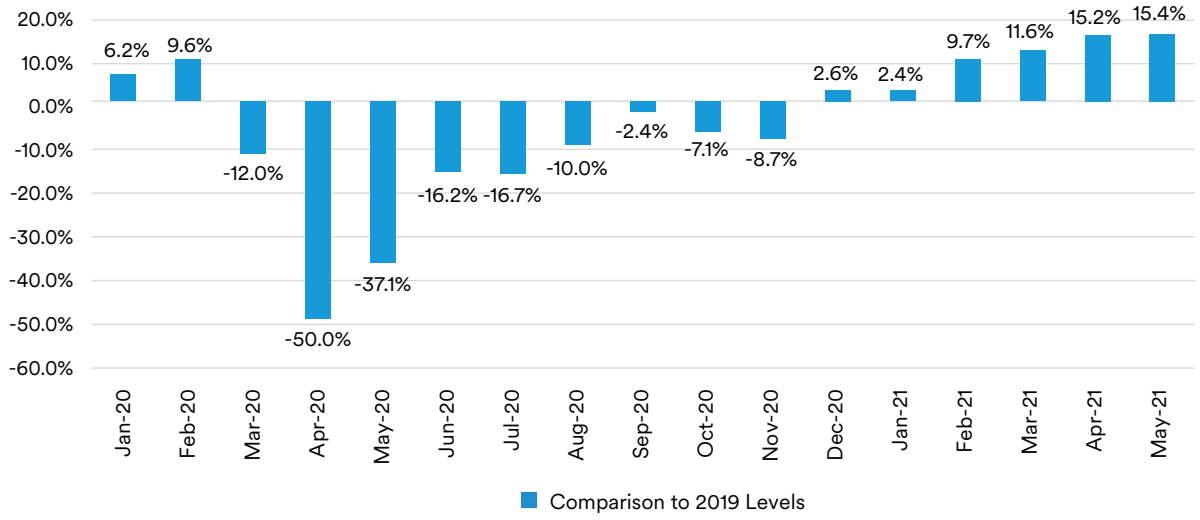
Recap: In the aggregate, third-quarter municipal issuance was $117 billion, $15 billion lower year-over-year. The lower supply level was most notable in taxable municipals with $28 billion in issuance versus $45 billion in the same period in 2020. Taxable advanced refunding volume declined during the quarter as the interest rate environment was not conducive to cost savings. In addition, issuers have benefited from stimulus measures enabling them to build liquidity versus issuing incremental debt.

The political landscape, as it relates to a proposed infrastructure spending package, remains uncertain. Provisions drafted by the House Ways and Means Committee contain $548 billion in aid to multiple transportation sectors, including Highways, Road and Bridges, Public Transportation, Airports, and Seaports. Also being considered are direct-pay bonds, similar to the 2009 Build America Bond program, and private activity bonds. The overall size of the final bill will determine which, if any, municipal provisions are included. We believe the bill, if enacted as drafted, will be both a fundamental and technical positive for the municipal market.

Toll road revenues have largely recovered to 100% of pre-pandemic levels, which is sufficient to cover O&M expenses and debt service without severely tapping reserves and scheduled toll increases have been implemented as planned. Traffic on managed lanes continues to recover but revenue projections need to be remodeled to incorporate new, lower baseline revenues in 2020 and 2021, and debt amortizations may need to be restructured. Conduent Transportation published an analysis of tolling trends for six of the 10 largest toll systems in the U.S. which includes California, Florida, New Jersey, and New York. There was a slight decline from January to February this year, however the trend turned positive in March. As of their most recent data (May), traffic was 82% higher than May 2020 levels and 15.4% higher than May 2019.

Toll Road Traffic

(as of May 31, 2021)

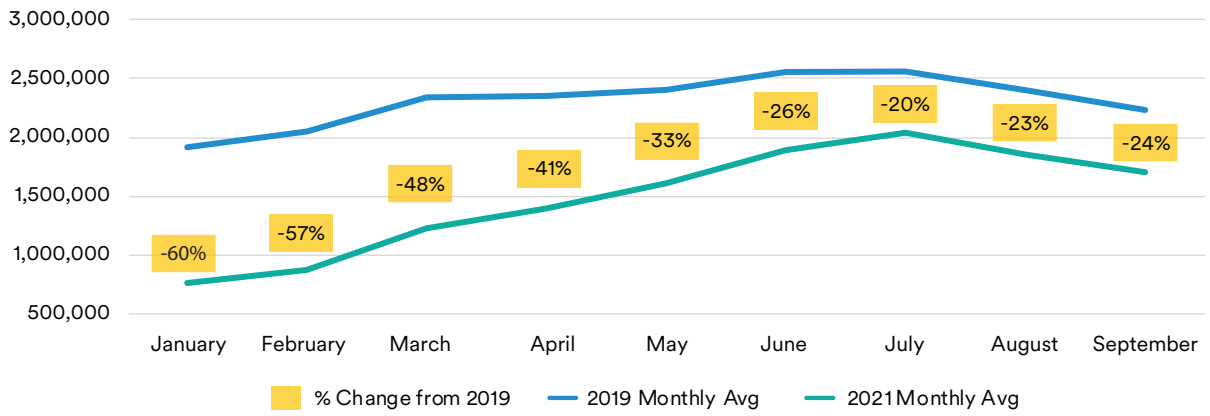


Source: Conduent

Air traffic continued to recover from 2020 lows, with enplanements returning to 78% of 2019 levels, on average, during the third quarter. This represents an improvement from the second quarter average of 67% of 2019 levels. Enplanements returned to 80% of 2019 levels by the end of July, before easing up to 77% of 2019 levels in August, which is usually the most popular travel month. Airports operate on long-term contracts with the airlines utilizing their facilities and have a favorable cost recovery structure whereby revenue shortfalls can be mitigated with increased passenger costs. Vaccine rollouts along with federal aid helped bolster their recovery adding to their already strong liquidity profiles pre-COVID.

TSA Traveler Throughput

(as of September 30, 2021)



Source: TSA

There have been four surges in COVID-19 cases since the pandemic began – Spring 2020, late Summer 2020, Winter 2020/21, and the current late Summer 2021 Delta variant uptick. With each surge, not-for-profit hospitals have gained significant insight into the treatment of COVID-19 and have gotten better at treating both COVID and non-COVID patients simultaneously by dialing down non-COVID surgeries when COVID cases surge. The current Delta variant pickup among the unvaccinated is skewed towards younger patients insured by commercial payers and, as a result, hospitals financial positions are improving as they see a more favorable payer mix.

Portfolio Actions & Outlook: We reduced overall exposure to the municipal sector as market technicals provided a good opportunity to capture performance and redeploy proceeds elsewhere where we saw better relative value opportunities. Purchase activity in our shorter duration strategies was concentrated in high quality tax-backed and state & local general obligation debt adding incremental yield pickup over similar tenor money market instruments. Adds were also made in the airport, seaport, and healthcare sectors across our strategies. We are constructive on municipals from a credit perspective with fiscal year 2022 state budgets supported by an improved economic outlook and favorable revenue trends. Easing strains at the state level and continued strong personal income tax revenues, along with continued real estate appreciation should help support local governments. Within the transportation sector, we expect demand for leisure air travel to soften in October before picking up for the holiday seasons in November and December. While the Delta variant may somewhat temper demand for leisure travel over the next few months, we expect it will have a more profound impact on business travel and delay its return to normalcy. U.S. airlines had a strong summer although they have lowered revenue guidance for the third quarter 2021 due to a resurgence of COVID-19 cases given declining future bookings. Should the Infrastructure

bill pass, airports are slated to receive $25 billion. We continue to have a positive stance on the transportation sector given balance sheet strength and liquidity. Regarding healthcare, subsequent to the initial lockdown on elective surgeries in the second quarter of 2020, there has been a steady rebound in patient surgical volumes with most hospitals back to 90-105% of 2019 pre-pandemic levels. Technological advances in the healthcare space, such as tele-medicine, that were previously on multiyear growth trajectories experienced exponential growth during the pandemic, helped cushion revenue declines and found a meaningful degree of acceptance with patients. The federal government continues to provide financial support to hospitals with the last remaining infusions of CARES Act grants and by temporarily raising Medicare Diagnosis Related Group rates for treating COVID patients by 20%. We will continue to look to add to municipals as a high-quality surrogate to corporate credit where relative value and credit fundamentals are positive.

Performance: Our municipal holdings generated positive performance across our strategies. On an excess return basis, some of our better performing sectors included Airports, Toll Roads, and Higher Education. Essential Service and Local General Obligation sector excess returns were mixed but positive in aggregate.

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