PUBLIC FIXED INCOME

Quarterly Commentary

Fourth Quarter 2020

As we reflect on the past year, 2020 has been anything but ordinary. The pandemic's grip around the world has effectively caused immense devastation with loss of lives and a shutdown in many economies, leading to spikes in unemployment and business closures. Market moves have been extreme this past year, with wild swings from the among the worst quarter on record for credit excess returns in the first quarter, followed by the among the best. While we believe that this level of volatility will unlikely repeat in the near-term, we do expect sporadic jolts in spreads and market dislocation. Overall, economic conditions continued to stabilize during the period as central banks reiterated their unwavering support and the pace of U.S. Treasury and MBS purchases remained robust at $120 billion per month. On the employment front, following a spike in April to 14.7%, the U.S. unemployment rate has been steadily declining and edged down to 6.7% in November. However, nonfarm payroll remained below its February level by 9.8 million as COVID-19 infections rose and more states re-introduced restrictions, while a new stimulus bill which would provide support to millions of Americans was approved in the final days of the year. Despite an immense amount of volatility throughout the year, the OAS on the Bloomberg Barclays U.S. Aggregate Index closed the year at 41.9 after touching an intra-year wide of 126.5 and just three basis points wider than the end of 2019. Additionally, the Treasury curve steepened during the quarter with the 5-year yield rising from 0.28% to 0.36%, the 10-year yield rising from 0.69% to 0.93%, and the 30-year yield rising from 1.46% to 1.65%. However, yields across the curve remain substantially lower than the beginning of the year with the 30-year closing 2020 slightly lower than 5-year closed 2019.

Table of Contents

Investment Grade Credit	3
Structured Products	4
High Yield	6
Emerging Market Debt	8
Taxable Municipals	10

MetLife Investment Management

While we would like to leave 2020 in the rearview mirror, the demarcation of the calendar year does not provide respite from challenges of last year; however, there is reason for optimism. We expect the first quarter to endure the challenges associated with post-holiday and seasonal surging virus activity, with the attendant pressures on economic activity and employment. The new administration, anxious to demonstrate a differentiated approach from the predecessor, will likely err for more restrictive measures. We anticipate the first weeks of the year to be amongst the most challenging since the onset of the pandemic. Market participants; however, are keen to look past the very immediate term and focus instead on the expected tailwinds as the weakness in the initial part of the quarter yields to the expected strength into the spring. We believe late first quarter economic data will appear very strong, in some cases records, as year-over-year rate of change data compares to the depression-like early pandemic numbers. If progress is incrementally achieved against COVID-19, we expect to see economic activity surge, especially on a comparative basis, as pent up demand and excess savings are deployed towards leisure, dining, travel, and other COVID-suppressed consumption. That said, much hinges on the roll-out of the vaccines and what path the U.S. takes to achieve herd immunity. Early indications are concerning, both in terms of vaccine administration and compliance. The initial roll-out has not been well organized, dramatically missing pre-announced milestones of production and vaccinations. Additionally, there is concern that health care workers have overwhelmingly declined to be inoculated, casting doubt on compliance among younger and healthier cohorts even once the vaccine is widely available. There is still a non-zero chance that herd immunity in the U.S. is achieved not by vaccinating 70+% of the population, but by excruciating exponential spread of the virus. This is a key risk we are monitoring.

Aside from COVID-19, we are also closely watching the sea change in the U.S. political landscape. Given the benefit of writing a few days into the new year after the Georgia run-offs, we now know Democrats control the executive and legislative branches of government, albeit by a small margin in the House and just the one tie breaking vote of the Vice President in the Senate. The initial market expectation is that vast stimulus spending is on the horizon which could lead to a strong reflationary environment driving both government yields and risk assets higher. We caution against this near ubiquitous outlook for a number of reasons. Firstly, the senate is only able to pass certain budgetary agenda items with a simple majority. The even party split amongst Senators has had the unexpected consequence of rapidly transferring significant power in Washington towards the center. Swing voting Senators Manchin(D), Collins (R), Murkowski (R) and Sinema (D) will wield significant power in a Senate that still requires 60 votes to pass major legislation, and are unlikely to give the administration the blank check that financial assets appear to be pricing in. Additionally, it is doubtful the power-dove couple Yellen & Powell would risk stifling the housing market and the broader economy by allowing rates to move significantly higher, instead opting to implement Japanese style yield curve control as opposed to negative rates.

Turning toward domestic fixed income markets, we see competing forces in the marketplace. We cannot argue that domestic bond markets are currently ‘cheap,’ but the pressures against higher yields and spreads are significant. Record Treasury issuance to support deficit spending and skyrocketing total debt to GDP are certainly trending in the wrong direction technically and fundamentally. That said, U.S. rates remain among the highest available, certainly among developed nations. At the time of publication, the tally of negative yielding debt topped $17.5 trillion, representing over 25% of global investment grade fixed income assets. The supportive global technical demand for U.S. yields cannot be understated. Furthermore, investors in U.S. fixed income assets are confident investing alongside a central bank that has demonstrated unlimited support in the event of market volatility. The U.S. Federal Reserve balance sheet is expected to eclipse $8 trillion by the middle of the year, up over 100% in just 18 months. With respect to spread assets, while the corporate bond buying programs expired at the end of 2020, it is widely assumed they would be quickly reinstated and implemented by the new congress at the first sign of market stress. The technical bid combined with the ultra-accommodative central bank will likely keep rates and spreads from rising significantly or persistently in the near to intermediate term.

Investment Grade Credit[1]

Technicals have continued to outweigh fundamentals; and although the pace has slowed, corporate issuers continue to come to market with solid performing new issuance. This, accompanied by an increase in demand, has pushed corporate spreads tighter with investment-grade spreads closing the year not far from their December 2019 levels. During the quarter, investment-grade credit recouped all the negative excess returns from earlier in the year, ending 2020 with an excess return of 0.18% for the Bloomberg Barclays U.S. Credit Index. For the quarter, the index returned 2.79%, for an excess return of 3.80% over similar duration Treasuries; and spreads narrowed by 36 basis points to close with an OAS of 92 basis points – just two basis points wider than where they started the year. Corporate credit outperformed non-corporate credit in both the quarter and the year with excess returns of 4.11% and 0.49%, respectively for the Bloomberg Barclays U.S. Corporate Index. Not surprisingly, despite increasing by 23 basis points in the quarter, the Bloomberg Barclays U.S. Credit Index yield ended the year substantially lower from where it started, falling 111 basis points to close the year at 1.72%.

Excess returns were broadly positive in the quarter as spreads narrowed across the investment grade market. As fallen angel risk subsided, BBBs outperformed and posted an excess return of 5.03% versus 3.26% and 2.92% for As and AAs. In all, the 5s/10s spread curve flattened by nine basis points to end the quarter at 40 basis points. At the sector level, commodity-related and COVID-19 impacted sectors outperformed on improving economic outlook and vaccine development. Oil Field Services, Independents, Midstream, Finance Companies, Metal and Mining, Aerospace/Defense, and Airlines led the gains, while higher quality and defensive sectors underperformed but still generated positive excess returns.

While COVID-19 defined much of the year, there were bright spots in the market. For example, issuers that came into the year with balance sheet flexibility and the ability to access primary markets received a boost from a lower yield and Fed supported environment. As a result, issuers came to market to accumulate liquidity and retire higher coupon debt in record numbers, with total new issuance for the year hitting a historic level of $1.7 trillion in supply - 57% higher than the year before. However, 4th quarter supply was down sharply with just $215 billion in new issuance. The average tenor of new issues fell to 11.5 years from 12.6 years in the 3rd quarter but is still longer year-over-year. In all, demand remained very strong with concessions close to zero and deals three to four times oversubscribed. Finally, fallen angel volumes stabilized to $22.6 billion during the quarter versus $18.2 billion in the third quarter and were down significantly from first half of the year.

	4Q 2020	4Q 2020	12/31/2020	12/31/2020
	Total Return (%)	Spread change (bps)	OAS/DM (bps)	Yield to Worst (%)
Bloomberg Barclays U.S. Corporate Index	3.05	-40	96	1.74
Bloomberg Barclays U.S. Long Credit Index	4.92	-43	141	2.78

Within the investment grade corporate market, we evaluate the market via the lenses of fundamentals, technicals and valuations. From a fundamental perspective, pandemic depressed EBITDA combined record issuance has left IG corporate balance sheets over-levered for their ratings as debt ratios are more than a full turn higher than pre-pandemic and near historic highs. While certainly a negative on the surface, we believe the current state of balance sheets will serve to limit bondholder unfriendly activity as shareholders and lenders are aligned with respect to balance sheet repair. Also, the 2020 programs of investment grade only corporate purchases by the Federal Reserve has created additional and new motivation to maintain investment grade ratings even in an environment of tight BBB/BB spreads. Against this backdrop and the aforementioned pick-up in economic activity, we would expect to see fundamentals trending in a positive direction from a bondholder perspective in 2021. Turning toward technicals, here too we find a supportive situation for credit spreads. Aside from being the highest yielding available, recent quarter's liability management exercises have dampened the amount of upcoming maturing debt, lessening the need for refinancing issuance activity. In fact, expected issuance for 2021, while wide ranging, will be significantly less than 2020 concurrent with bondholder friendly, debt reducing liability management that expected to continue apace. It's in valuations that we are less compelled. Adjusting for credit quality and duration, spreads are well through historical tights. In fact, there have never been 12-month forward positive excess return from these valuations as measured by spread compensation per unit of duration. Never is a long time. We feel investment grade corporates will likely struggle to generate positive total return in the year, and we believe any excess return will be driven by security selection, steep curve roll down and avoiding underperformers. The pandemic accelerated pre-existing trends of remote work, telemedicine, online shopping and digitization. The implications could be wide ranging across sectors, especially REITs, travel related, retail, technology and energy. Additionally, we are closely monitoring the relative value between investment grade issuers and fallen angels in comparable sectors to identify attractive opportunities within High Yield.

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Structured Products[2]

Fixed income asset prices continued to improve in the fourth quarter of 2020. In fact, as we ended the year, most securitized spread sectors had fully recovered to their Pre-COVID levels with some trading through those levels. Overall, fundamentals gradually improved for consumer related assets while structured assets such as CMBS still face significant headwinds.

While spreads tightened, longer dated interest rates moved higher as the worst of the pandemic related economic slow-down faded from view. 10-year rates started the fourth quarter at .69% and marched higher with some modest volatility and ended the quarter at .91%. While interest rate volatility as measured by the MOVE Index briefly touched 64 during the quarter, it remained well contained, especially relative to the high of 163.7 reached on March 9th of this year. This relatively benign volatility regime has been an important component allowing spreads to recover as hedging costs fall and transparency improves in the market. Lower volatility is especially important to the mortgage market as it allows lenders to offer the lowest mortgage rate possible for a given interest rate environment. As mentioned in previous quarterly reviews, the Fed was determined to restore order to the mortgage market so that the housing market could act as an engine of growth. This is apparent in the Freddie Mac U.S. 30-year mortgage commitment rate which fell to 2.67% from 2.88% in September, while the 10-year U.S Treasury yield rose .22% over the quarter.

While lower mortgage rates are favorable for borrowers and the overall economy, these lower rates make mortgages a challenging asset class as prepayments rise and supply increases. Fueled by consistent Fed buying, the Bloomberg Barclays U.S. Fixed Rate MBS Index posted a quarterly excess return of 0.34% relative to equal duration Treasuries. This positive excess return was a nice respite for the mortgage market as returns have been challenged in recent periods, as demonstrated by the Index's -0.17% excess return for 2020. The nominal spread of the current coupon mortgage versus the 5-year/10-year U.S. treasury blend tightened 22 basis points to close the quarter at 70 basis points. In all, performance across the components of the mortgage index was mixed during the quarter, with conventional 30-year mortgages posting 0.36% of excess return, while GNMA's posted 0.26%. 15-year MBS outperformed both 30-year mortgages and GNMA's, adding 0.41% of excess return. Coupons closest to the Fed's purchase program outperformed higher coupon mortgages and were the primary driver of excess return within the index. While demand for specified pools remained strong, the specialness and added carry advantage of lower coupon TBAs weighed on pay-ups during the quarter.

ABS and CMBS posted solid excess returns of 0.34% and 1.50% versus duration matched Treasuries for the quarter. Spreads within both sectors tightened as yield hungry investors were willing to overlook challenging fundamentals especially in CMBS. In ABS, less followed sectors such as AAA-rated timeshare and unsecured consumer loans continued to rally as the basis between these sectors and the more on the run sectors such as prime autos and cards compressed. At the Index level, ABS started the quarter at 41 OAS and rallied into 33 OAS, with index level OAS slowly and consistently marching tighter during the quarter. As a point of reference, the index briefly touched 325 OAS in March.

Similarly, CMBS continued to recover with the 8.5+ AAA-rated portion of the Index posting a 2.02% excess return. The OAS of the 8.5-year portion tightened from 91 to 63 and was as wide as 239 during the year. Looking further down the capital stack at A-rated and BBB-rated portions, the move tighter was strong but with levels still wider than their 2020 tights. A-rated bonds finished the quarter at 347 OAS, 129 tighter and posting a 7.19% excess return. BBB's at the index level tightened from 981 to 716 OAS and posted 6.89% of excess return. As a point of reference, A-rated and BBB-rated bonds were as tight as 160 and 323 OAS in the first quarter.

	4Q 2020	4Q 2020	12/31/2020	12/31/2020
	Total Return (%)	Spread Change (bps)	OAS/DM (bps)	Yield to Worst (%)
Bloomberg Barclays US Aggregate Index	0.67	-15	42	1.12
Bloomberg Barclays US Mortgage Index	0.31	-12	42	1.24

While not a part of the Index, AAA-rated CLOs saw a slow but consistent tightening as well. In fact, top tier AAA's rallied approximately 20 basis points during the quarter.

Fundamentals continued to improve as the fourth quarter progressed despite rolling shut-downs throughout the country due to COVID-19. Some of this improvement is the result of various government stimulus programs as well as lender deferment programs that have, for the time being, tempered delinquency rates for a host of consumer related collateral. Consumer fundamentals have also been supported by declining unemployment and less harsh lockdowns throughout the quarter versus earlier in the year. This causes us to be encouraged, as a bridge has been provided to borrowers helping them make it through these challenging times. However, much of this stimulus is transitory, as lender deferment programs and extended unemployment benefits expire.

As a result, it makes assessing the quality of consumer related data more challenging. We still believe that the disruption that consumers have faced as a result of the pandemic will ultimately work its way into fundamentals, resulting in modestly higher delinquencies especially for lower quality borrowers. This is especially true if government support programs are not renewed and lenders become less accommodating in granting forbearance.

The commercial mortgage market has had to deal with bespoke solutions to handling pandemic related rent shortfalls. As noted above, the consumer has benefited from government stimulus and various forbearance programs. Commercial real estate is still on an island, with assistance being more on a property specific basis. We remain cautious on both hospitality and retail based commercial real estate. Retail property was already feeling pressure prior to the pandemic, and these difficult circumstances will likely accelerate the demise or repurposing of less desirable locations. While still cautious on the hospitality sector, the roll out of an effective vaccine gives us some confidence that travel related spending will accelerate in the second half of the year. As far as commercial office space is concerned, it is less clear to us how the long-term effects of the pandemic will play out. The longer-term nature of office leases has allowed lenders to weather the immediate impacts of COVID-19. However, the concerns around office usage given the changing nature of office work, specifically the acceptance of work from home programs and the technology to allow it, make it more difficult to assess the amount of office space needed in a post pandemic world. Therefore, despite the strong rally down in credit within CMBS, we expect volatility to continue as problem loans play out over a longer time horizon. Much like ABS, technicals have led the market while fundamentals continue to weigh on the CMBS sector. We remain constructive on certain parts of the AAA portion of the capital stack but are finding valuations to be challenging. We also see opportunity in Single Asset/Single borrower deals primarily at the AAA level.

Turning to agency MBS, we believe the Fed will continue to support the mortgage market, but they have accomplished their unstated goal of lowering mortgage rates. With this success comes a challenge, consistently high prepayments for investors. Mortgage excess returns versus treasuries were uninspiring in 2020, and as we enter the first quarter, we do not see the prospect of significant out-performance near-term.

Current valuation metrics appear tight to us and as a result we favor having a shorter spread duration expressed via an up-in-coupon bias. Given Fed support and bank demand we do not anticipate a dramatic widening in mortgage basis, provided interest rates remain centered around 1% and volatility remaining contained. We continue to favor TBA in the production coupons and specified pools in higher coupons to provide prepayment protection.

Within non-agency MBS, our concern about increasing losses as a result of the pandemic has been assuaged given lower unemployment, strong housing fundamentals and the roll-out of the vaccine. Despite delinquencies being elevated in some collateral types, we continue to believe that seasoned AAA securities should benefit from the conservative underwriting standards in place prior to the crisis.

High Yield[3]

The high yield market faced heightened volatility in the fourth quarter centered around COVID-19 surges, vaccine progress, the U.S. election, and ongoing stimulus talks. The market rallied in early October amid hopes for a vaccine and anticipation of a U.S. stimulus bill. Before long, risk assets came under pressure with virus cases spreading across Europe, causing a tightening of restrictions and re-escalating pressure on the economy. Election results and promising vaccine headlines spurred an impressive rally in November. Investor's risk appetite emerged as a Biden victory appeared likely and election uncertainty faded. In December, vaccine and stimulus optimism overrode concerns over the dramatic increase in virus cases and hospitalizations, driving yields to record lows to close out the year.

Overall, the high yield market returned 6.47% during the quarter, led by an impressive performance by triple-C securities in November and December. Bond yields fell to record lows in the quarter. The yield to worst on the ICE Bank of America Merrill Lynch US High Yield Constrained Index dropped by 78 basis points to 4.26% while spreads narrowed by 155 basis points to 387 basis points.

In terms of flows, following October and November's inflows of $4.6 billion, December recorded the second month of outflows over the past four months and only the fourth outflow in 2020. High yield mutual funds reported net inflows of $8.3 billion. Full year inflows totaled $44.3 billion, which compares to 2019's inflows of $18.8 billion.

The primary market continued to impress investors in the final months of the year. Following record high issuance in the second quarter and impressive volumes in the third quarter, a commendable $99.6 billion priced in the fourth quarter. Gross high yield volume in 2020 totaled $449.9 billion, an increase of 57% from the $286.6 billion of issuance that priced over the course 2019. Excluding refinancing, volume totaled $152.7 billion, an increase of 64% from 2019's levels.

In December, the U.S. high-yield default rate (par-weighted) increased to 6.17%, an increase of 353 basis points from 2.63% at the start of the year due to the pandemic. Including distressed exchanges, the US high-yield default rate ended the year at 6.76%. Excluding the energy sector, the default rate dropped to a more modest 4.46%. In 2020, a total of 88 companies defaulted totaling $129.6 billion in bonds and loans, with 21 distressed transactions totaling $11.8 billion. Inclusive of distressed transactions, the total of $141.4 billion ranks as the second highest annual default total on record and trailing only 2009's level of $205.0 billion.

After a risk-off sentiment saturated markets in late October, the leveraged loan market mounted an impressive rally in November amid encouraging vaccine developments and as election results quelled market uncertainty. Despite the increase in virus cases and hospitalizations, the leveraged loan market concluded a truly tumultuous year on a strong note, amid optimism for a cyclical recovery in 2021. The S&P LSTA All Loans Index (the "Index") returned 3.81% for the quarter, underperforming high yield bonds. High beta loans led the rally with triple-C's returning 9.21%, B's 3.78%, and BB's 2.75%. The index returned 3.12% in 2020, lagging bonds and equities for the second year in a row. Notably, loan prices recovered to $96.19 by year-end, roughly 50 basis points short of pre-pandemic levels in late February.

	4Q 2020	4Q 2020	12/31/2020	12/31/2020
	Total Return (%)	Spread change (bps)	OAS/DM (bps)	Yield to Worst (%)
ICE BofAML U.S. High Yield Master II Constrained Index	6.47	-155	387	4.26%
S&P/LSTA All Loans Index	3.81	-85	L+475	N/A

We have maintained the cautious approach established in the early stages of the rally, as we identified valuations were being driven by unprecedented Federal support despite largely weak fundamentals. While uncertainty surrounding the election lifted and encouraging vaccine trial results were announced, we viewed the events as catalysts to become fully invested. While we continue to cautiously participate in the primary market, we will also look to reduce and maintain duration through consolidation of existing holdings into shorter-dated maturities. Surging virus cases, hospitalizations, and the uncertain receptiveness of the vaccine by the broader population will certainly challenge federal support and dominate the economic outlook throughout 2021.

Against the backdrop of a broad rally in risk markets fueled by vaccine developments, U.S. leveraged loan issuance displayed strength heading into year-end. Loans supporting buyouts and acquisitions drove fourth quarter volume of $80.5 billion, the highest reading since the first quarter of the year and a 9% increase from third quarter levels. Although the primary loan market finished the year on a strong note, the tally for the year was the lowest since 2016. Total U.S. institutional leveraged loan issuance in 2020 was $287.8 billion, down 7% from 2019. Sponsored companies accounted for 88% of the fourth-quarter M&A volume. Corporate M&A was just $5.1 billion, the lowest for any quarter since the fourth quarter of 2012. Total M&A loan issuance declined 12% on the year, including a 25% decline in LBOs, while corporate M&A increased slightly. In the higher pricing environment, refinancing activity fell 18%, as dividend recapitalizations jumped 25%.

Emerging Market Debt[4]

Central banks took a wait-and-see approach in quarter after already cutting rates to record lows, with most central banks maintaining low rates to support the recovery process. The Council on Foreign Relations Global Monetary Policy Tracker is at its lowest level (-9.65) since September 2012, using a scale of +10 (tightening) to -10 (easing), indicating the strong monetary easing trend that the globe has seen over the last nine months.[2] The exception was Turkey, where the one-week repo rate was raised 475 basis points in November, then raised another 200 basis points to 17% in December in order to lower risks to the inflation outlook.

Hard currency sovereign spreads (EMBI Global Diversified[1]) staged a significant rally into year-end, but slightly lagged corporates. The index ended the quarter 81 basis points tighter, therefore putting the EMBI 61 basis points wider than where it started the year. Emerging Market (EM) high yield (HY) sovereigns lead the strength, 146 basis points tighter to end at 608 basis points, while EM investment grade (IG) contributed 45 basis points of tightening to end at 148 basis points. Both EMBI GD IG and HY were able to produce positive quarterly returns, of 2.96% and 9.32% respectively, with overall returns of 5.80% for the EMBI GD. Africa led the strength in high yield returns, with Angola and South Africa contributing significantly. Mexico notably outperformed IG peers this quarter.

Corporates saw significant strength as third quarter earnings reports revealed recovering quarter over quarter data. Industries that were severely impacted by COVID-19 lockdowns, such as travel, leisure, and retail recovered loses and were some of the top performers this quarter. Metals & mining continued to be a strong leader in the space. Corporates (CEMBI Broad Diversified[1]) tightened 100 basis points, with HY names compressing 147 basis points and IG tightening an additional 51 basis points. After gapping 385 basis points wider in Q1 2020, the index ended the fourth quarter only 3 basis points wider on the year. CEMBI BD IG returned 2.71% this quarter, while CEMBI BD HY returned 6.88%, with overall returns of 4.44% for the CEMBI BD. Latin American corporates, particularly out of the Dominican Republic, Ecuador, and Jamaica, drove performance.

EM local markets underperformed during virtually all of 2020 but outperformed during the fourth quarter with the majority occurring after the U.S. election outcome and vaccine news. The GBI[1] returned 9.62% for the 4th quarter with roughly three quarters of the returns coming from currency moves. The South African rand, often considered a proxy for risk sentiment, led the strength in currencies as investors looked for high beta opportunities to invest cash. The Colombian peso, a currency that has lagged in recent quarters, was able to recover some losses aided by the improved outlook around oil supply and demand.

Market technicals for EM remained intact this quarter as we saw strong flows into the asset class and record level issuance to close out the year. EM hard currency saw over $18 billion of inflows and local currency recorded over $11 billion of inflows in the fourth quarter.[1] For all of 2020, sovereign issuance hit a new record of over $180 billion, 20% of which was Euro denominated deals. Corporates recorded over $495 billion of new deals this year, driven by IG credits ($333 billion). Asia comprised $320 billion of the issuance, including some high yield issuers and new corporates who came to the market as deals continued to be well absorbed by investors.

In EM specific news – In Chile, the vote to write a new constitution passed with overwhelming support and Fitch downgrade the country one notch to A-. Morocco was downgraded to junk by Fitch after showing a decline in fiscal revenues and large GDP contraction due to the COVID-19 pandemic. Political volatility ran high in Peru as its congress voted to impeach President Vizcarra. The interim president faced several days of social unrest and resigned, leading to the appointment of Francisco Sagasti, who so far has been able to restore peace to the country. On the US/China front, President Trump signed an executive order prohibiting U.S. persons from investing in securities related to 35 Chinese companies previously identified by the Defense Department as having links to Chinese military. The Romanian election resulted in a less market-friendly outcome than expected, with the center-left party taking more votes than expected. In Turkey, the central bank governor was fired and replaced with the ex-finance minister, and President Erdogan made an optimistic speech regarding foreign policy and the economy, promising market-friendly policies going forward.

	4Q 2020	4Q 2020	12/31/2020	12/31/2020
	Total Return (%)	Spread Change (bps)	OAS/DM (bps)	Yield to Worst (%)
JP Morgan Emerging Markets Bond Index Global Diversified	5.80	81	352	4.53
JP Morgan Corporate Emerging Market Bond Index Broad Diversified	4.44	100	328	3.42

We anticipate a healthy economic recovery for EM countries and corporates in 2021, supported by accommodative DM monetary and fiscal policy. With vaccines being administered around the globe, countries are hopeful about getting their economies back on track and re-opening for business. China was the only large country to experience growth in 2020, and it is expected that it will continue to lead the global recovery in 2021 as other countries catch up. Further the U.S. policy changes under President-elect Joe Biden should emphasize a more multilateral engagement on global issues including trade.

We have seen unprecedented levels of both monetary and fiscal stimulus globally in 2020 due to the COVID-19 pandemic, and we expect to see some lingering affects going forward. EM central banks have cut rates by an aggregate 40 percentage points in 2020; however now some countries, such as Brazil, need to monitor rising inflation levels and act accordingly. After posting the largest annual increases in EM debt levels in 2020 due to the pandemic, countries must make policy adjustments to ensure debt sustainability. In the latest resiliency study update conducted by MIM's sovereign research team, just 42% of the countries in the EMBI Broad Diversified are projected to stabilize their credit profile in 2021. The remaining countries will have more work to do beyond 2021 to ensure debt sustainability and stabilized ratings. In the meantime, the agencies continue to act: Peru was recently placed on watch negative, South Africa was downgraded, and Morocco was cut to junk all due to increased spending and debt. We do expect ongoing multilateral support in 2021, after the IMF and others provided $102 billion in aid to 83 countries in 2020.[3]

Default rates were elevated in 2020. Sovereign defaults included Argentina, Ecuador, Lebanon and Zambia. While Argentina and Ecuador defaults were resolved in 2020, the others remain pending and could be joined by countries such as Sri Lanka and Suriname. EM Corporate defaults rose to 3.5%, significantly below earlier expectations and outperforming US HY (6.7%). We anticipate defaults will recede to a more typical rate of 2.8% in 2021.

Looking at issuance for 2021, the market is expecting noteworthy issuance once again. Sovereign issuance is expected to lessen next year, around $150 billion, in line with average issuance, with an increase in HY sovereign issuance likely. Net corporate issuance is expected to be ~$75bn most of which will again come from Asia and to a lesser extent MEA while LatAm and CEE are expected to be negative. We will continue to be strategic in cash positioning to allow us opportunities to participate in new deals that we are comfortable with and where we see beneficial upside.

> We anticipate a healthy economic recovery for EM countries and corporates in 2021, supported by accommodative DM monetary and fiscal policy.

Upcoming country specific events: In Q1 2021, we will be focused on the foreign policy approach of incoming US President Biden, especially as it relates to China (pending DoD sanctions on Chinese military linked companies) and Russia (suspected Russian hacking of US government agencies). Romania will officially form their government and focus on fiscal consolidation. Brazil needs to restart fiscal reform momentum. In Turkey, the country will likely continue working towards tighter monetary policy, lower inflation, and increasing the real interest rate to re-stabilize the lira. Presidential elections in countries including Ecuador, Peru, Mongolia, Chile, and Uzbekistan are scheduled for later in the year, along with important legislative elections in Mexico and Argentina.

Taxable Municipals[5]

The taxable municipal market ended 2020 on a strong note. New issuance of taxable municipals set a monthly record in October at $36.9 billion, which was then followed by an aggressive move tighter in spreads through the end of the year. The spread rally was driven by positive vaccine news, increased hopes for aid to state and local governments under a Democratic administration, and a very strong technical environment. The OAS on the Bloomberg Barclays Taxable Municipal Aggregate Eligible index tightened 34 basis points in the quarter, generating 3.57% of excess returns relative to duration-matched Treasuries. The ending OAS of 127 basis points is just 22 basis points off the 2020 pre-COVID tights and 135 basis points through the wides in the depths of the pandemic. At year end, the benchmark OAS level reflected a bifurcated market with large, high quality issuers trading within close range of their all-time tights on one hand, and the more COVID sensitive, higher beta issuers at least 100 basis points behind their 2020 tights on the other. The best performing sectors in fourth quarter were leasing, state GOs and healthcare, while sectors with the lowest excess returns were pre-refunded, industrial revenues, and special tax.

Looking back at the full year, taxable municipal issuance of $179 billion eclipsed the previous record set in 2009 when Build America Bonds ("BABs") were issued. Last year's taxable issuance surpassed the total issuance in 2019 by more than 2-times. Still, the Bloomberg Barclays Taxable Municipal Aggregate Eligible index recorded an impressive total return of 12.1%, helped in no small part by the 74 basis point collapse in the 30-year Treasury. The index OAS widened by 11 basis points, resulting in an excess return of negative 0.80%. Municipal credit was remarkably resilient through 2020. By the end of the fourth quarter, the budget deficits projected by many state and local governments were orders of magnitude smaller than those contemplated just month earlier, with much of the difference attributed to the unprecedented federal stimulus. Rating actions skewed negative, as expected, but it was primarily a story about isolated pockets of weakness. Out of the more than 3,000 municipal issuers rated by Fitch Ratings, 3.0% were upgraded in 2020 while 5.5% were downgraded.[6]

	4Q 2020	4Q 2020	12/31/2020	12/31/2020
	Total Return (%)	Spread Change (bps)	OAS/DM (bps)	Yield to Worst (%)
Bloomberg Barclays Taxable Municipal Bond Index	2.17	34	127	2.39

Looking forward, the outlook for total returns on taxable municipals is more challenging in 2021 given the combination of the starting point of 0.91% on the 30-year Treasury, the long duration of the Aggregate-Eligible Taxable Municipal benchmark (11.8 years), and the likely upward pressure on rates from an expected pickup in GDP growth as the vaccine becomes more widely distributed. However, we expect that taxable municipal excess returns to be positive in 2021, driven by strong global demand and further federal stimulus that should help boost GDP growth and that will likely include aid targeted at state and local governments. However, we feel the environment of yield grab and limited spread dispersion reinforces the importance of security selection to try and identify those securities with the best return potential if the inevitable unknowns cause a pullback.

One segment of the market where the reach for yield has stretched valuations, in our view, is long callable taxable municipal bonds (defined generically as bonds with 20+ year final maturities and 10-year par calls). Recent trading levels on certain long callable taxable municipals appear overstretched when viewed through an option valuation framework. This suggests to us that the decision factors in the valuation analysis for some investors relate less to performance considerations or mathematics, and more to yield bogeys. These conditions may well persist for some time but we urge caution on callable bonds that appear to assign little value to the option. The mispricing of callable securities may get exposed in an environment of rising rates and more robust new issuance, which could cause the bonds to underperform as trading levels adjust to the valuation framework of the next, and potentially more performance sensitive, marginal buyer.

At the top of our list of things to look out for in 2021 is the possibility that Democrats could restore tax-exempt advanced refundings, which is the process whereby an issuer issues new tax-exempt bonds and places funds in escrow to defease outstanding tax-exempt bonds issued at higher yields. Recall that tax-exempt advanced refundings were prohibited by the Tax Cut & Jobs Act of 2017. In isolation, the restoration of tax-exempt advanced refundings would have negative implications for the future issuance of taxable municipals because the surge of taxable municipal issuance in 2020 was fueled by advanced refundings shifting into the taxable market. The process would likely reverse as municipal issuers seek the lowest borrowing costs. This would be unfortunate because the sharp increase in taxable municipals in 2020 brought many new investors to the market both domestically and overseas. This added an important measure of depth and liquidity to the market while also giving municipal issuers a critical financing alternative to bolster their access to capital under various economic environments. Should this materialize, it could be accompanied by legislation that also restores taxable direct pay with a federal subsidy, similar to the Build America Bonds of 2009-10. These were very well received by issuers and resulted in a record amount of annual taxable municipal issuance.

Endnotes

1 All data sourced from Bloomberg Barclays.

2 All data sourced from Bloomberg Barclays.

3 Bank of America Merrill Lynch.

4 All data sourced from JP Morgan.

5 The total issuance in 2020 includes $142 billion of municipal CUSIPs and $37 billion bonds issued by municipal issuers with corporate CUSIPs.

6 Fitch Ratings

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2 At estimated fair value. Includes MetLife general account and separate account assets and unaffiliated/third party assets.

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