

# Short & Intermediate Duration

## Q1 2021 Themes, Strategy & Outlook

- **Fiscal Stimulus / Growth** - An increase in fiscal stimulus is now expected to spur a meaningful increase in U.S. real GDP growth in 2021, however we continue to expect an uneven recovery as many small businesses are slow to reopen and consumers reluctant to return to their pre-Covid consumption patterns. We believe growth will be pulled forward by fiscal spending which will provide temporary support, not a long-term structural fix to the economy. Fiscal and monetary stimulus lines will continue to blur as coordinated efforts between Congress, the Treasury and Federal Reserve will move to address socio-economic issues in our view. We expect the U.S. federal deficit continues to expand coupled with a sharp increase in the national debt, both representing long-term challenges.
- **Business** - Uneven access to capital as well as technology in the current environment continues to disproportionately benefit larger enterprises versus smaller and medium companies. We do however expect large corporations will work to trim costs (labor) in the face of profit margin pressures while small and midsize businesses continue to grapple with staffing challenges. Credit fundamentals for many large companies have begun their gradual repair, which may be slowed by higher costs, margin squeezes, and potential for liquidity buffers being redirected to M&A or increased shareholder payouts. Banking fundamentals continue to be strong, especially for issuers with capital markets businesses. The rollback of the prior administration's regulatory changes may be marginally less business friendly.
- **Consumer** - Additional stimulus should help support consumption and aid households in staying current on their financial obligations (e.g. rent, credit cards, auto loans). Post-coronavirus behavior remains altered as spending patterns have shifted and social distancing persists, which will negatively impact many of the service sectors until a vaccine is widely distributed and herd immunity is reached. Absent requirements that individuals get vaccinated, a reluctance to be inoculated serves as headwind to the consumer sector's contribution to economic growth. The savings rate will likely remain elevated as high-income earners, who have a lower propensity to spend an incremental saved dollar, are less inclined to spend on services.
- **Employment** - The recent drop in the unemployment rate was largely driven by a decline in the labor market's participation rate and bears watching as it has negative longer-term implications for economic growth. Divergences persist across the economy with a disproportionate number of jobs lost in lower paying service sectors, especially leisure & hospitality and retail. Permanent job losses remain elevated, raising concerns arising from the potential for lasting damage due to diminished job skills and lower productivity growth unless recent trends are reversed. The loss of jobs in industries that tend to pay less than the average hourly earnings rate (AHE) has skewed the distribution of earnings to high wage earners and biased the AHE number higher.
- **Monetary Policy** - The Fed's focus on producing an uptick in inflation through using its policy toolkit takes precedence over seeking improvement in labor market measures. Given the close relationship between Chair Powell and incoming Treasury Secretary Yellen, we expect increasingly greater coordination between fiscal and monetary policy efforts to achieve economic policy goals. Over the near term, the bar for the Fed to taper its post-crisis QE program is high due to continued downside risks to the economy. U.S. monetary policy will not be tightened pre-emptively based on the Fed forecasting higher inflation above its target as it has done in past cycles. The Fed's adoption of AIT (average inflation targeting) implies old models of its reaction function should be discarded.

- **Inflation** - U.S. inflation is expected to rise in the short run due to base effects but would not be reflective of underlying inflationary pressures. The focus of the Fed and in turn the market will shift to survey and market-based inflation expectation measures under the Federal Reserve's Average Inflation Target framework. Lingering labor market slack and low nominal economic growth are expected to temper inflation longer term, however. The future demand outlook for services in a post-Covid environment is clouded and could be problematic. Based on the failure to reach inflation targets in other regions (e.g. Japan and the eurozone), the track record of employing easy monetary policy to drive inflation is not encouraging.
- **Residential / Commercial Real Estate** - Low mortgage rates along with tight single-family property inventories from the migration of urban dwellers keep inventories tight, supportive of mid-single digit home price appreciation. Originators continue to add processing capacity and have the ability to absorb the impact of rising interest rates rather than passing them through to borrowers, thereby keeping mortgage rates low and prepayments elevated. Additional fiscal support will likely delay the expiration of forbearance programs. Supported by strength in industrial and multi-family properties, commercial real estate delinquencies have stabilized, but headwinds remain for retail, lodging and office properties. Overall, we feel benchmark commercial property price indices are likely to show modest declines.
- **International** - Global central banks will likely maintain loose financial conditions in an ongoing attempt to generate growth and inflation as the coronavirus and potential mutations linger. More fiscal stimulus in the U.S. and an expanding budget deficit may limit the U.S. dollar's ability to rebound. Geopolitical risks are expected to rise, posing challenges on multiple fronts including an emboldened China (i.e. Taiwan, South China Sea, IP theft) as well as a more confrontational Iran and Russia, especially with a new U.S. president. While U.S. tariffs on Chinese imports are expected to remain in place, the incoming president is not expected to levy tariffs on European goods and should adopt a less isolationist approach. ESG and climate change will likely garner more attention, playing an increasingly larger role in driving international policy and business decisions.

## Investment Grade Credit

**Recap:** Despite a few hiccups along the way, the fourth quarter saw the investment grade credit market benefit from healthy market technicals as investors continued to search globally for yield and a supportive Federal Reserve helped front-end credit spreads continue their steady grind tighter. The market overcame jitters centered on the U.S. election, a resurgence in the coronavirus, fitful efforts to reach agreement on another fiscal support/stimulus package and the prospect of an end to political gridlock in Washington as the Democrats won narrow control over both houses of Congress and the White House. Investors were buoyed by the announcements in early November that substantial progress had been achieved on the vaccine front with potential approvals and initial rollouts in terms of vaccinations before year-end, which came to pass but at a slower distribution rate than expected. The rollout, however, helped the market look past the near-term impact of the persistent spread of the virus as well as the discovery of a potentially more transmissible variant to a point when the global economy will likely be on a stronger, more sustainable growth trajectory. Consequently, despite the virus forcing renewed closures and delaying the reopening of certain sectors of the economy in the U.S. and other regions, a risk-on backdrop largely prevailed heading into the new year helped by the passage of a \$900 billion fiscal support package.

**Portfolio Actions & Outlook:** With the further tightening seen in credit spreads over the fourth quarter we ended the year through spread levels at where we began 2020 with our bellwether 1-5 year investment grade corporate index closing at an option-adjusted spread (OAS) of 60 basis points, not far above its all-time lowest spread level. Given our view that valuations are a bit stretched as we perceive a disconnect from underlying fundamentals with an uncertain near-term outlook, we maintained a more cautious, defensive approach. We reduced our sector weightings slightly heading into the election on concerns over the market reaction to a potential "Blue Wave" or Democratic sweep, which did not exactly occur, at least not to the degree thought in the leadup to the election. In terms of trading activity, we were more selective in our activity this past quarter with a focus on higher-quality issuers mainly in our favored, more defensive sub-sectors such as banking, consumer non-cyclicals and electric utilities. At the start of the quarter we added a new issue, three-year

floating-rate bond from a Canadian Bank. We selectively purchased several secondary banking issues across portfolios as well, including in our shorter dated strategies as well as our 1-3 year strategy.

Reflective of our desire to monetize some of the significant spread tightening we witnessed over the middle of 2020 and redeploy the funds into other sectors offering better opportunities or higher yields, we sold a three year energy bond in a number of our portfolios in addition to trimming some of our short dated 2021 maturity positions at de minimis yields, often at spreads through their make-whole prepayment provisions.

In the 1-5 year strategy in similar fashion, early quarter moves saw us trim short dated 2021 BBB rated names at all-in low yields. Trading activity was a bit more active mid-quarter in our shorter strategies, highlighted by our purchase of an electric power company three-year floating-rate new issue and in our 1-3 year strategy portfolios, we were active on both the new issue and secondary fronts, buying new issue bonds in the banking and healthcare sectors. In secondaries, we added four-year bonds in banking and continued to trim some low-yielding 2021 maturity bonds in the 1-5 year strategy portfolios as well. At quarter's end, we purchased an electric utility one-year floating-rate new issue across our strategies as well as some secondaries, mainly 2021 and 2022 maturity callable securities, in both our shorter and 1-3 year strategy portfolios.

### ICE BofA Corporate 1-5 Year Index

(as of December 31, 2020)



Source: ICE Data Services

Given the uneven economic recovery we foresee unfolding, stretched credit metrics, rich valuations seemingly pricing in a strong business rebound, and still heightened level of uncertainty prevailing, our investment grade credit sector outlook remains somewhat guarded. The resurgence of the coronavirus has caused a return of business shutdowns, stay-at-home orders and other restrictions here in the U.S. and in parts of Europe over the past month to help check the virus's spread. We expect these actions will show up in reduced economic growth for the fourth quarter and into the first quarter until additional stimulus is crafted by the incoming administration. The steady improvement in the U.S. labor market has already exhibited signs of faltering as colder weather and the aforementioned stepped up restrictions have hit many service sector businesses hard and forced their closure or curtailed such activities as indoor dining. In addition, we are somewhat concerned that the rush on the part of many companies to tap the bond market in 2020 to increase balance sheet liquidity to respond to coronavirus-driven uncertainty with the result being all-time record-high issuance and debt

leverage for investment grade companies will likely be unwound very slowly as issuers turn to M&A or raise shareholder payouts via dividends and stock buybacks to justify perhaps unsustainably high equity prices.

With the grind tighter in credit spreads over the fourth quarter, investment grade credit spreads closed 2020 only slightly wider than the record lows reached in early 2018. This has occurred even as certain sub-sectors continue to face severe operating pressure due to the coronavirus and changes in consumer demand, such as airlines, lodging, leisure, and restaurants. In our view, some of these industries will experience lasting damage to their businesses and are sure to experience extended recoveries for those that survive. Consequently, we anticipate maintaining a somewhat lower sector weighting for investment grade credit relative to our historic norm and remain up-in-quality generally in more defensive sub-sectors offering what we perceive as “safe carry”. Some of our preferred sub-sectors include banking, consumer non-cyclicals, communications, technology and electric utilities. We will also selectively utilize the primary calendar to capitalize on opportunities to invest in attractively priced new issues where we see relative value.

Overall, we will be patient in awaiting a better entry point to substantially take up our weight to the investment grade credit sector or significantly increase the risk profile by moving down the ratings spectrum until spreads widen or a strong, sustained economic recovery becomes more assured. While the current tight level of credit spreads does give us pause and might ordinarily warrant more caution or a reduced sector weighting, we recognize that credit spreads continue to offer attractive carry vs. U.S. Treasuries’ paltry risk-free yields. Importantly, the technical backdrop remains favorable, especially given the amount of liquidity pumped into markets by the Fed while the U.S. is a preferred investment destination for global capital in a world with more than \$17 trillion of negative-yielding debt securities.

**Performance:** The investment grade credit sector was a positive contributor to relative performance across all our strategies in the fourth quarter. Excess return contributions were driven by broad-based spread tightening in the sector with stand-out performances from our positioning in the Insurance, Basics, Pharmaceuticals, and Electric Utility sub-sectors and overweights to Banking and Health Care (including hospital issues traded in the Municipals market but categorized as investment grade corporates).

## Treasuries / Agencies

**Recap:** Early in the fourth quarter optimism regarding an economic recovery from the pandemic was the most relevant theme but as the quarter progressed, rising case counts and an accompanying increase in government restrictions called into question the pace of the recovery even as the approval of several highly effective vaccines offered a path forward. U.S. Treasuries held a modest “bear steepening” trend despite some talk that the Federal Reserve may seek to change the composition of its QE bond purchases and buy more securities out the maturity spectrum, thereby extending the weighted average maturity of its Treasury holdings. At the December FOMC meeting, however, they did not change the makeup of their buying but did offer forward guidance that the Treasury purchase program would continue at least at the current pace until there is progress toward achieving its dual mandate. Policy rates at the effective lower bound and ample reserves translated to a benign short rates market over the fourth quarter. The combination of the Fed projecting rates at zero through 2023 and a commitment to provide liquidity via ongoing repo operations minimized any year end funding market volatility.

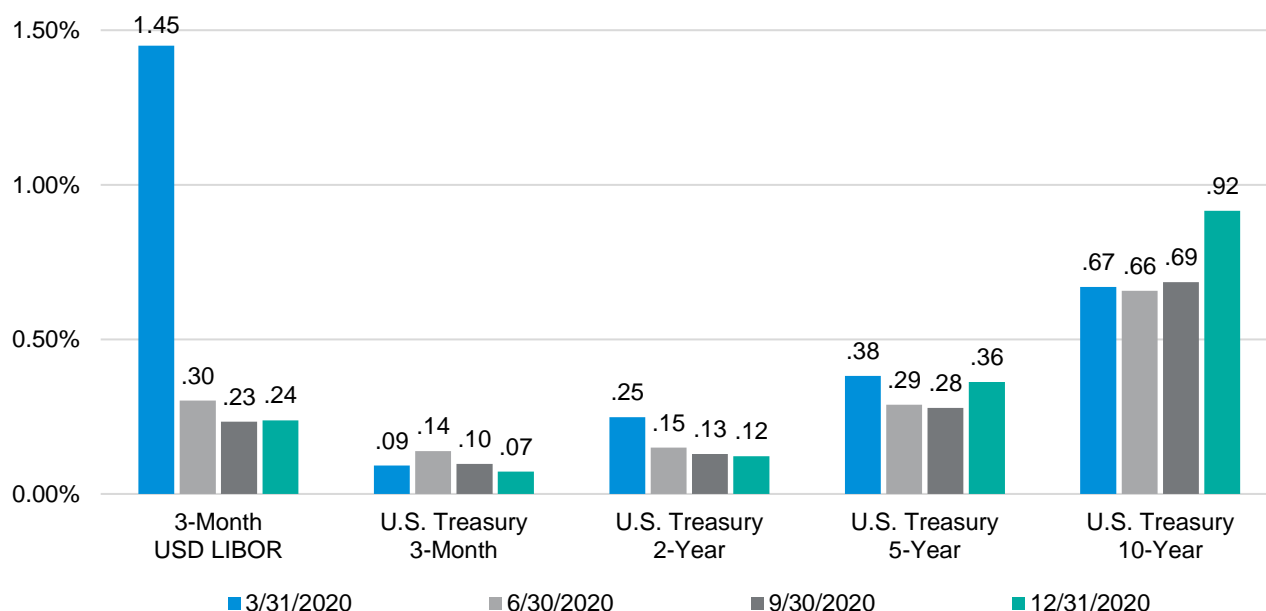
Looking at longer rates however, 10-year Treasury yields moved steadily higher over the quarter as inflation expectations picked up and estimates of projected issuance of longer dated Treasuries, which had earlier been anticipated to decline, were increased. The trading range was once again redefined in the fourth quarter as the 10-year Treasury ended the year at a 0.91% yield after beginning the quarter at 0.68%. In terms of the Treasury Inflation-Protected Securities (TIPS) market, inflation expectations rose steadily throughout quarter as the combination of the economic recovery and rollout of the vaccine translated into increased expectations for higher inflation. Real yields remained deeply negative as the Fed continued to be committed to keeping monetary policy accommodative for the next several years. The 10-year breakeven rate closed the year at 1.99%, close to the Federal Reserve’s 2% target. The 10-year real yield closed the year at -1.09%, close to its all-time low. Nominal Treasury notes finished the quarter with the two-year Treasury at 0.12%, the five-year Treasury at 0.36% and the ten-year Treasury at 0.91% as mentioned previously. The five-year less two-year

Treasury interest rate differential ended the quarter at a spread of 24 basis points, nine basis points higher than the end of the third quarter. The longer dated ten-year less two-year differential moved 24 basis points higher to +79 basis points.

In the very front end, the yield on the three-month Treasury bill decreased by three basis points to 0.06% while 3-month Libor increased by one basis point to end the year at 0.24%. In the Agency sector, U.S. agency and Supranational, Sovereign and Agency (SSA) spreads continued to tighten over the quarter, in sync with spread product in general amidst the persistent hunt for yield in a low rate environment globally. Front-end Government-Sponsored Enterprise (GSE) debt spreads continued to grind tighter as the option-adjusted spread (OAS) of the ICE BofA 1-5 Year U.S. Bullet (fixed maturity) Agency Index ended the fourth quarter at four basis points, a full four basis points tighter over the quarter. U.S. dollar-denominated SSA fixed-maturity securities' spreads were 9 to 10 basis points tighter and finished the quarter at a spread of 25 basis points over comparable-maturity Treasuries.

### U.S. Treasury Yields

(as of December 31, 2020)



Source: Bloomberg

**Portfolio Actions & Outlook:** Over the quarter we increased our allocation to nominal U.S. Treasuries as a means of maintaining portfolio duration and to adjust our yield curve positioning. We continued to trim our TIPS positions into strength as inflation breakevens edged higher. In addition, we increased our allocation to the Agency sector by adding discounted GSE callable bonds to capture additional spread pickup over duration-matched fixed maturity GSE agency bullet securities. Our increased weight in callable positions was driven by our expectations that front-end interest rate volatility would remain low with a Federal Reserve on hold for the foreseeable future, anchoring short interest rates. We added 3-year, non-call 1-year and 2-year, non-call 6-month maturity structures across portfolios.

As mentioned, we expect a dovish Fed will continue to keep front-end rates pinned for the foreseeable future, however, increased stimulus spending expectations with Democratic control of the House and Senate and the potential for more Treasury issuance should continue to put pressure on longer maturity interest rates. We feel the yield curve should remain directional with rates flattening or compressing if yields decline and steepening if yields move higher. Regarding the TIPS market, the Fed's willingness to embrace higher inflation



should continue to help support an inflation risk premium but near-term the TIPS market may take a pause after a strong post-election run.

Looking forward, we expect GSE supply to increase as Fannie Mae and Freddie Mac are likely to have positive net issuance needs in 2021 as a result of the COVID-19 pandemic. Any increases in the GSEs' debt outstanding are limited however by their \$300 billion debt limit, imposed by the Preferred Stock Purchase Agreements (PSPAs). In the fourth quarter both GSEs were roughly \$10 billion below their caps, which suggests positive net issuance will be quite limited. We expect any increase in issuance will be geared towards long-term debt, with a concentration in fixed-maturity issues. We have historically seen the GSEs issue callable debt to buy back volatility to hedge their mortgage assets, but Freddie Mac was mandated by the FHFA to reduce its agency MBS holdings by roughly \$40 billion by mid-2021 and Fannie Mae has already adjusted its MBS holdings lower, thus further reducing their need to issue large amounts of callable debt.

Turning to the SSA space, we expect the large European issuers to remain in line with their recent issuance averages while the increases in gross supply should come from the Washington, D.C.-based Supranationals. The World Bank Group has already committed to deploying up to \$160 billion to their countries in response to the pandemic, which is expected to run at least through June 2021. Despite the increases in supply, we expect spreads in the Agency sector to remain at tight levels with some possible range-bound movements throughout the first quarter of 2021. We see fundamental factors like narrowing pressure from tighter high-grade spreads supporting the sector. As implied volatility has fallen to historically low levels, new callable bonds now appear unattractive as yield pickup vs. duration-matched bullets are minimal, but we will continue to look for better entry points to add as opportunities arise.

**Performance:** Performance from our yield curve posture was mixed with duration offsetting detractors in our yield curve positioning. Our allocation to TIPS once again added positive excess return as break-even spreads continued to move higher. The Agency sector performed well over the quarter as it followed credit spreads tighter. Our positions tied to the oil sector falling into the non-credit foreign agency sub-sector were amongst our best performing Agency holdings. In addition, our callables and Supranationals also contributed favorably to excess returns in the quarter.

## ABS

**Recap:** Building on third-quarter momentum, spreads on short-tenor ABS tranches continued to tighten throughout the fourth quarter. For reference, AAA-rated, two-year fixed-rate credit card, prime auto and subprime auto tranches moved 5 basis points, 11 basis points, and 8 basis points tighter to end the fourth quarter at spreads of 10 basis points, 15 basis points, and 29 basis points over Treasuries, respectively. Three-year floating-rate FFELP student loan tranches also tightened 10 basis points over the quarter to end the year at a spread of 60 basis points over Libor. In our view, the continued strong performance of the asset-backed sector reflects investor preference for high-quality, short-tenor liquid alternatives to Treasuries and agencies. ABS issuance was relatively light over the quarter due to both the continued impact of the pandemic as well as the typical holiday slowdown. Compared to 2019's fourth-quarter volume of \$54 billion, this year's ABS new issue supply in the fourth quarter was \$35 billion with most new deals (\$24 billion) occurring in October. For the year, issuance totaled \$175 billion, lower than the \$229 billion of new ABS deals brought in 2019. Not surprisingly, the auto sub-sector was the largest contributor of new supply with over \$18 billion of new auto ABS deals coming to the market this quarter. This was followed by \$9 billion of issuance in the "other ABS" sector (which includes collateral like cell phone payment plans, timeshares, mortgage servicer advances, insurance premiums, aircraft leases, etc.) and almost \$4 billion of new student loan ABS issuance.

With mostly prime underlying receivables, credit card trust performance remains solid. Based on December's remittance reporting as measured by the JP Morgan credit card performance indices, credit card ABS master trust credit metrics showed charge-offs and delinquencies remain below pre-pandemic levels, while payment rates and excess spread are at, or near, record highs. As we have noted in prior commentaries, we continue to monitor the data and expect to see some deterioration in credit card trust metrics due to the impact of the pandemic. However, we do not anticipate any material credit impact for AAA-rated credit card tranches due to their ample levels of credit enhancement.

New vehicle sales surprised to the upside at quarter end, printing at a 16.3 million SAAR (seasonally-adjusted annualized rate) pace ahead of economist projections, led by strength in higher priced vehicles like SUVs and trucks. Since collapsing in April to a record low 8.6 million SAAR pace at the onset of the pandemic, auto sales trended higher through the end of the third quarter only to pull back in October and November before December's rebound. Cox Automotive noted that the average list price of new cars in December was \$40,423 (up 6.2% for the year), reflecting the dominance of the pricey, well-equipped 2021 model SUVs and trucks at the expense of low priced, entry-level vehicles. In some ways, the auto market illustrates the K-shaped recovery in the economy with the top leg of the K representing upwardly mobile people who are able to work remotely and have benefitted from surging financial markets and the bottom leg of the K encompassing the financially vulnerable who have lost income or jobs, are struggling with credit issues and are frozen out of the new-vehicle market with the former group driving new vehicle sales volumes. Reflecting this dynamic, the Manheim Used Vehicle Index continues to hover near its record of high of 163.7, ending the year at 162.6, which reflects a 15.3% increase from December 2019.

With robust new vehicle sales numbers and solid used car prices, ABS auto trust performance continued to be strong over the fourth quarter. Through November, the 60+-day delinquency rates on the Fitch Auto ABS indices were 0.22% for prime and 3.84% for subprime, lower than year-ago levels by 5 basis points, and 159 basis points, respectively. As we have noted in prior commentaries, we believe that loan forbearance programs, the receipt of government stimulus funds and the strong used car market are supporting auto ABS performance, particularly in the subprime sector. We continue to anticipate that performance will begin to deteriorate once stimulus payments and forbearance plans are wound down later in 2021. Nonetheless, we believe our portfolio holdings of short-tenor tranches have ample credit enhancement to help compensate for any slippage in credit performance.

**Portfolio Actions & Outlook:** Over the course of the quarter we worked to generally maintain our ABS exposure across most strategies. We did however reduce our holdings in credit cards, taking advantage of the tight spreads in that sector to fund purchases of higher-yielding alternatives both within ABS and in other spread sectors. In our longer strategies we increased our exposure to fixed-rate private student loan tranches. We concentrated on deals from top-tier originators, collateralized by loans to prime credit quality borrowers. Although offering a yield advantage relative to prime auto alternatives, we were reluctant to increase our subprime holdings due to uncertainties surrounding a possible second wave of the virus, further lockdowns of the economy and uncertainty regarding the amount of future stimulus. We were active in both the new issue and secondary markets. For example, in the new issue market, over the quarter we participated in an inaugural prime auto deal as well as four other auto deals. We also participated in a new issue insurance premium securitization and a new private student loan securitization.

Going forward, we are biased to increase our ABS holdings across most strategies as we believe at current spreads short-tenor ABS tranches offer good value relative to competing spread sectors. We will continue to favor more liquid tranches and find dealer floorplan and fleet lease securitizations attractive relative to benchmark auto alternatives. We also continue to favor the prime quality private student loan sub-sector and expect to continue to add to our exposure. As at the end of last quarter, we do not expect to meaningfully increase our exposure to CLOs or other more 'off-the-run' esoteric ABS sub-sectors.

**Performance:** Our ABS holdings generated positive performance over the fourth quarter across all our strategies after adjusting for their duration and yield curve positioning. Benefitting from tighter benchmark spreads, all sub-sectors were positive with our fixed-rate holdings generally outperforming our floating-rate positions. In particular, our fixed-rate subprime auto positions showed notable performance led by our AA-rated subordinate tranches. Our fixed-rate private student loan tranches also did well, and our CLO positions were flat for the quarter.

## CMBS

**Recap:** Like other spread sectors, CMBS spreads continued to move tighter over the fourth quarter. At the end of the year, compared to like-duration Treasuries, three-year and five-year AAA-rated conduit tranches stood at spreads of 28 and 77 basis points, approximately 29 basis points and 18 basis points tighter for the

quarter, respectively. Supported by strong bank demand and the Fed's continued purchase of agency CMBS in its MBS buy program, agency CMBS spreads were also tighter. Five-year Freddie Mac "K-bond" tranches ended the year at a spread of 29 basis points above comparable Treasuries, six basis points tighter over the quarter. We attribute the relative outperformance of three-year, non-agency conduit tranches to the scarcity of these short-tenor, AAA-rated securities as most newly written CMBS loans are originated with an IO period and deals are being structured with relatively small "A1" three-year tranches. Over the course of the quarter, \$72 billion of new issue CMBS came to market, well behind last year's fourth quarter volume of almost \$91 billion. For the year, almost \$242 billion of new CMBS were sold, compared to \$281 billion in 2019. The decline in volume reflects the impact of the pandemic on the non-agency sector, while agency origination volumes exceeded last year. This year only \$63 billion of non-agency deals priced, compared to \$117 billion last year while \$179 billion of agency deals priced, relative to \$164 billion last year.

CMBS delinquencies continued their downward trend from the third quarter with the Trepp 30+-day delinquency rate closing out the year with six consecutive months of decline to close the year at 7.81%. With the onset of the pandemic, delinquencies experienced a large surge, reaching a peak of 10.32% in June (just under July 2012's 10.34% all-time high) but have trended downward since then. On a year-over-year basis, delinquencies have risen 547 basis points. Hotel loans continue to be the worst-performing sub-sector, as delinquencies climbed over the last two months of the year to 19.80% but still improved over the quarter from the 22.94% level seen at the end of Q3. For perspective, one year ago lodging delinquencies stood at only 1.53%. Likewise, retail properties, the next worst performing sub-sector, closed the year with delinquencies at 12.94%, an improvement compared to the third quarter's 14.76% level but well above the end of 2019 when delinquencies stood at 4.42%. Industrial properties remained the best performing sub-sector with delinquencies ending the year at 1.14%, down 31 basis points from the 1.45% level seen at the end of the prior year.

Despite the pandemic, commercial property prices finished the year on a strong note with the December release of the RCA CPPI National All-Property Composite Index showing prices rose 5.7% on an annualized basis through November to 146.0. The reading was the largest annualized gain since the onset of the pandemic and was bolstered by strength in the industrial and apartment sub-sectors which compensated for year-over-year declines in retail and office properties.

**Portfolio Actions & Outlook:** Over the course of the quarter we generally maintained our CMBS exposure across our strategies. Any declines were a result of portfolio runoff rather than a strategy to actively reduce exposure. One notable trade was the sale of a Manhattan office building position. With this Manhattan office property being recently refinanced and our expectation that the bond would be paid in full soon, we exited the position above par and deployed the proceeds into other spread assets. During the quarter, we dropped out of several new issue conduit deals as pre-launch spreads were tightened into levels we found unattractive and hence of our quarterly trading activity consisted mostly of secondary market purchases. Notable trades included purchases of two agency "K-bond" mezzanine tranches (the most senior, non-guaranteed portion of the deals). We also purchased a 1.9-year, AAA-rated tranche, a 2.0-year, AA-rated tranche and a 2.9-year, AA-rated tranche during the quarter. We also added to our holdings in a conduit deal, increasing our position in a 2.0-year, AAA-rated tranche.

As we enter 2021, our investment thesis remains, and we will not materially increase our CMBS allocation across most of the portfolios although we will continue to look for "one-off" opportunities in both agency and non-agency securities. At the present time we are biased more towards non-agencies as spreads on short-tenor tranches offer more value than comparable agency alternatives. However, we continue to avoid deals with high levels of retail and lodging exposure. In the single-asset, single-borrower ("SASB") sub-sector, we continue to prefer deals from strong sponsors collateralized by industrial, multi-family, and health-care properties over retail and lodging alternatives.

**Performance:** After accounting for duration and yield curve positioning, our CMBS positions added to performance over the fourth quarter. Our non-agency conduit and SASB holdings were the biggest contributors with roughly equal contributions from each of these sub-sectors. Our agency holdings also performed well with our Freddie "K-bond" holdings generally performing better than our Fannie Mae DUS holdings.



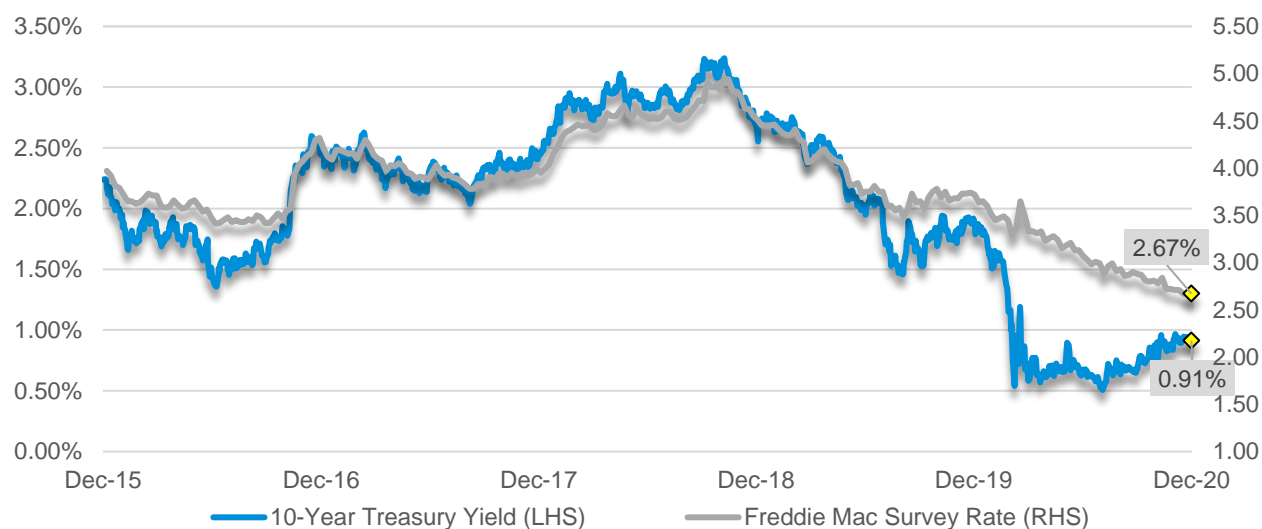
## RMBS

**Recap:** Residential mortgage-backed securities' spreads surged tighter over the fourth quarter supported by the Federal Reserve's QE buy program and investor desire for alternatives to lower yielding Treasuries and agencies. Bonds backed by 15-year and 30-year collateral ended the year at spreads of 35 basis points over five-year Treasuries (26 basis points tighter) and 43 basis points over ten-year Treasuries (29 basis points tighter), respectively. Non-agencies were also tighter in spread with prime jumbo front cashflow tranches ending the quarter at a spread of 108 basis points over Treasuries, 60 basis points tighter. We attribute the strong performance of non-agencies to investors' never-ending hunt for high-quality, short-tenor assets with yield.

Mortgage rates continued to reach new record lows over the course of the fourth quarter with the Freddie Mac 30-year mortgage commitment rate ending the year at 2.67%, 21 basis points lower than at the start of the fourth quarter and 105 basis points lower than at the end of 2019. The combination of record-low mortgage rates, scarce supply of single-family homes for sale and heightened demand from urban dwellers looking to leave large cities were strong catalysts for home price growth. The latest release of the S&P CoreLogic Case-Shiller 20-City Home Price Index showed price gains accelerated over the fourth quarter with December's release up 7.9% year-over-year through October for the twenty cities tracked by the index. On a national level, Case-Shiller's December release showed prices rose at an 8.4% annualized pace, up from 7.0% the prior month.

### Freddie Mac 30-Year Mortgage Rate vs. U.S. 10-Year Treasury Yield

(as of December 31, 2020)



Source: Bloomberg

Home sales remained strong over the quarter with December's release showing existing home sales volumes falling only 2.5% from November's almost 15-year high to a 6.7 million annualized pace, an increase of 25.8% from the prior year. In our view the decline likely reflects the impact of limited inventories and higher prices keeping some buyers out of the market. At the present level, existing home sales are well above pre-pandemic levels and stand near the highest levels seen since 2005. New home sales, however, dropped over the quarter to a five-month low, with December's numbers coming in at an 841,000 annualized pace. We believe the drop in new home sales is likely the result of a lack of available inventory as builders struggle to meet robust demand. Despite the pullback in the quarter, new home sales numbers are still running at the fastest pace seen since 2007. Home builders are grappling with limited availability of land and materials and shortages of skilled labor as they try to meet the demand for new housing.

On the regulatory front, the results of the 2020 presidential election likely mean that substantive GSE reform is off the table for the foreseeable future. We believe that the new administration will continue to keep Fannie Mae and Freddie Mac under government conservatorship while using them to promote housing policies favored by Democrats.

**Portfolio Actions & Outlook:** Over the course of the quarter, with spreads moving tighter and prepayments at elevated levels, we slightly reduced our exposure to RMBS across most strategies through a natural runoff by not reinvesting paydowns. Continuing the strategy, we have favored since the onset of the pandemic, most of our trading activity was focused in the agency specified pool sub-sector since we prefer highly liquid securities given the uncertainties that continue to face the market. For example, at quarter end we purchased a 2019 vintage agency 3.5% pool collateralized by low loan balance 15-year mortgages. In our view, low loan balance and/or seasoned collateral offers some degree of protection against the negative convexity effects of prepayments and going forward, we anticipate continuing to add to our holdings of pools backed by this type of collateral.

As we look forward to the continued rollout of Covid-19 vaccines, the economy should begin to slowly reopen from the pandemic-related shutdown. However, despite this positive development, the new administration in Washington is unlikely to rapidly remove government support for borrowers. Instead, we anticipate the gradual wind-down of mortgage forbearance programs and foreclosure and eviction moratoriums. We project that mortgage rates will remain low and prepayments at their current elevated levels for the foreseeable future. In this uncertain environment, we will continue to favor more liquid defensive sectors like specified pools. We remain opportunistic in the non-agency space and would add exposure, provided bonds are structured and priced to weather the negative convexity effects of extreme prepayment volatility.

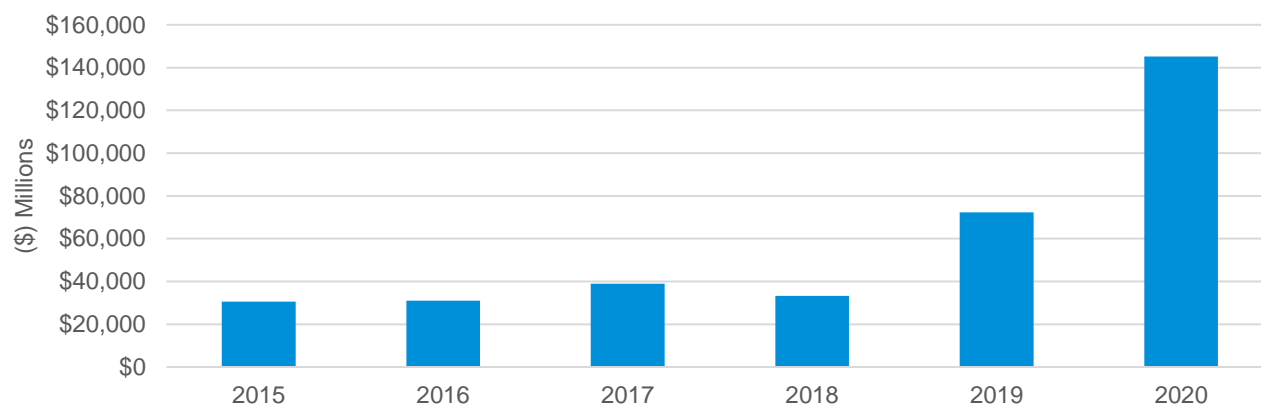
**Performance:** Our RMBS holdings showed mixed performance across the strategies in the fourth quarter after adjusting for their duration and yield curve exposure. Performance was generally flat or modestly positive in our three and five-year strategies but slightly negative in both our 1-10 year strategy and shorter portfolios. The underperformance was driven by our CMO holdings in both the agency and non-agency sub-sectors, which suffered from the negative convexity impact of heightened prepayments. The divergence across strategies resulted from the relatively heavier weighting of our three and five-year strategies to specified pools relative to CMOs in comparison to the shorter and longer strategies. Our specified pool positions were generally the best performers with tighter benchmark spreads resulting in positive attribution across all strategies.

## Municipals

**Recap:** The municipal sector closed out the year on a strong note as total issuance for 2020 was \$474 billion, nearly \$50 billion higher than the \$426 billion issued in all of 2019. Impressively, \$145 billion of taxable new deals came to market, representing over 30% of the total municipal supply, more than double the \$72 billion of the taxable issuance in 2019. Municipal bond buyers eagerly absorbed this healthy supply increase, as municipal bond mutual funds received \$19 billion of investor inflows in the fourth quarter alone that needed to be put to work. In addition, performance over the fourth quarter was strong as both taxable and tax-exempt municipal bonds outperformed U.S. Treasuries across the maturity spectrum according to the ICE BofA indices.

## Taxable Municipal Issuance

(as of December 31, 2020)



Source: Thomson Reuters, Bank of America

The results of the November election have implications for the municipal market as with Democrats controlling both houses of Congress, albeit by a slim margin, many of the potential roadblocks for the new administration's agenda are out of the way. Past policies we anticipate might be impacted include the reintroduction of tax-exempt advanced-refundings, the removal of the state and local tax (SALT) deduction cap from the tax code, expanding federal funding in areas like Medicare/Medicaid or other healthcare-related payment increases to hospitals, COVID-19 relief funding to state and local governments, additional COVID-19 stimulus money for individuals, and infrastructure bills that would benefit transportation and utility issuers.

Specific to some of the municipal sub-sectors we invest in, the global pandemic ushered in plenty of uncertainty in the not-for-profit healthcare sector in 2020. Once elective procedures resumed post the Q2 shutdown, hospitals saw patient volumes recover to 85%-95% of pre-COVID-19 levels with some at full recovery by the end of the year. CARES Act grant funding offset three quarters of lost income and Medicare advance payments provided substantial liquidity infusions. Technological advances such as tele-medicine that were previously on multiyear growth trajectories experienced exponential growth during the lockdown, cushioning revenue declines. In addition, the federal government continued to provide financial support to hospitals with incremental infusions of CARES Act grants in the fourth quarter.

Institutions of higher education moved to a combination of face-to-face learning, virtual learning, or a hybrid model during 2020. Higher education enrollment declined by approximately 4% overall with the sharpest drop-offs at community colleges and among colleges and universities with large international enrollments. In order to de-densify campuses and enable increased social distancing, many colleges cut the number of students housed on campus quite sharply. This reduced student housing revenue, requiring institutions to carry out expense reductions in other parts of their operations to offset the revenue losses. While the transition to virtual learning worked smoothly from a technology point of view for most schools, students are eager for a return to a full on-campus college experience. Some institutions are increasing the number of students who will be welcomed back on campus for the Spring 2021 semester, and most institutions anticipate a return to normal operations by Fall 2021.

The transportation sector continued to improve, albeit at a slower pace than the progress made in the third quarter. Activity on traditional toll roads now stands at over 80% of 2019 levels, as commercial activity remained steady and leisure travel over the summer increased as vacationers and other travelers opted for road trips in lieu of airline travel. While many toll authorities could raise rates as needed, at current throughput levels, revenues are sufficient to cover operating expenses and debt service without tapping into reserves.

Activity at U.S. airports, as tracked by TSA Throughput, has also recovered from the lows experienced in April when enplanements were down 96% from 2019 levels. Enplanements recovered to 19%, 32% and 38% of 2019 levels by the end of the second, third and fourth quarters, respectively. We estimate breakeven enplanement levels, assuming fees and charges are held constant, are between 40% and 60% of 2019 levels for most airports. While the national average is close to 40%, it is important to note that not all airports have enjoyed this recovery equally; mid-continent, large hub, and airports that have historically had a low international traveler mix have fared significantly better than coastal airports and those with a higher international component. In general, airports entered the pandemic with strong liquidity metrics and have worked to cut costs, effectively utilized CARES Act money and either tabled or reassessed their capital improvement plans to minimize cash burn.

**Portfolio Actions & Outlook:** We were active in the fourth quarter in both the primary and secondary markets. We purchased bonds in the transportation sub-sector, including toll roads and airports, as well as the healthcare, public power, housing areas and select state and local government issues. Given the more defensive nature and financial resiliency of toll road systems and essential providers of power, water and sewer services, we see these bonds as helping us establish a more defensive profile in the portfolios. We required greater spread for our purchases in the more opportunistic sub-sectors such as airports and healthcare and were selective in the names we added. Municipal spreads did compress throughout the fourth quarter, however, and we ended up passing on several new issue deals which were priced too aggressively or secondaries that traded with not enough spread compensation for the risk we perceived.

We expect taxable municipal issuance to have a slow start to the year and pick up towards the end of January. Total issuance for 2021 would be hard pressed to match the high levels we saw in 2020, but much of that is dependent upon the upcoming legislative agenda. If the SALT deduction cap is removed from the tax code, tax-exempt bonds would likely become less valuable to high net-worth individuals and could sell off. If tax-exempt rates widen out enough and become comparable to taxable rates, we would expect to see an increase in taxable supply as issuers take advantage of the greater flexibility afforded taxable municipal market relative to tax-exempt new issue proceeds which need to be used to benefit the community at large. In addition, while not high on the legislative agenda, there has been talk of implementing a federally subsidized municipal bond program, similar to the Build America Bonds (BABs) program of 2009, which would incentivize infrastructure borrowers to access the taxable municipal market to fund their projects.

The vaccine rollout has been slower than initially hoped, but we expect the administrative kinks will be worked out and that vaccination will be widely available by the summer. A successful widespread COVID-19 vaccine effort represents a positive credit catalyst for municipal credits. Since the announcement of the vaccines in November and their subsequent FDA approvals, like other spread sectors, we have seen spreads compress across the municipal market and most notably on transportation, healthcare and higher education bonds. While there are still opportunities in these sub-sectors, we will be selective in our purchase decisions as we evaluate credit trends and cross-sector relative value. Although sales, income and other economic activity tax revenues have been stronger than originally predicted, we remain cautious on state and local issuers, especially those that entered the pandemic in a weak financial position.

**Performance:** Performance of our municipal holdings over the fourth quarter was positive across all of our strategies. On an excess return basis, some of our best performing municipal sub-sectors included Transportation, Utilities, and Healthcare as well as a few select Local Government bonds.

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