DUCENTA SQUARED
ASSET MANAGEMENT

Economic and Sector Summary & Outlook

First Quarter 2021

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US Economy

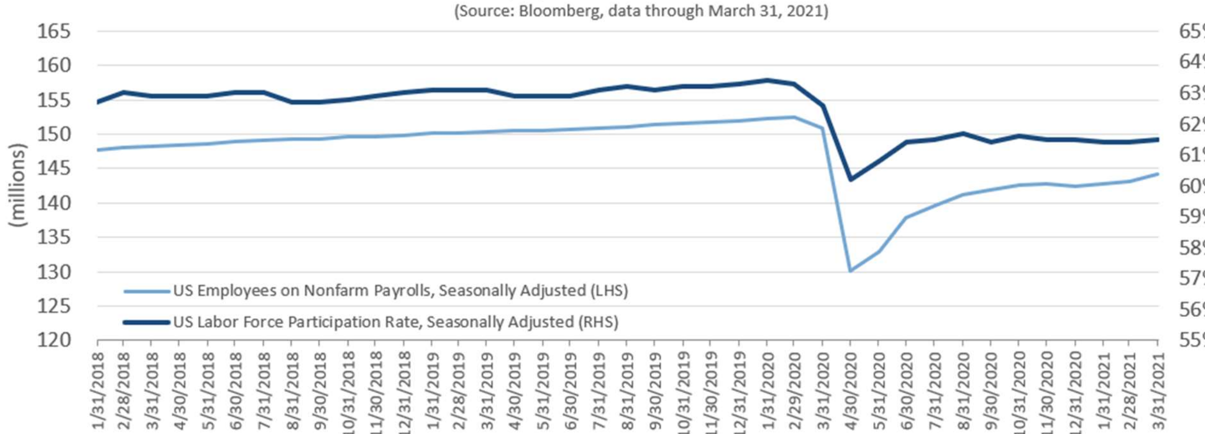
Summary

The US economy's rebound from COVID-related shutdowns and other restrictions appears to be occurring sooner and more forcefully than previously expected. Despite the negative effects of severe weather in February 2021, economists and analysts raised their forecasts and now believe that US GDP will increase by 5.4% in the first quarter of 2021 and 6.2% for the entire year.

Consumer spending declined in February 2021, as the effects of December's fiscal stimulus waned and Winter Storms Uri and Viola significantly affected economic activity in the Northeastern and Southern US, causing major damage to the power grid in Texas. In March, however, healthy consumer fundamentals began to point to a strong economic rebound. We believe consumer spending will continue to increase due to a powerful combination of high savings levels, net worth gains, a recovery in the labor markets, additional fiscal stimulus, and pent-up demand as the economy reopens.

Labor market trends correlate closely with consumer spending and economic activity. Approximately 14 million jobs have been recovered since the depths of the pandemic, and while employment lags pre-pandemic levels by more than 8 million, the gap continues to close. On April 2, 2021, the US Bureau of Labor Statistics reported that nonfarm payroll employment rose by 916,000 in March 2021 and the unemployment rate fell to 6.0%. The March employment report surprised to the upside, and we believe that up to one million new jobs per month could be added in the second quarter as the economy reopens and service sector employment accelerates.

US Nonfarm Employment and Labor Force Participation Rate
(Source: Bloomberg, data through March 31, 2021)



The housing market remains robust and, despite a decline in activity in February, both new and existing home sales reside well above pre-pandemic levels. Higher mortgage rates and home prices have negatively impacted affordability. But existing home sales inventories, which declined 30% year-over-year to hit a record low of 1.03 million units as of February 28, 2020, likely represent the primary reason for the recent decline in home sales activity. This quarter's Credit Spotlight addresses housing affordability.

Inflation fears continue to grip the bond markets. Inflation expectations, as represented by the breakeven rate on 10-year US Treasury Inflation-Protected Securities (TIPS), hit an eight year high of 2.37% on March 31, 2021. For now, annualized inflation remains modest with Core CPI (i.e., ex-food and energy costs) reaching 1.6%, also at the end of March. Inflation appears positioned to move above the Federal Reserve's 2% target rate, as a result of a combination of reopening demand, supply shortages, the base effect of negative pandemic inflation readings falling out of the rolling twelve month figures, and the Federal Reserve's own plan to let inflation run hot for a period before it intervenes.

On January 5, 2021, runoff elections in Georgia allowed the Democratic Party to add two seats in the US Senate and achieve and even split on the floor, putting Vice President Kamala Harris in a position to cast tie breaking votes to further her party's initiatives. The Georgia runoff election paved the way for further stimulus and, on March 11, 2021, President Biden signed the $1.9 trillion American Rescue Plan Act of 2021, which increases the combined stimulus since the beginning of the pandemic to a staggering $5.6 trillion, or 23% of overall US GDP. Embracing a "go big" fiscal policy stance, President Biden also announced plans on March 31, 2021 for a $2 trillion infrastructure plan to be paid for largely with corporate tax increases. President Biden hopes to increase the corporate tax rate to a flat 28%; it was previously reduced in 2017 by Donald Trump to a flat 21% from a tiered rate of 15% (on taxable income up to $50 thousand) to 35% (on taxable income greater than $18.3 million).

US Federal Reserve Chairman Jerome Powell noted the recent rise in interest rates and reiterated that changes to current policy are tied to "substantial further progress" towards the committee's goals of stable 2% inflation and maximum employment. For now, the Federal Reserve views the rise in interest rates as a "healthy" confirmation of the market's confidence in the economic recovery. In its March 2021 meeting, the Federal Reserve boosted forecasts for economic growth and inflation but maintained the projection for zero rate hikes through 2023.

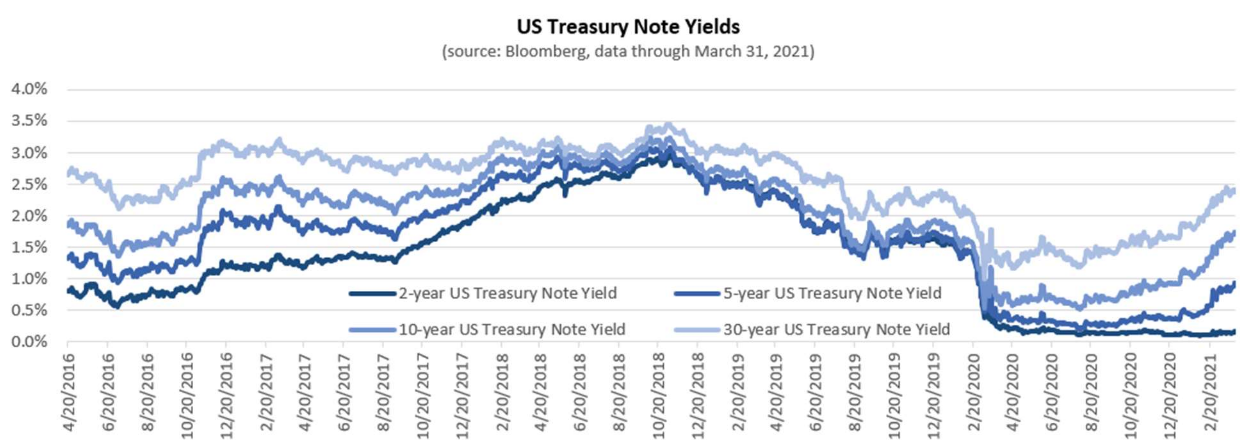
Outlook

The US economic outlook has improved significantly since the beginning of the year. The economy is benefiting from the successful roll-out of vaccines, additional fiscal stimulus, easy monetary policy, and pent-up demand as consumer and commercial activity return to pre-COVID levels. We expect full-year 2021 US GDP growth of 6.5%. Inflation represents a significant risk in the near term, but we continue to believe the rise in inflation will be temporary given the ample slack still available in the economy, especially in the labor markets. In addition, we expect that inflation will end the year around the Federal Reserve's target of 2.0%. Importantly, the US economy appears to be moving rapidly towards the Federal Reserve's threshold of "substantial progress", which it previously identified as a prerequisite to any change in monetary policy. We believe the Federal Reserve's first step toward any monetary policy adjustment will be a September 2021 announcement signaling a tapering of asset purchases at the start of 2022.

Sector Analysis

US Interest Rates

US Treasury yields rose considerably during the first quarter of 2021 and the yield curve steepened. The 10-year US Treasury Note yield rose to 1.74%, an increase of 83 basis points during the quarter, while the yield on the 2-year US Treasury Note increased 4 basis points to 0.16%. The increase in yields was driven primarily by the introduction of COVID-19 vaccines and expectations regarding additional potential stimulus (ultimately realized as the $1.9 trillion American Rescue Plan Act of 2021), which drove investors into risk assets. Also, poor demand for the $62 billion 7-year US Treasury Note auction in February accelerated the increase in yields as investors increasingly considered that US Treasury yields would have to increase to generate sufficient demand to meet additional supply. With rising expectations regarding economic growth and short-term rates anchored, the yield curve steepened 79 basis points to 157 basis points, as measured by the spread differential between 2-year and 10-year US Treasury Note yields.



Real yields also increased during the first quarter, rising 45 basis points to a level of -64 basis points, as measured by the yield on 10-year US Treasury Inflation Protected Securities. While the Federal Reserve expects inflation to increase as the economy improves and approaches full employment, it believes any inflation gains will be transitory.

In the short term, rates could move sideways. However, we continue to expect that rates will rise in the second half of the year as vaccinations accelerate the economic recovery, near term inflation pressures persist, and the US Treasury issues more debt to fund the growing fiscal deficit.

Securitized Products

In the first quarter of 2021, MBS provided +15 basis points of excess return versus US Treasuries, while spreads tightened to 12 basis points from 39 basis points at the beginning of the period. Importantly, continuing fiscal stimulus creates a concern for the MBS market regarding when the Federal Reserve will begin removing monetary accommodation. The Federal Reserve's direct purchases of MBS via its quantitative easing (QE) policy has significantly impacted mortgage valuations. Given the recent rapid economic recovery, mortgage investors appear to be preparing for the beginning of a taper to the QE program. For the time being, however, the Federal Reserve continues to purchase $40 billion of MBS per month and re-invest principal paydowns.

ABS provided +15 basis points of excess return versus US Treasuries in the first quarter of 2021. The ABS market, exclusive of collateralized loan obligations (CLOs), experienced a 38% supply increase in the first quarter of 2021 versus 2020. Despite this healthy supply increase, strong investor demand prevented spread widening in the sector.

CMBS generated +46 basis points of excess return versus US Treasuries, as the OAS tightened from +81 basis points to +71 basis points. In a somewhat unusual development, private label, non-agency CMBS supply remained stable versus the prior year, while out-of-index single-asset single-borrower (SASB) and CRE CLO supply dominated conduit issuance. That trend effectively created a shortage of CMBS conduit supply, which significantly benefited spreads.

The CLO sector proved similarly active in the first quarter, setting an all-time record by issuing approximately $38.5 billion of new debt and resetting or refinancing $70.3 billion of existing liabilities. Despite this deluge of issuance and repricing activity, spreads across CLO capital stacks modestly tightened. That impressive performance suggests that the market expects solid corporate fundamentals in the credit markets.

The outlook for securitized products in the coming months remains favorable from a fundamentals perspective, but we remain cautious regarding valuations. Broadly, market technicals remain extremely favorable for the securitized products sector. Within the MBS space, the Federal Reserve and banks continue to purchase large quantities of product, easily absorbing supply and driving spreads to very tight levels. Consequently, we view the sector as an underweight and focus portfolio holdings on coupons providing favorable interest rate carry. In ABS, both fundamentals and technicals remain favorable. The CLO subsector continues to provide select opportunities for outperformance. CMBS technicals also appear extremely favorable and contribute to spreads that reside at their tightest level since the 2008 financial crisis. However, while CMBS broadly appears to offer little opportunity for excess returns, we continue to monitor the sector to identify unique opportunities suitable for client accounts.

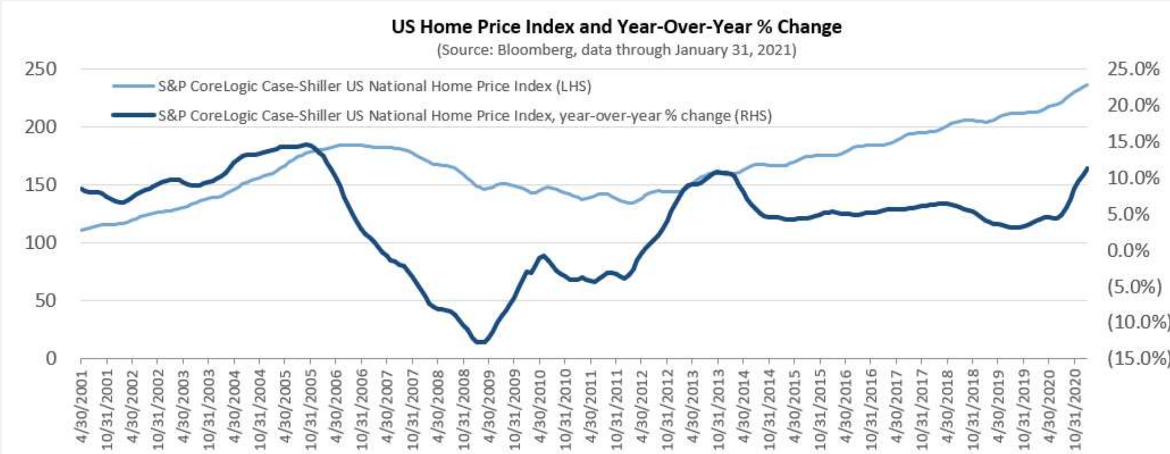
Credit Spotlight

Housing Affordability - Has the Hot Housing Market Run Its Course and Is It at Risk of Stalling?

Has the hot housing market run its course and is it at risk of stalling because of a decline in housing affordability? Traditional measures of housing affordability include housing prices and a buyer's ability to pay. The ability to pay includes not only the cost of the mortgage, represented by interest rates, but also income levels.

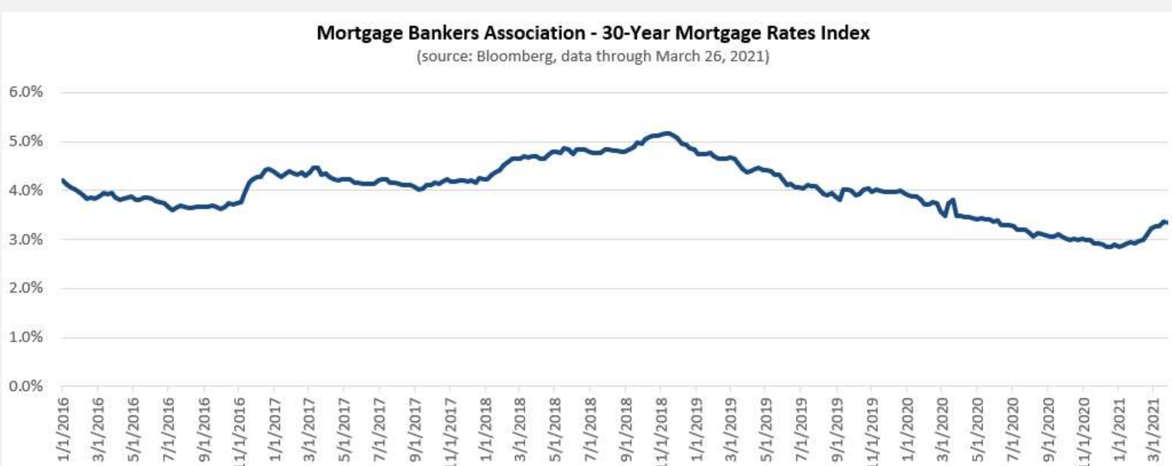
Home price appreciation, as measured by the Case-Shiller National Home Price Index (see chart, below), has accelerated in recent months.

Credit Spotlight (continued)



Except for a brief disruption at the onset of the COVID pandemic, existing home sales and new home starts reflect an active housing market.

While multiple factors contribute to this very strong housing market over the last twelve months, we believe that the major contributors include the dramatic fall in mortgage interest rates since the beginning of the COVID lockdowns in March 2020. The 30-year mortgage rate, as measured by the Mortgage Bankers Association (MBA) weekly survey (see chart, below), fell from 3.77% on February 14, 2020 to a low of 2.85% on December 11, 2020.



Credit Spotlight (continued)

The purchase price of a home, as reported by the MBA, averaged $366,000 over the time period from February 2020 to present, and implies that the fall in mortgage rates from 3.77% to 2.85% reduced a buyer's monthly mortgage payments by approximately 10.9%.

Not only has the decline in interest rates been beneficial to borrowers, but both personal income and savings have increased as a result of the significant government aid provided to individuals. This has, to a large degree, offset the negative impacts of the dramatic increase in the unemployment rate. The result is a healthy consumer that has been anxious to buy.

The National Association of Realtors publishes a quarterly affordability index, calculated using median income and median home prices and conventional 30-year mortgage financing. An index level of 100 indicates a median income buyer can purchase a median priced house. Consequently, increases in the index indicate a family is more likely to be able to afford a house. From December 2019 to December 2020, the index increased from 163.0 to 168.9, or 3.6%, indicating improving housing affordability. This suggests that the effect of higher home prices during 2020 was offset by lower mortgage rates.

With regard to the effect of recent rate increases on housing affordability, we consider the relationship between mortgage rates and US Treasury note yields. The 30-year mortgage contract rate increased 37 basis points since year end 2020, while the yield on the 10-year US Treasury Note increased 74 basis points. The smaller increase in the mortgage rate relative to US Treasury rates is a result of aggressive competition among mortgage lenders. To maintain market share, mortgage lenders have been biased toward maintaining as low a mortgage rate as possible. Concurrently, significant fiscal stimulus in the form of both direct payments and extended unemployment insurance benefits provided increased assistance to consumers. This, combined with continued improvement in employment metrics bodes well for potential home buyers and supports the housing market.

In conclusion, we do not believe the increase in interest rates will either curtail the growth of the housing market or squeeze borrowers and buyers out. Indeed, we expect that demand will remain strong and support housing prices, and that the housing market will remain strong and positively contribute to overall GDP growth.

Investment Grade Credit

In the first quarter of 2021, the Bloomberg-Barclays US Corporate Index generated +95 basis points of excess returns over similar duration US Treasuries, as spreads tightened 5 basis points during the period. Headwinds during the period included a substantial increase in US Treasury note volatility, negative total returns, tight corporate spreads, an administration transition in Washington DC and heavy high grade corporate new issuance. Yet spread volatility in investment grade credit markets remained contained throughout the quarter, due to solid technicals and improving corporate fundamentals, positive high grade fund flows, reduced hedging costs for foreign investors, dovish Federal Reserve policy and an improving corporate outlook. Risks persist, however, including increasing geopolitical tension, interest rate volatility and a potential for a re-leveraging of corporate balance sheets to fund M&A transactions.

The best performing industries and sub-segments of the Bloomberg-Barclays US Credit Index on an excess return basis comprised airlines, independent energy, pipelines, refining and telecommunications. Domestic banks, home construction, packaging, retailers and technology ranked among the worst performing industries and sub-segments during the quarter.

We remain market weight in investment grade credit, as an improving corporate fundamentals outlook is offset by tight valuations for high grade corporate spreads. Although US Treasury note yields recently spiked higher, all-in corporate yields remain at the lower end of their recent range. The option adjusted spread (OAS) on the Bloomberg-Barclays US Corporate Bond Index ended the first quarter at 91 basis points, 282 basis points tighter from the pandemic period peak and 5 basis points tighter than the beginning of the year. Demand technicals and favorable corporate fundamentals remain supportive to high grade corporate credit, however, investment grade corporate spreads remain near their record level tights. In light of this, it appears that investment grade corporate spreads have already pulled forward and priced in a substantial amount of positive economic news into current valuations.

High Yield

The US high yield bond market fought off the increase in rates in the first quarter as the Bloomberg-Barclays US Corporate High Yield Bond Index (the High Yield Index) returned +0.85 basis points. High yield bond spreads continued to march tighter in the quarter, ending the period at 310 basis points, 50 basis points tighter from year-end 2020 and through the 2020 pre-COVID tights of 315 basis points. However, higher interest rates offset the spread tightening; and on a yield basis the High Yield Index finished the first quarter five basis points wider at 423 basis points, briefly posting a new record low yield of 389 basis points in mid-February.

With the US economy and credit fundamentals on track to recover in 2021, lower-rated tiers of the high yield market continued to outperform in the first quarter, with CCCs posting a +3.6% return, followed by Bs at +1.2%, and BBs at -0.2%. The so-called "reopening" sectors continued to outperform, with transportation (+4.4%), energy (+3.6%), leisure (+2.6%), retail (+2.5%), and aerospace / defense (+2.4%) leading the market during the first quarter. Less cyclical and more rate-sensitive sectors underperformed, including utilities (-1.8%), supermarkets (-1.2%), and communications (-0.4%).

Analysts currently expect first quarter 2021 S&P 500 earnings to increase approximately 25% on a year-over-year basis. Given that strong earnings expansion, fourth quarter 2020 high yield earnings trends seem hardly relevant. Nevertheless, revenue and EBITDA increased 7% and 3% on a sequential basis, respectively, while year-over-year declines moderated to -5% and -13%, respectively. However, average leverage reported by high yield issuers continued to increase, rising to 6.1x at the end of the first quarter of 2021, versus 5.8x in the third quarter of 2020 and 4.2x at the end of the fourth quarter of 2019. Notably, for comparison purposes, during the 2008 financial crisis leverage peaked at 5.2x. The default rate improved from its recent plateauing trend in the low 6% level to 4.8% at the end of the first quarter. We expect leverage to continue to decline as earnings growth resumes throughout 2021.

High yield retail funds experienced $10.3 billion of outflows in the first quarter, more than reversing the inflow of $7.7 billion in the fourth quarter of 2020. Nevertheless, high yield technicals remain sound as fixed income investors persistently hunt for more yield. A record $158.6 billion of new issuance priced in the first quarter, with refinancing accounting for over 75% of that volume. Although companies may continue to issue to lower their cost of capital and push out maturities, net new issuance is likely to remain low for the remainder of the year, with M&A related financing posing a potential wildcard. Lastly, following a record year for fallen angels in 2020 ($237.5 billion), the tide has reversed thus far in 2021 as ratings agencies downgraded only $1.8 billion of debt to high yield from investment grade, while rising stars totaled $13.9 billion.

While fundamentals and technicals will likely remain supportive of the high yield market in 2021, valuations could pose a challenge for performance going forward. Spreads are hovering around post-crisis tights, but a catalyst for widening is not obvious against the backdrop of further stimulus spending, a successful vaccine rollout, and continued quantitative easing from the Federal Reserve. We continue to focus on rotating into sectors that will benefit as the economy normalizes, with a particular focus on higher-coupon bonds not exposed to the potential for near-term calls. While BBs remain attractive relative to BBBs, we still see value in lower-rated tiers of the high yield market that offer more carry in today's low-rate environment.

Leveraged Loans

The leveraged loan market posted a +2.01% total return in the first quarter of 2021, as measured by the Credit Suisse Leveraged Loan Index, outpacing the +0.85% gain on the High Yield Index. Average loan prices climbed another 1.75 points to approximately $97.50 at the end of the quarter, adding to the 6.25-point gain in the second half of 2020 and ending a point above the year-end 2019 level of $96.50. During the first quarter, spreads (3-year discount margin) tightened 37 basis points to 449 basis points, in line with mid-2019 levels but still wide of post-crisis tights (unlike high yield spreads). With LIBOR holding relatively stable at around 0.20% during the quarter, yields (assuming a 3-year life) declined 22 basis points in the period to 4.88%. As was the case for the High Yield Index, lower-rated leveraged loans outperformed again in the first quarter as CCCs returned +7.5% and split Bs returned +4.6%; whereas BBs and split BBBs gained +1.2% and +0.7%, respectively. At the sector level, energy posted the best return by far at +7.4%, while broadcasting generated the only negative return (-1.3%).

Loan market technicals proved extremely favorable during the first quarter as the back-up in rates drove an $11.1 billion retail fund inflow (compared to outflows of $16.3 billion in 1Q20). Additionally, CLO issuance reached record levels during the quarter, with 235 deals totaling over $106 billion pricing, up from $32 billion in the fourth quarter of 2020 and $42 billion in the first quarter of 2020. To meet stronger demand, primary loan issuance jumped to over $300 billion in the quarter (+52% year-over-year), but over 75% of that volume represented refinancings or repricings. Excluding refinancings, net new issuance jumped 56% year-over-year to $38 billion. With just one default occurring in the first quarter, the leveraged loan default rate declined 60 basis points to 3.3% at the end of March 2021, which is still up nearly 150 basis points compared to the prior-year period. We expect the default rate to continue trending down during 2021 as earnings and credit metrics rebound sharply.

With leveraged loan yields and spreads now slightly above the comparable high yield figures and high yield spreads at the tightest levels since 2007, we maintain our preference for loans over high yield bonds at this juncture. Our base case asserts that much of the returns in fixed income during 2021 will come from coupon carry, an environment well-suited for loans, particularly if upward pressure on interest rates resumes. At the sector level, we continue to target opportunities that should benefit as the economy reopens, although we acknowledge that markets have priced in much of the economic optimism at this point.

The MOVE Index is a measure of US interest rate volatility that tracks the movement in US Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries.

The Bloomberg-Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

The Bloomberg-Barclays US Credit Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

The Bloomberg-Barclays US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

The Bloomberg-Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1 / BB+ / BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

The Credit Suisse Leveraged Loan Index tracks the investable market of the US dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's / S&P ratings of Baa1 / BB+ or Ba1 / BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.