FIXED INCOME UPDATE FOURTH QUARTER 2021

KEY POINTS

- Inflation, central bank policy and the yield curve remain prominent in bond investors' minds despite the persistence of COVID-19.
- Global central banks have turned markedly more hawkish as they prepare to fight "sticky" inflation.

IN THIS ISSUE

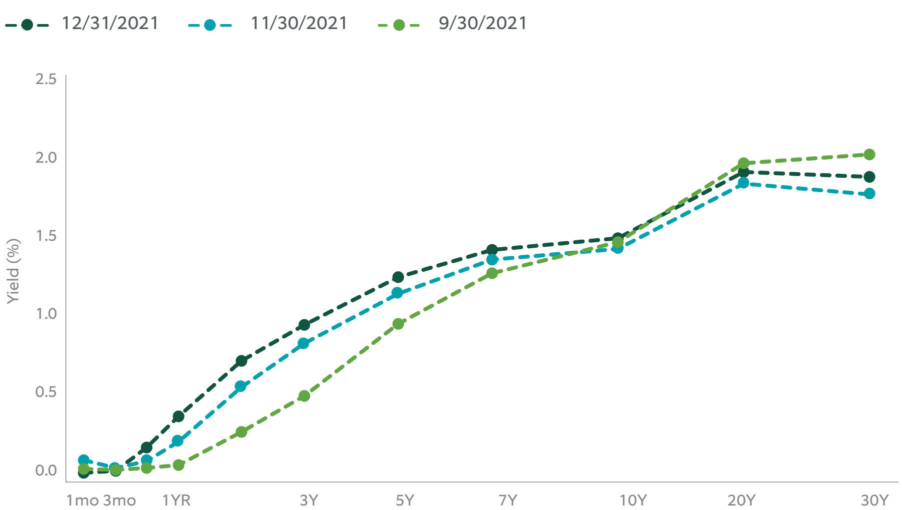
Long-Term View

Inflation remains elevated. However, investors expect inflation will eventually return to pre-pandemic levels.

EXHIBIT 1: TREASURY CURVE FLATTENS, SIGNALING FED RATE HIKE

The Treasury curve flattened meaningfully as the front end moved higher and the long end declined. Front end moves are sensitive to Federal Reserve policy and its outlook while the back end focuses on growth and inflation. The shape of the curve signals that the Fed will raise rates soon. However, growth and inflation are expected to return to pre-pandemic levels in the medium term.

Treasury Yield Curve



Source: Bloomberg, as of December 31, 2021

ECONOMY

- Despite intra-quarter headwinds and the pandemic persisting longer than many had anticipated, the U.S. economy continued to show signs of recovery. Employment data, as measured by nonfarm payrolls and ADP's National Employment Report, was positive, although reported figures did not consistently beat consensus estimates. The unemployment rate fell to 3.9% while labor force participation ticked up to 61.9%.
- Inflation remained at the forefront for financial pundits and politicians alike. Headline inflation — +0.8% for November versus consensus of + 0.7% — delivered its highest rate since 1982. Year-over-year inflation rose to 6.8%.

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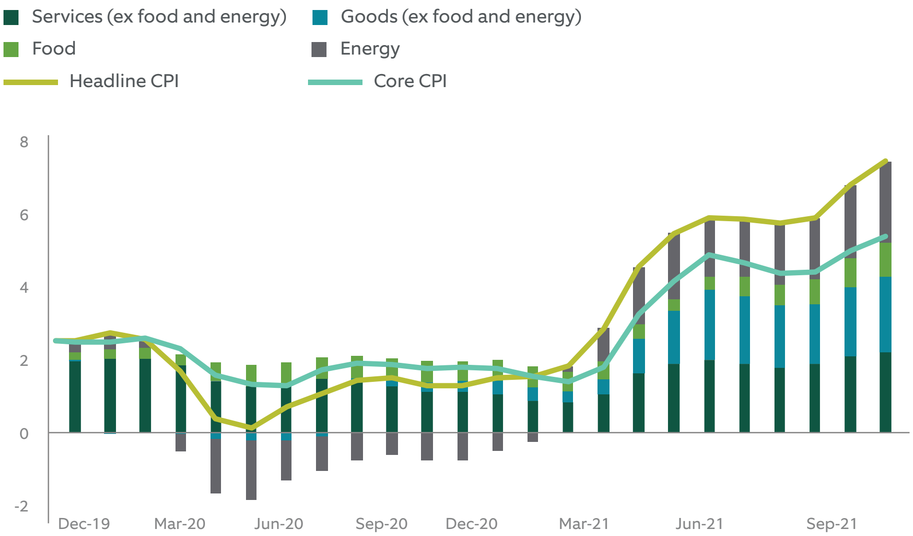
EXHIBIT 2: INFLATION SURGE

Inflation remains broad-based and continues to move higher.

Consumer Price Index (CPI) Year-Over-Year % Change (not seasonally adjusted)



Source: Bloomberg, as of December 31, 2021

FEDERAL RESERVE

- After remaining accommodative throughout the year, the Fed reeled in more of its pandemic stimulus by announcing a reduction in its asset purchase program. Following the initial announcement, the Federal Open Market Committee (FOMC) announced further acceleration, aiming to end the program by March 2022. Additionally, the committee dropped the word "transitory" from its communications about inflation.
- Despite a personal trading scandal affecting three Fed staffers, Jerome Powell was renominated as the Fed's chair and Lael Brainard was elevated to vice chair. While Powell and Brainard share similar policy views, the FOMC turned much more hawkish, signaling that their approach to interest rates may change soon. The median FOMC member projection, according to the most recent "dot plot," is for three rate hikes in 2022.

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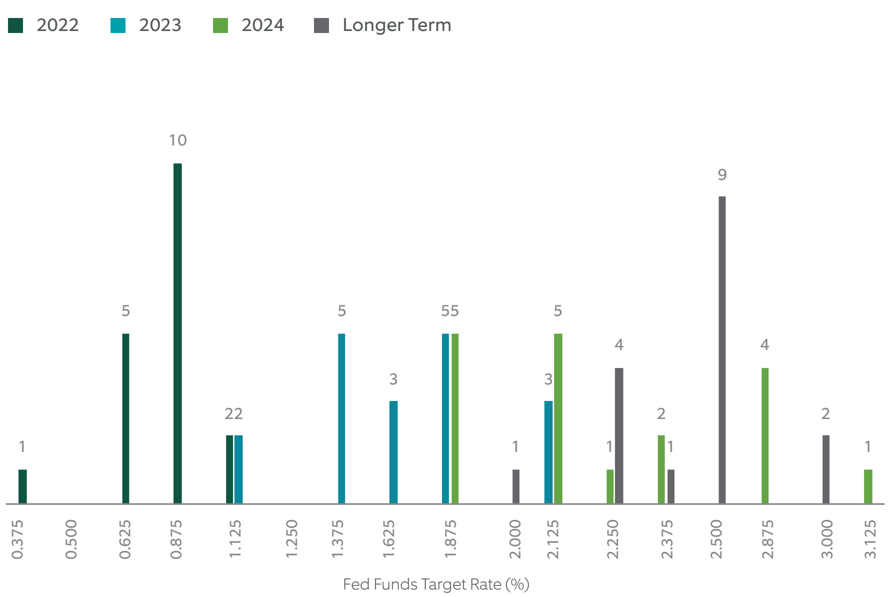
EXHIBIT 3: "DOT PLOT" SUGGESTS HIGHER RATES SOONER

FOMC members share their interest rate expectations anonymously in their "dot plot" graph. The latest graph suggests the FOMC will achieve higher interest rates sooner than many investors had expected.

FOMC Members' Expectations for Fund Funds Rate at Year-End (# of member votes)



Source: Federal Reserve, as of December 31, 2021

GLOBAL CENTRAL BANKS

- As inflation ran hot around the globe, central banks began pivoting toward reducing monetary accommodation. The Bank of Canada ended its quantitative easing program by November. Both the Bank of England and the Fed turned more hawkish as they grappled with high inflation and potential pandemic-related lockdowns.
- The Bank of England and Reserve Bank of New Zealand raised rates by 15 and 25 basis points, respectively. Several emerging market central banks also raised rates. Central banks are signaling that they are concerned about inflation, so the days of ultra-accommodation are may have passed.

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EXHIBIT 4: GLOBAL INFLATION AND CENTRAL BANK TARGETS

Inflation remains well above major central bank target ranges around the globe, with the exception of Australia and Japan. The sustained inflation may justify direct policy responses from multiple central banks.

Global Inflation and Central Bank Targets

	Headline Inflation (%)	Central Bank Target Inflation (%)
Australia	3.0	2.0-3.0
Canada	4.7	2(+/-1)
Eurozone	5.0	<2.0
Japan	0.6	2.00
New Zealand	4.9	1.0-3.0
U.K.	5.1	2.00

Source: Bloomberg, as of December 31, 2021

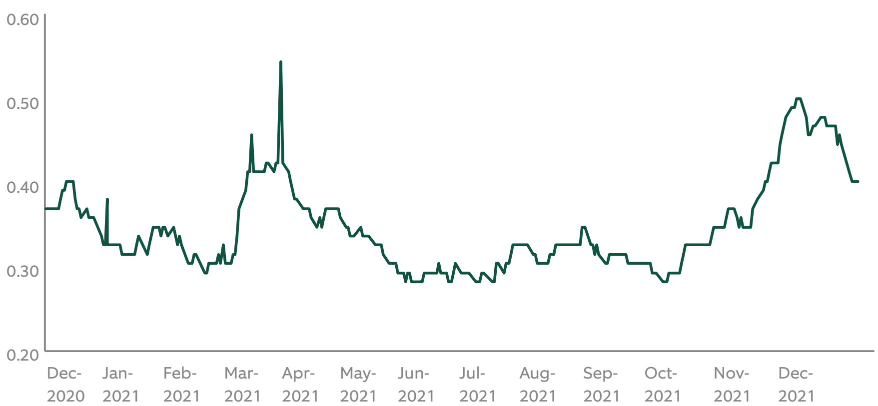
ULTRA-SHORT/CASH

- Option adjusted spreads (OAS) for bonds with 1-3 years maturity widened 10 basis points over the quarter and ended the year at 42 basis points. The widening can be attributed to interest rate volatility and poor liquidity. However, demand for front end corporate paper remained strong.
- Following the Fed's pivot, Treasury and agency paper with maturities beyond March 2022 sold off. Shorter paper continued to trade on top of or through the Fed reverse repo facility floor of 5 basis points.

EXHIBIT 5: TIGHTER SPREADS FOR 1–3 YEAR MATURITIES

Spreads tightened at year end on the back of strong demand.

1–3 Year Fixed Income Option Adjusted Spreads (OAS, %)



Source: Bloomberg, as of December 31, 2021

Performance

- Contributors: duration, trading
- Detractors: curve, asset allocation

Current Positioning

Portfolios are positioned neutral-to-long duration relative to their benchmark. Their cash benchmark means purchasing corporate or Treasury bonds makes the portfolios long duration.

TREASURYS AND TREASURY INFLATION-PROTECTED SECURITIES (TIPS)

- The Treasury market experienced increased volatility over the quarter in anticipation of upcoming changes in monetary policy. Investors are expecting the Federal Reserve to hike rates sooner rather than later, causing a strong curve flattener. The 10-year Treasury yield moved as high as 170 basis points and as low as 134 basis points intra-quarter.
- TIPS breakevens were volatile and moved higher as the breakeven curve steepened. The move was most pronounced in the front end of the curve, due to its sensitivity to Fed policy.

EXHIBIT 6: VOLATILE TIPS BREAKEVENS MOVE HIGHER

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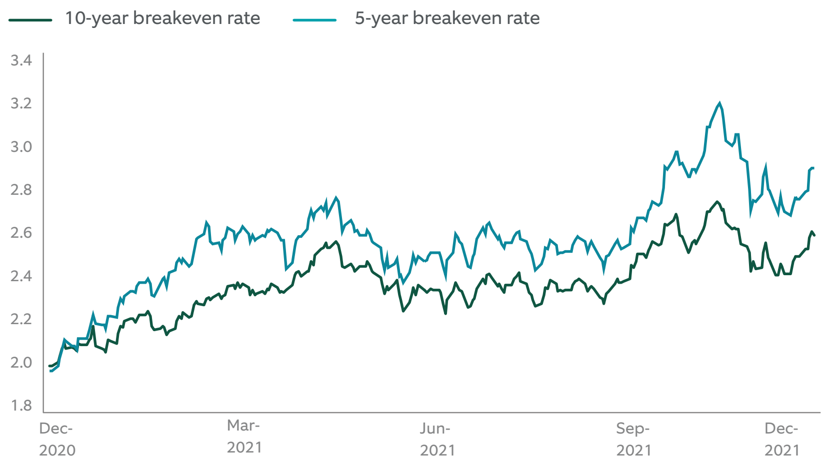
U.S. TIPS Breakeven Rates (%)



Source: Bloomberg, as of December 31, 2021. Breakeven rates are the difference between yields of TIPS and Treasurys of the same maturities, representing inflation expectations.

Performance

- Contributors: inflation carry, longer dated rates
- Detractor: duration in the belly of the curve

Current Positioning

Portfolios are positioned neutral-to-long duration relative to their benchmarks because we believe the market is incorrectly pricing in inflation and the Fed tightening cycle.

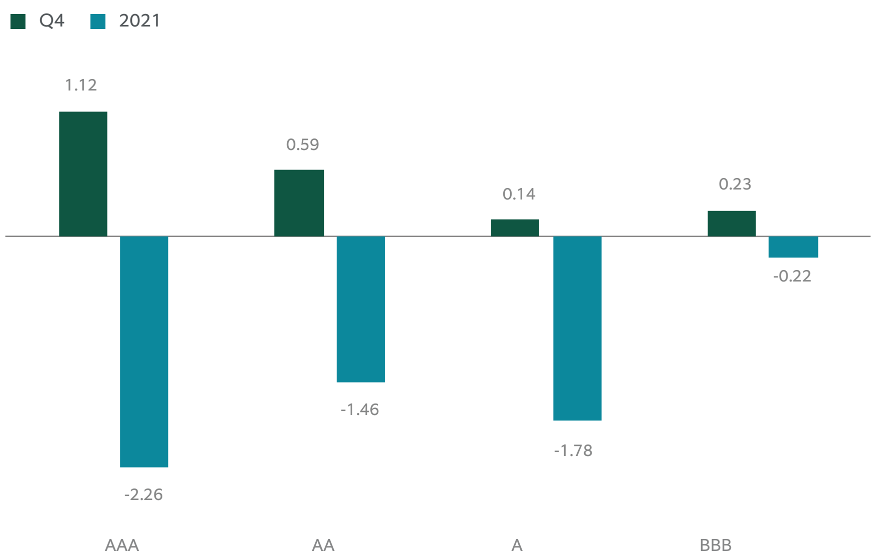
INVESTMENT GRADE BONDS

- High grade companies significantly slowed their bond issuance, due to the holidays and interest rate volatility. December was the lightest issuance month of the year, with roughly $62 billion of bonds issued. Demand for corporates remained strong, with the average deal oversubscribed by more than two-and-a-half times.
- Higher credit quality corporate bonds performed better over the quarter. Returns: AAA (+1.12%), AA (+0.59%), A (+0.14%), BBB (+0.23%).

EXHIBIT 7: HIGHER QUALITY BONDS PERFORMED WELL

Higher quality bonds provided strong returns as investors looked for quality this quarter.

Investment Grade Corporate Returns by Credit Quality (%)



Source: Bloomberg, as of December 31, 2021

Performance

- Contributor: curve, asset allocation
- Detractor: security selection

Current Positioning

Portfolios are positioned neutral-to-long duration relative to their benchmarks, while maintaining a moderate overweight to corporate bonds.

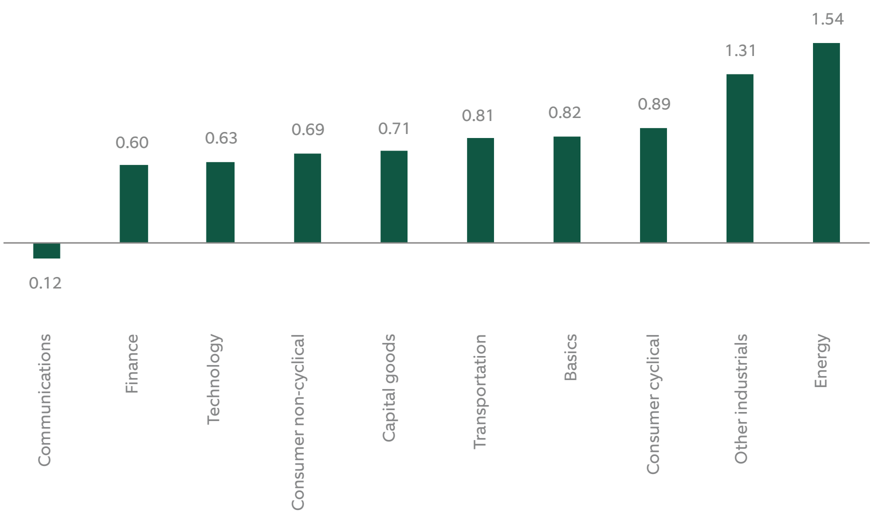
HIGH YIELD RETURNS

- High yield credit spreads tightened 6 basis points over the quarter to close at 282 basis points, after widening to 336 basis points in November. The transportation sector tightened (-33 basis points) the most while technology experienced the most spread widening (+27 basis points). B rated bonds (+0.84%) were the best performing bonds within high yield, followed by BB (+0.75%) and CCC (+0.54).
- While 2021 was a record issuance year for high yield companies, fourth quarter issuance was the lowest of the year. The index finished up 5.28% for the year and up 0.71% for the quarter.

EXHIBIT 8: ENERGY SECTOR PERFORMED BEST

While the price of oil was negatively affected by concerns around the omicron variant of COVID-19, energy remained the best performing sector. Year-end positioning may reflect a positive outlook for the sector in 2022 as we expect economic conditions to normalize.

Fourth Quarter High Yield Sector Returns (%)



Source: Bloomberg, as of December 31, 2021

Performance

- Contributor: security selection
- Detractor: curve, duration

Current Positioning

Portfolios are positioned to manage the impact of market and sector volatility, while focusing on income generation and downside risk protection. We will remain positioned in the mid-range of the credit risk spectrum.

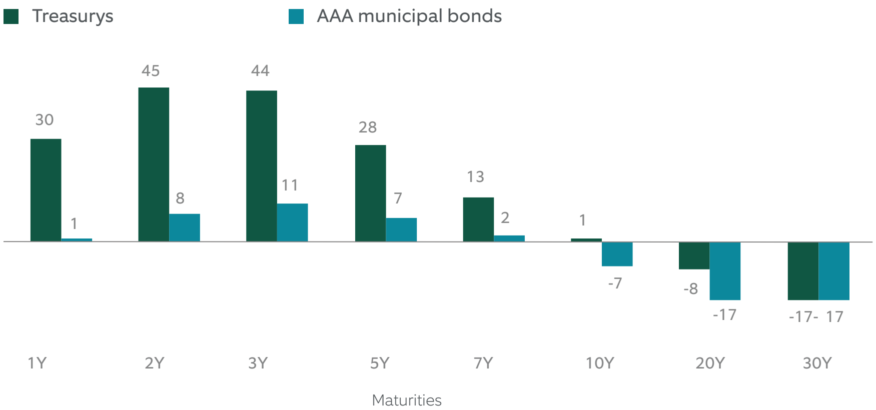
MUNICIPAL BONDS

- Yields rose on shorter maturities and fell on maturities 10 years and longer as the yield curve flattened, helping relative performance versus most indices.
- Longer mandates generally outperformed their shorter counterparts.

EXHIBIT 9: INCREASES IN MUNICIPAL BOND YIELDS LAGGED THOSE OF TREASURYS

Increases in municipal bond yields lagged those of Treasurys as the yield curve flattened.

Changes in Yields: Treasurys Versus AAA Municipal Bonds (basis points)



Source: Bloomberg, as of December 31, 2021

Performance

- Contributor: duration
- Detractor: yield curve

Current Positioning

Interest rate risk should typically be neutral to start the year, but trend defensive into February and March. Higher quality credits are attractive, as BBB and A rated spreads remain tighter than pre-pandemic levels

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