Portfolio Commentary

Navigator® Fixed Income Total Return

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Whiplash

It's hard to believe 2020 is half over. I think most people probably wish it was already over and in the history books. It certainly has been a wild ride in the markets, and the second half of the year may provide a bumpy ride, too. With the recent surge in COVID-19 cases, reopenings in some states have been paused or reversed. The Presidential Election is just four months away and is likely to be very divisive and could spark an additional bout of volatility. I think we will need to keep our seat belts fastened tightly.

A global recession and bear market took hold in March as governments around the world implemented social distancing and "shelter-in-place" restrictions to slow the spread of the COVID-19 pandemic. The swings in the market have been massive over the past few months. At the lows for the year, equities were down in excess of 30% on average and high yield bonds were down almost 20%; only cash, U.S. Treasuries, and gold offered safe haven status. The rebound has been spectacular, driven by massive coordinated central bank and fiscal policy actions.

Mean reversion was the story of the second quarter, with areas most impacted by the first quarter liquidity crunch (commodities, small-caps, high yield) among the best performers. Risk-on assets were major benefactors of the rebound. The S&P 500 posted its best quarter since 1998, gaining over 20%. Major indices around the globe advanced, led by large-cap growth stocks. Small-cap and high beta stocks, high yield bonds, investment grade bonds, and commodities all rallied. Supported by the Federal Reserve's buying activities, and rebounding from a brutal first quarter, below investment grade bonds posted their best quarterly return since the third quarter of 2009, while new issuance surged to a record of more than $58 billion in June. Companies rated high yield, which have been torpedoed by the coronavirus, are tapping lenders who are betting that either the pain will be temporary, or they are just buying time to defer a reckoning into the future.

Second Quarter Attribution

For the quarter, Fixed Income Total Return underperformed the Bloomberg Barclays U.S. Corporate High Yield Index (gross and net of fees) and outperformed the Bloomberg Barclays U.S. Aggregate Bond Index (gross and net of fees). Year to date, the strategy is handily outperforming the Bloomberg Barclays U.S. Corporate High Yield Index (gross and net of fees) and underperforming the Bloomberg Barclays U.S. Aggregate Bond Index (gross and net of fees).

Credit spreads blew out during the March sell-off with high yield spreads reaching 1100 bps, their highest levels since 2009 during the Credit Crisis. The portfolio came into the second quarter fully allocated to high yield bonds, having purchased high yield on March 27th, four trading days off the bear market lows. The strategy owned high yield for almost the entire quarter, exiting the position on June 29th, and buying intermediate-term U.S. Treasuries. High yield bonds produced strong returns during the quarter, especially when compared to U.S. Treasuries. The Bloomberg Barclays

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U.S. Corporate High Yield Index gained 10.18%, and the iShares High Yield Corporate Bond ETF (HYG) gained 6.5%. Treasuries lagged with the Bloomberg Barclays 7-10 Year U.S. Treasury Index gaining only 0.89%. The rally in high yield and other risk assets was driven by optimism regarding an economic recovery, support from the Federal Reserve, fiscal stimulus adding massive amounts of liquidity, and the Federal Reserve's statement that it would buy corporate credit and ETFs to stabilize the markets.

Outlook

As we extend into the summer months, we are likely to see economic data continue to improve from the depths of the contraction. We will see the worst quarter of economic decline in history when the second quarter GDP statistics are released later this month. The economy already bottomed, and we anticipate this will end up being the shortest recession on record. We expect a strong economic recovery in the second half of the year and to then resume a slower growth trajectory into the future. As long as the Fed has the market's back, flooding the system with liquidity, we can expect the market to remain resilient. However, the renewed surge in the COVID-19 case count, the slower than expected improvement in employment trends, social unrest, the election cycle, and our model's risk-off stance suggest that a time of consolidating the gains may lie ahead. We are likely to see additional bouts of volatility this year, especially as the Election heats up.

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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.

The Bloomberg Barclays U.S. Corporate High-Yield Index covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable 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.

Bloomberg Barclays U.S. Aggregate Bond Index: The index is unmanaged and measures the performance of the investment grade, U.S. dollar denominated, fixed-rate taxable bond market, including Treasuries and government-related and corporate securities that have a remaining maturity of at least one year.

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