Portfolio Commentary

Navigator® Fixed Income Total Return

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Navigate Your Future. Enjoy the Journey.

Economic Growth Rebounds, but Risks Remain

It has been quite a year so far. The markets have endured a global pandemic that caused the deepest recession since the Great Depression, the fastest decline into bear market territory for equities, a record recovery to new highs for the major indices, and now the presidential election is next on the event list. A combination of fiscal and monetary policy initiatives served to stabilize the markets and bridge the economic chasm created by the response to the pandemic.

Now we are in a position where the economy has gradually re-opened, economic growth has sharply rebounded, and the market, at least the S&P 500 and Nasdaq 100, has hit fresh record highs. But there is still a lot of uncertainty with the presidential election front and center, rising cases in COVID again here in the U.S., and a second spike in cases across Europe.

The markets endured a correction in September following a run into record territory, giving back a small portion of the massive gains from the March lows. The good news is that the uptrend remains intact, the correction has relieved some pressure driven by overly optimistic investor sentiment, and we are beginning to see some of the economic re-opening themes perform well, including basic materials, cyclicals, and industrials.

Corporate bond issuance along with investment grade and high yield new issuance, has already eclipsed its prior yearly record highs. Companies are taking advantage of the low rates and Fed backstop and are issuing debt and refinancing existing debt at lower rates, levering up their balance sheets. From a corporate finance standpoint, we believe it makes sense given the yield environment. Currently, there is an insatiable demand from investors for bonds, which is evident in the massive fund flows into fixed income mutual funds and ETFs.

Given the record issuance of new debt at longer maturities with lower interest rates, we now have record duration across fixed income asset sectors. Record duration and the likelihood of being in a downgrade cycle highlights the risk currently embedded in bonds. Our position is that investors need to be active and tactical in fixed income more now than ever before. Particular attention needs to be paid to credit risk, duration risk, and liquidity risk. Our fixed income solutions manage each of those risks by being active and tactical and as a result, we believe they are well-positioned for the current fixed income environment.

Third 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 of fees), underperforming net of fees. Year-to-date, the strategy is outperforming the Bloomberg Barclays U.S. Corporate

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High Yield Index (gross and net of fees) and underperforming the Bloomberg Barclays U.S. Aggregate Bond Index (gross and net of fees).

We believe Fixed Income Total Return has done well this year managing through challenging markets. The strategy stepped away from risk in February and March and was positioned defensively during the market selloff. It entered back into high yield on March 27th, four days after the crisis low and enjoyed the bulk of the recovery as risk assets surged. The strategy assumed a brief risk-off position on June 29th, which resulted in relative underperformance during the quarter, before moving back into high yield on July 30th where it has stayed invested for the remained of the quarter.

Our position has been lower yields for longer, and the Fed confirmed they will keep rates low on the short end for at least the next three years. There is no yield at the short end of the curve. For example, the yield on Treasuries are: 0.127%, 0.277%, and 0.684% for two, five, and ten-year notes, respectively. On a yield basis, high yield remains attractive with a 5.77% yield.

Credit remained firm during the quarter as the economy reopened. Spreads contracted by over 100 basis points and ended the quarter at 517 basis points. The high yield market did have a correction in September, as did other risk-on asset classes. The Bloomberg Barclays U.S. Corporate High Yield Index declined 1.99% from its peak on 9/2/20, which was an all-time high for the index, to its recent low on 9/25/20. During that corrective period, credit remain well supported and there was little evidence of a flight to safety with U.S. Treasury yields remaining flat.

Outlook

We expected a "square root" type of recovery, with a very sharp rebound in Q3, followed by slower, but still positive growth in subsequent quarters. That type of recovery still looks very likely as the economy continues to reopen. The Atlanta Fed's GDP Now forecast model is calling for 35% real GDP in Q3.

We think that the economy will rebound close to 30% on a seasonally adjusted annual rate (SAAR) basis in Q3, then 10% in Q4, and then average 5% in 2021. Supporting factors of the strong recovery include a 25% year-over-year surge in the money supply, which gives the economy a lot of momentum. Housing starts have hit new highs, which equates to pent up demand for future spending. In addition, inventories have been drawn down as consumer spending has outpaced inventory accumulation. Therefore, we believe that we are likely to see inventories replenished over the next couple of quarters, which will be supportive for growth.

There could be a fair amount of volatility around the presidential election. It's very likely we won't have a winner declared on election night, or even shortly after, due to the massive amounts of mail-in ballots that will need to be counted. A few key battleground states do not allow mail-in ballots to be counted until Election Day. That alone could result in a delay of declaring a winner. This election is likely to end up in the courts, similar to the 2000 election, but this time across multiple states.

In 2021, the election will be behind us, there will likely be a vaccine that is widely distributed, and there will be more fiscal stimulus. We believe this will all lead to continued solid economic growth, absent a massive shutdown again, which there is no appetite for.

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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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