Portfolio Commentary

Navigator® Fixed Income Total Return

Portfolio Manager

K. Sean Clark, CFA®
EVP, Chief Investment Officer

Credit and High Yield Hold Up Strong in the Face of Rising Yields

Market Review

2021 is off to a strong start with the economy very strong and gaining momentum as the vaccine rollout continues and the economy reopens. The markets are being driven by stronger-than-expected economic growth, very easy monetary policy, and fiscal stimulus in the form of a $1.9 trillion COVID relief package and new a massive infrastructure package working its way through Congress.

We are now a little over a year since the market bottomed last March, and the returns for risk assets have been spectacular. For example, over the past 12 months, the S&P 500 has gained 56.33%, the Russell 2000 surged 94.82%, and the Bloomberg Barclays U.S. Corporate High Yield Index gained 23.72%. Risk assets continued their rally in the first quarter with the S&P 500 gaining 6.17% and the Russell 2000 adding 12.69%.

The first quarter of 2021 was one of the worst quarters for fixed income on record. Rising Treasury yields led to large losses in long duration bonds. During the quarter, high yield bonds offered refuge from the losses experienced in other fixed income sectors. The Bloomberg Barclays U.S. Corporate High Yield Index gained 0.85%, the Bloomberg Barclays U.S. Aggregate Bond Index lost -3.37%, its worst quarterly loss since 1981, and the U.S. Treasury 7-10 Year Index declined -5.74%.

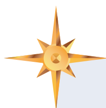
The Federal Reserve has committed to keeping interest rates anchored at the short end of the curve until there is meaningful improvement in employment. The Fed's comments suggest that they will let the economy run hot for a while and not act preemptively. As such, supply chain shortages, rising inflation expectations, and massive Treasury auctions have resulted in Treasury yields pushing higher. The 10-year U.S. Treasury yield bottomed at 0.50% on March 9, 2020 and rose to 1.75% to close the first quarter. At the same time, the yield curve has steepened with the Fed holding short rates anchored near zero.

First Quarter Performance Highlights

For the quarter, Fixed Income Total Return outperformed the Bloomberg Barclays U.S. Corporate High Yield Index gross of fees, and outperformed the Bloomberg Barclays U.S. Aggregate Bond Index (gross and net of fees). It was a challenging quarter for fixed income as interest rates continued higher, weighing on returns.

- The strategy entered the New Year with a risk-on bias and remained fully invested in high yield bonds throughout the quarter.
- Credit and high yield bonds held up very well in the face of rising yields. The strategy's allocation to high yield bonds proved defensive due to high yield bonds' lower duration and interest rate exposure than Treasuries and investment grade bonds.

Past performance is not indicative of future results.
This is not a recommendation to buy or sell a particular security. Please see attached disclosures.



- The extra yield investors received by investing in high yield bonds instead of U.S. Treasuries fell to 310 basis points by quarter end. Yields are close to all-time lows as well, fueling a surge in borrowing as companies look to lock in historic rates. The first quarter was the busiest ever for high yield debt sales. A record $164 billion in U.S. high yield corporate issuance was priced in the first quarter, driven by sustained low rates and aggressive refinancing.
- High yield bonds benefitted from the economic re-opening theme. Even within high yield, lower quality outperformed, signaling no credit stress.

Positioning and Outlook

We expect the economic re-opening theme to continue in 2021 and look for economic growth to surprise to the upside in the U.S. Strong economic growth should provide for a fairly benign default environment. Previous recessions saw the U.S. high yield default rate peak in the double-digits before mean-reverting over a three-year period. Mean-reversion could happen faster this time given the shorter recession and stronger economic recovery.

We continue to favor high yield bonds and the economic backdrop is supportive of continued relative outperformance. However, high yield spreads and riskier CCC bond spreads are now at or near their lowest levels since the 2008 Financial Crisis. As long as the macroeconomic backdrop remains favorable, which is our expectation, we could see high yield bonds continue to grind higher. On the risk management front, should the economy or credit markets falter, our models stand prepared to move into a risk-off position in Treasuries or cash.

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Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

The Russell 2000 Index measures the performance of the 2000 smallest U.S. companies based on total market capitalization in the Russell 3000, which represents approximately 11% of Russell 3000 total market capitalization.

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.

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 Treasury: 7-10 Year Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with 7-9.9999 years to maturity.

Fixed income securities are subject to certain risks including, but not limited to: interest rate (changes in interest rates may cause a decline in market value or an investment), credit, prepayment, call (some bonds allow the issuer to call a bond for redemption before it matures), and extension (principal repayments may not occur as quickly as anticipated, causing the expected maturity of a security to increase).

Non-investment-grade debt securities (high-yield/junk bonds) may be subject to greater market fluctuations, risk of default or loss of income and principal than higher-rated securities.

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