## Reams Asset Management

# Investment Outlook 2021

## Executive Summary

While the flip of the calendar to 2021 will be greeted warmly by most, the Walt Disney Company has even greater reason for celebration: 2021 marks the 50th anniversary of the Magic Kingdom in Walt Disney World Resort. The self-declared "Vacation Capital of the World" was completed near Orlando, Florida, five years after the company namesake founder passed and largely under the direction of Walt's brother Roy Disney. At once both hopelessly behind schedule and well over budget, a recurrent characteristic of Disney's theme park construction, the Disney team worked arduous hours to complete construction of their second park for its October 1, 1971 dedication. Lead designer Marty Sklar humbly recounted that his team of "Imagineers" made "every mistake in the book" but noted that "we didn't make the same one twice."

For his part, Disney Parks president Dick Nunis recalled that the chaotic run-up to media day left the Contemporary Resort a veritable demolition zone of dirt and debris just hours prior to the press corps arrival. In the early hours of the morning, Nunis grabbed any available cast member and together laid sod over the sprawling 15 acres of ground. When one restaurant employee informed Nunis he had no prior knowledge of landscaping, Nunis retorted that anyone can do it: "Just remember: green side up!" The Contemporary was well appointed come sunrise; press day went off without a hitch; and Walt Disney World opened its gates the following day. Everyone, as the story goes, lived happily ever after.

Ever after…until year 49, that is to say. To state that 2020 brought a jarring and abrupt halt to life as we know it is a gross understatement. Luxuries both large and small came to a shocking halt overnight as COVID-19 pandemic fears gripped the world, and the virus continues to have very tragic and real consequences. Globally, per the New York Times, over 75 million people have contracted the virus, and 1.5 million have perished as of early December 2020. In the United States alone, the statistics are sobering, with over 15 million infected and more than 300,000 deceased as of this writing. The late-year rise in cases and deaths is buffered only by the hopeful news of promising vaccination development and the first distribution rollout.

While perhaps more trivial in human terms, the pandemic's impact on the economy has been no less profound. In March, businesses were largely shuttered as in-home lockdowns commenced nearly around the world. Unemployment spiked massively, and travel and leisure ground to a halt. Look at Disney itself as but one of many examples of just how far reaching COVID-19's impact has been felt: Theme parks were shuttered for months and then re-opened gradually and partially; the firm's studio division went dark, and movie theaters remain effectively closed; new TV production ground to a halt; the cruise industry remains docked in North America, and merchandise and retail sales are down precipitously. One bright spot in the company's lineup was its fledgling streaming service, Disney+, a competitor to Netflix. With everyone homebound for much of 2020, movie and television series libraries were one of the few entertainment outlets still viable for hungry consumers.

For many smaller, standalone companies well below the ranks of the Fortune 500, the impact was perhaps even more severe, forcing layoffs, closures and bankruptcies. Capital markets, which had entered 2020 anticipating more smooth sailing, seized up dramatically in early March, with the S&P 500 falling nearly -25% in just three weeks prior to a late-month rally. Interest rates collapsed to near zero, as spooked investors piled into relatively safe U.S. Treasury securities and the Federal Reserve responded by slashing the Fed Funds rate accordingly. Risk asset spreads ballooned wider in a highly illiquid trading backdrop, with the Barclays spread index pushing out more than +200bps in March alone. Ultimately, high-quality borrowers rushed to fortify themselves with new debt financing, and in late March 2020, the Federal Reserve unveiled unprecedented steps to backstop asset valuation by direct purchase of fixed income instruments – including, for the first time, corporate debt.

From April onward, despite the virus caseload and harrowing statistics never fully getting under control, investor risk appetite re-emerged, and the “don’t fight the Fed” mantra of much of the previous decade came back as the primary driver for asset value reflation. Equities gained back first quarter losses and then some, with the S&P 500 +14% year to date by the end of November. Credit spreads tightened all the way back to +100 by November’s end, nearly retracing levels of early 2020. And the low interest rate environs made a heady backdrop for real estate: Refinancing to ever-low rates became all the rage, and home price appreciation zoomed.

The end of 2020 brought further validation for the bulls, as the capital markets cheered on speedy vaccine development from pharmaceuticals such as Pfizer, Moderna, and AstraZeneca. Additionally, the decisive election victory of former Vice President Joe Biden to the presidency brought some predictability going forward in the political sphere. Even better for capitalists, the very entrenched and narrowly divided government suggest that the next four years will see little in the way of truly transformational or disruptive legislation for the business community at large. Both houses of Congress have razor-thin majorities, and what legislation will be passed must be borne of consensus from a centrist collective.

At Reams, the events of March generated an opportunity set the likes of which we had not witnessed since the 2008-09 Financial Crisis. While the truly extraordinary levels were available for only a short time, our defensive posture heading into 2020 positioned us well to pounce at the severe pricing dislocations as liquidity dried up in credit markets.

Pounce we did, pivoting sharply to a significant overweight in investment grade corporate bonds, which in part helped us deliver exceptionally strong total returns for our clients across our mandates.

A volatile 2020 sets up a particularly challenging framework as we enter 2021: What now? The optimistic economic recovery forecast by investors seems to stand at odds – at least for the time being – with the very different health pandemic impacts felt across the global landscape. And now valuations no longer appear particularly attractive, with low yields pointing to a challenged near-term total return picture in fixed income.

We acknowledge that the immediate future might have more than a few bumps in the road. A health crisis the likes of which we have not witnessed since 1918 – truly a once in a 100 years event – still looms large for society as a whole. Volatility in either direction could be elevated, at least compared to the standards of the relatively benign 2014-19 timeframe. The margin of safety in risk assets appears low, and we are already witnessing evidence of excessive risk taking and risk in the system.

Nevertheless, we look at where we have traveled and what we now know, and still champion the indefatigable human spirit and the resilience of long-term investing. While the setup does not warrant unbridled optimism, neither does it beckon excessive despair and misery. The problems that exist, be they societal, health, or financial, are not so insurmountable that they cannot largely be solved with intuition, evolution, teamwork, time, and some forward thinking. This health crisis will abate, thanks in no small part to the scientists, doctors, healthcare workers, and everyday heroes coming together and working for the collective good. In capital markets, volatility has emerged, and the complex puzzle will require both a degree of patience and a degree of nimbleness in the year ahead. We at Reams welcome the challenge. So all hands on deck for 2021. Just remember: “Green side up!”

What follows is our attempt to lay out key economic data and issues we are tracking as well as to gauge where consensus estimates are, what tail risks exist to that consensus, and what opportunities may present themselves going forward.

## Reams' Key Areas of Focus for 2021

### Capital markets are looking past the COVID-19 pandemic, but the pervasive optimism may prove premature as early 2021 headlines could be negative

- Vaccine development, production and rollout may hit logistical problems/delays that reduce the efficiency and speed at which they reach the population – global suffering could extend
- Vaccine uptake and results could underwhelm, causing fear to persist and delays to resumption of normal life activities and consumer spending behavior
- Businesses could be hit with a "second wave" of closures and solvency issues in the first half of 2021; the worsening employment picture, increasing defaults, and school closures could negatively impact workforce availability
- Markets/economic estimates are poised for a rebound story, though the timeline could get pushed out substantially with a sharply negative first half of 2021; on the positive side of the ledger, an increased misery index may heighten the odds of further fiscal intervention

### Federal Reserve policy is still accommodative but efficacy is in question; future ability to be the asset backstop may be tested

- Federal Reserve support of asset valuation proved crucial in 2020, and credit markets may need implicit proof that the Fed at least retains ability for direct purchase of corporate debt to sustain the recent rally
- Likely bias to remain accommodative and maintain zero-bound front end rates, given high unemployment and increased economic inequality as a result of pandemic, would likely allow inflation to run past target in short term
- The Federal Reserve may be limited on additional measures going forward given the low altitude of rates and could have limited effectiveness in combating rising rates in an overheated market/rising inflation scenario
- Some consternation in the legislative branch over scope of Federal Reserve tools and ability under the CARES Act of March 2020 to extend indefinitely these lending programs and direct capital infusions; could foreshadow Federal Reserve having reduced ability to expand balance sheet in a post-pandemic environment

### Fiscal stimulus gives economy recovery a ramp, but may not be enough to save the day a second time

- Political compromise on both sides led to the passage of a second round of direct U.S. government stimulus in December 2020, though this second fiscal stimulus is considerably smaller and more limited than the prior round
- The first stimulus in April provided key income substitution for impacted citizens in the forms of direct checks, increased unemployment benefits, rent and mortgage relief, and other benefits. The recently approved package has direct checks of half the size ($600 per individual), extends rent moratorium and unemployment benefits for a limited time, and may not prove to have the same multiplier impact on the economy
- Depending on the results of the second package, the Biden Administration may push for increased fiscal stimulus, though concerns over increased federal debt levels as well as prolonged lifespan of programs that were designed to be temporary may make such passage even more difficult going forward
- New legislative and regulatory framework may or may not be harmful to business conditions, dependent on what is accomplished and how substantive the legislation is. A corporate tax hike is the most likely scenario and could temper positive capital market views, though passage in a divided government is uncertain

### Inflation remains 'X' factor, and re-emergence could quash a fledgling recovery, while continued absence could foretell low rates persisting indefinitely

- Inflation remains subdued despite more than a decade of experimental monetary policy globally, though recently expectations of increasing inflation have started to surface
- A second fiscal stimulus added to the monetary accommodation could grease the wheels for a roaring recovery – only to give way to uncontrolled inflation reemergence that puts an end to higher equity and fixed income prices
- On the flip side, if inflation fails to materialize to the Federal Reserve's 2% target, and gross domestic product (GDP) growth is middling, the "escape velocity" coming out of the 2020 recession could be underwhelming, and rates could remain tethered to a zero-bound area or go negative at the front-end of the curve
- This impact could have major ramifications, increasing additional borrowing and skipping the de-levering economic growth phase entirely; savers would be hurt and risk-takers emboldened in a reach-for-yield climate

## What is the Consensus Viewpoint?

| | 2020 Actual | 2021 Consensus | 2021 Downside | 2021 Upside |
|---|---|---|---|---|
| **GDP Growth** | **-2.90%** | **3.90%** | **2.50%** | **4.50%** |
| Unemployment Rate | 6.90% | 6.00% | 8.20% | 5.00% |
| CPI Inflation Rate | 1.80% | 2.00% | 1.25% | 3.00% |
| Federal Funds Target Rate | 0.09% | 0.10% | 0.00% | 0.50% |
| 10-Year U.S. Treasury Note | 1.84% | 1.20% | 0.60% | 2.00% |
| IG Corp OAS Spread | +101 | ---- | +140 | +80 |
| ML High Yield YTW | 4.59% | ---- | 6.25% | 3.50% |
| VIX Index | 24.35 | ---- | 35.00 | 12.00 |

**Consensus Economic Forecasts based on Bloomberg Survey Results as of December, 2020. Federal Funds Target Rate represents upper band guidance.*

For 2021, surveyed economists (per Bloomberg, see chart above) collectively forecast GDP growth of +3.9%, which represents the largest single year economic output increase since 2004. Of course, this comes with a huge asterisk, as the gain really comes only on the heels of 2020's estimated decline of –2.9%. Thus, net-net for the two years, economic output is still slightly down, and certainly some sectors, such as consumer discretionary spending in travel and leisure, may take several years to return to 2019 levels. Nevertheless, there is reason to be hopeful that 2021 will spur a substantive GDP pickup, aided by the recently passed second round of fiscal stimulus. The income substitution of the first bout of fiscal stimulus passed in April 2020, coupled with the Federal Reserve's actions, showed the potency of fiscal and monetary policy working in concert. 2021 could be more of the same. Many economists have suggested some "pent up" demand as consumers have tabled spending on discretionary items while confined to the home. Certainly, the behavior patterns and tracked weekly spending are suggestive that while not 2019 again, the U.S. consumer will indeed prove hard to keep down.

Elsewhere, major economic markers are likely to show similar upward positive trend. Unemployment likely won't return to pre-pandemic 50-year low watermark levels but should see continued improvement from the current 6.7%. Given the vast employment "slack" in the system, it's not unreasonable to see estimates approaching mid-to-low 5% unemployment by year-end 2021. Inflation, meanwhile, continues to be a vexing problem for both economists and central bankers. Near-term, the Core Consumer Price Index (CPI) is anticipated to increase up to +2.0%, matching the long-term target of the Federal Reserve. Recent price action in the Treasury Inflation-Protected Securities (TIPs) market showed long-term anticipated break-even inflation right at 2%. This is a "goldilocks" forecast of not too hot but not too cold. As we speak to later, the path of inflation could take many avenues, but over the next 12 months is likely to be tempered by that still-high unemployment rate and modest wage growth.

Rates cratered in mid-March 2020 as the Fed Funds rate went effectively to 0%. The Federal Reserve has communicated a desire to keep front end rates in the zero bound until at least 2023, though we have seen that regulatory body change course of action for expediency before. Nevertheless, near-term rates will be anemic, particularly so in the front end. While not the base case, negative rates are quite possible for a short timeframe, particularly in any kind of a corrective equity market backdrop. A modest curve steepener in the second half of 2020 helped convey that inflation expectations (or fears) may dictate the long end having a different path. Consensus estimates are for the 10-year U.S. Treasury to end 2021 at 1.20%, which would imply a mild increase from current levels befitting a rate normalization path consistent with the economy bouncing back and the impacts of the pandemic receding.

The VIX Index, a key measure of equity volatility, blew out to levels above 80 briefly in March, levels last seen in late 2008 in the depths of the Financial Crisis. By December, however, the index had returned to just over 20, still elevated versus staid periods but perhaps underselling the disparate ways U.S. equity markets could move going forward. Levels are expected to remain in the 15-25 range in 2021, and if that materializes, that would suggest ample volatility to berth several opportunistic investment timeframes for patient investors.

Elsewhere in the world, GDP rates are expected to rise precipitously from sunken 2020 levels, with global GDP anticipated to rise 5.2%. The European Union, hit by dual economic lockdowns of even worse severity in some respects than the U.S, is anticipated to grow +4.7%, led by France, Spain, and Italy, all of whom saw their economies shrink in excess of -7.0% in 2020. Japan's growth will be lower than the U.S., but given the low organic growth of economic output for the past three decades, +2.6% growth nominally is not bad if a -5% drop had not preceded it. China, where the virus first permeated, has at least seemingly resumed "normalized" lifestyles as reported case counts are now fairly low. GDP growth there is estimated at +8.2% after 2020 contracted to just +2.0% positive, the lowest figure in 30 years. Given its dominant consumption of raw materials, China could move up or down dependent on how underlying commodities play out in 2021. (Source: Bloomberg)

Consistent with Reams' traditional approach to scenario analysis, we prefer to focus on the factors that might cause results to deviate from the consensus, either to the upside or downside.

## What is the downside case (in interest rates) to consensus?

At first blush, there would not appear to be a great probability of lower interest rates. For starters, the nominal levels are already extremely low: The 10-year U.S. Treasury yielded a meager 0.84% at the end of November 2020, and many front end curve points yielded less than 0.25%. Given the troubles Eurozone members have had battling potential deflation amid negative-yielding interest rates, as well as the low growth, flat rates Japanese experience of the past 30 years, the Federal Reserve has substantial motive to keep rates in positive territory. That said, Federal Reserve Chairman Jerome Powell is on record stating that front end rates would be kept low until 2023, in an effort to spur investment incentive and an accommodative risk lending environment. Notwithstanding Federal Reserve precedent of moving the goalposts when the data is convenient, for 2021 at least, the "lower-for-longer" rates would seem applicable, particularly on the front end, which is heavily dependent on the Fed Funds rate.

A move lower still would most likely result from an equity sell-off and risk-off appetite moving more aggressively into U.S. Treasurys. Any number of conditions could cause this outcome, and we consider two timeframes on this question: an immediate (next six months) and then a slightly longer time horizon (six-24 months). In the immediate future, a very real risk exists of a new COVID-related "wave" causing further economic lockdowns/business closures, delayed re-openings, and the like. Cases continue to spike, and vaccine treatment is either not widely available or has experienced minor setbacks. Unemployment, currently at 6.7%, could easily retreat to 8%+ levels. If such a set of circumstances materializes, an already heated equity market in the U.S. would likely be primed for a correction, and U.S. Treasury yields naturally would fall, possibly to negative territory on any maturity within 5 years. While this is all downside risk that is not in the baseline expectation, and as tragic as some of these events would be, the impact would probably be short-lived and not disrupt the longer term, post-COVID "return to normalcy" for those with longer investment horizons. One positive we would note is that the poor economic trends in the above scenario could heighten the need for more fiscal stimulus, potentially increasing the size and scope of any additional congressional relief package to come in 2021. Lastly, though the Federal Reserve efficacy would be a question mark, the direct bond buying programs may put a bit of a floor on short-term damage as there still exists capacity for buying securities directly. Thus while initially painful, this early 2021 downside rate situation may not necessarily be fatal even to the baseline full year 2021 economic case. Bonds would perform adequately from a total return standpoint as interest rates fell, though spread product would likely underperform.

The more significant lower rate proposition is the intermediate term horizon: six to 24 months. Here, rates would move lower due to GDP results that simply fall well short of consensus estimates. In this scenario, further fiscal stimulus would be insufficient in size, not timely, or not comprehensive enough amid a divided U.S. Congress. Whatever the cause, the net result would likely be middling GDP growth that fails to properly ignite a recovery to pre-COVID 19 levels. A multitude of factors could weigh on results here: Perhaps persistent virus-related negative impacts to the economy, such as changes to consumer behavior and spending patterns, keep people homebound longer, to the detriment of many sectors such as leisure and service industries. The first round 2020 fiscal stimulus and increased unemployment benefits saw neatly proportional income substitution, with recipients of government largesse saving approximately 25% of proceeds and a debilitated economy successfully propped up for the short-term. If the multiplier effect is less substantial on this current fiscal go-round, the "escape velocity" of the economy could be far less than estimated. The direct stimulus cash infusion is just half of the first round amount, and the increased unemployment benefits and rent moratorium benefits received only temporary extensions. Once exhausted, the inequality picture in the U.S. economy, already exasperated by the pandemic, may be magnified.

Additionally, the new Biden Administration could temper animal spirits in capital markets if costly regulatory or tax reform is enacted. The incoming president certainly has tax legislation on his to-do list, which, if passed, could increase corporate tax rates upwards to 28%, possibly shaving approximately 10% off aggregated corporate profits. Regulatory oversight and scrutiny in sectors such as technology and pharmaceuticals could also be increased, and on this point may draw support from both sides of the aisle in reigning in the formidable clout of the largest players in these respective industries.

Trade and geopolitical risk also deserve mentions here, as they annually do. Tense China trade relations have taken a backseat amid the health pandemic and then an election season, but President-elect Biden may be compelled to keep the pressure on China from a trade standpoint. At the very least, the heavy tariff activity of the past decade may not be rolled back anytime soon. Hopes of a larger trade deal seem remote at best, and any new perceived hostilities could refocus capital markets on the fragile relations between the world's two largest superpowers. Away from China, there continues to be unresolved trade issues with the United Kingdom with regard to its prolonged and seemingly haphazard exit from the European Union – a failure to find consensus there would trigger tariff enactment in 2021 that could be very painful for the U.K. Any geopolitical hotspots, be they known agents such as North Korea and Iran or new actors, could also roil a fairly favorable world economic growth picture for 2021.

In all of the above scenarios, rates are likely to fall in the U.S., at least initially, as investors seek safe haven. Spread product underperforms until such time that the desperation for yield kicks in. Here we have the genesis for a potential prolonged period of extremely meager returns across a multitude of asset classes, not unlike that which Japan has experienced the past 30 years. Though there are substantial differences related to the demographics of Japan when compared with the United States that make the connection an imperfect one, a perpetual low-rate investing environment cannot be discounted and should absolutely concern the long term investor.

## What is the upside case (in interest rates) to consensus?

Interest rates would theoretically rise in a robust GDP growth scenario, as rate normalization augers less demand for the relative safe haven of debt instruments and incentivizes equity ownership. Since the March collapse, rates have risen, albeit fractionally, and the curve has steepened slightly, reflective of less imminent risk than was in the system in March. The baseline economic consensus expects these trends to persist into 2021, albeit quite modestly. Bear in mind the low absolute yield levels give little cushion to absorb higher rates. Fixed income securities would likely struggle to produce positive total returns in the low single digits, even with spread product faring well in a largely positive economic backdrop.

Still, there is one clear upside case to interest rates rising more substantively: a turbocharged economic recovery greater than consensus, ultimately giving way to inflation expectations marching upwards in lock step. Lastly, skeptical market participants would want to see definitive confirmation of inflation rising well above the Federal Reserve longstanding target inflation of 2%. This would most likely be the worst outcome for fixed income investors. Rising interest rates would eat into returns sharply, likely into negative total return zones for the year. The long end of the curve, inherently far more susceptible to inflation expectations and with far greater interest rate sensitivity, would bear the full brunt of such a move. A higher inflation, higher interest rate endgame then would produce additional headaches going forward for the fixed income market: substantially lower demand for credit, higher debt repayment burdens, and weaker credit metrics.

The most obvious causes of a better-than-expected GDP growth outcome would be a rapid uptake of vaccinations, the quick denouement of the virus and resumption of normal day-to-day business, increased fiscal stimulus beyond the currently approved package, and a divided government not passing burdensome tax or regulatory legislation. While this confluence of events could certainly materialize, the magnitude of these successes would have to be far greater and quicker than the fairly rosy consensus that is largely priced into securities today.

Moreover, while inflation is rightly a concern on the horizon for investors, historically the inflation correlation to employment wage growth is material. With unemployment at 6.7% in December 2020 (Department of Labor Statistics), well above the low-water 3.5% unemployment of just a year ago, there are reasonable doubts that wage growth can be robust when certain sectors of the economy, such as consumer discretionary entities, are in such dire condition as a result of the pandemic. A challenging winter of rising cases and cold weather could exacerbate the "stay at home" mantra, and for certain businesses that might unfortunately require additional furloughs, layoffs, and even closures. Some evidence suggests there is ample labor "slack" in the system –i.e. job postings/listings – and perhaps unemployment can in fact bounce rather quickly post vaccine distribution. Still, inflation may not emerge until we see the wage growth of a more mature unemployment picture, and that would probably imply calendar 2022.

However, we still feel the arrival of inflation could potentially be very problematic. The quantitative easing of the past decade, which has been, if anything, amped up even more in 2020, is in some ways inherently inflationary by its very nature. Global central banks added a whopping $8.2 trillion to their balance sheets in 2020, while for their part, corporate entities in the U.S. investment grade universe alone issued a record $1.8 trillion of new debt and are now 3.4x levered on average. The U.S. national debt, which barely elicits so much as a shrug from Wall Street to Main Street, has increased to $27.5 trillion and now represents 128% Debt/GDP. Federal debt held by the public as a percentage of GDP ballooned to 99% as of the third quarter, up 20% from the beginning of the year. Our capitalistic tendencies notwithstanding, the Modern Monetary Theory (MMT) movement is at least at some level already well underway domestically. All this to say there is now massive debt in the system, at the government, corporate, and individual level. We continue to point to the waning months of 2018 as instructive for a glimpse of what occurred when the Federal Reserve attempted to incrementally draw down its balance sheet and move away from quantitative easing. In some respects, the global economy is in many ways tethered to low rates and high leverage. The decoupling of those rates as a result of runaway inflation, should it come to pass, could be painful on many levels. The Federal Reserve would have few remaining tools and could struggle to keep rates under control.

## Corporate Sector Outlook

After a disastrous first quarter of 2020 for corporate bonds, the remainder of the year saw a remarkable risk-on rally to essentially finish close to where levels started. On a spread basis, corporates blew out from a starting point of +93 to briefly exceed +350 in mid-March, only to finish November back at +104, or +11 wider YTD through November 2020. In excess return terms, first quarter 2020 posted a staggering -1,296 basis points return lower than Treasurys, while the next eight months saw positive results to close that underperformance gap to just -37 basis points.

Remarkably, much of this outperformance in the last three quarters came at a time of record supply from corporate issuers. Issuance came from all corners beginning in mid-March as borrowers looked to relatively cheap capital market funding – even in an illiquid trading environment – to fortify themselves for the COVID-related pause in economic activity. The success of Fortune 500 companies in accessing capital at favorable rates went a long way to quell fears of a large wave of bankruptcies at the highest levels.

While issuance is expected to slow moderately to more normalized levels in 2021, refinancing incentives remain high with extremely low rates, and even some of the debt issued in spring 2020 could be swapped for new lower coupons by savvy corporate treasurers. Additionally, the resumption of pre-COVID shareholder payouts and a ripe environment for merger and acquisition activity could loom large for supply going forward, as well as spread and ratings levels. Ratings agencies downgraded more than $200B to high yield in 2020, but broadly continue to show significant patience for marginal investment grade credits at the “BBB-“ level.

In response to the incredible volatility witnessed in March, we aggressively ramped up corporate weight (measured best by contribution-to-duration from credit), and maintained that posture for several months before gradually scaling back corporate exposure by CTD to be more in-line with the benchmark in fourth quarter 2020. While all corporate bonds rallied to varying extent in the back half of the year, we still believe there are individual issues and sectors that can still generate substantive alpha moving forward. This cohort includes the niche Airline Enhanced Equipment Trust (EETC) sector of secured aircraft collateral. While our nominal percentage weight of corporates remains overweight, we have moved down the curve, and currently favor the 3-to-5 year maturity area in both the “alpha” names as well as more generic high quality corporate holdings such as financial institutions and insurers.

## Securitized Sector Outlook

Securitized products were not immune to the extreme volatility experienced throughout 2020. Federal programs became the main focus early in the year as the government rushed in to support significant swaths of the securitized and corporate markets alike. After purchasing $30 billion Agency Mortgage-Backed Securities (MBS) per day in late March, the Federal Reserve has now settled into a steady diet of $40 billion Agency MBS and $80 billion Treasurys per month. These purchases in particular have at least encouraged the Fed’s desired environment in which we now find ourselves: namely, low Treasury rates, low mortgage rates, and high levels of refinancing and increasing home prices. Another subtle but significant change to the Fed’s purchase program was to categorize the program as an accommodative quantitative easing tool. With this change, the purchase program is no longer an emergency only tool but will now be used alongside Federal Reserve target rates as a lever to control the accommodative level of financial conditions. In other words, expect the federal government to be a major player in the Treasury and Agency MBS markets well into the future.

As expected, with these Federal Reserve purchases come significant winners and losers within the Agency MBS market. Through the end of November 2020, the overall 30-year Agency MBS index underperformed Treasurys by -18 basis points. However, the 30-year Agency MBS securities most supported by the buy program outperformed Treasurys by up to +250bps. Agency MBS securities left out of the Fed program suffered from a fatal combination of no Fed support, premium prices, high refinance rates and a continuously misplaced expectation that the refinance wave is nearly complete. Away from Agency MBS, Federal Reserve lending programs created to support commercial mortgage backed securities (CMBS) could not stem the wave of increasing delinquencies as economic activity slowed. Commercial loans struggled most acutely in the retail and hospitality sectors with delinquencies rising to 14% and 19% respectively. Forbearance, loan modification and even foreclosures in this sector will take some time to work through.

While we welcome the end of 2020, we enter 2021 with a market increasingly desperate for yield. We are reluctant to add significant risk in structured products as the market continues to reach for yield as confidence in the economic recovery increases. Agency MBS is increasingly exposed to rate volatility as well as changes to the Fed purchase program, and as a result we will likely remain underweight and maintain our ability to react tactically to any weakness. Overall, the "risk on" environment encourages our focus back to our long-term bias of short-dated (1-5 year) positions in asset-backed, commercial mortgage-backed and agency multi-family backed securities. These biases are rooted in the strong structural support, collateral strength and stability of cash flows that can be found in these securities.

For more information regarding Reams Asset Management, please contact us at 812.372.6606.