2nd Quarter 2020

Highlights

- **Despite a painful economic shock, financial markets recovered with the help of monetary and fiscal authorities. Liquidity improved and higher risk markets rallied;**
- **Forecasters expect a 6.0% decline in 2020 GDP even with a strong second half. Inability to fully contain the virus may delay the global economy's restoration;**
- **Defaults increased precipitously during the first half of the year and are expected to climb further. Ironically, the damage to lenders may not be as bad as feared.**

Markets

		Returns (%)			
GIA*	Average Quality	2Q20 Gross	2Q20 Net	12 Months Gross	12 Months Net
Core Plus Composite	**(A)**	**6.95**	**6.85**	**7.24**	**6.87**
Global Credit Plus Composite	**(BBB+)**	**9.52**	**9.39**	**7.04**	**6.50**
Emerging Market Corporate Debt Composite	**(BB+)**	**14.79**	**14.62**	**-0.06**	**-0.66**
High Yield Composite	**(B+)**	**15.81**	**15.65**	**-3.75**	**-4.28**
Benchmark Bonds					
Bloomberg Barclay's U.S. Agg. Index	(AA+)	2.90		8.74	
Treasury	(AAA)	0.48		10.45	
Credit	(A)	8.22		9.07	
Mortgage	(AAA)	0.67		5.67	
Government/Credit	(AA)	3.71		10.02	
ICE BofAML U.S. Corporate & Yankees	(A-)	8.46		9.07	
ICE BofAML U.S. Corporate	(A-)	9.27		9.30	
ICE BofAML U.S. High Yield	(B+)	9.61		-1.10	
ICE BofAML EM Corporate Plus	(BBB)	9.56		4.61	
ICE BofAML Global Gov't ex-US	(AA-)	0.76		1.71	
JPM Emerging Markets EMBI+	(BB+)	9.06		1.23	
JPM CEMBI Broad	(BBB-)	9.35		4.59	
JPM GBI-EM Global Diversified	(BBB)	9.82		-2.82	
Benchmark Equities					
S&P 500	NA	19.95		5.39	
Nasdaq Composite	NA	30.63		25.64	
Russell 2000	NA	25.00		-7.99	
MSCI EAFE	NA	14.17		-7.37	
Europe	NA	14.33		-8.84	
Japan	NA	11.47		0.87	
MSCI Emerging Markets Equity	NA	17.27		-5.67	

* Please refer to the respective factsheets for the long-term composite and benchmark returns for each strategy.

Markets

Given the dislocations thrust upon us last quarter, year-end 2019 seems like an eternity ago. In just six months, we lived through a national lockdown we never would have envisioned, we witnessed one of the most rapid economic collapses in America's history and we maneuvered an unprecedented market melt-down and recovery. Facing virtual ruin in March, financial markets staged an impressive recovery in the second quarter buoyed by speedy and comprehensive action from the Fed and the U.S. Treasury. After declining 31% as the COVID pandemic erupted, the S&P 500 stock index came back to end the second quarter down only -4.04% year-to-date. During the quarter, the Fed reassured markets by purchasing U.S. treasuries and agency mortgages, while the federal government handed out extensive aid to households and small businesses. Prices of riskier securities recovered enabling challenged industries to raise much needed funding. However, the health pandemic was not defeated and the consequences of the crisis have not yet been fully absorbed. The second quarter closed on a more optimistic note than the first, but that optimism may be tested as we push to further reactivate a debilitated economy.

Investment grade credit had an impressive quarter driven by the Fed's support, abundant liquidity and record-breaking issuance. Driven by cash needs to confront the pandemic, corporations prioritized market access over pricing to raise funds early in the quarter. Lower interest rates orchestrated by the Fed provided a further boost. The investment grade corporate bond index, the ICE BofAML U.S. Corporate Index (C0A0), was up 2.02% in June and 9.27% for the quarter. By comparison, the U.S. treasury index returned 0.11% in June and 0.21% for the quarter. However, year-to-date, treasuries were up 9.02% compared to 4.84% for corporates. Corporate option adjusted spreads (OAS) narrowed by 143 b.p. to 160 b.p., while the yield to worst of the index declined from 3.66% to 2.21%. Issuance for the quarter was a record $834.4 billion, including the largest two months of supply ever in April and May. Year-to-date issuance topped $1.37 trillion surpassing 2019's total borrowing of $1.3 trillion. Previously, the highest annual issuance was 2017 with $1.47 trillion.

The high yield market also recovered forcefully, although industries like energy, services and retail suffered lasting damage from the COVID-induced lockdown. While the authorities tried to aid every economic group, high yield borrowers did not qualify for many of the Fed's facilities. If assistance did not come directly from the CARES Act, companies were forced to approach banks and public markets. Nevertheless, the ICE BofAML U.S High Yield Index (H0A0) gained 9.61% for the quarter substantially offsetting the -13.12% first quarter loss. Energy, which constitutes about 12.9% of the index, roared back by 33.05%, yet was still negative -19.76% year-to-date. Spreads to worst narrowed 206 b.p. from 857 b.p. to 651 b.p., while the yield to worst decreased from 9.06% to 6.87%. Despite the economic headwinds, high yield retail investors added a record $47.3 billion to the sector. This haul included two record months of inflows in May and April, handily erasing the first quarter's $16.7 billion outflow. The default rate increased to 6.19% in June (6.61% including distressed exchanges) the highest in ten years. Through June, 60 companies defaulted, and the quarter's $82.2 billion in defaults and distressed exchanges beat the first quarter of 2009 for the highest default volume on record. Not surprisingly, defaults were led by distress in energy where reduced demand and collapsing prices weakened the entire industry. Meanwhile, the new issue market was lively with a record $145.5 billion pricing during the quarter including a monthly high of $61.5 billion in June. Despite depressing news in some industries, the "haves" took advantage of low rates and abundant liquidity to refinance, and fund previously planned investments.

Emerging markets bonds experienced similar price recoveries as high yield and investment grade credit, although few countries enjoyed the prolific support U.S. authorities were able to give domestic borrowers. Countries like Russia, India and Brazil experienced an explosion in COVID-19 cases which forced them into varying degrees of lockdown and economic drag. Away from India, some Asian countries, including China, experienced revivals after reopening their economies. The JPM Emerging Markets Bond Index – Global Diversified (EMBIGD), a dollar denominated sovereign index, was up 12.3% in for the quarter, but down -2.8% over the last six months. The JPM Corporate Emerging Markets Broad Diversified Index (CEMBI BD) improved 11.1% for the quarter, but remained down -0.2% year-to-date. The JPM Global Bond Index – Emerging Markets Global Diversified (GBI-EM Global Diversified), a local markets index, rose 9.8% for the quarter, yet was down -6.9% for the year.

Economy

With a tinge of irony, we met for our quarterly economic discussion exactly three months after the first quarter remote session. Accepting a complete reversal of sentiment versus reality, the conversation focused on damage assessment and expectations for a world still struggling to reopen. Inability to truly corral the pandemic places an enormous burden on global monetary and fiscal authorities that, at best, will likely prolong the time it will take to restore what we had.

Updated WSJ Economic Survey forecasts for June revealed an average expected second quarter contraction of -33.5% at an annual rate for the U.S. The first quarter's decline was confirmed at -5.0% implying a near -9.0% actual shrinkage in the U.S. economy over the first six months of 2020. Grasping for a silver lining, economists expect a 14.2% recovery in the third quarter followed by a relatively strong fourth. Despite the expected second half bounce, the year-over-year contraction remains forecast at -6.0% which implies a loss of output exceeding $1.3 trillion. Some economists envision a full recovery by the end of 2021, although the realities of a flawed reopening are forcing many to push the restoration well into 2022.

Having traversed the worst days of the lockdown during 2Q, many companies were able to assess the impact on their sales and financial status. Not surprisingly, there were distinct winners and losers, although many industries reported encouraging trends. One theme that clearly had senior managements' attention was the proper balance between boosting liquidity and containing leverage. The experience of some industries helps frame expectations for the rest of the year:

- Auto sales ended 2019 at around 17 million units, dropped to a historic low of 8.6 million at an annual rate in April and recovered to a 13.1 million pace in June;
- Rail carloads were 14.3% below last year, but intermodal transport volumes were back at February 2020 levels by June;
- Steel production remained well below last year and operating rates were still unprofitable, however prices rose from the lows. Iron ore prices stayed high, and other commodities, like copper, benefited from supply disruptions and favorable end market dynamics (housing);
- Financials were mixed with strong balance sheets and ample liquidity, but reduced margins, and forced concessions to borrowers and deteriorating creditworthiness in their loan portfolios;
- Tech and telecom were winners, although mobile phone operators faced higher customer delinquencies and significant demand for additional bandwidth;
- Healthcare was not uniformly up as hospitals struggled to provide non-COVID care and doctors were forced into "virtual treatment;"
- Services companies continued to suffer along with retailers as customers were forced or chose to stay away. Media saw significant declines in ad spending.

The lockdown also highlighted trends that may secularly alter the trajectory for certain industries. For example, many businesses began to reassess their commercial real estate needs, and the preference for urban habitation may wane. While it is early to attach permanence to lockdown-related behavioral shifts, some post-lockdown decisions by employers and young families have substantial financial and quality of life endorsement.

Reviewing the rest of the world yields a modest dose of optimism amidst an avalanche of poor data. The good news comes from China where COVID-19 originated. Economic recovery after reopening has been gratifyingly robust even with the rest of the world still fighting the disease. Away from China, economic data in Western Europe confirms a debilitating contraction, and contagion outbreaks in Brazil, Mexico, South Africa and India leave little room for optimism in emerging markets.

Scenarios

We propose three scenarios for the U.S. economy over the next 6 months:

1. Our most likely case has the economy growing about 14.0% at an annual rate in 3Q, and then slowing to a 5.0% rate in 4Q. Most western nations began to reopen by June. While protocols continue to restrain aggregate demand, the change alone will yield a big bounce. Early retail sales data indicate consumers purchased autos, leisure equipment and apparel upon reopening. Supported by fiscal stimulus and low interest rates, demand for housing, durables and personal items should continue. While demand for services like travel and dining will likely remain sluggish in 3Q, successful implementation of protocols should deliver some momentum into 4Q PROBABILITY 60%

2. A second scenario has the economy recovering more modestly at 12.0% during 3Q and only 3.0% in 4Q. The U.S. is being hit by a second wave of infections. While concentrated in southern states, the associated opening delays may zap the recovery and defer the restoration of output. This delay may also strain industries like airlines that banked on a quicker reactivation as they raised liquidity to bridge the initial lockdowns. PROBABILITY 20%

3. A third scenario has the economy recovering strongly in 3Q at around 15% and carrying strong momentum into 4Q at 6.0% or more. Citizens of severely affected second wave states may adopt a more careful approach leading to brief closures and a resurgence of activity. By the fourth quarter, medical advances may generate the confidence needed to get people back into airplanes and restaurants. PROBABILITY 20%

Market Outlook

The Federal Reserve reiterated its intent to support markets and keep policy rates low for a prolonged period. The Fed's balance sheet grew from about $4.2 trillion at the beginning of March to $7.1 trillion at the end of June. In addition, the central bank activated many of the facilities that were established in conjunction with the Treasury to ease the flow of credit. With low rates and abundant liquidity, borrowers are raising money aggressively. We expect that to continue, albeit at a slower pace. Given ongoing policy support, we think higher yielding sectors continue to be compelling and investment grade credit provides attractive carry opportunities. While defaults have risen and certain industries face solvency challenges, keeping the portfolios skewed to higher yielding opportunities continues to make sense.

July 17, 2020

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Index Definitions

Bloomberg Barclays U.S. Aggregate Index
The Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

Bloomberg Barclays U.S. Treasury Index
This index is the U.S. Treasury component of the U.S. Government index. Public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Bloomberg Barclays U.S .Government/Credit Index
The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries and agencies. The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

Bloomberg Barclays U.S. Credit Index
This index is the U.S. Credit component of the U.S. Government/Credit index. Publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

Bloomberg Barclays U.S. Mortgage Backed Securities Index
This index is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

ICE BofAML U.S. Corporate & Yankees Index
The ICE BofAML U.S. Corporate & Yankees Index tracks the performance of US dollar denominated investment grade debt publicly issued in the US domestic market by US and non-US corporations and non-US quasi-governments.

ICE BofAML U.S. Corporate Index
The ICE BofAML U.S. Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch) and an investment grade rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long term sovereign debt ratings).

ICE BofAML U.S. High Yield Index
The ICE BofAML U.S. High Yield Index tracks the performance of below investment grade US dollar-denominated corporate bonds publicly issued in the US domestic market.

ICE BofAML Global Government Excluding the U.S. Index (N0G1)
The ICE BofAML Global Government Excluding the U.S. Index tracks the performance of publicly issued investment grade sovereign debt denominated in the issuer's own domestic currency. N0G1 excludes U.S. government bonds.

JP Morgan Corporate Emerging Markets Bond Index Broad (CEMBI Broad)
The CEMBI tracks total returns of US dollar-denominated debt instruments issued by corporate entities in Emerging Markets countries. Two variations are available: CEMBI Broad and CEMBI. The CEMBI Broad is the most comprehensive corporate benchmark followed by the CEMBI, which consists of an investable universe of corporate bonds. Both indices are also available in Diversified versions.

JP Morgan EMBI+ Index
The EMBI+ tracks total returns for U.S-dollar-denominated debt instruments of the emerging markets: Brady bonds, loans, Eurobonds. The EMBI+ currently covers 104 instruments across 15 countries.

JP Morgan Government Bond Index-Emerging Markets (GBI-EM)
The GBI-EM is the first comprehensive, global local Emerging Markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. Variations of the index are available to allow investors to select the most appropriate benchmark for their objectives.

S&P 500 Index
An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

Nasdaq Composite Index
An index that tracks the change in the total market value of all companies listed on the Nasdaq Stock Market.

Russell 2000 Index
An index measuring the performance of the 2,000 smallest companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small cap stocks in the United States.

MSCI EAFE Index
The index is a capitalization weighted index that monitors the performance of stocks from Europe, Australasia and the Far East.

MSCI EAFE- Europe Index
The index is a capitalization weighted index that monitors the performance of stocks from Europe.

MSCI EAFE- Japan Index
The index is a capitalization weighted index that monitors the performance of stocks from Japan.

MSCI Emerging Markets Equity
The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.