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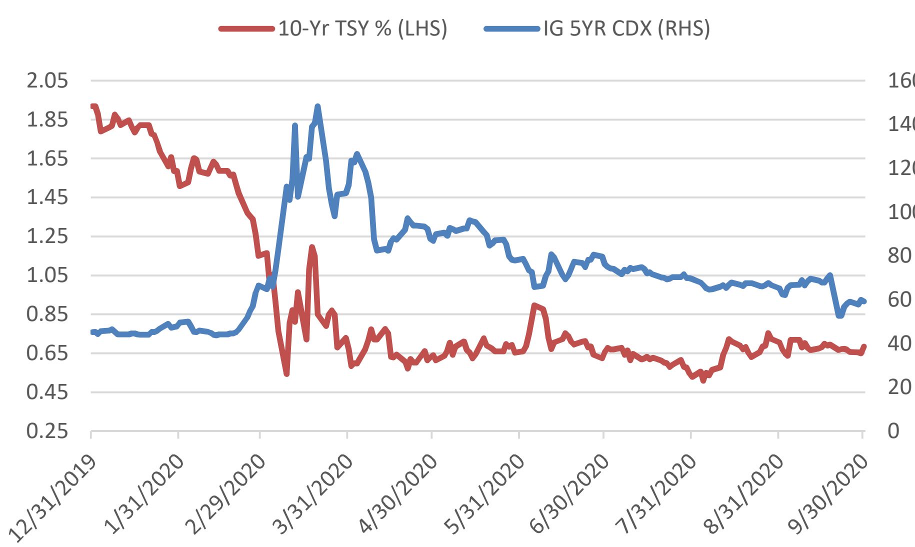
MARKET Commentary

Q3, 2020

Macro View

Fixed income markets largely treaded water over the quarter as states reopened and isolated surges were watched with trepidation (see Figure 1) while equity markets pushed ever higher as economic data demonstrated the resilience of the domestic economy. Negotiations for further fiscal stimulus dissolved into political chaos as each party held fast even as bipartisan attempts to bridge the gap looked reasonable. The quarter closed with investors forecasting a Biden victory and keenly focused on the outcome in November.

Figure 1: A Quiet Quarter



Source: Bloomberg

The Federal Reserve maintained course on zero interest rate policy as well as asset purchases, $80B of Treasury and $40B of agency mortgage-backed securities a month. Further, the Fed announced a shift in future monetary policy implementation with less emphasis on raising rates preemptively if inflation moves higher.

Economic data continues to come in stronger than consensus leading to a sharp increase in Q3 GDP offsetting much of the steep decline in the spring. Unfortunately, certain sectors and socioeconomic groups are not participating in this recovery illustrative of the long broader recovery path ahead.

Front-end and intermediate treasury yields will remain low, tethered by 0.00-0.25% fed funds and quantitative easing measures for the foreseeable future.

Federal Funds Target

0.00-0.25%

U.S. Treasuries

As of 30-Sep

Benchmark	Yield
3 Month	0.09%
6 Month	0.10%
1 Year	0.12%
2 Year	0.13%
5 Year	0.28%
10 Year	0.68%
30 Year	1.46%

ICE BofAML Index Returns

2020 YTD Return

Index	Return
0-3 Month UST	0.52%
1-3 Yr Gov/Corp ≥ A	3.11%
1-3 Yr Municipals	1.96%
1-3 Yr Agencies	2.54%
1-5 Yr Gov/Corp ≥ A	4.26%
S&P 500	5.57%

Source: US Treasury, Bloomberg, ICE/BofAML, and S&P

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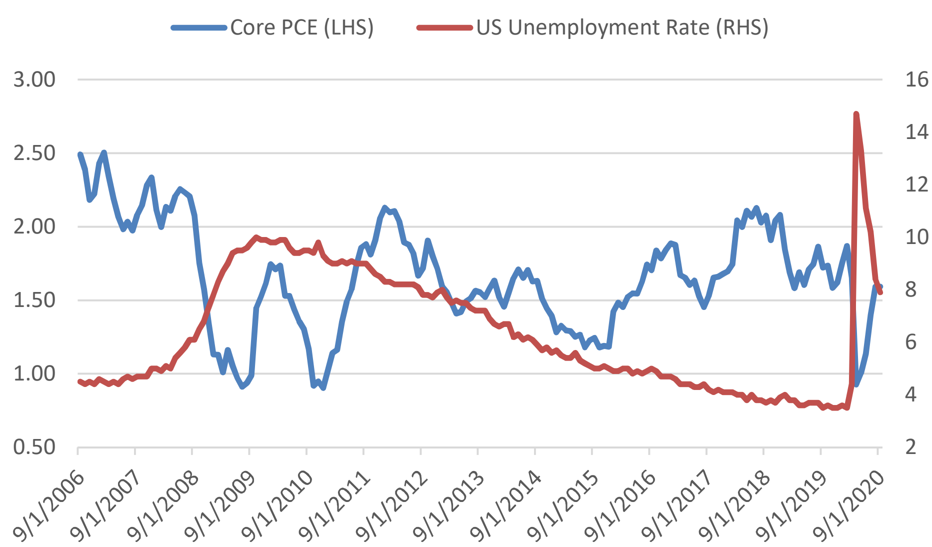
Volatility will likely increase around the election and pandemic news. We view these bouts of spread widening as opportunities to add to sectors across portfolio mandates.

Monetary Policy

The August Economic Policy Symposium held annually in Jackson Hole has provided a backdrop for the communication of major monetary policy shifts in the past. This year's virtual event was no exception. In early 2019, the Fed launched a review of its monetary policy strategy to assess how best to achieve its congressionally assigned goals of maximum employment and price stability. In his speech this past August, Fed Chair Powell laid the groundwork for a shift in how monetary policy will be implemented going forward by stating that the Fed will look at average inflation over a period rather than preemptively raising rates to head off higher inflation. This likely means rates will be lower for longer as the Fed may accept inflation above 2% while striving for full employment (see Figure 2) as core PCE, the Fed's preferred measure of inflation, hasn't breached 2% very often or for long in recent history.

Figure 2: Core PCE and U.S. Employment



Source: Bloomberg

The September FOMC meeting marked the fourth in a row at which the fed funds target remained unchanged at 0-0.25% and again signaled that they expect to stay low for some time. Quantitative easing measures continued on auto-pilot and market support facilities (like the commercial paper funding facility) remain little used and set to expire at year-end.

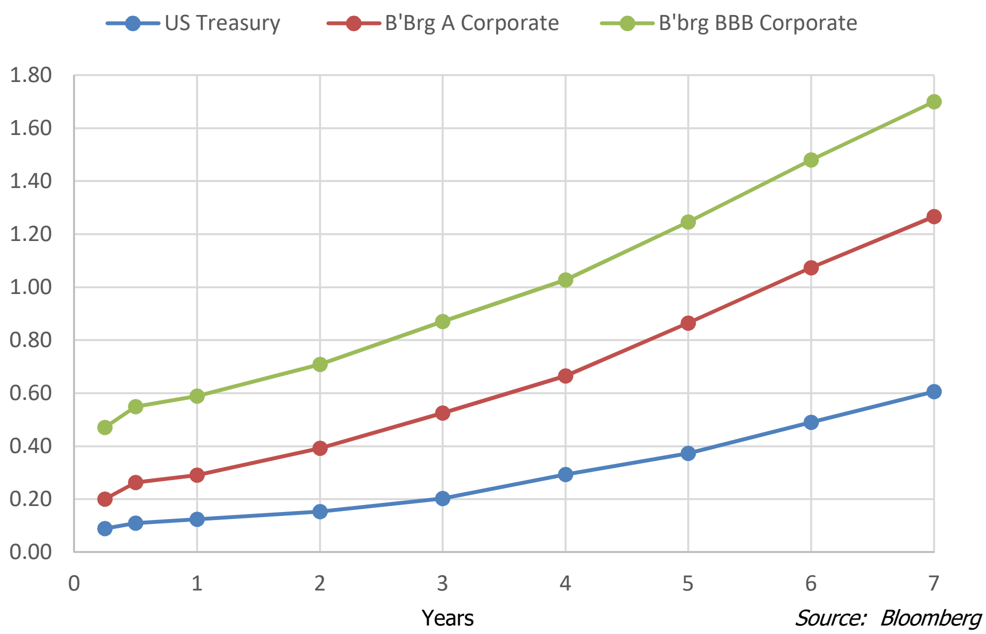
Markets

The fixed income landscape continued to build on Q2 themes. Front-end treasury yields were anchored by Fed policy, spreads tightened – albeit at a slower pace, primary issuance remained robust while pandemic news and political headlines injected very brief periods of modest volatility. As the quarter progressed, money market yields inched closer to the fed fund target of 0-0.25%.

A prominent financial blogger recently wrote a post titled "Negativity is not an investment strategy" emphasizing that doing nothing has risk. His post focused more on personal wealth management, but this tenet applies to all investors. Complaining about low rates or the political landscape can be comforting, but it is not an investment strategy.

Therefore, given the current environment what can a fixed income investor do? After ensuring appropriate high-liquidity needs are met with a balance in bank deposits or government money funds, look to take advantage of duration and spread product. Corporate curves look reasonably steep and offer value especially beyond the five year maturity window the Fed has been purchasing within (see Figure 3).

Figure 3: Market Update (09/30/20)



Securitized sectors look attractive as well and can balance lower-rated credit exposure to maintain higher average portfolio credit quality. AAA-rated prime auto and credit card security offer 10-20 basis points over treasuries while agency mortgage-backed securities offer more depending on the structure and duration profile. Additionally, it is an opportune time to review your investment policy and ensure appropriate flexibility is permitted to maximize yield with the Fed on hold for the foreseeable future.

Money fund reform resurfaced as several regulatory officials touched on a need to do more. The most recent instance was at a mid-October SEC virtual roundtable where Fed Vice Chair of Supervision Quarles highlighted the structural vulnerabilities that were exposed in March. His comments followed those by U.S. Treasury and SEC staff suggesting the need for further money market fund reform. Quarles noted that "prior reform efforts fell short". As a result, Treasury, SEC and the Fed's Financial Stability Board are working on solutions to address vulnerabilities in the short-term funding markets. If the Fed's zero interest rate policy doesn't push prime funds to extinction, coming regulation might.

The yield curve was modestly steeper as short rates fell about 4 basis points and longer maturities rose 4 basis points. Within the quarter, yields touched record lows on pandemic concerns over the second surge domestically. However, as states navigated these surges and the broader economy continued to show resilience, yields sold off modestly. Heading into the national election, the country is seeing another surge in cases which should add to the noise surrounding the election.

Looking Forward

Financial conditions have returned to accommodative levels as capital is accessible and inexpensive. The worst of the pandemic's economic impact is, hopefully, behind us. Further, the sharp recovery experienced in Q3 will now give way to more moderate growth dependent on vaccine progress, pandemic infection levels and governmental response. More broadly, the outcome of the national election will have significance even though the impact will take time to ascertain and create market volatility.

Investors shouldn't accept the opportunity cost of extremely low rates in funds or deposits. Take advantage of current policy flexibility to extend duration and maximize prudent spread product exposure. Further, revisit your investment policy to ensure your investments can take advantage of the current opportunity set.

Please contact the desk with questions on policy reviews or to discuss investment opportunities as 2020 comes to a close.

Form ADV Part 2

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