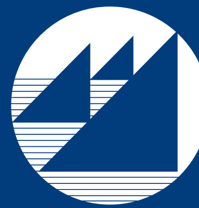
MANAGER COMMENTARY

FIXED INCOME



GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY

Second Quarter 2020

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MARKET REVIEW

The quarter ended June 30 was all about the fiscal stimulus from the Fed and Government pledges of support to businesses in an effort to keep the economy from locking up. Massive amounts of money were injected into the system, and the response from the markets was decidedly positive, resulting in benchmarks doing an about face from Q1. Many new programs were enacted to keep people at work, and by and large this has worked to keep commerce intact, albeit at much lower levels. The federal government stimulus programs, as well as state initiatives in unemployment compensation and new guidelines for phase-in return-to-work will drive the markets for the near term. The biggest concern of all is indeed the pandemic and how flare-ups and waves of new cases will affect restarting the business world. This quarter may be viewed as "bad" compared to last quarter being "worst". We are squarely in a recession, but the equity and fixed markets have seen a remarkable comeback.

INDEX RETURNS FOR THE PERIOD ENDING JUNE 30, 2020

	Q2 2020	YTD
BB Aggregate	2.90%	6.14%
Corporate	8.99%	5.02%
Treasuries	0.48%	8.71%
ABS	3.54%	3.32%
Mortgages	0.67%	3.50%
High Yield	10.18%	-3.80%
Municipal	2.72%	2.08%
2-year Treasury	0.14%	2.96%
10-year Treasury	0.68%	12.70%
30-year Treasury	-0.71%	24.91%

Source: Bloomberg

SECTOR HIGHLIGHTS

Credit: Corporate spreads were tighter by 122 basis points during the 2nd quarter. Spreads started the quarter at 272 basis points and ended at 150 basis points. Longer-dated corporates performed better than shorter-dated corporates. Lower quality corporates outperformed higher quality corporates. Both utilities and industrials outperformed financials. Specifically, within industrials, energy and basic materials had the best excess return for the quarter. After the U.S. Congress allocated capital on March 27 to the U.S. Federal Reserve for it to purchase corporate bonds, spreads compressed. The credit fundamentals did not improve, with nearly a record number of downgrades for the quarter as businesses temporally closed, and businesses also issued record amounts of debt. The Bloomberg Barclays Aggregate Index returned 290 basis points for the quarter, the Bloomberg Barclays Intermediate Govt/Credit Index returned 291 basis points, and the Bloomberg Barclays Corporate Investment Grade Index returned 899 basis points for the quarter. The U.S. economy fell into a recession during the first quarter and likely did not come out of it during the second quarter with the advent of the Coronavirus. Liquidity within the corporate market improved after the Federal Reserve said it would purchase corporate bonds.

Municipals: Municipal bonds bounced back sharply after a violent downswing in March. Munis, in line with most fixed income assets, saw a spike last quarter with 10 year AAA yields hitting nearly 3% after having been in the 0.90% level in mid-March. Although still volatile, the muni market ended the quarter with solid flows back into the asset class, settling in near 1.25% for 10 year AAA paper. Liquidity improved markedly after the Fed vowed financial support for certain Muni issuers, a first from the Fed.

The Barclays indexes produced these returns:

	Q2 2020	YTD
Bloomberg Barclays 1-10 Year Muni	2.69%	2.12%
Bloomberg Barclays 3-15 Year Muni	2.84%	2.27%

Source: Bloomberg

Mortgage-Backed Securities: Mortgages returned 67 basis point for the second quarter and 350 basis points year-to-date. Throughout the quarter, spread tightening has been broad-based as spreads tightened across TBA, specified pools, CMO, and CMBS. Heavy new issuance was met with even heavier demand. Given the current low level of interest rates, MBS origination is high and CMO issuance is the highest since 2011. (source: Morgan Stanley)

MBS have been well supported by the overall risk-on trade, continued Fed buying operations, lower volatility, and broad-based demand from money managers and banks. Within the sector, lower coupons outperformed the up-in-coupon trade and 30 years outperformed 15 year mortgages.

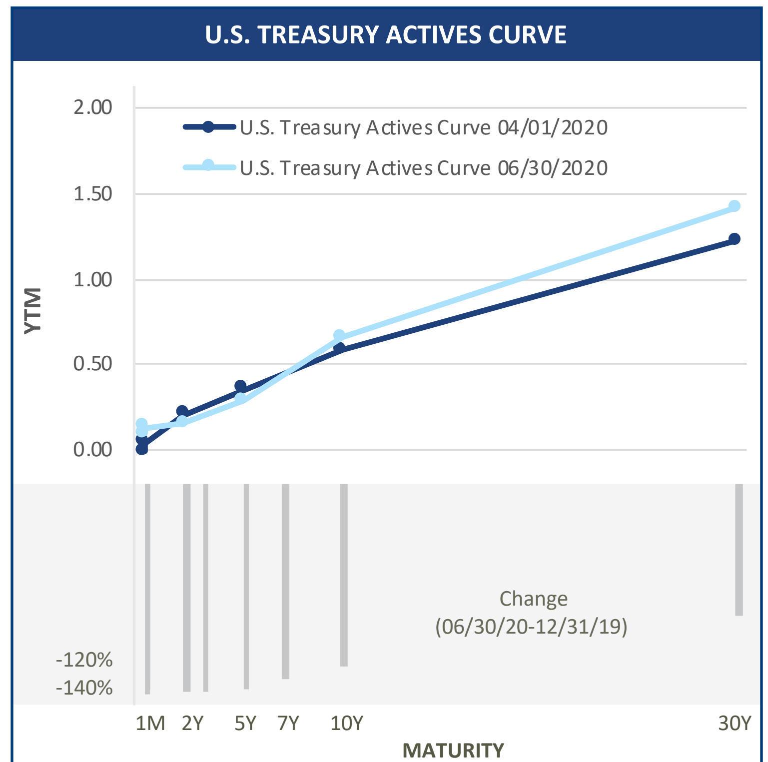
We continue to like prepay storied specified pools and structured CMO's. We look for bond characteristics that provide cash flow protection in our current low interest rate environment.

Commercial Mortgage-Backed Securities: CMBS spreads continued to tighten throughout the quarter and finished June another 10 basis points tighter. Fundamentals have held in well as the pace of forbearance has slowed into quarter end. In the non-agency CMBS space, the new issue market has stepped back up. Good demand from banks and overseas investors have kept spreads firm in the sector.

Asset-Backed Securities: ABS returned 350 basis points for the second quarter as spreads are significantly tighter for consumer ABS over the last quarter. The senior part of the capital structure is tighter by 30 basis points while subordinate tranches are tighter by 100-200 basis points. Technicals have supported the sector as issuance is lower versus 2019 levels. Liquidity has greatly improved in the sector as the Fed extended its buying operations to include ABS. Fundamentals rely on consumer recovery and on unemployment benefits and loan modification programs.

Treasuries: Even with rates near all-time lows, treasuries still posted a positive return for the quarter with the treasury index returning 0.48%. How low can rates go is on every investor's mind as the 2yr, 5yr and 7yr parts of the curve reached their all-time lows of 0.14%, 0.27% and 0.46%, respectively. The front end of the curve is anchored at zero following the Fed's statements about keeping short-term rates near zero until 2022. This, along with states reopening, helped the curve steepen during the quarter with the 2yr/10yr curve steepening from 37 bps to 68 bps in early June before ending the quarter at 50 bps. However, states are having to pull back on reopening parts of their economies due to spikes in COVID cases, which could derail any chance of a V shaped recovery. These spikes are likely to keep a lid on treasury rates, preventing them from increasing significantly. As the dynamics between spikes in COVID cases, additional government stimulus, and states reopening continue to fluctuate, we view rates as range - bound with no real conviction one way or the other. The one thing that could break this dynamic and change the course of treasury rates would be a medical breakthrough in the form of an improved treatment or a vaccination. Without this medical breakthrough, we should continue to see treasury rates bounce around these historic lows.

The graphic below shows the move in Treasury securities over the last quarter.



Source: Bloomberg

GLA FIXED INCOME PRELIMINARY RETURNS

	Q2
Core	4.28%
BB Agg	2.90%
Intermediate G/C	2.88%
BB Int G/C	2.81%
Short Term	3.59%
BB Gov/Credit 1-3	1.17%

ATTRIBUTION

- The second quarter proved to be a successful risk-on environment. Spread product outperformed treasuries while lower corporate credit outperformed the up-in-credit trade.

- Corporate spreads tightened 113 basis points after the Federal Reserve announced that they would begin to purchase investment grade corporates.

- Although the fundamental picture within corporate bonds was poor with a near record number of downgrades for the quarter, the Fed's involvement in the primary and secondary corporate markets overshadowed that fundamental weakness.

- Portfolios are solidly overweight the financial sector which had strong performance throughout the quarter. Long corporates outperformed short corporates so increasing duration in the sectors was additive to performance.

Short-Term Fixed

- The short-term portfolios benefitted from being overweight spread product versus treasuries. Throughout the quarter we increased exposure to corporates by both percentage weight and contribution to duration versus the benchmark.

- These portfolios hold a small out of benchmark exposure to mortgages. This position offers portfolio diversification and additional yield over treasuries. While the Fed continues to support the mortgage market by actively purchasing current coupons, the mortgage sector underperformed corporates.

- Portfolio duration is short at 95% of the benchmark. This was executed by being underweight 2 year treasuries.

Intermediate Fixed

- The intermediate portfolios benefitted from being overweight spread product versus treasuries. Throughout the quarter we increased exposure to corporates by both percentage weight and contribution to duration versus the benchmark.
- The intermediate portfolios hold a small out of benchmark exposure to mortgages. This position offers portfolio diversification and additional yield over treasuries. While the Fed continues to support the mortgage market by actively purchasing current coupons, the mortgage sector underperformed corporates.
- Portfolio duration is short at 95% of the benchmark. This was executed by being underweight 10 year treasuries which was positive as the curve steepened throughout the quarter.

Core Fixed

- The core fixed income portfolios benefitted from being overweight spread product versus treasuries. Throughout the quarter we increased exposure to corporates by both percentage weight and contribution to duration versus the benchmark. Portfolio allocation drove second quarter performance
- Core portfolios gave up some performance in the mortgage sector. Portfolios are long structured products versus current coupon MBS. With Fed participation in the MBS pool sector, structured product CMO's lagged in performance. Within the MBS sector, portfolios hold an overweight to Agency CMBS which provided positive portfolio performance.
- Portfolio duration is short at 95% of the benchmark. This was executed by being underweight the long end of the treasuries curve (10yr-30yr) which was positive as the curve steepened throughout the quarter.

MARKET OUTLOOK

The coming quarter may be another tough one, with yield compression making purchases painful at renewed low yields. We expect a steepening curve scenario, as the main buyers of the long end (LDI's and Pension type accounts) are stepping back. The future remains difficult to gauge, as economic data is expected to be erratic. We will need to see continued improvements on the energy front, which will depend of course on an increase in demand and a return to work by millions currently sheltered in place or laid off due to the pandemic.

Corporate earnings will undoubtedly be lower, and we may see several bankruptcies and many more downgrades over the next few quarters. We have, however, taken advantage of market anomalies and were able to add some meaningful positions in short, investment grade corporates. In fact, we have sold short government securities at near zero yield, and increased portfolio yield by buying the aforementioned corporates when liquidity was much worse than it is now. Credit will be challenging in the coming months, and we will continue the diligent surveillance of all of our exposure and adjust if need be.

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