COMMENTARY

FIXED INCOME

GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY

Second Quarter 2021

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MARKET REVIEW

The bond market is wrestling with two main dynamics. First, whether inflation is transitory or not, and second, when will the Fed start to taper their QE program and possibly even raise interest rates. Looking at the second point, economic data was very strong in Q2, the ISM was above 60, ISM Services reached an all-time high of 64, and GDP increased to 6.4 quarter over quarter. However, the jobs market has been weaker than expected, which is likely due to a combination of the continued unemployment insurance payments and lack of child care during the summer months. We anticipate a strong jobs recovery in the 2nd half of this year as schools return to full in-person learning and the unemployment insurance runs out. Therefore, with solid economic data and the possibility of a better labor market, the question becomes will the Fed start to taper their QE program and raise interest rates sooner than expected? In regards to the first point, in Q2 the market started to believe inflation would be transitory with PCE possibly peaking around 3.9% year over year. Prices should flatten out and inflation should fall as global supply issues start to resolve themselves. We are seeing this in the breakeven numbers with the 2yr, 5yr, and 10yr numbers down from their peak in mid-May, ending Q2 at 2.7%, 2.5%, and 2.3%, respectively.

INDEX RETURNS FOR THE PERIOD ENDING JUNE 30, 2021

	QTD	YTD
BB Aggregate	1.83%	-1.60%
Corporate	3.55%	-1.27%
Treasuries	1.75%	-2.58%
ABS	0.34%	0.18%
Mortgages	0.33%	-0.77%
CMBS	1.87%	-0.50%
High Yield	2.74%	3.62%
Municipal	1.42%	1.06%
2-year Treasury	-0.09%	-0.13%
10-year Treasury	3.06%	-4.17%
30-year Treasury	7.83%	-9.25%

Source: Bloomberg

SECTOR HIGHLIGHTS

Credit

- Corporate Spreads were tighter by 5 basis points in the second quarter, moving from 96 to 91.
- Shorter-dated securities outperformed longer-dated securities and BBB-rated securities outperformed A-rated securities.

Mortgage-Backed Securities

- Mortgages returned 0.33% on a total rate of return basis for Q2 2021, bringing YTD performance to -0.77%.
- Mortgage spreads have remained range bound through most of the quarter as Fed buying and bank purchases have lent support to spreads.

- Refi activity has dropped sharply for lower coupon mortgages, but still remains healthy in the higher coupons.
- Performance has been tight around all coupons, conventionals versus GNMA and 15 year versus 30 year.
- We have not changed our mortgage strategy and continue to prefer story paper like low loan balance bonds that offer better convexity and carry than current coupon bonds.

Asset-Backed Securities

- ABS returned 0.34% for Q2 and 0.18% year-to-date on a total rate of return basis.
- The new issue market picked up in the quarter with nearly $125 billion issued to date.
- Consumer credit continues to improve as more of the economy comes online.
- We continue to maintain our ABS positions as a yield pick up to short treasury and corporate holdings.

Commercial Mortgage-Backed Securities

- CMBS returned 1.87% of total return for Q2 and -0.50% year-to-date on a total rate of return basis.
- AAA LCF CMBS only tightened 5 basis points year to date. The down in credit trade has driven CMBS performance. BBB CMBS tightened as much as 90 basis points this year.
- We continue to hold AAA CMBS as well as Agency CMBS paper as a yield pick-up vehicle versus treasuries.

Treasuries

- Treasuries returned 1.75% in the second quarter of 2021.
- The 2yr, 10yr, and 30yr parts of the curve returned -0.09%, 3.06%, and 7.83%, respectively.
- The curve flattened in Q2 with the pivot point at the 5yr tenor. The 2yr/5yr flattened 14 basis points, 2yr/10yr flattened 36 basis points, and the 2yr/30yr flattened 41 basis points in Q2.
- The treasury curve did unexpectedly flatten in Q2 with the prospects that inflation will be transitory, a weaker than expected labor market, and the possibility that we have reached peak economic growth.

Municipals

- With continued inflows into tax-exempt funds, muni rates dropped throughout the period to end up about 25 basis points lower at the quarter end.
- Once again, continued demand and decreasing relative supply drove rates lower, as investors assume higher tax rates from a new democratic presence in the White House to pay for stimulus funding.

GLA FIXED INCOME PRELIMINARY RETURNS AS OF JUNE 30, 2021[1]

	QTD	YTD
Core	1.79%	-1.28%
BB Agg	1.83%	-1.60%
Intermediate G/C	1.11%	-0.67%
BB Int G/C	0.98%	-0.90%
Short Term	0.34%	0.18%
BB Gov/Credit 1-3	0.04%	0.00%
Municipal	1.12%	1.05%
BB Muni 1-10	0.62%	0.36%

CORE FIXED

- We underperformed by 4 basis points versus the index for the quarter.
- Our duration call hurt us during the quarter as longer-dated duration assets outperformed. We are underweight the longer part of the treasury curve which experienced larger gains. The duration positioning detracted 38 basis points.
- On an asset class basis, our overweight to Corporates added about 16 basis points with spreads tightening for the quarter. Most of this return was derived by our overweight.
- Our underweight to Mortgages added 7 basis points as the asset class underperformed the index.
- Our overweight to ABS detracted 10 basis points as the asset class underperformed the index.
- Treasuries detracted 15 basis points as we are underweight and Treasuries performed in line with the index.

INTERMEDIATE FIXED

- Intermediate Gov/Credit outperformed its benchmark by 13 basis points for Q2 2021.
- Portfolio allocation was the lead performer for the quarter. Portfolio duration, curve exposure, and selection all deterred from overall performance.
- Curve flattening over the quarter was the main culprit for performance give up as the portfolios continue to be short duration via the 10 year.
- Intermediate securities outperformed in the portfolio.
- Our mortgage allocation contributed roughly 5 basis points for the quarter.

- 7-10 year corporates also provided solid performance.

SHORT-TERM FIXED

- We outperformed the index by 30 basis points for the quarter.
- Duration in the front of the curve was significantly less volatile than last quarter, and this added 3 basis points to the returns for the quarter. The two year underperformed for the quarter which benefited us. We continue to have a barbell position with an overweight to 4 year names, and an overweight to less than one year securities.
- ABS added 18 basis points for the quarter, which are short-dated assets with relatively wider yields than corporates.
- Corporates added 9 basis points for the quarter, with both selection and our allocation contributing equally.

MARKET OUTLOOK

For the remainder of 2021, we are content to maintain our posture of underweighting all-in duration and increasing exposure in credit in the five year area despite rates seeming to want to grind lower. The continued specter of rising long-term rates and an expected increase in inflation suggests that we should be well positioned over the near term, albeit a painful position to take at times. Although we believe we will see higher rates later in 2021, we also anticipate volatility as the Fed moves toward an actual rate hike. Again, we have continued concerns that the Delta variant of COVID could spread across the U.S. and may stall chances of more economic recovery.

1. Returns are preliminary and from a representative account as of June 30, 2021.