COMMENTARY

FIXED INCOME

GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY

Third Quarter 2021

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MARKET REVIEW

Volatility was the name of the game for most of the third quarter, but by the end of Q3 the bond market was essentially unchanged. The 10yr Treasury rate went from 1.47% to start the quarter down to 1.17% before ending the quarter right back where we started at 1.48%. Stepping away from the rollercoaster ride in Q3 and looking only at the beginning and end of the quarter, the Bloomberg Barclay's Aggregate, Corporate, Treasury, and Structured Product indices all returned at or near 0% for the quarter. That isn't to say Q3 wasn't eventful. CPI and PCE continue to be well above the Fed's target of 2%, ISM data continued to show strong expansion levels, and the economy grew around 6.5%. The surprise came from nonfarm payrolls where we saw an unexpected drop in the August numbers going from 943k down to 235k. Then, what the market had been waiting for, the Fed laid out plans to start tapering their $120B a month bond purchase program in November. The Fed plans to reduce purchases by $15B a month through June 2022. Then the focus will shift to how inflation has behaved in the first half of 2022, determining when and how aggressively the Fed will start raising interest rates in the second half of 2022.

INDEX RETURNS FOR THE PERIOD ENDING SEPTEMBER 30, 2021

	QTD	YTD
BB Aggregate	0.05%	-1.55%
Corporate	0.00%	-1.27%
Treasuries	0.09%	-2.50%
ABS	0.05%	0.23%
Mortgages	0.10%	-0.67%
CMBS	-0.03%	-0.53%
High Yield	0.89%	4.53%
Municipal	-0.27%	0.79%
2-year Treasury	0.10%	-0.03%
10-year Treasury	-0.07%	-4.24%
30-year Treasury	0.39%	-8.90%

Source: Bloomberg

SECTOR HIGHLIGHTS

Credit

- Corporate Spreads were tighter by 5 basis points in the third 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 0.10% on a total rate of return basis for Q3 2021, bringing YTD performance to -0.67%.
- Mortgages held up relatively well into higher yields and curve steepening. A higher yield environment is supportive of continued bank buying.
- Prepayment reports through the month of September have indicated a flattish prepayment scale. However, higher rates have driven the 2.5% coupon out of the money by 20 basis points, which indicates even slower prepayment speeds going forward.

- Securities with shorter average lives and better convexity profiles have outperformed current coupon mortgages.
- We continue to be short overall mortgage exposure versus the index and we 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 0.05% basis points for Q2 and 0.23% year-to-date on a total rate of return basis.
- The month of September saw $27 billion in ABS supply which is the highest monthly issuance this year.
- Heavy supply was easily absorbed as investors continue to use prime ABS as a treasury surrogate offering a bit of a yield pickup.
- Spreads remain unchanged in prime ABS sectors and we see some spread pick up in off-the-run sectors.
- We continue to maintain our ABS positions as a yield pick up to short treasury and corporate holdings.

Commercial Mortgage-Backed Securities

- CMBS returned -0.03% of total return for Q2 and -0.53% year-to-date on a total rate of return basis.
- AAA LCF CMBS only tightened 3 basis points year to date. The down in credit trade had driven CMBS performance year-to-date. However, BBB CMBS securities gave up ground into the curve steepening, widening approximately 30 basis points over the quarter.
- We continue to hold AAA CMBS as well as Agency CMBS paper as a yield pick-up vehicle versus treasuries.

Treasuries

- Treasuries returned 0.09% in the third quarter of 2021.
- The 2yr, 10yr, and 30yr parts of the curve returned 0.10%, -0.07%, and 0.39%, respectively.
- The belly of the curve was the only part that ended the quarter different from where we started, with the 5yr tenors moving up 7 bps. The short-end and long-end were essentially unchanged in Q3.

Municipals

- Flows into munis were much slower this quarter as the muni market took a breather. Returns for the quarter were down, but still very much positive for the year-to-date.
- As was previously put forth, we believe there will be continued demand for tax-exempt bonds, in light of what is almost certain to be a higher tax environment in the coming year.
- Policy proposals were front and center in the past quarter. Tax-free advanced refundings and a revival of BABs, as well as tax changes are being discussed.

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

	QTD	YTD
Core	0.11%	-1.15%
BB Agg	0.05%	-1.55%
Intermediate G/C	0.10%	-0.57%
BB Int G/C	0.02%	-0.87%
Short Term	0.13%	0.31%
BB Gov/Credit 1-3	0.09%	0.09%
Municipal	0.01%	1.06%
BB Muni 1-10	-0.01%	0.35%

CORE FIXED

- Our Core Aggregate portfolios outperformed the benchmark by roughly 6 basis points for Q3 2021.
- Security selection led performance by contributing 29 basis points. Allocation and curve exposure were detractors from overall performance.
- Overall sector performance was strong in the portfolio. Both mortgages and corporates contributed positively to the portfolio.
- We remain short duration at 85-90% of the benchmark as well as overweight spread product versus treasuries.
- We believe the curve will continue to steepen over the next quarter and we maintain our current duration and curve exposure.
- We also maintain our overweight to spread product to out carry the benchmark for continued performance.

INTERMEDIATE FIXED

- Intermediate Gov/Credit outperformed its benchmark by 8 basis points for the quarter.
- The curve steeping over the quarter added 2 basis points, as the Federal Reserve indicated that they would likely begin to start their asset taper in the coming months. We have an underweight to the longer end, which benefited performance.

- Corporates added 6 basis points for the quarter, with selection adding 4 basis points. Our position in Ally Financial was beneficial to us as the firm was upgraded during the quarter by Moody’s.
- Mortgages were not a large contribution to the portfolio.

SHORT-TERM FIXED

- We outperformed the index by 4 basis points for the quarter.
- Duration did not add nor detract from performance even though rates were volatile during the quarter.
- ABS added 1 basis points for the quarter, which are short-dated assets with relatively wider yields than corporates with similar maturities.
- Corporates added 7 basis points for the quarter, with both selection and our allocation contributing equally.
- Treasuries detracted 4 basis points for the quarter, as the benchmark owns more Treasuries than our portfolio.

MARKET OUTLOOK

We continue to believe that rates will rise and the curve will steepen. It appears as though we are seeing the scenario we envisioned to be materializing. 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, with the outlook for continued market volatility due to the aforementioned potential disruption in the economy, government, and of course, the recovery from the pandemic. Careful positioning on the curve with proceeds from cash flow and additions will continue to be our mission, as always. When the scenario we envision comes into full view, we will begin our extension and increase yield in portfolios, but we believe a bit of patience and bit of time is really important here.

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