Portfolio Commentary

Navigator® Fixed Income Total Return

Portfolio Manager

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Risk Assets Continue to Rally

Market Review

The markets capped off one of their best first half of the year starts in this century. During the quarter, leadership shifted from cyclical value driven by economic reopening themes to growth leading the markets higher into quarter end. Credit has remained very firm and supportive of the market backdrop with continued economic reopening, strong economic growth, and a benign default environment. The massive amount of liquidity continues to find a home in risk assets across equity and credit.

At the June FOMC meeting, the Federal Reserve acknowledged rising inflation pressures and began discussing tapering the purchase of securities sooner than expected. That announcement pushed investors dramatically away from value, cyclicals, small-caps, and international stocks and instead towards large-cap growth in June. Ultimately, a reversal in Central Bank easing lowered the expectations of future economic growth, which drove 10-year Treasury yields to 1.44%.

Risk assets continued their rally in the second quarter with the S&P 500 gaining 8.55% and the Russell 2000 adding 4.29%. Inflation expectations seem to have peaked during the second quarter as the Federal Reserve hinted that interest rate hikes could start as soon as 2022. As a result, the 10-year Treasury yield peaked on March 31st at 1.75% and declined to 1.44% by the end of the quarter. During the quarter, the Bloomberg Barclays U.S. Corporate High Yield Index gained 2.74%, the Blomberg Barclays U.S. Aggregate Bond Index gained 1.83% and the U.S. Treasury 7-10 Year Index advanced 2.5%.

Inflation arrived in the second quarter as expected, with the Consumer Price Index (CPI) rising 5% year-over-year. We liken it more to reflation as the economy continues to re-open. We believe the base effect should diminish over the next few months, providing a better handle on the underlying trend in inflation. Ultimately, we believe that the inflation we are seeing will be more cyclical than structural.

The market may be leaning in that direction too, with the recent decline in the 10-year Treasury yield. In our opinion, there are several factors working against inflation. Structurally, the massive debt overhang and deteriorating demographics are deflationary, suggesting lower inflation down the road. In addition, in the worst year for the economy on record, businesses raised their spending on IT equipment and software to the point where automation as a share of GDP has risen to an all-time high. This boom in productivity is also an inflation killer.

Second Quarter Performance Highlights

For the quarter, Fixed Income Total Return slightly underperformed the Bloomberg Barclays U.S. Corporate High Yield Index (gross and net of fees) and outperformed the Bloomberg Barclays U.S. Aggregate Bond Index (gross of fees and net of fees). For the year to date, Fixed Income Total Return is slightly underperforming the Bloomberg Barclays U.S. Corporate High Yield Index (gross and net of fees) and outperforming the Bloomberg Barclays U.S. Aggregate Bond Index (gross of fees and net of fees).

- The strategy was invested with a risk-on bias throughout the quarter and remained fully invested in high yield bonds. In fact, it has remained allocated to high yield bonds for 11 months.
- Credit has remained very resilient as interest rates rose early in the year, and even now as rates have declined. High yield credit spreads sank to 268 basis points at quarter end, declining 42 basis points. The steady grind lower in corporate credit spreads has continued virtually unabated since the COVID lows. The positive economic momentum and accommodative stance of monetary policy have supported risk appetite for credit.
- Lower credit quality bonds outperformed during the quarter with CCC and below up 4.00% and BB up 2.90%, both outperforming the broader high yield index.

Positioning and Outlook

Risk assets performed very well through the first half of the year. Coming into 2021, we expected the market and economic gains to be front-loaded, and they certainly have been. The economy and markets have more room to advance given the accommodative stance of the Fed and economic re-opening. As we get further into the second half of the year, we could see some volatility as we pass peak earnings growth, peak economic growth, and the economic re-opening is largely completed.

As far as credit is concerned, the backdrop is fairly benign. New issuance of corporate debt is up and on pace for another record year and the market is absorbing it. We are still in the economic recovery phase and in an environment of strong earnings growth, low default volumes, upward rating migration, and tighter spreads.

Inflation is front and center, and the next couple months will provide a lot of information on supply chain issues and labor shortages. We expect that the inflation we are seeing now is more cyclical than structural.