Government Credit Managed Account

Quarterly Review

- After experiencing volatility in the first three months of the year, the bond market stabilized during the second quarter. Two factors contributed to the shift in tone. First, labor market data out of the United States and the rest of the world indicated that the economic growth—while still robust—may take longer to fully recover than initially expected. Second, investors appeared to gain confidence in the US Federal Reserve's (Fed's) assertion that the recent spike in inflation is in fact "transitory." Although inflation numbers have indeed been running hot in the past six months, the markets seem assured that supply-chain bottlenecks will ease and inflation will soon return closer to its typical level. While the Fed has continued to communicate its intention to keep short-term interest rates near zero for an extended period, their "dot-plot" now indicates they forecast two hikes in the Fed Funds Rate in 2023, which signals to the market that they will act to reduce inflation if it does appear to remain persistent. More immediately, the Fed also signaled the possibility that it could begin planning tapering quantitative easing purchases in the near future.
- Corporate bonds provided the biggest benefit to performance largely through an overweight position during the quarter as spreads declined. Conversely, security selection within corporate bonds was negative, partially paring down positive excess returns from sector allocation.
- During the quarter we maintained a meaningful underweight to US Treasurys as we continue to favor spread sectors. This positioning proved beneficial as risk assets outperformed US Treasurys during the period.
- We are targeting duration neutral to that of the benchmark. Portfolio duration was neutral to slightly shorter than the Index during the quarter. Duration and yield curve positioning detracted from performance slightly.

Outlook

- We believe the Federal Reserve will remain accommodative for the foreseeable future, keeping the fed funds rate unchanged at the zero lower bound and anchoring the front-end of the Treasury yield curve into 2023. We expect the Fed to address balance sheet policy later this year, and for the start of tapering to occur late in 2021 or early in 2022. We expect economic growth to accelerate through the summer months and return to pre-COVID levels in the third quarter, as fiscal and monetary policy remain very supportive. We expect to reach full employment by late 2022.

- We believe the credit cycle is currently in the expansion phase, with strong corporate fundamentals and a healthy consumer supported by significant excess savings and easy financial conditions. We believe risk appetite should remain elevated given the strong expansionary environment, expectations for robust global growth and continued monetary accommodation.
- The inflationary pressure we have seen recently, while in part transitory due to base effect, may prove more lasting in our view. We expect core inflation to remain above the Fed's target of 2% for several quarters until some of these temporary effects roll off. The Fed's surprisingly hawkish tone at the June Open Market Committee meeting indicated that the Fed may be less patient should personal consumption expenditures data remain elevated.
- Corporate fundamentals are healthy, reflecting the recovery in the US and, to a lesser degree, the global economy, where vaccine rollout has been more tepid. Additionally, very accommodative global central bank and fiscal policy has been a significant tailwind, although elevated leverage and extended valuations may start to be a greater focus for the Fed. A majority of industries have stable-to-improving margins and significant free cash flow. However, valuations are not as compelling, although we may see some additional spread tightening given low expectations for losses.
- We continue to favor spread sectors, such as corporate bonds and securitized assets. However, we have reduced the portfolio's overall risk level to the lower end of our range, a similar posture to the beginning of 2020.
- Corporate bond risk is at the low end of our risk budget based on valuation.
- For strategies that use securitized assets, we continue to favor both agency and non-agency commercial mortgage-backed securities, particularly senior parts of the capital stack.
- For strategies that use securitized assets, we believe the high-quality asset-backed securities sector remains attractive relative to government bonds, and favor auto loans and credit card receivables within the sector.