DUCENTA SQUARED
ASSET MANAGEMENT

Economic and Sector Summary & Outlook

Third Quarter 2020

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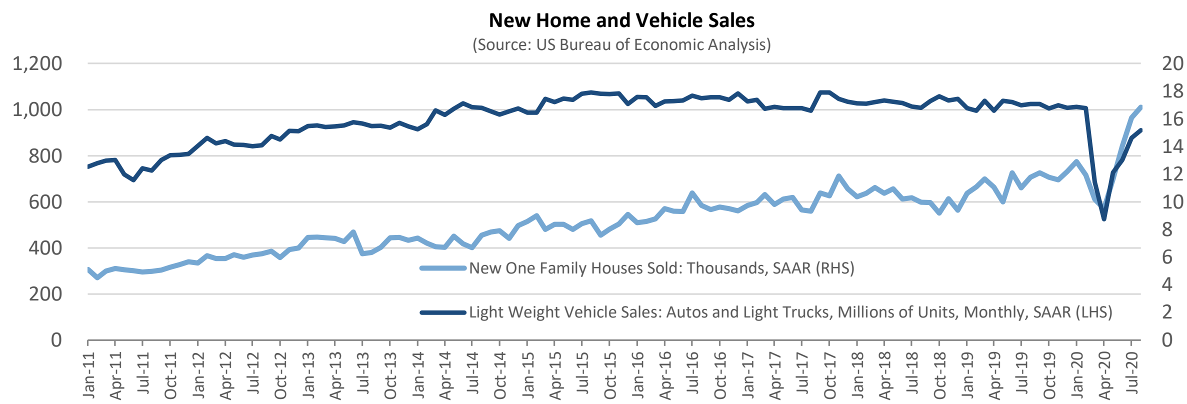
US Economy

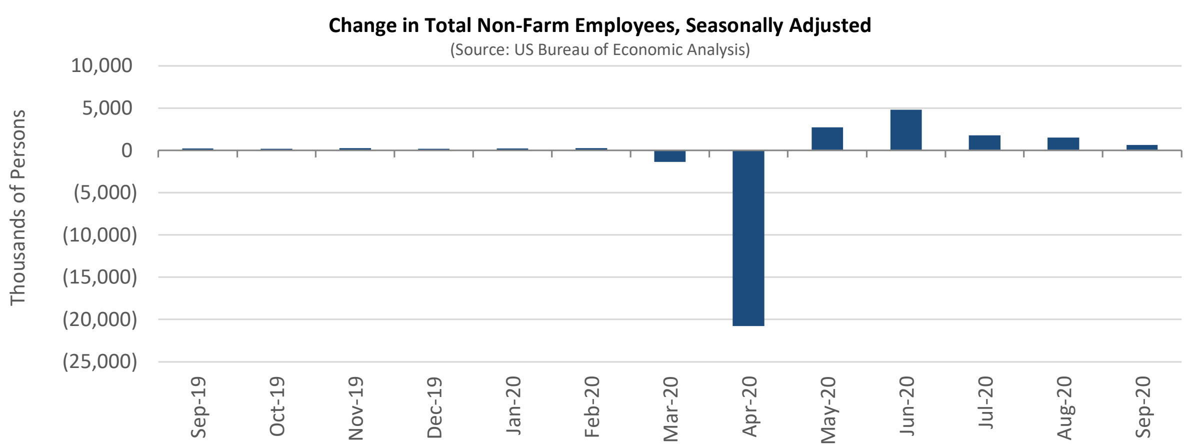
Summary

It has been eight long months since the COVID-19 pandemic hit the US, plunging the economy into a record collapse. The recovery has been surprisingly swift, aided by a forceful monetary and fiscal response. Economic data trended better than expected in the third quarter of 2020 but shows signs of moderating as we head into year end. Economists expect that US GDP will grow at a rate of 30% in the third quarter and a more modest 3% to 5% rate in the fourth quarter of 2020. Federal Reserve Chairman Powell has called the outlook "highly uncertain", which seems like an understatement given the growing list of potential downside risks.

In the third quarter of 2020, the US economy benefited from a resilient consumer resulting in a strong "V" shaped recovery in housing, auto sales, and retail spending. The additional $600 in weekly unemployment benefits from the CARES Act supported households by producing record increases in personal incomes and savings. Consumption held up reasonably well even with the expiration of the expanded benefits in August.



However, service industries, which rely on more in-person contact, such as travel, hospitality, and restaurants, continue to struggle and remain well below pre-COVID activity levels. Labor markets continue to improve, but at a more modest pace with approximately half of the job losses recovered and the unemployment rate falling from a peak of 14.7% in April 2020 to 7.9% in September 2020. Continuing jobless claims remain elevated at around 12 million and a number of well-known companies such as American Airlines (19,000 jobs), Disney (28,000), MGM Resorts (18,000), Raytheon (15,000), Regal Theaters (40,000), Schlumberger (21,000), and United Airlines (16,000) have announced layoff plans.



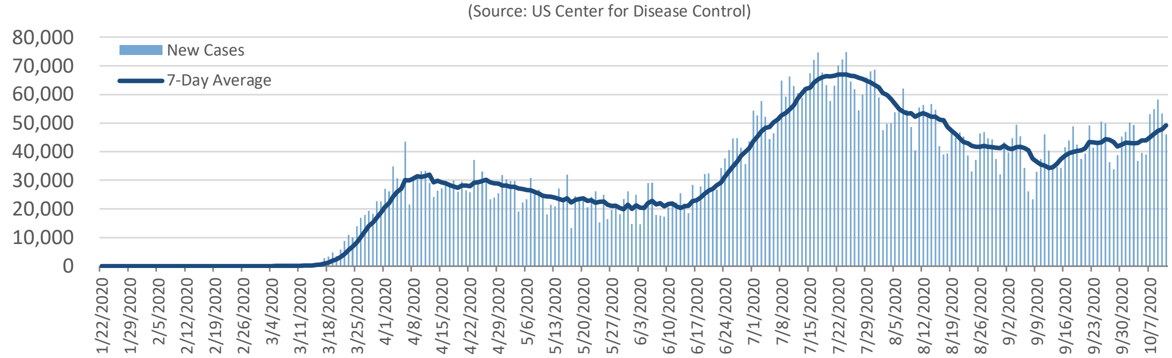
Inflation pressures increased in the third quarter of 2020 but CPI growth remains below the Federal Reserve's 2% target. Headline CPI (includes food and energy) moved from a recent low of 0.1% in May to 1.4% in September;

and Core CPI (excludes food and energy) increased from a recent low 1.2% in June to 1.7% in September. Large increases in the volatile used car, apparel, and airfares categories were partially offset by below trend readings in shelter and medical care. During the quarter, the Federal Reserve released its new "flexible average inflation targeting" policy which will allow inflation to move moderately above 2% to allow the average to reach 2% over time. Longer term this could lift inflation, but in the short term deflationary pressures in the form of below trend growth and slack in the labor markets should prevail.

Outlook

The outlook for the US economy and financial markets remains unclear and momentum in the recent recovery appears slowing. Fiscal support is waning, and additional stimulus is still unlikely before the election. The chaotic election will likely provide additional surprises and potentially a contested result. Lastly, there is a possibility that a second wave of virus infections could delay or reverse the reopening of the economy. Despite these risks, we remain optimistic that the economy can maintain sufficient momentum heading into the fourth quarter. Reasons for optimism on our part include the high savings rate which should support spending in a downturn, improved therapeutics and a likely vaccine breakthrough, and the massive stimulus enacted globally to combat the downturn.

New COVID-19 Cases per Day in the US
(Source: US Center for Disease Control)



Sector Analysis

US Interest Rates

In its September meeting, the Federal Reserve Open Market Committee for the fourth consecutive time maintained the federal funds target rate range at 0% to 0.25% and signaled that it expects to keep short-term rates low for the foreseeable future. Shortly before that, in August, the Federal Reserve adopted a new "inflation targeting strategy" which may allow the economy to grow faster and achieve a higher level of employment. Since those events, US rates remained relatively stable as investors moved out of safe-haven investments while tactically adding to risk assets.

As the third quarter of 2020 ended, US Treasury yields continued their range-bound bias, while beginning to show a shift to a slightly steeper yield curve. Short-term rates fell and longer maturities increased while the US Treasury 10-year note yield maintained the middle ground by increasing a mere 2 basis points. More specifically, the US Treasury 10-year note yield began the quarter at 0.66% and ended the period at 0.68%; while the 30-year bond yield began the quarter at 1.41% and increased 5 basis points to end the period at 1.46%. The short end of the yield curve fell with the US Treasury 2-year note yield declining 2 basis points and ending the quarter at 0.13%. Similarly, the US Treasury 5-year note yield ended the quarter at 0.28%, declining 1 basis point during the period.

We continue to believe US Treasury 10-year note yields will remain within a range defined in early April of between 0.50% and 0.78% and that the yield curve will continue to steepen. The US Treasury 10-year note yield has only briefly traded above 0.78% since June and, as the Federal Reserve continues to support the market, any move toward and through the top of the range presents a repricing hurdle that may not be sustained. We believe that breaking through the top of the range will depend on a few factors, including the availability of an effective

COVID-19 vaccine, a clear presidential election result and a reopening of economies (especially hard hit service industries) in most, if not all states.

Securitized Products

Interest rates hit close to rock bottom over the course of the third quarter of 2020. With the Federal Reserve indicating a lower policy rate for a longer time period (the current summary of economic projections shows no increase in the federal funds rate through at least 2023), many market participants appear comfortable with the expectation that rates will remain low across the yield curve for the foreseeable future. As a result, interest rate volatility collapsed with the MOVE Index hitting an all-time low of 36.62 on September 29, 2020. A decline in interest rate volatility generally boosts mortgage backed security valuations and, consequently, MBS option adjusted spreads (OAS) tightened 9 basis points during the third quarter of 2020 to end the period at 61 basis points.

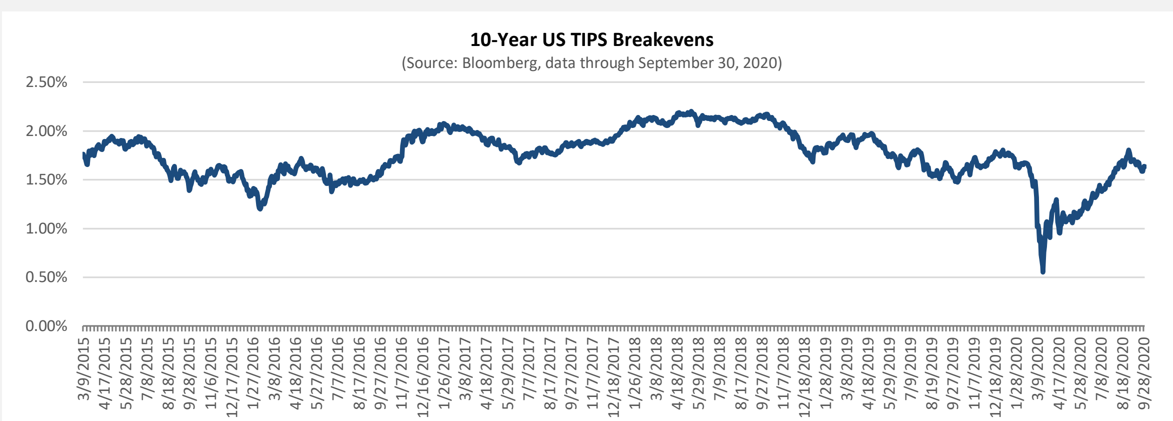
Despite a narrowing of OAS in the MBS market, the sector very slightly underperformed Treasuries as a result of high prepayments. MBS returns trailed US Treasuries by 7 basis points in the third quarter of 2020. Both the ABS and CMBS sectors of the Bloomberg-Barclays US Aggregate Bond Index outperformed US Treasuries in the quarter, providing +65 basis points and +148 basis points of excess return, respectively. Both ABS and CMBS benefited from relatively limited supply in the sector and strong investor demand. This resulted in an OAS spread tightening of 27 basis points and 26 basis points, respectively, for the ABS and CMBS sectors of the Bloomberg-Barclays US Aggregate Bond Index.

Looking forward, we see limited spread tightening opportunity in either the ABS or the CMBS sectors. Fundamentals in the ABS sector are positive, as government transfers have boosted consumer incomes, which in turn have supported their personal balance sheets. The ABS sector appears to provide safe positive carry and we expect to maintain our overweight. The CMBS sector has retraced almost all of the spread widening experienced since the COVID-19 lockdowns, this despite fundamentals trending significantly weaker. Hardest hit sectors within the commercial real estate market include retail, hospitality, and office. We believe that these sectors will continue to face performance headwinds and are selectively reducing exposure to CMBS. In MBS, we are positioned for continued fast prepayment speeds and will target a neutral weighting versus benchmark indices.

Credit Spotlight

Has the Fed changed our view on TIPS?

The Treasury Inflation Protected Securities (TIPS) market has recovered since the onset of COVID-19, with 10-year breakeven inflation rates moving from a low of 0.55% on March 19, 2020 to 1.63% to end the third quarter. The breakeven inflation rate represents a measure of inflation expectations calculated as the difference between the nominal yield on US Treasuries and the real yield on TIPS. In general, TIPS are cheap to nominal Treasuries when future levels of inflation exceed the inflation breakeven rate. TIPS appear less attractive than nominal Treasuries when the inflation breakeven rate exceeds future realized inflation. Several factors support higher inflation expectations, including aggressive Federal Reserve monetary policy, trillions of dollars in stimulus spending and the better than expected economic recovery.



Credit Spotlight (continued)

In addition, the Federal Reserve recently adopted a more permissive stance toward potentially higher rates of inflation. The new policy shifts from targeting a 2% rate of inflation to a "flexible form of average inflation targeting." In effect, the Federal Reserve will, going forward, allow elevated levels of inflation in the hopes of strengthening the labor market. Federal Reserve Chairman Jerome Powell emphasized the importance of a strong labor market with the shift away from preemptively raising rates to head off higher inflation, to a more flexible policy based on the average rate of inflation.

Despite these positive factors, we remain neutral the TIPS market for two main reasons. First, we expect inflation to remain low and below the Federal Reserve's 2% target at least until 2023. Price pressures have increased with the Core CPI rising to 1.7% in September from a low of 1.2% in June. The recent rise in inflation, however, was heavily influenced by large increases in volatile categories such as used car prices, apparel, and airfares. We view these increases as more temporary and unsustainable in the longer term. Conversely, categories that have historically exhibited more "sticky" pricing such as housing / shelter, have started to trend lower. Shelter prices comprise 40% of the Core CPI and in September increased at an annual rate of only 2.0%, the lowest since 2011.

Secondly, that the Federal Reserve changed its inflation target to an average of 2% does not necessarily jolt inflation beyond current levels or create an immediate concern regarding higher inflation expectations. Following the financial crisis, the Federal Reserve held interest rates at zero for seven years, embarked on three quantitative easing programs, and pushed the unemployment rate to a record low of 3.5%, but was still unable to move inflation above the 2% target. Ultimately, despite the Federal Reserve's best efforts to talk inflation up, we believe the economic slack created by the pandemic will keep inflation and the TIPS market in check.

Investment Grade Credit

The third quarter of 2020 started strongly for investment grade credit only to reverse course in the final two weeks of the period as volatility unexpectedly picked up, ultimately pressuring spreads wider to close out the month of September. The political landscape became even more contentious with the passing of Ruth Bader Ginsburg and subsequent nomination of Amy Coney Barrett by President Trump, raising serious doubts about whether the two political parties could reach an agreement on a second fiscal support package before the elections. Negative headlines related to renewed COVID-19 concerns and fears of additional lockdowns in Europe contributed to broad market weakness at the close of the quarter. Despite heightened volatility, the Bloomberg-Barclays US Credit Index (the Credit Index) OAS still managed to finish the quarter 14 basis points tighter and the sector generated 136 basis points of excess returns over similar duration US Treasuries.

The best performing industries and sub-segments of the Credit Index, on a spread basis, included independent energy, metals and mining, airlines, packaging, building materials and finance companies. The worst performing industries and sub-segments during the quarter comprised the non-corporate portion of the Credit Index, domestic banks, refining, pipelines, apartment REITs, telecommunications and pharmacueticals.

We still maintain a moderate overweight to investment grade credit, primarily due to strong demand technicals that are partially offset by struggling credit fundamentals as the economy recovers from the COVID-19 pandemic. Investment grade corporate bond demand technicals remain firmly intact and continue to be supportive for modest spread tightening through year end. Global central bank accommodation, Federal Reserve corporate bond purchases and approximately $15 trillion of negative yielding global debt have led to strong retail bond demand and the market's ability to digest record setting corporate supply in August and September.

In terms of valuation, the Bloomberg-Barclays US Aggregate Corporate Bond Index OAS ended the third quarter of 2020 at 136 basis points, 237 basis points tighter from peak during the pandemic, however, spreads are 43 basis points wider from the beginning of the year. We expect continued improvement in corporate earnings as we move closer to a vaccine and reopening of the economy. Technicals will remain supportive and will benefit from a light new issue calendar heading into the November elections and year end. Valuations appear modest and will likely be range bound with the potential for more volatility surrounding election uncertainty and / or negative headlines regarding COVID-19. We remain slightly overweight investment grade corporate credit with a continued focus on industry allocation and issuer selection.

High Yield

The US high yield bond market continued to rebound in the third quarter of 2020 on the back of stronger-than-expected earnings reports for the second quarter and expectations of additional stimulus, posting a +4.6% return on the Bloomberg-Barclays US Corporate High Yield Bond Index (the High Yield Index). This follows the +10.2% total return (strongest quarterly return in over a decade) in the second quarter of 2020 and the first quarter's large, pandemic-induced sell-off (-12.7%).

High yield bond spreads continued to grind tighter during the quarter, recovering to 517 basis points at September 30, 2020 from 626 basis points at the beginning of the third quarter and from the cyclical wide level of 1,100 basis points on March 23, 2020 (the widest since 2009), which compares to the pre-COVID year-to-date tight of 315 basis points in mid-January. The High Yield Index finished the third quarter approximately 110 basis points tighter to yield 5.77%, down from 6.87% at June 30, 2020 and the recent peak of 11.69% (also on March 23).

As investors in high yield bonds became more comfortable with the trajectory of the economic recovery and credit fundamentals, lower-rated tiers of the market led returns in the third quarter, with CCCs posting a +7.4% return, followed by Bs at +4.5%, and BBs at +4.0%. On a year-to-date basis, BBs remain the only ratings bucket in positive total return territory (+4.2%), while Bs (-1.2%) and CCCs (-7.0%) lag well behind. We believe BBs remain attractive, particularly relative to BBBs, while the outlook for lower-rated tiers is mixed, depending on the path of the pandemic and default trends.

At an industry subsector level, positive news regarding vaccine development led travel and consumer cyclical sectors to outperform in the third quarter, including aerospace / defense (+10.4%), airlines (+8.1%), leisure (+8.0%), retail (+7.2%), and gaming (+6.4%). Higher rated, less cyclical sectors, including wireless (+2.5%), health insurance (+2.6%), and utilities (+2.9%), lagged during the quarter. The energy sector, which has been extremely volatile this year, posted mixed results in the third quarter, with the oilfield services subsector returning -10.9% while E&P and midstream gained +5.0% and +4.2%, respectively.

Positive technicals continued into the third quarter, as retail flows remained positive ($10.7 billion in the third quarter of 2020 versus $44 billion in the second quarter) and fallen angel trends slowed ($20.4 billion in the third quarter of 2020 versus $47.6 billion in the second quarter). This backdrop proved favorable for the high yield bond primary market, as another $132 billion of new deals priced in the third quarter of 2020, the second highest quarterly amount on record following the $146 billion reported in the second quarter of 2020. With the liquidity position stabilized for many issuers, new issuance trended toward refinancing higher-coupon debt.

In contrast, high yield issuer fundamentals remain challenged. Although the default rate has plateaued around 6% (5.8% at September 30, 2020), credit metrics deteriorated sharply in in the second quarter of 2020. Average leverage reported by high yield issuers climbed more than a full turn to 5.6x, up from 4.5x in the first quarter of 2020 and 4.2x in the fourth quarter of 2019, exceeding the 5.2x at the peak of the financial crisis of 2007-2008. Although the second quarter of 2020 will likely represent the worst quarter for earnings this cycle, leverage metrics will surely climb further when third quarter earnings reports start coming out over the next few weeks.

Despite this, our expectations for further stimulus spending, positive news on the vaccine front, and supportive quantitative easing from the Federal Reserve lead to a positive outlook for high yield bond spreads once the market moves past potential election driven volatility. We would use such volatility to add to high yield bond allocations and explore rotation into sectors that will benefit as the economy continues to normalize.

Leveraged Loans

Leveraged loans posted a +4.1% total return in the third quarter of 2020, as measured by the Credit Suisse Leveraged Loan Index, building on the second quarter's +9.7% gain and resulting in a year-to-date return of +0.8% (notably includes the first quarter's -13.2% total return). After gaining nearly seven points in the second quarter, average prices climbed another three and a quarter points in the third quarter to finish the period at $92.77, almost 20 points higher than the year-to-date low, but still short of the $96.50 level at year-end 2019. Spreads (3-year discount margin) retraced approximately 120 basis points during the third quarter (similar to high yield bonds) to end the period at 579 basis points, while yields declined nearly 125 basis points to 6.02% as LIBOR dropped another 7 basis points to 0.23% during the quarter (briefly touching a record low 0.218% in September). As was the case with high yield bonds, lower-rated segments of the loan market outperformed in the third quarter, with CCCs returning +9.6% and split-Bs +7.1%, whereas BBs and split-BBBs both returned approximately 2.5%. At the industry sub-sector level, retail (+8.0%), metals (+6.7%), and consumer non-durables (+6.6%) posted the strongest quarter returns, while laggards included utilities (+1.7%), cable / wireless (+2.5%), and diversified media (+2.6%).

Loan market technicals improved during the third quarter although they remain decidedly less supportive than technicals in the high yield bond market. Retail outflows – which have been negative for 24 consecutive months – continued to taper in the third quarter (-$3.3 billion, the smallest outflow in eight quarters), while CLO issuance picked up as $22.1 billion in new deals priced, representing the strongest quarter of 2020. With an improvement in technicals, primary loan volumes improved to $67.8 billion in the third quarter of 2020 from $46.4 billion in the second quarter, although issuers continued to prefer utilizing the high yield bond market for funding (particularly for secured bonds). On a year-to-date basis, net primary loan volumes are down 22% from 2019. The leveraged loan default rate edged up further during the third quarter, ending September at approximately 4.25% (up 284 basis points year-over-year).

We remain concerned that recent downgrades, on top of a general trend of higher single-B issuance, has caused the average credit quality of the loan market to deteriorate. Many of the recent vintage deals that were underwritten with high leverage and weak credit documentation are likely to get tested in the next few quarters, even as the economy reemerges from COVID-19 lockdowns.

Within the leveraged loan space, our preference remains for higher-rated credits that have adequate liquidity, manageable leverage profiles, and aren't reliant on aggressive EBITDA growth assumptions to meet their pro forma leverage targets. While we continue to prefer the high yield market over loans, the incremental yield of loans over high yield bonds suggests that our allocation between the two sectors is likely to be more balanced than it was in recent quarters when the Federal Reserve's purchase of fallen angels proved highly supportive of the high yield bond market.