FIRST QUARTER 2021
SGIA
FIXED INCOME COMMENTARY

Rhapsody in Bonds

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Smith Graham
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It has been a little over a year since the world was placed in the longest "timeout" in history. On January 1, 2020, copyrighted works from 1924 entered the U.S. public domain along with tens of thousands of other works of art, including musical compositions, books, plays and films. They are now free for all to use and build upon. Rhapsody in Blue is a musical composition by George Gershwin that entered the public domain last year. The piece is known for its integration of jazz rhythms and classical music; it is one of Gershwin's most famous. Its opening clarinet glissando is one of the most recognized musical passages in the world.

Since the 1980s, United Airlines has used the Rhapsody in Blue arrangement in its advertisements, in pre-flight safety videos, and in the Terminal 1 underground walkway at Chicago O'Hare International Airport. With the shelter in place mandates and limited understanding of the coronavirus at the time, air travelers stayed home during most of 2020. Airlines around the globe dramatically scaled back the number of flights to preserve cash. Few people got to hear that beautiful song as they settled into their United Airlines seats.

The textures of jazz music and the financial markets range from the very simple to the complex. The Merriam-Webster dictionary describes musical texture as determined by how many layers of sound there are in a composition and what the relationships of those sounds are to each other. If the texture is very simple then we get bored, comparable to having low volatility. If it is too complicated the music gets confusing. This translates to the financial markets with nervous investors and increased volatility.

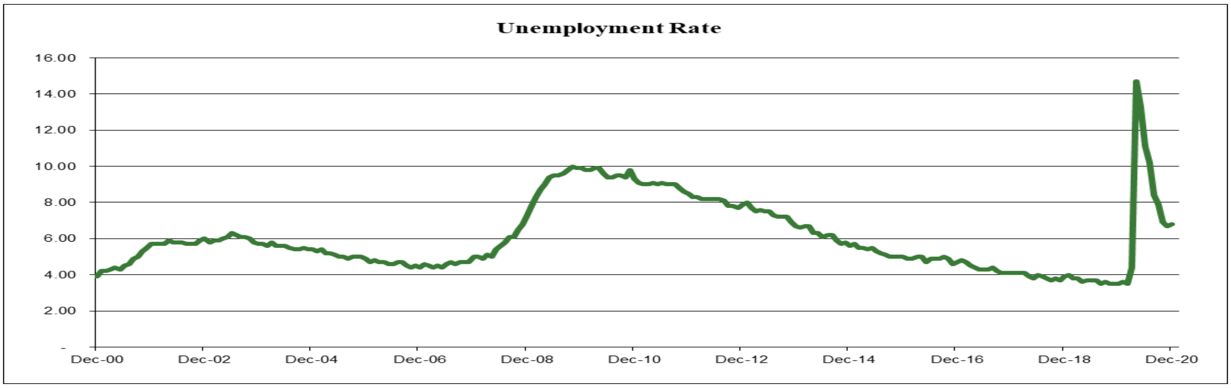
"Leisure and travel related credits are anticipating a vaccine-enabled return to travel."

Right now, the texture is fairly simple. Leisure and travel related credits anticipate a vaccine-enabled return to travel. With Covid-19 cases down as vaccines roll out, consumers are expected to spend some of their record savings on vacation getaways. There is certainly pent-up demand. Will the Fed signal that it may delay tapering if the bond market remains volatile? A lot of progress is being made, but the recovery is far from complete. Can this last? Have the equity and credit markets moved too high, too fast? While the rally may continue, the financial markets must be very selective not to hit a blue note.

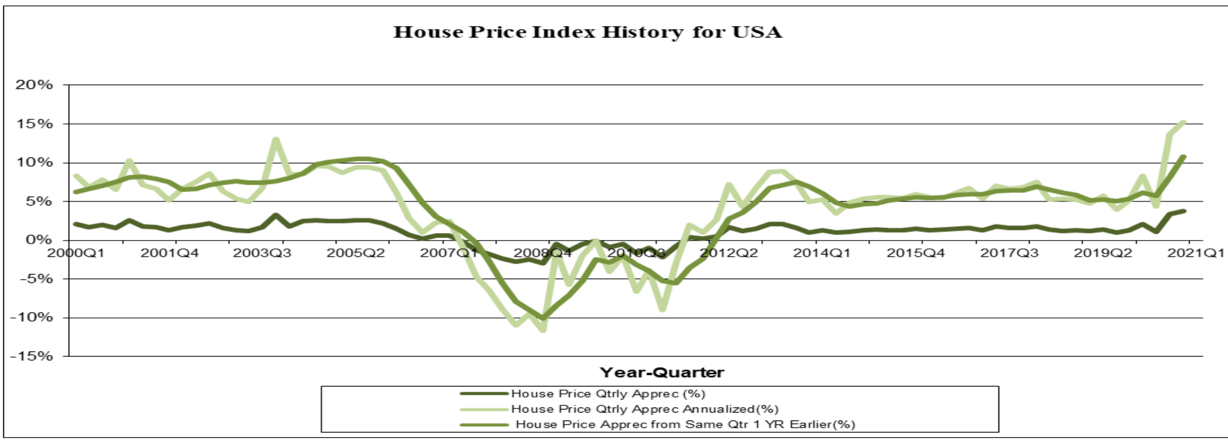
Treasury yields have climbed more than 75 basis points (bps) to start the year over concerns that inflation is positioned to resurface during an economic surge powered by vaccines, pent-up consumer demand and another round of government stimulus.

The "Great Reopening" owing to increasing vaccinations to move freely around the country, is the optimistic driving force for economic growth over the next several quarters, in my opinion. Travel, leisure, restaurants, hotels, and entertainment could lift the bonds of these industries that have lagged most of the pandemic year. Let us see if summertime living can be easy for travel.

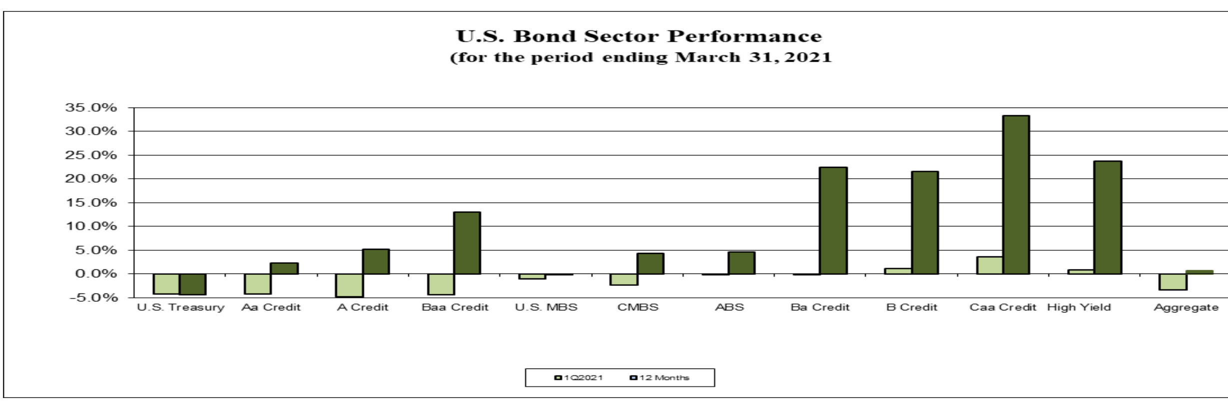
Please see "Gershwin" on page 4



Source: Bureau of Labor Statistics



Source: FHFA



Source: Bloomberg Barclays Indices

Source: Bloomberg

REVIEW AND OUTLOOK

This year's rise in U.S. long-term interest rates has been matched with a sharp improvement in the U.S. growth outlook, driven by an extraordinary amount of fiscal policy support. The sharp first quarter move higher in Treasury yields has begun to slow. Thirty-year Treasury yields increased 18 bps in January, 32 bps in February and only 26 bps in March. We would expect long-end flows to pick up even further as investors look to monetize the higher levels of yields.

The S&P 500 is up more than 6% for 1Q2021 while the NASDAQ could not get to 1%. Investors maintain strong risk-on equity flows. The flows are led by domestic and global mid and large caps. Nearly 88 cents of every dollar of in-flows have been directed into equities, the most since October 2018. The hunt for value continues given economic optimism and successful fiscal stimulus. Investment grade credit OAS ended the quarter at 86 bps. OAS are now trading though pre-pandemic levels.

All major domestic fixed income indices posted negative return numbers for 1Q2021, starting the year with continuing inflation concerns regarding the recovery/reopening. The U.S. Aggregate index decreased 3.37% during the quarter but is up 0.71% over the last 12 months. High yield and investment-grade debt produced mixed returns during the first quarter, according to Barclays Capital indices. The total returns from corporate high yield up 0.85% for the quarter. Investment-grade corporate debt produced total returns of -4.45%. High yield debt is rated below Baa3 by Moody's Investors Service and lower than BBB- by S&P.

The 2-year Treasury yield increased 4 basis points while the 10-year Treasury yield climbed 83 basis points during the quarter to yield 0.16% and 1.74% for the period, respectively. Asset-Backed Securities and Mortgage-Backed Securities were the best performing sectors within the U.S. Aggregate index. These two sectors returned -0.16% and -1.10%, respectively, for the quarter. Aaa bonds were the best-performing investment-grade credit quality during the first quarter, down -2.88%. Transportation, Energy, Basic Industry and Consumer Cyclical were the best performing industries within the high yield corporate sector.

The Bloomberg News monthly forecast of bond yields – which includes input from nearly 60 economists – forecasts that U.S. Treasury 10-year yields will increase to 1.50% in 2Q2021 and then rise to 1.51% in 3Q2021. All the yields are greater than the forecasted yields of the February survey.

We expect credit spreads to remain firm as the search for yield stays intact with a constructive technical backdrop. We have and continue to extend credit spread duration in industries that will play a substantial role in the economic recovery. Issuer selection will be paramount as corporation's cash balances have been building and could result in share repurchases, dividends and merger/acquisition activity.

"The U.S. economy is not threatened by rising bond yields at present."

The transportation storyline in the investment grade credit space has been all about airlines. Spread performance for airlines has been remarkable as the reopening of the consumer services economy comes back online. While railroads and transportation services have seen spreads hold steady or drift wider, airline spreads have tightened sharply. The passage of fiscal stimulus and confirmation of rising passenger volumes have dramatically reduced liquidity and balance sheet uncertainty for the industry.

Is it possible to overstimulate the U.S. economy? The U.S. economy is not presently threatened by rising bond yields. The expansion should be able to absorb a further rise in bond yields, provided the uptrend occurs in in an orderly fashion. Fiscal policy looks increasingly likely to remain meaningfully expansionary for several years. The risk of the economy overheating has risen, but market-implied long term inflation expectations are still contained.

“Gershwin” from page 1

The yield curve shows the relationship between the Treasury bond interest rates and the time to maturity. The yield spread is the difference between long term and short-term Treasury bonds rate. Usually, the long-term Treasury bond rate should be higher than short term rates because of the risk associated with the longer period. But when the economy is not doing well or during a recession, short term rates start increasing more than that of long-term rates flattening or inverting the yield curve. This is not the current case. The U.S. Treasury curve has steepened due to anticipated high levels of economic growth and potential uncontainable levels of inflation. Higher spreads show that long term bonds are giving more return than short term bonds and the economy is positioned to do better. This is referred to as a bear steepener.

Chart and Table 1 present the month-end Treasury yields and the change in Treasury yields over the three periods from December 2019, December 2020, and March 2021. The spread between the two-year Treasury Note and the ten-year Treasury Note has ballooned to 78 bps, while the spread between the two-year Treasury Note and the thirty-year Treasury Note has increased 73 bps.

Chart 1 *Source: Bloomberg, SGIA*

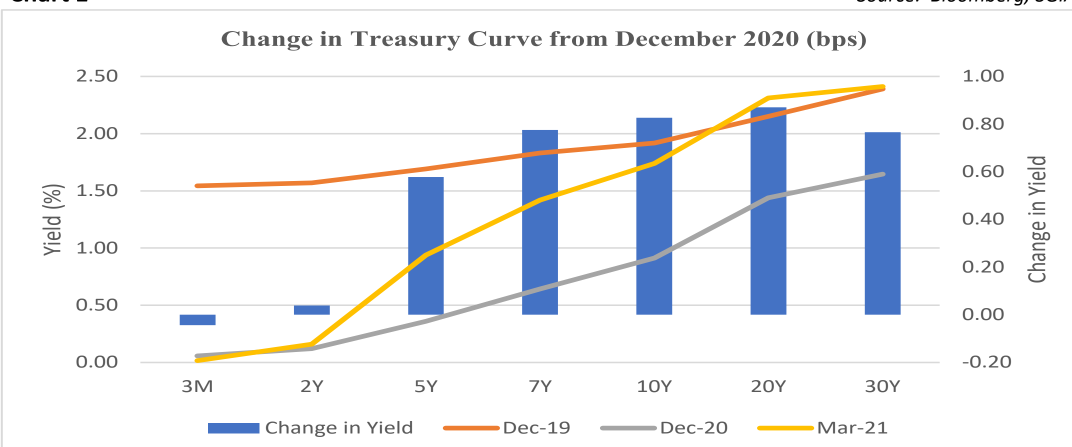


Table 1 *Source: Bloomberg SGIA*

	3M	2Y	5Y	7Y	10Y	20Y	30Y
Change in Yield	-0.04	0.04	0.58	0.78	0.83	0.87	0.77
Dec-19	1.54	1.57	1.69	1.83	1.92	2.15	2.39
Dec-20	0.06	0.12	0.36	0.64	0.91	1.44	1.65
Mar-21	0.02	0.16	0.94	1.42	1.74	2.31	2.41

“Your seat cushion cannot be used as a floatation device if the economy begins to take a nosedive.”

The past twelve months have been more than challenging for issuers of airline bonds. It has been like having a middle seat in economy class during a pandemic, having to go to the bathroom with the lavatory occupied and then later not finding your baggage on the carousel! Your seat cushion cannot be used as a floatation device if the economy begins to take a nosedive. The economy can anticipate some turbulence along the way, and it will be a while before we make the final approach to recovery.

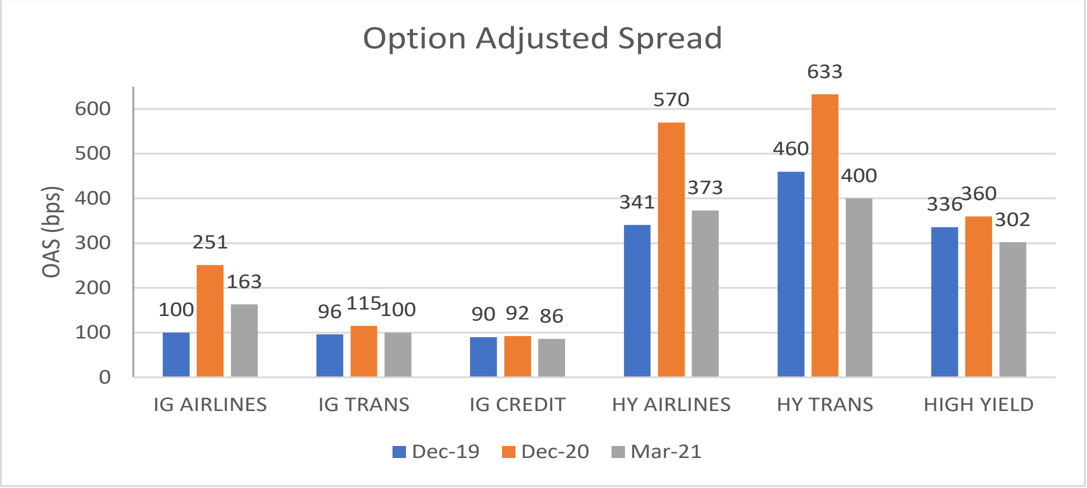
Domestically, we still expect leisure customers to lead the way as many large companies continue work-from-home plans. Conferences or trade shows are postponed into late 2021 or 2022. As price-sensitive leisure fliers will lead, low-cost carriers will have the early advantage of seizing a larger market share on their ability to discount more to fill short-haul and vacation destination seats. Let us see if the skies can return to being friendly for this industry.

A little over a year ago we saw spreads on the U.S. investment grade and high yield indices reach their COVID-19 peak. Non-callable corporate bonds are priced as a spread to U.S. Treasuries, bonds with embedded call options trade on an option adjusted spread (OAS) to Treasuries/swaps.

Chart 2 looks at the OAS for 1Q2021 and compares it to year-end 2019 and year-end 2020. The lockdown and shelter in place mandates weighed more heavily on airlines and transportation bonds than industries that made working from home a bit more manageable. The sharp swings, yet steady recovery, show that it takes a lot to suppress the asset classes. We expect relative airline spread compression to the general credit indices over the next few quarters. Higher Treasury yield levels along with higher spreads in industries that have yet to break out provide potential opportunity for excess returns.

Chart 2

Source: Bloomberg Barclays Indices and SGIA



The global economy has plenty of stimuli at its back in 2021. The combination of monetary easing, fiscal spending and vaccinations should keep economic activity improving at a rapid pace for the foreseeable future. As spreads for investment grade and high yield credits come back to near pre-pandemic levels, there are potential opportunities in industries focused on the great reopening (i.e., airlines and transportation bonds).

"There is a decent amount of runway for investment grade and high yield airline credits to outperform the general bond market."

The focus on transportation and airlines is like having a great rhythm section that provides the pulse, beat and harmonic material for the U.S. economy. It may be a while before business and international passenger traffic picks up, but leisure passengers are positioned to move sales closer to pre-pandemic levels. There is a decent amount of runway for investment grade and high yield airline credits to outperform the general bond market.

Revenue growth is perhaps the best indicator of economic activity with the indication of demand and supply rolling into the revenue numbers. Revenue is the metric from which a lot of other transaction choices spring (i.e., hiring/firing, expanding, debt management, and/or enhancing shareholders). The emphasis in framing the direction of credit quality is on cash flow and leverage but gauging the direction of revenue is almost always step one.

The question investors face is whether further spread compression is possible given the move so far for airlines. Airline credits continue to offer sizable yields at lower durations, a potentially attractive combination in a possible rising rate environment.

Chart 3 plots the monthly total returns of the investment grade (IG) airline and transportation indices that are subsets of the IG credit index from January 2020 to March 2021. The breath of the rally across the airline industry and issuers gets support by more tangible macro data points.

Chart 3 *Source: Bloomberg Barclays Indices and SGIA*

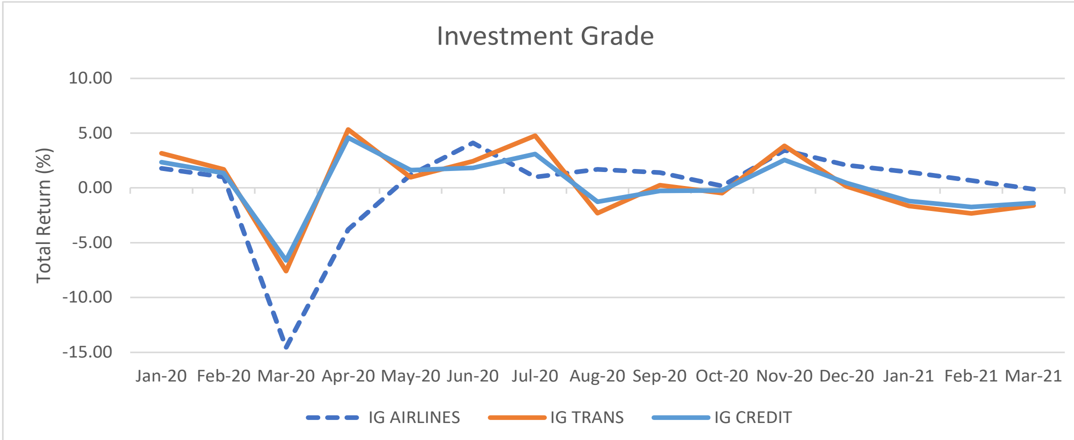
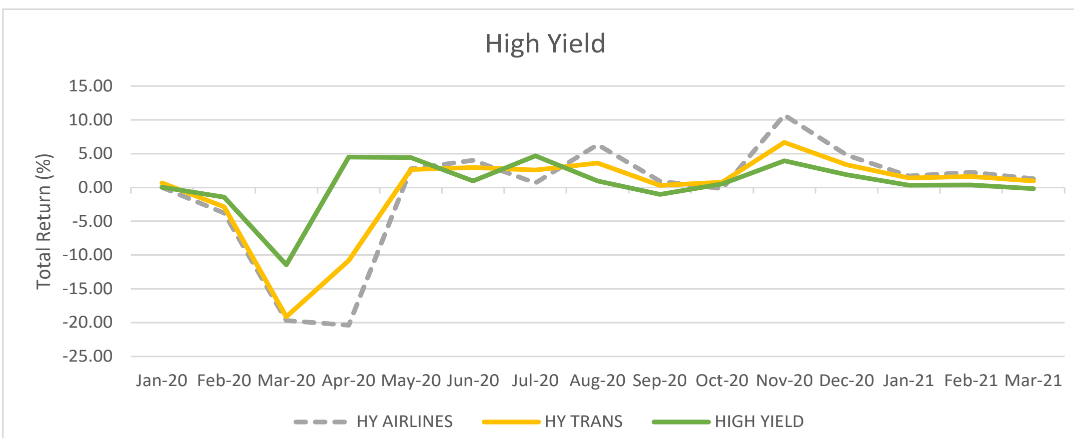


Chart 4 plots the monthly total returns of the high yield (HY) airline and transportation indices that are subsets of the HY credit index from January 2020 to March 2021. It is difficult to come up with high probability pushbacks to derail the airline industry rally.



"Our investment economic dashboard is our written version of portfolio management music."

Our investment economic dashboard is our written version of portfolio management music. Musicians call it a score. Both lay out the complex piece that shows the music for several instruments (investments, sectors, and industries). Can the scales of the economy continue to climb to higher and higher levels? Being played on a worldwide stage, this set is far from over. If we get the recovery right, we will all be relieved and free flowing with enthusiasm. This ecstatic expression of feelings from gaining control over the coronavirus over months later is nothing but rhapsody over the blues.

"You are now free to move about the country." - Southwest Airlines

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- **Credit risk.** Credit risk refers to an issuer's ability to make payments of principal and interest when they are due. Bond prices typically decline if the issuer's credit quality deteriorates. Lower grade securities may experience high default rates, which could mean that an account may lose some or all of its investments in such securities. If this occurs, the account's value would be adversely affected.
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This newsletter may include forward-looking statements. All statements other than statements of historical fact are forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct.

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