SECOND QUARTER 2021

SGIA

FIXED INCOME COMMENTARY

Two Trains Running

By Lorenzo Newsome, Jr., CFA, FRM, PRM
Chief Investment Officer

Click below to jump to your area of interest.

Smith Graham
INVESTMENT ADVISORS

"Corporate bond investors have been aware of the great magnitude of tourism and the tourism dollar."

States, cities, and municipalities across the county are nearly fully reopened. Broadway's 41 theaters have been closed since March 12, 2020, and until now the earliest resumption date is Sept. 14th, excluding "Springsteen on Broadway". The theater industry in New York City is vital to the city's economy and is a global tourism magnet. Historically, nearly two-thirds of those going to Broadway shows have been tourists, from outside the country or outside of New York. Corporate bond investors have been aware of the great magnitude of tourism and the tourism dollar. As the country moves towards a vaccine-enabled return to all types of travel, leisure and travel related credits have been one of the best performing industries during the first half of the year.

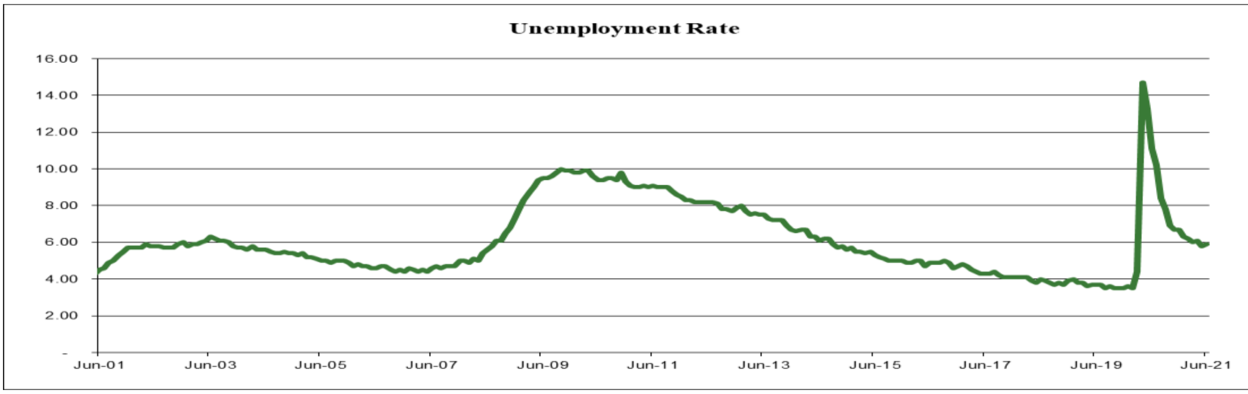
The late August Wilson is one of my favorite playwrights. Mr. Wilson's work includes a series of ten plays that are set in different decades of the 20th century. They are about Black American life in the Hill District of Pittsburgh, PA. Audiences are exposed to questions of self-discovery, forcing one to confront parts of yourself that you may feel a little uncomfortable with. His plays show the commonalities of different cultures and humanity as individuals wrestle with philosophical and ordinary questions as they go about their daily lives.

Two Trains Running is the seventh installment in Wilson's ten-part series, The Pittsburgh Cycle, and premiered on Broadway in 1992. The title is appropriate for the current economic and investment environment. The financial markets are at a point where divergent ideas cannot occur during the same time and space. Is inflation permanent or transitory? Is there reflation or inflation? Is the market producing turning signals or is it noise? The intersection in each of those three economic related questions connects the overriding theme of Two Trains Running. These two themes are: the bitter economic reality of life after COVID-19 and the need for the Federal Reserve to promote, foster and preserve stability, integrity, and efficiency of the nation's monetary, financial, and payment systems amid such conditions.

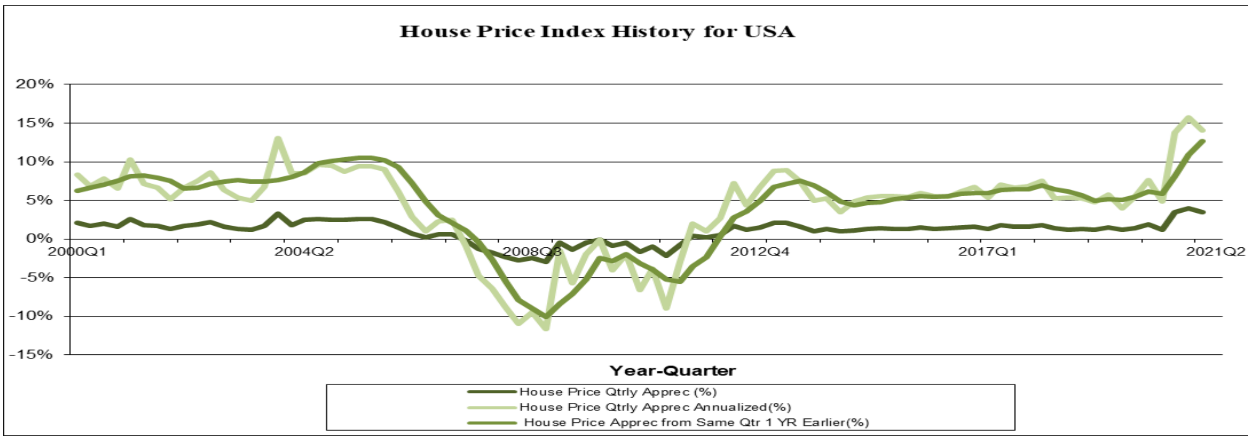
Broadway theater is live storytelling. The pace of the play can be slow or fast and its tone can be melancholy or lively. The drama is sometimes language-oriented and action-driven at other times. The narrative structure is what keeps the audience engaged. The oral and written tradition of the Federal Reserve currently drives and divides the economic recovery. This structure has been partitioned into three parts: the Setup (COVID-19 health crisis that became an economic crisis), the Confrontation (employing emergency actions by cutting interest rates effectively to zero and a $700 billion round of quantitative easing) and the Resolution (the part of the story where investors and central bankers attempt to figure out how this drama will end).

The characters Memphis, Wolf, Holloway, and Sterling become reliable storytellers in Two Trains Running. Fed Chairman Powell is acutely aware that storytelling can be both an act of memory and a means of calm communication with the financial markets in this fragmented and uncertain economic landscape. Will investors eventually recognize the Federal Reserve's performance with a curtain call?

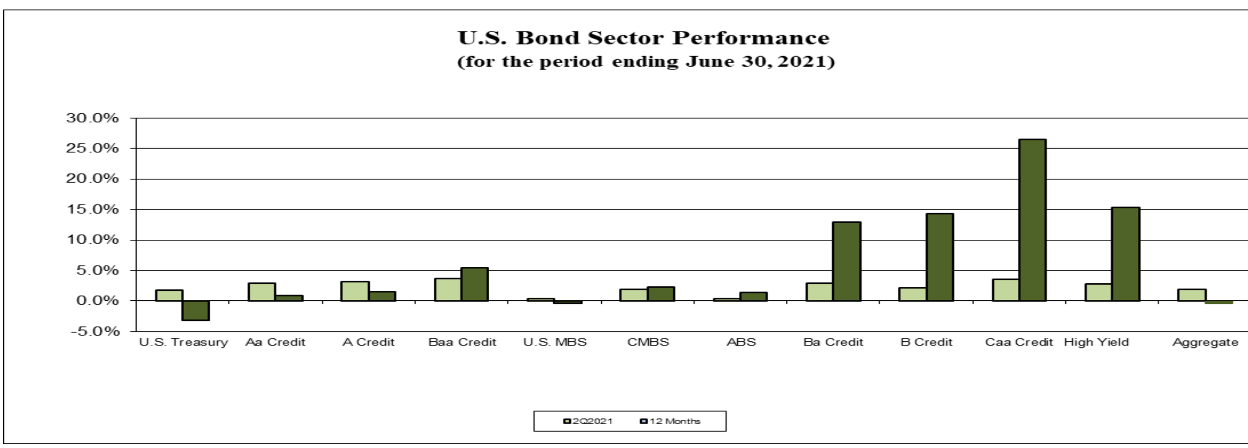
Please see "Wilson" on page 4



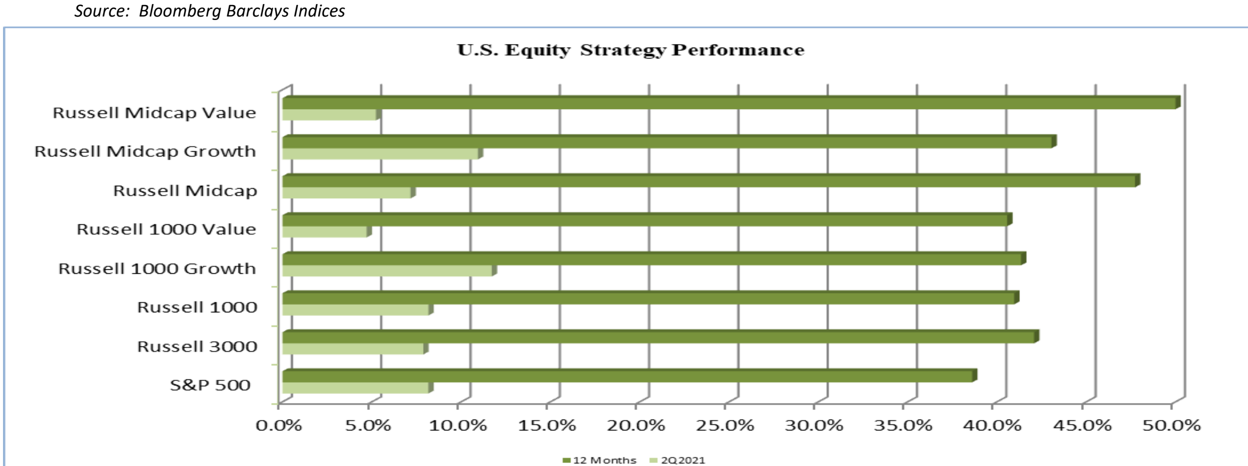
Source: Bureau of Labor Statistics



Source: FHFA



Source: Bloomberg Barclays Indices



Source: Bloomberg

REVIEW AND OUTLOOK

The anticipation of live theater and further signals around the Federal Reserve tapering will be highly anticipated and dominate thinking through the balance of the summer. Fixed income investors could be content to wait until after Jackson Hole and Labor Day to make any significant portfolio moves. The timing and path of how much the U.S. Central Bank pulls back will be data dependent. It could be cause for a choppy ride along the way as the U.S. economy digests temporary supply constraints and pent-up consumer demand.

Thirty-year Treasury yields decreased 11 bp in April, 1 bps in May and 10 bps in June. U.S. interest rates began a bear flattener trend after the June 16th Fed meeting. Fed officials revised up their forecasts for economic growth and interest rates at the June FOMC meeting. Their median projection, which previously showed rates on hold until the end of 2023, now points to two 25 bps rate hikes in 2023.

The S&P 500 is up nearly 6% for 2Q2021 while the NASDAQ rose nearly 4%. Investors continue to maintain strong risk-on equity flows. The corporate bond market has remained broadly stable. Investment grade credit OAS ended the quarter at 78 bps. OAS continue to trade though pre-pandemic levels. Spreads have narrowed further and, in some cases, are nearing their lows of the last decade.

All major domestic fixed income indices posted positive return numbers for 2Q2021. The U.S. Aggregate index increased 1.23% during the quarter but is down 0.33% over the last 12 months. High yield and investment-grade debt produced strong returns during the second quarter, according to Barclays Capital indices. The total returns from corporate high yield up 2.72% for the quarter. Investment-grade corporate debt produced total returns of 2.72%. 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 10 basis points while the 10-year Treasury yield declined 23 basis points during the quarter to yield 0.26% and 1.51% for the period, respectively. Industrial and Utility were the best performing sectors within the U.S. Aggregate index. These two sectors returned 3.35% and 3.34%, respectively, for the quarter. Baa bonds were the best-performing investment-grade credit quality during the first quarter, up 3.16%. Energy, Food/ Beverage and Metal and Mining 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 1.79% in 3Q2021 and then rise to 1.88% in 4Q2021. All the yields are greater than the forecasted yields of the May survey.

Credit spreads have continued to grind tighter this year. Beta compression has been the dominant theme recently as spreads continue to go further below pre-pandemic levels. There has been little dispersion within most industries, excluding energy and some of the reopening theme trades that were mentioned in the last newsletter. Lower-rated credits have outperformed well against a strong economic growth backdrop and considering the vaccination progress in the U.S. The focus now is on relative value to generate excess return.

"We expect that when this range is broken, it will be toward higher yields."

10-year yields have been range-bound for months. We expect that when this range is broken, it will be toward higher yields. As we noted in the story above, with high and rising inflation, the risk is that real yields could shoot higher quickly. We will continue to manage portfolios that tend to exhibit less volatility than their relative index and strive to deliver attractive risk-adjusted returns. Our portfolios are designed to perform over a full market cycle with a focus on downside risk, a style we believe will succeed over the long term.

"Wilson" from page 1

Let us review the cost, attendance and revenues of Broadway shows before we dive into an examination of U.S. inflation. Table 1 shows that both the average price per ticket and gross revenue nearly doubled over the past twelve seasons. Attendance swelled over 20% during the period. Ticket prices increased at an alarming rate despite a comparatively moderately growing national economy. Input costs for productions probably have grown steadily over time. But the primary driver for rising ticket prices is undoubtedly that people are willing to pay more for the experience. Pricing power is important in all industries.

Table 1 *Source: Statista, The Broadway League and SGIA*

Season	Gross Revenue (by millions)	Attendance (by millions)	Plays $ per Ticket	Musicals $ per Ticket
2018/19	$1,829	14.77	$116.12	$122.73
2017/18	$1,697	13.79	$89.17	$125.70
2016/17	$1,449	13.27	$85.48	$113.10
2015/16	$1,373	13.32	$89.59	$105.68
2014/15	$1,365	13.10	$104.46	$104.11
2013/14	$1,269	12.21	$92.99	$106.50
2012/13	$1,139	11.57	$82.54	$102.45
2011/12	$1,139	12.33	$79.54	$94.85
2010/11	$1,081	12.53	$75.10	$88.30
2009/10	$1,020	11.89	$72.79	$88.77
2008/09	$943	12.15	$65.98	$80.50
2007/08	$938	12.27	$62.68	$78.94

"Over the past three decades, a sustained surge in inflation has been nonexistent in the U.S."

Few experts accurately forecasted the economic destruction and swift recovery during this COVID-19 pandemic in my opinion. Inflation has been and will be no different, over the past three decades, a sustained surge in inflation has been nonexistent in the U.S. As a result, investors face the challenge of having limited experience and no recent data to guide the repositioning of their portfolios in the face of heighted inflation risk. The analysis below looks to provide some insight by examining strategies across a variety of asset classes for the U.S. market.

Yields on the 10-year Treasury have been in a narrow trading range for the past four months. We expect that when this range is broken, it will shift towards higher yields. With high and rising inflation, the risk is that real yields could advance higher quickly. The common thinking on Wall Street, although not often correct, is that interest rates only rise for one reason: strong real growth. The surprise will be the reaction when interest rates rise for that other reason - higher inflation.

Interest rates move up and down with changes in expected nominal gross domestic product (GDP), which is the combination of real economic growth and inflation. Nominal growth can come from either reflation or inflation, a difference that matters greatly to the economy and financial markets.

If interest rates are rising on the heels of reflation and real growth, this is positive for risk assets. In principle, reflation can be described as controlled inflation by stimulating the economy by fiscal or monetary policy. In the last few decades when interest rates rose it was due to real growth. The financial markets have shown that they can accept the Federal Reserve's containment of interest rates in such a scenario.

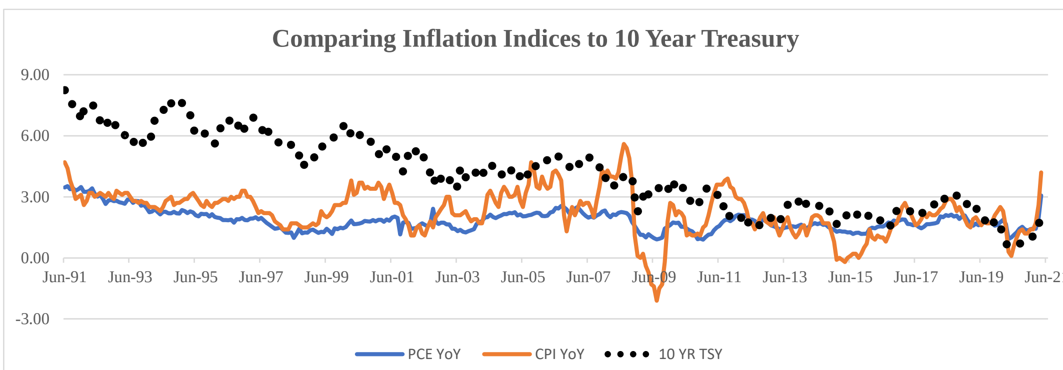
But if interest rates are rising because of faster inflation, this is not good for risk assets. All else being equal, inflation depresses real economic growth and earnings as purchasing power dwindles. Inflation has not been a problem since the 1990s. If inflation is pushing nominal growth higher, I believe any attempt by the Fed to suppress interest rates will be rebuffed by the bond market.

The Consumer Price Index (CPI) released by the Bureau of Labor Statistics and the Personal Consumption Expenditures price index (PCE) issued by the Bureau of Economic Analysis are the two common measures of inflation in the U.S. The CPI is probably the better known of the two. The two measures, though following broadly similar trends and directions, are certainly not identical. Do the PCE and CPI accurately reflect inflation levels? The pandemic has dramatically changed the basket of goods that we purchase.

"Do the PCE and CPI accurately reflect inflation levels?"

Chart 1 displays the PCE and CPI indices over a thirty-year period compared to the 10-year Treasury. In general, the CPI tends to report somewhat higher inflation with about twice the volatility of the PCE. The two series have a 0.65 correlation for the period. The 10-year Treasury has a correlation of 0.52 and 0.46 to the PCE and CPI, respectively. The Federal Reserve states its goal for inflation in terms of the PCE.

Chart 1 *Source: Bureau of Labor Statistics, Bureau of Economic Analysis and Bloomberg*



Inflation approaches for fixed income and equity assets are defined for this exercise as the times when headline, year-over-year PCE is accelerating, and when the level moves to 2% or more for a minimum of three months. Based on this definition, six U.S. inflationary periods were identified in Table 2.

Table 2 Fixed income and equity assets in inflationary situations.

Start Month	Jun-91	May-04	Sep-04	Sep-07	Dec-11	Mar-18		Average
End Month	Jan-96	Jul-04	May-07	Sep-08	Apr-12	Sep-18	Average	ex. Sep-07 -
Length (months)	56	3	33	13	5	7		Sep-08
Strategy								
U.S. Treasury 30 Yr	8.63	8.41	4.80	12.94	1.06	0.87	6.12	4.75
U.S. Treasury 10 Yr	7.77	6.08	1.58	9.23	6.19	-0.12	5.12	4.30
U.S. Treasury 2 Yr	6.18	0.66	2.36	7.01	0.33	0.78	2.89	2.06
Investment Grade Credit	9.04	3.84	3.39	-3.73	13.48	2.24	4.71	6.40
High Yield Credit	13.57	4.36	9.30	-8.26	23.70	4.90	7.93	11.16
TIPS	n/a	11.67	2.86	7.01	7.20	1.71	6.09	4.69
U.S. Aggregate Index	8.03	4.70	3.38	4.09	6.18	0.86	4.54	4.63
MBS	7.58	6.41	3.89	7.38	4.73	1.31	5.22	4.79
S&P 500	10.06	-2.01	12.62	-19.41	31.57	13.03	7.64	13.05
NASDAQ Composite	15.79	-6.68	13.52	-18.06	43.58	19.00	11.20	17.05

Source: Bloomberg Barclays U.S. Indices, Bloomberg and SGIA

This table reports total returns that turn out to be reasonably positive for most of the inflationary periods over the past thirty years. One caveat is that current Treasury yields are at very low levels relative to historical periods. That could put a considerable cap on positive returns in a rising interest rate environment. High yield and investment grade credits tended to perform well during the inflationary periods relative to other fixed income strategies. Equities were able to navigate well, outside of part of the financial crisis of 2008.

"The inflationary periods of the recent past could be just a dress rehearsal for what's to come in the next six to nine months."

The inflationary periods of the recent past could be just a dress rehearsal for what's to come in the next six to nine months. We are in a range that could be considered intermission. The Federal Reserve board members are in the analogous green room waiting for the August 26th -28th Jackson Hole, WY retreat. This prestigious annual event is attended by the world's top central bankers and economist and could be the event that puts tapering and inflation at centerstage.

Get ready for a summer of inflation confusion! There will be something for everyone. For now, bond investors are refusing to chase any story, which is causing tight trading ranges. A breakout back to higher yields could present the opportunity for amplified volatility. Keep a close eye on those Broadway ticket costs and Treasury bonds trading ranges! Hopefully, Brunch and Broadway will be back soon.

"The simpler you say it, the more eloquent it is." - August Wilson

Contact Us

For additional information please contact:

inquiries@smithgraham.com

www.smithgraham.com

DISCLOSURE STATEMENTS

Additional Disclosure - A copy of Smith Graham & Co. Form ADV Part 2A, which describes our investment advisory services, fees and operations in more detail, is available upon request.

Investment Risk Disclosure - Fixed income securities are subject to the following investment risks:

- **Interest rate risk.** Interest rate risk is the risk that debt securities will decline in value because of changes in market interest rates. Generally, when market interest rates rise, the value of debt securities declines, and vice versa. An account's investment in such securities means that the value of the account will tend to decline in market interest rates rise. The prices of long-term debt obligations generally fluctuate more than prices of short-term debt obligations as interest rates change.
- **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.
- **Investment grade bond risk.** Investment grade bonds are considered less risky than bonds whose ratings are below investment grade; however, ratings are no guarantee of quality. The credit quality of these bonds can decline which would normally cause the prices of these bonds to decline.
- **Below investment grade bond risk.** These bonds, commonly known as "junk bonds", involve a higher degree of credit risk. In the event of an unanticipated default, an account would experience a reduction in its income, a decline in the market value of the securities so affected and a decline in the account's value. During an economic downturn or period of rising interest rates, highly leveraged and other below investment grade issuers may experience financial stress that could adversely affect their ability to service principal and interest payment obligations, to meet projected business goals and to obtain additional financing. The market prices of below investment grade bonds are generally less sensitive to interest rate changes than higher-rated investments but are more sensitive to adverse economic or political changes or individual developments specific to the issuer. Periods of economic or political uncertainty and change can be expected to result in volatility of prices of these securities. NRSROs consider these bonds to be speculative in nature.
- **Mortgage-backed securities risk.** Mortgage-backed and securities are subject to prepayment risk. When interest rates decline, unscheduled prepayments can be expected to accelerate, and an account would have to reinvest the proceeds of the prepayments at the lower interest rates then available. Unscheduled prepayments would also limit the potential for capital appreciation on mortgage-backed securities. Conversely, when interest rates rise, the values of mortgage-backed securities generally fall. Since rising interest rates typically result in the decreased prepayments, this could lengthen the average lives of such securities, and cause their value to decline more than traditional fixed-income securities.

Performance Disclosure - Past performance is no guarantee of future results. Therefore, no prospective or existing client should assume that the future performance of any specific investment, investment strategy recommended and/or purchased by Smith Graham & Co. will be profitable or equal to corresponding indicated performance levels. Historical performance results do not reflect the deduction of transaction charges, investment advisory fees and/or other expenses, which, if included, would decrease the historical performance results. The collection of fees produces a compounding effect on the total rate of return net of management fees. As an example, the effect of investment management fees on the total value of a client's portfolio assuming (a) quarterly fee assessment, (b) $1,000,000 investment, (c) portfolio return of 8% a year, and (d) 1.00% annual investment advisory fee would be $10,416 in the first year, and cumulative effects of $59,816 over five years and $143,430 over ten years.

Index Comparison – Barclays Capital indices have been used as comparative benchmarks because the goals are to provide fixed income like returns. These indices are some the world's most recognized indices by investors and the investment industry for fixed income markets. These indices, however, are not managed portfolios and are not subject to advisory fees or trading costs. Investors cannot invest directly in these indices. These indices' returns also reflect the reinvestment of interest. Smith Graham & Co.is aware of the benchmark comparison guidelines set forward in the SEC Clover No-Action Letter (1986) and compares clients' performance results to a benchmark or a combination of benchmarks most closely resembling clients' actual portfolio holdings. However, investors should be aware that the referenced benchmark funds may have a different composition, volatility, risk, investment philosophy, holding times, and/or other investment-related factors that may affect the benchmark funds' ultimate performance results. Therefore, an investor's individual results may vary significantly from the benchmark's performance.

Forward Looking Statements

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.

Past Performance

Past performance is not indicative of any specific investment or future results. Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor.

Risk

Investment in securities, including fixed income instruments, involves the risk of loss.