PERSPECTIVES

2021 Outlook

Bond yields plunged in 2020 as a result of the COVID-19 pandemic and the subsequent monetary policy response. The FOMC cut rates to near-zero in 2020 and has indicated this will likely remain the case for several years. The bar for rate increases is very high and would require sustained inflation readings above the Fed's 2% target, in addition to signs of stronger economic growth. Despite very low absolute yields, the slope of the yield curve increased during the year. Regardless, we anticipate yields will remain low by historical standards and range-bound in the near-term.

Relative value in spread sectors, after increasing significantly at the height of the pandemic period, has become less attractive going into 2021, meaning compensation for risk in the form of bond spreads is lower. For example, on average, corporate bond spreads only widened by three basis points during 2020, after tightening 60 basis points in 2019.

Economic Outlook

The U.S. economy was rocked by the COVID-19 pandemic, with large-scale business closures and social distancing measures leading to very high levels of unemployment at the beginning of the year. This in turn led to an unprecedented level of support at the federal level, which largely calmed markets, resulting in a relatively quick recovery in risk assets into the latter half of the year. Major equity indices hit all-time highs, and bond yields remain near historic lows.

Real U.S. GDP growth is anticipated to be 4-5% in 2021 according to consensus, after a projected contraction of (3.5%) in 2020. However, growth will be heavily dependent on the pace of COVID-19 vaccinations, as well as potential shutdowns, particularly during the winter months. Other risks to the outlook include inadequate support at the federal level (in the form of fiscal stimulus and accommodative monetary policy), surprise inflation, increased trade tensions, and commodity price volatility.

After pivoting to an accommodative stance in 2019, the Fed leaned more sharply dovish in March 2020 in response to the onset of the pandemic. Rates were lowered to effectively zero, with forward guidance indicating a continuation of near-zero rates over the near-term. Markets are not pricing in any additional Fed moves throughout 2021. The vast majority of market participants do not expect inflation to be a key risk in 2021, which is a risk in and of itself. An abrupt and sustained move higher in inflation, while unlikely, could cause the Fed to reverse course and move to a tighter policy stance. The market could be caught off guard in this scenario.

Fiscal policy was stimulative, again in response to the pandemic and the resulting economic slowdown. Congress passed the CARES Act in March 2020, which provided expanded unemployment benefits and direct aid to individuals, as well as aid to small businesses and to states and local governments. Loan backstop facilities were also created, allowing the Fed to purchase fixed income securities in the open market, which assuaged liquidity concerns. Further fiscal stimulus, in the form of direct aid to individuals, small business loans, enhanced unemployment benefits, and aid for education services served as a further boost toward economic growth prospects.

Further federal government support for the markets, in the form of additional fiscal stimulus and, if necessary, a reintroduction of the Fed's open market purchase programs for corporate and municipal debt, will likely be subject to protracted negotiations between a divided Senate. Changes to tax and regulatory policy would hurt profit margins and potentially discourage M&A activity.

Corporate Sector

The credit market and economy are recovering from their biggest test since the financial crisis, which was brought about by the sudden shock COVID-19 had on growth, corporate profits, and credit quality during 2020. Looking ahead to 2021, the outlook for corporate credit has strengthened based on the expectation that the economic recovery will gain further momentum

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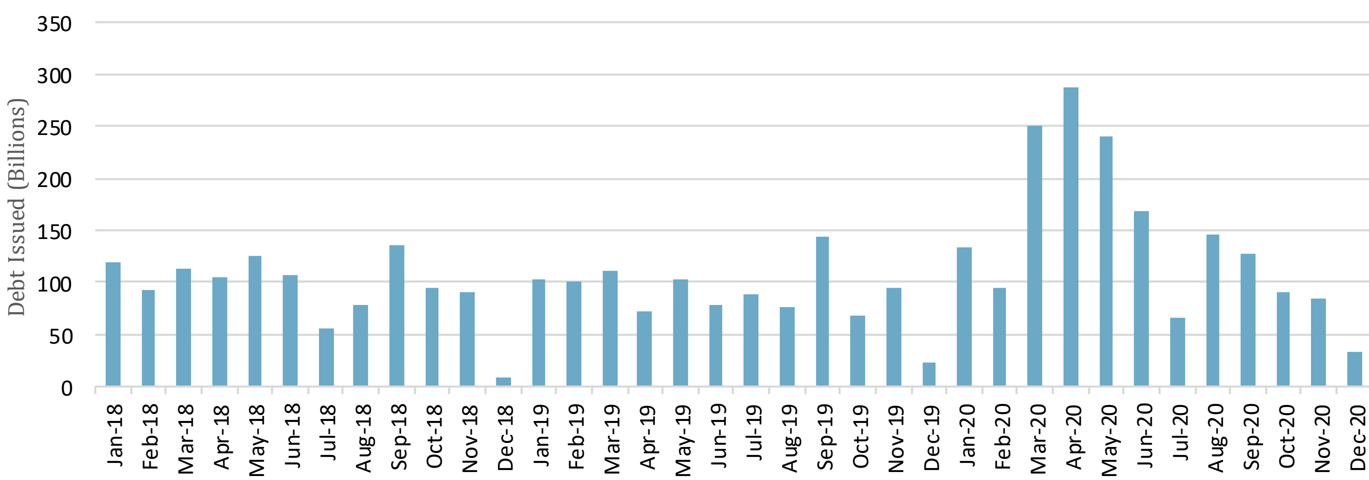
and lead to: (1) solid GDP growth, (2) declining unemployment, (3) stronger corporate revenue and earnings growth, and (4) more stable credit quality. These factors, in combination with expectations that borrowing costs for issuers will remain low and capital markets accessible for low-rated companies to refinance their debt when needed, should provide a supportive backdrop for credit fundamentals and result in a lower speculative grade default rate, and fewer higher risk credits (i.e. credits of concern and potential fallen angels).

As we begin 2021, business leaders, consumers, and investors remain more optimistic and confident in the outlook lifted by promising signs of near-term vaccine approval. In addition, while the current challenge of controlling the virus is proving difficult and is an example of a downside risk to growth and corporate profit forecasts, considering that mass immunizations will not reach impactful levels until the second or third quarter of 2021, policymakers are expected to provide liquidity and stimulus to support the economy and markets as needed.

Furthermore, market technicals are expected to remain strong, supported by solid investor demand, comparative yield advantage of U.S. high-grade credit versus overseas high-grade credit, and lower gross and net supply expected in 2021. However, valuations are rich based on the significant tightening in spreads since peaking in March 2020. In 2021, we expect investment grade credit valuations to benefit from solid GDP growth, stronger earnings, and robust supply and demand technicals. Despite the current credit backdrop, current valuations leave limited room for outperformance and make it more difficult for investors to generate investment income.

The main risk in the next few months is surging COVID-19 cases. While recent breakthroughs in vaccines mean the outlook for 2021 and beyond looks increasingly bright, in the meantime, the wave of new restrictions being imposed by state authorities is raising the likelihood that the recovery temporarily stalls or even goes into reverse. Other challenges include: (1) tight valuations that already price in significant good news, (2) high leverage for non-financial issuers and record levels of BBB-rated bonds outstanding, (3) potential bullish sentiment takes hold in combination with low rates, emboldens more debt-funded event risk (e.g. M&A or buybacks), and brings downgrade risk back in focus, (4) uncertainty around the new administration's policies that could lead to idiosyncratic risks by sector or issuer, and (5) geopolitical risks.

Exhibit 1: Investment grade corporate bond supply hit an all-time high during 2020 as companies issued debt to build cash reserves during the pandemic



Source: SIFMA, Opus

Municipal Sector

Municipal bonds remain a core allocation in a diversified fixed income portfolio, providing attractive risk-adjusted returns in addition to overall correlation benefits to the portfolio. The impact of the COVID-19 pandemic was acutely felt in the municipal market in the form of demographic shifts, reduced tax collections, and significant expenditure reductions. Despite these challenges, the municipal market has proven resilient in the face of past challenges, and we expect higher quality credits that took advantage of economic growth prior to the pandemic to bolster reserves/reduce leverage will be well-positioned to strengthen once the pandemic abates.

Unlike other sectors, core challenges in the municipal sector are long-term in nature and require long-term solutions. Specifically, costs of entitlement programs continue to grow as a percentage of state and local government budgets, crowding out spending for infrastructure and pressuring education funding. Shifting demographics coupled with rising Medicaid costs and the threat of reduced/inadequate federal support also strain state budgets.

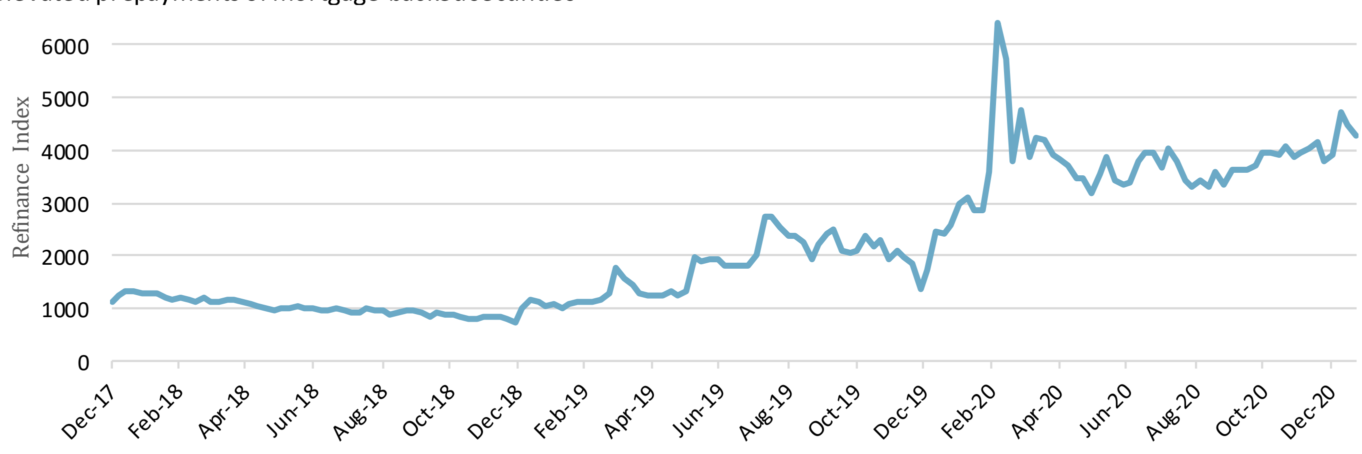
The Tax Cuts & Jobs Act of 2017 had a significant impact on how we invest in the municipal market due to the reduction in the corporate income tax rate from 35% to 21% (compared to the reduction in the top individual tax rate from 39.6% to 37%). Whereas the corporate and top individual tax rates were relatively similar in past years, the divergence between the corporate rate and the top individual rate created two very different outcomes for each investor. The value of the tax exemption is significantly higher for individual investors as a result of their higher income tax rate. With approximately 70% of the municipal buyer base represented by retail investors (e.g., mutual funds, high net worth individuals), relative value reflects their tax status and as such, remains unattractive for insurance clients. Due to the onset of the pandemic in the March/April 2020 time period, there was a window during which the ratio of tax-exempt/taxable municipal bond yields increased to a point that, even with this reduced tax benefit, it was economically worthwhile to participate in the tax-exempt market. This opportunity is no longer viable given a reduction in ratios. However, with minimal existing exposure to tax-exempt municipal bonds, we remain well-positioned to take advantage of any pricing dislocations should they occur.

Primary risks in the municipal sector are: (1) declining tax revenues due to the pandemic-induced economic slowdown, (2) inaction by the federal government in providing required fiscal aid to municipal issuers, (3) significant unfunded, and growing, pension and OPEB liabilities, which over time have become a much larger component of state and local operating expenditures, (4) a return to sluggish economic growth, as measured by GDP, which would further pressure state and local government finances due to lower tax revenues, and 5) unfunded federal liabilities (Medicaid and education mandates).

Residential Mortgage-Backed Securities (RMBS)

2020 was a year of ups and downs for Agency RMBS. In March 2020, the pandemic created outsized moves in the sector and liquidity reached an all-time low. Prices moved multiple points per day and specified (collateral with attractive characteristics) pay-ups eroded from their recent highs to near zero before the Federal Reserve stepped into the markets with its fourth round of quantitative easing since the Financial Crisis in 2008. At the onset, the Fed was purchasing more than $40 billion of agency RMBS per day, which has since been scaled back to $40 billion per month. Throughout the course of 2020, the Fed had purchased more than $1.4 trillion on a gross basis and net added nearly $700 billion. Performance during the year was largely driven by this technical factor and the demand from the bank community, as 2020 loan growth faltered, and deposit balances hit their highest level ever. That demand was enough to offset all-time high gross issuance and extraordinarily fast prepayment speeds, as the 30-year primary mortgage rate fell to an all-time low of 2.67%. Each of the above noted factors, coupled with ultra-low volatility since March and a 10-year U.S. Treasury trading in a 20bps range (60 – 80bps) for much of the year, led to lower coupon Agency RMBS significantly outperforming Treasuries.

Exhibit 2: With interest rates declining over the last two years, the incentive to refinance has rapidly increased leading to elevated prepayments of mortgage-backed securities



Source: Mortgage Bankers Association, Opus

Entering 2021, due to the quick and significant rate moves in 2020, there are still 80% of mortgage borrowers who have a 50bps or more incentive to refinance. This, in conjunction with a historically wide primary/secondary mortgage spread and an expected increase in originator capacity, leads to continued fast prepayment speeds being the largest headwind to Agency RMBS in 2021.

From a spread perspective, Agency RMBS are relatively tight to their own history; however, the technical backdrop does not warrant or suggest a catalyst for a meaningful spread widening in the sector until it's clear the Fed will step away and inflation begins to surface north of 2% for a sustained period. Housing fundamentals remain quite strong with new and existing home sales reaching new highs, as are purchase mortgage applications and the national home price index closing in on a 7% year-over-year increase, the largest increase since 2014.

Due to the previously mentioned risks and positive technicals along with limited implied rate volatility, the risk/return profile for Agency RMBS remains balanced and somewhat attractive relative to some other fixed income sectors.

Commercial Mortgage-Backed Securities (CMBS)

As with much of the market, the CMBS sector was dominated by effects of the COVID-19 pandemic. With widespread lockdowns in the second quarter of 2020, fears of an increase in defaults in the CMBS space led to material spread widening. The retail and lodging sectors have fared the worst as the impact has been the most immediate and greatest. As the summer wore on and restrictions were eased, the performance of the CMBS sector improved, albeit at a slower pace than some other sectors. Delinquencies peaked in June 2020 and have moderated since. Spreads have continued to tighten as positive news about vaccinations became the focus. In December, AAA spreads returned to pre-COVID-19 levels.

As we look forward, COVID-19 has accelerated trends in brick-and-mortar retail, which may never return to pre-COVID-19 levels. It is widely expected that demand for lodging in aggregate will return, although business-focused properties may see long-term impacts due to changes in business travel. Similarly, there is uncertainty over the long-term impact to office demand, especially in high-cost cities like New York and San Francisco, which have strong representation in CMBS deals. Despite overall concerns for the sector, we continue to find selective opportunities and will do so into 2021.

Asset-Backed Securities (ABS)

The ABS market started off 2020 on strong footing, building off solid fundamentals it had experienced in 2019. As 2020 developed further, it proved to be extremely challenging from a credit perspective given the economic shock from COVID-19. However, many ABS sectors experienced strong performance. While some sectors will remain challenged (e.g., aircraft ABS, small business loan, and rental car ABS), delinquencies and losses remain well below pre-pandemic levels across most of the consumer ABS sub-sectors. Government assistance helped significantly during the initial phase of the pandemic, but as we entered the back half of 2020, many consumers had exited relief programs. ABS structures functioned as they were intended to by deleveraging and with ABS sponsors actively supporting facilities to boost credit enhancements.

From the spring and summer onward, AAA spreads in benchmark ABS asset classes rallied back to pre-pandemic levels. Spreads in more off-the-run asset classes and further down the capital stack have underperformed, especially in harder hit sectors such as aviation lease and small business loan ABS, which are still well wide of levels seen at the start of the year. Within the Whole Business Securitization sector, restaurant systems with heavy sit-down emphasis should continue to be weak as increased restrictions are not off the table for the beginning of 2021. Businesses that offer a variety of off-premise services should remain less impacted and expect that trend to continue until a vaccine has been widely distributed.

As we look ahead to 2021, issuance is expected to pick up. Forecasts are calling for 13% higher issuance compared to 2020 levels but 6% lower than all-time high issuance from 2019. With consumer metrics back to pre-pandemic levels and the level of savings unclear for those that are unemployed, credit metrics should weaken moderately in the first half of 2021. The addition of further fiscal stimulus should provide consumers with more support. With the weakening credit fundamentals, we would expect spreads to widen but the impact should be limited. Regarding the used vehicle market, prices have reached record resale values as trends emerged for suburban transportation with consumers transitioning out of densely urban locations during the middle of the pandemic. This has created a lot of pull forward demand and we expect used car prices to moderate back to trend and the Manheim Used Vehicle Index to slightly weaken causing impact to residual values but again are expected to be modest.