INCORE Fixed Income Strategy Quarterly Commentary

As of March 31, 2021

Market Conditions

Through the first quarter of the year, the "reflation trade" continues to be the dominant market theme as fixed income investors were greeted with the worst quarterly performance in U.S. Treasuries (-4.25%) since 1980, led by the 10-year Treasury note yield, which increased by 89 basis points and closed at 1.74%, near its highest closing yield in the past year. The U.S. outpaced most of the globe in efforts to engineer a swift economic rebound, with nearly $3 trillion of additional fiscal stimulus since late December (and an additional $2 trillion proposed), continued monetary stimulus, effective distribution of vaccines, and economic reopening across the U.S. This combination caused markets to price in an even more powerful economic rebound and increasing risks of inflation. Traditional safe-haven currencies such as the Japanese yen and Swiss franc sold off, while the U.S. dollar strengthened. U.S. equity indices continued to set records, while small-cap and mid-cap indices outpaced the S&P 500® and Nasdaq as investors rotated portfolios from growth to value and favored small- and mid-cap stocks. The latest FOMC dot plot released in March indicates that most members of the FOMC expect the zero-interest-rate policy to continue through 2023, and the committee has clearly communicated their intention to allow inflation to exceed 2% for some time before tightening monetary policy. We expect the bond market will continue to challenge this assumption, as it did in 2018 and early 2019 when the Fed insisted rates would continue to rise and the market priced in the opposite. We are maintaining accounts relatively short duration versus benchmarks.

As we've written before, the Federal Reserve, Treasury, and Congress are embarking upon a bold experiment in Modern Monetary Theory (MMT), an untested concept where massive fiscal deficits theoretically don't matter for countries that control their own currency. Stimulus will not only be used to move demand forward, but also to promote social and environmental causes. While enormous monetary and fiscal stimulus is likely to be supportive of economic growth and market valuations over the next 1-2 years, increased taxes and regulation may offset some of these gains. While the Fed's favorite measure of inflation, Core PCE, is currently indicating a tame 1.4% rate of inflation, we remain concerned about possible higher inflation due to supply-chain issues, supply/demand imbalances as the economy reopens, and increased regulatory burdens. Longer term, unsustainable levels of debt and spending relative to GDP have the potential to cause higher interest rates and inflation if the currency is devalued as a result. Finally, irrespective of which political party is in control, government is notorious for inefficient use of capital. One need only revisit the tales of Solyndra, the Defense Department's $10,000 toilet covers, and the GSA boondoggle to Las Vegas in 2010 for vivid displays of recent waste, fraud, and abuse. And the history is long regardless of political party, so color us skeptical. For the sake of future generations, we hope "this time is different," and the experiment works. It is without doubt a bold gamble.

Market and Positioning Commentary

INCORE believes that while yields have risen substantially on intermediate- and long-term U.S. Treasuries, investors are still compelled to invest in corporate and consumer credit. We believe the U.S. economy is still in the early stages of economic recovery. As a result, we are maintaining a significant overweight to corporate credit, high yield, and investment grade convertible bonds as the economy recovers and interest rates rise. This positioning has been additive to performance in the first quarter, helping all INCORE strategies outpace their benchmarks during the quarter and the past year.

Enormous monetary and fiscal stimulus will continue to buoy markets in the near term as the Biden administration and the Federal Reserve shift the MMT experiment into high gear. However, it is likely to be a volatile and uncertain time, as the long-term effects of MMT are unknown. The key attributes we strive for when positioning client portfolios for an uncertain outlook are quality, balance and diversification. We believe we are well positioned across our portfolios for this uncertain environment, and we believe being overweight credit and underweight duration versus our benchmarks should be additive to performance during the remainder of 2021.

Performance and Attribution

Total Return Strategy: The INCORE Total Return Fixed Income Strategy started 2021 underweight U.S. Treasuries and mortgage-backed securities, with corresponding overweight allocations to investment grade corporate bonds, high yield corporate bonds, and investment grade convertible bonds. While Treasury yields have increased substantially from their pandemic lows, we maintain a corporate credit overweight as we are early in the current economic cycle. The strategy benefited from this positioning during the quarter, outpacing the Bloomberg Barclays U.S. Aggregate Bond Index benchmark by 0.70% (gross of fees).

Core and Intermediate Strategies: The INCORE Core and Intermediate strategies started 2021 underweight U.S. Treasuries and agencies, with corresponding overweight allocations to mortgage-backed securities and investment grade corporate bonds. Additionally, the strategies were short duration relative to their respective benchmarks throughout the quarter. While Treasury yields have increased substantially from their pandemic lows, we maintain these overweight positions as we are early in the current economic cycle. Our Core and Intermediate strategies benefited from this positioning during the quarter, outpacing their Bloomberg Barclays benchmarks by 0.38% and 0.26%, respectively (gross of fees). Furthermore, the strategies remain ahead of their benchmarks on a gross basis for all relevant time periods (e.g., 1-, 3-, and 5-year).

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Low Duration Strategy: The INCORE Low Duration Credit Strategy started 2021 underweight U.S. Treasuries and agencies, with corresponding overweight allocations to mortgage-backed securities, investment grade corporate bonds, high yield corporate bonds, and investment grade convertible bonds. Additionally, the strategy was short duration relative to its benchmark throughout the quarter. While Treasury yields have increased substantially from their pandemic lows, we maintain these overweight positions as we are early in the current economic cycle. The strategy benefited from this positioning during the quarter, outpacing the Bloomberg Barclays U.S. 1-3 Year Government Bond Index benchmark by 0.51% (gross of fees). Furthermore, the strategy remains ahead of its benchmark on a gross basis for all relevant time periods (e.g., 1-, 3-, and 5-year).

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