NORTHERN TRUST
ASSET MANAGEMENT

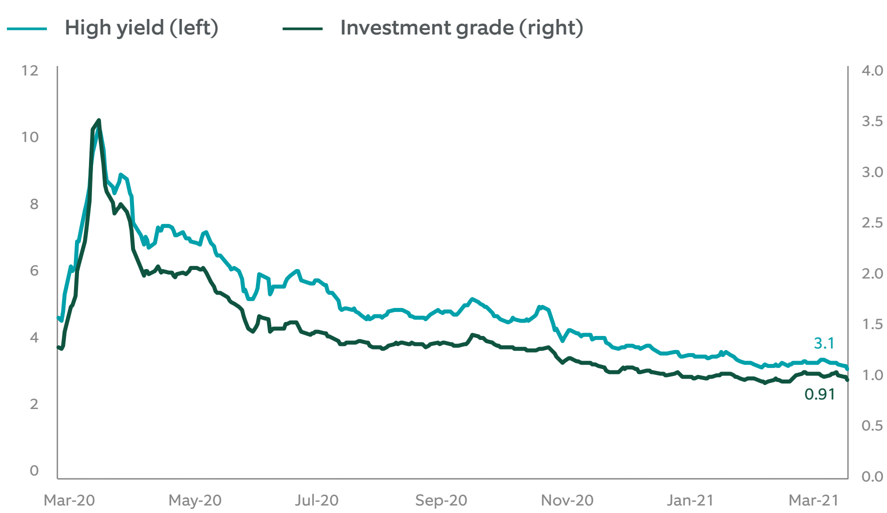
FIXED INCOME UPDATE FIRST QUARTER 2021

KEY POINTS

- The fixed income market's functionality and liquidity reached pre-pandemic levels during the quarter, and credit spreads continued to decline. Still, Treasury yields moved materially higher on fears of inflation, hurting fixed income returns depending on sector and maturity.
- Global financial markets and the economy received support from falling COVID-19 cases and accelerating vaccination rates, backing our positive fixed income outlook.

EXHIBIT 1: U.S. OPTION-ADJUSTED SPREADS (OAS): INVESTMENT GRADE VS. HIGH YIELD (%)

Credit spreads fell to pre-pandemic levels during the quarter while the economy recovered.



Source: Bloomberg, as of March 31, 2021

IN THIS ISSUE

Long-Term Views

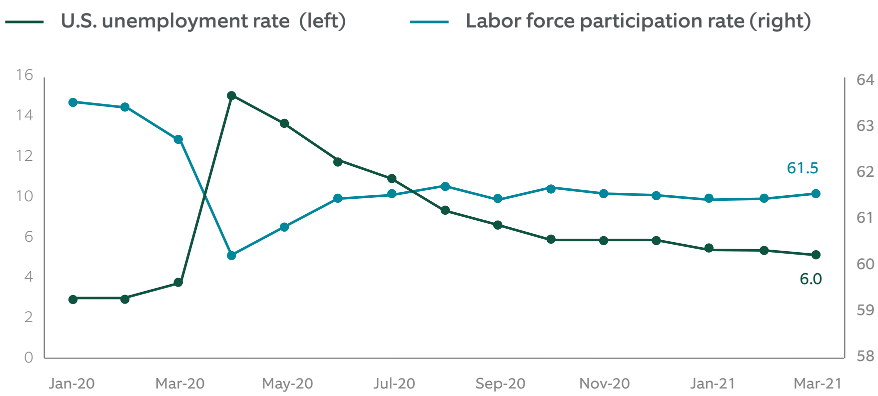
- Economies will continue to adapt to the virus. The public health policy approach will shift to minimizing hospitalizations and deaths while vaccines lead the path to herd immunity.
- We still believe in our "Stuck-flation" view of persistent low inflation despite massive government economic aid and central bank policies that maintain very low interest rates. U.S. unemployment that reduces spending, an aging population that consumes less, and technological efficiencies that lower costs support continued low inflation. Spikes in demand during the economic recovery may cause temporary inflation boosts.

ECONOMY

- The U.S. labor market improved as the lifting of lockdowns provided economic momentum. Continuing and initial jobless claims fell to pandemic lows while the unemployment rate decreased steadily during the quarter (though still remains high at 6%). Labor force participation — the percentage of working-age people who are employed or actively looking for work — moved slightly higher.
- U.S. household income increased significantly, aided by direct payments to consumers through the $1.9 trillion stimulus bill. The higher income fueled travel and leisure spending during the quarter and increased savings that we believe will spark future consumption.

EXHIBIT 2: U.S. EMPLOYMENT TRENDS (%)

The improving economy, supported by fewer pandemic lockdowns, lowered unemployment and increased labor force participation.



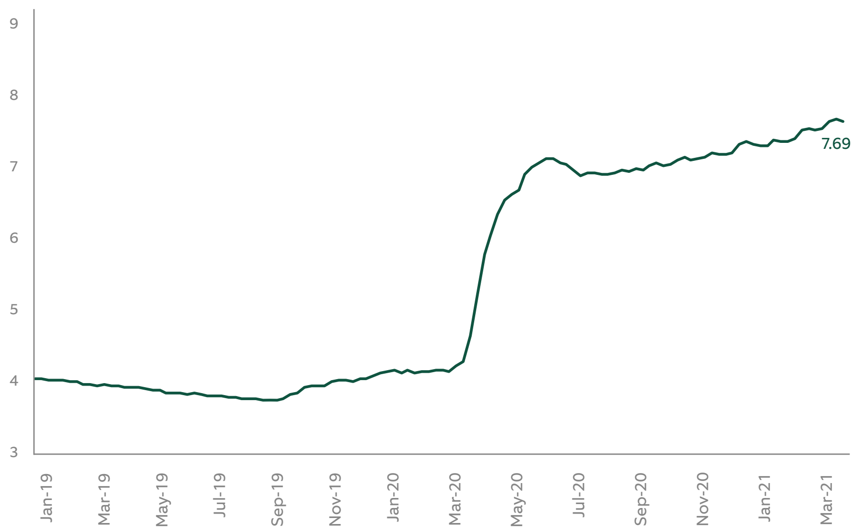
Source: Bloomberg, as of March 31, 2021

CENTRAL BANKS

- Global central banks remained accommodative, providing support for the economy and financial market conditions. Still, central banks allowed some crisis related policies to expire as pandemic conditions improved.
- The Federal Reserve met twice and left the target Fed funds policy rate unchanged (0.0-0.25%). The meetings were largely uneventful, but the Fed chose to allow the expiration of a virus-related exemption to the so-called supplementary leverage ratio (SLR). The exemption allowed banks to remove Treasurys and bank deposits from their reserve requirements.

EXHIBIT 3: FEDERAL RESERVE BALANCE SHEET ($ TRILLIONS)

The Federal Reserve continued to support financial conditions by expanding its balance sheet via asset purchases.



Source: Bloomberg, as of March 31, 2021

ULTRA-SHORT/CASH

- Investment grade issuance shifted heavily to bonds with shorter maturities as companies took advantage of low short-term rates. Maturities five-year or less accounted for 25% of new issuance in the quarter compared to 11% in first quarter of 2020.
- Cash market liquidity increased meaningfully, resulting in higher money market fund balances and bank reserve levels. More liquidity and a lower supply of bond issuance pinned cash rates near zero.

Performance

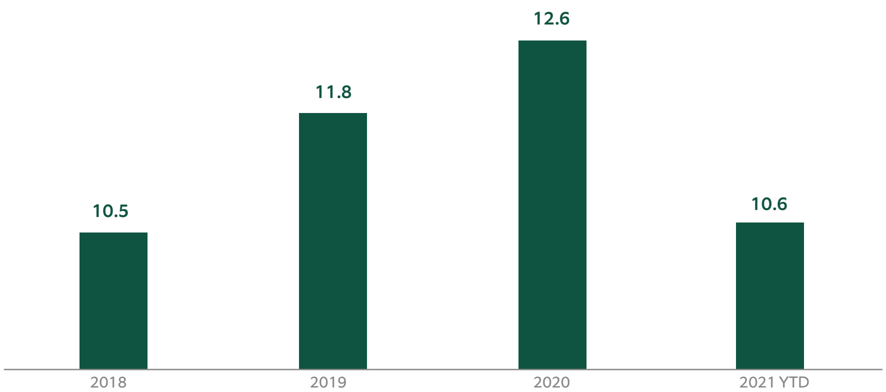
- Contributors: sector allocation
- Detractors: curve positioning, duration

Current Positioning

Portfolios are positioned neutral-to-long duration relative to their benchmark, as we purchased longer duration corporate or Treasury bonds.

EXHIBIT 4: U.S. AVERAGE MATURITY OF NEW ISSUES (YEARS)

The average maturity of new bond issuances has dropped this year as long-end bond rates rose more than short bonds, making it more beneficial for companies to issue shorter term bonds.



Source: Dealogic, J.P. Morgan, as of March 31, 2021

TREASURYS AND TREASURY INFLATION-PROTECTED SECURITIES (TIPS)

- Longer maturity Treasury yields reached the highest since the beginning of the pandemic on expectations of more inflation with the improving economy and crisis-related stimulus. The 10-year Treasury yield rose 83 basis points to 1.74% during the first quarter and the 30-year Treasury yield increased 77 basis points to 2.41%.
- In another indicator of higher expected inflation, the yield curve steepened as long-end bond yields rose more than those of short-end bonds.
- Inflation repricing was also visible in the TIPS curve, as breakevens increased across all maturities. However, the five-year and 10-year TIPS curve is inverted, suggesting that near-term inflation is not expected to last.

Performance

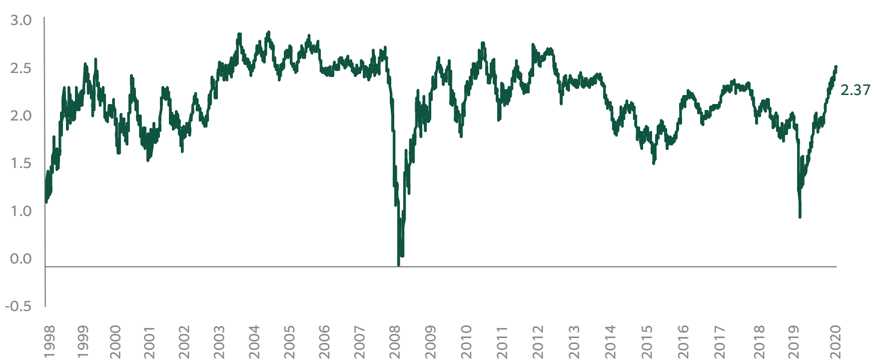
- Contributor: security selection
- Detractor: duration

Current Positioning

Portfolios are positioned neutral-to-long duration relative to their benchmarks because we believe the market is incorrectly pricing in inflation and Fed tightening.

EXHIBIT 5:10-YEAR TIPS BREAKEVEN RATE (%)

Ten-year breakeven rates, an inflation indicator, are trading at levels not seen since the 2003-2006 growth years and post-2008 after the Global Financial Crisis, when inflation worries were overblown.



Source: Northern Trust Asset Management, Bloomberg, as of March 31, 2021. Break-even inflation is the difference between the nominal yield on a fixed-rate investment and the real yield (fixed spread) on an inflation-linked investment of similar maturity and credit quality.

INVESTMENT GRADE BONDS

- Rising yields, spurred by worries of higher inflation, led to negative returns across the investment grade quality spectrum. Corporate bonds lost 4.65% in the quarter, the worst performance since the third quarter of 2008.
- Bonds with BBB ratings outperformed higher quality investment grade bonds by roughly 100 basis points during the quarter on an excess return basis, which removes the effects of duration.
- Companies issued $435 billion in investment grade bonds, the second highest quarter on record behind $480 billion in the first quarter of 2020. Corporates rushed to issue bonds due to a positive risk environment and the fear of higher rates, which would make it more expensive to borrow.

Credit Performance

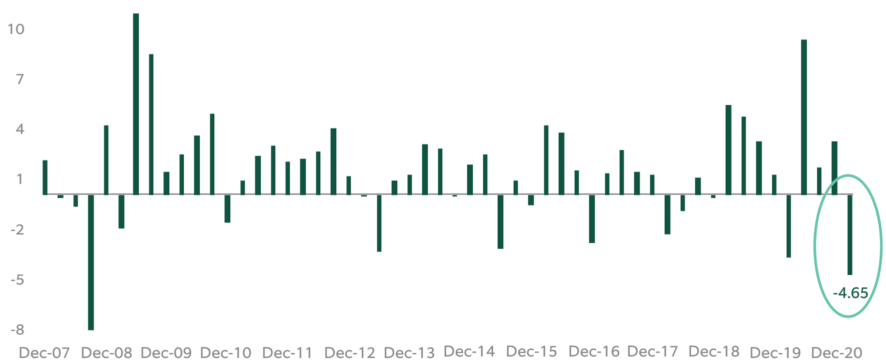
- Contributors: sector allocation, security selection
- Detractors: curve positioning, duration

Current Positioning

Portfolios are positioned neutral-to-long duration relative to their benchmarks, while maintaining a moderate overweight to corporate bonds.

EXHIBIT 6: U.S. INVESTMENT GRADE BOND QUARTERLY RETURNS (%)

Inflation worries by investors increased yields enough to cause the largest quarterly loss in more than 12 years.



Source: Northern Trust Asset Management, Bloomberg, as of March 31, 2021

HIGH YIELD BONDS

- Issuance hit a record $149 billion during the quarter, surpassing the previous record of $139 billion set during the second quarter of 2020. High yield issuers continued to refinance their debt at lower levels thanks to the improving economic growth outlook.
- High yield companies hardest hit by the pandemic continued to see strong recovery, resulting in a multi-year low $2.3 billion in defaults, the third straight quarterly decline.
- Spreads continued to compress, encouraging investors to pile into high yielding CCC bonds. Those bonds returned 3.58% in the quarter, the best return in the U.S. bond market.

High Yield Performance

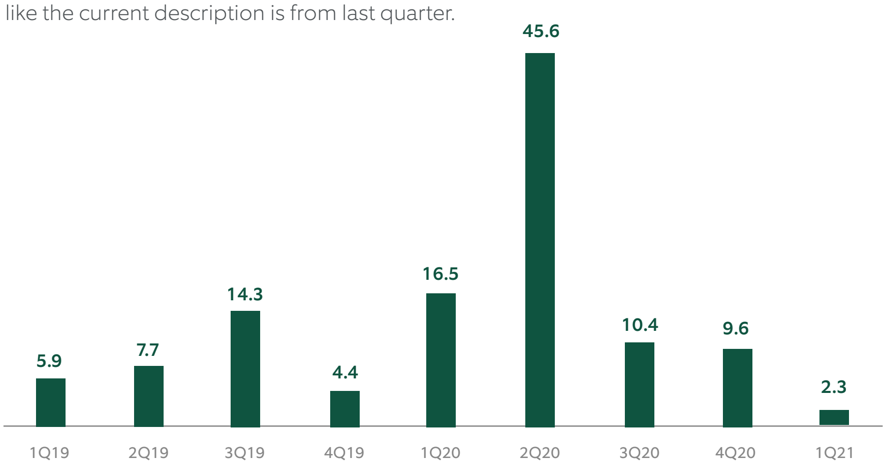
- Contributors: security selection
- Detractor: duration

Current Positioning

Portfolios are positioned to manage the impact of market and sector volatility, while focusing on income generation and downside risk protection. We will continue to be positioned in the mid-range of the high yield credit risk spectrum.

EXHIBIT 7: U.S. HIGH YIELD DEFAULTS ($ BILLIONS)

High yield defaults reach multi-year lows as the U.S. economy continues to recover. Looks like the current description is from last quarter.



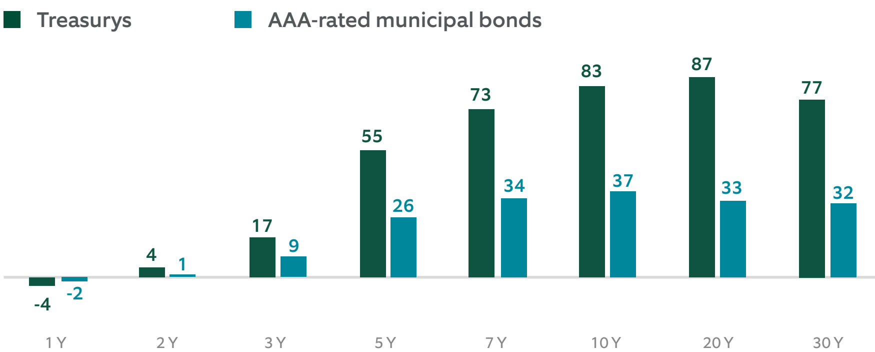
Source: J.P. Morgan, as of March 31, 2021

MUNICIPAL BONDS

- Resilient revenues and federal aid to municipal issuers from the $1.9 trillion stimulus plan fueled demand for municipal bonds, especially for lower rated credits.
- Search for yield and portfolio rebalancing from robust equity markets also supported demand.

EXHIBIT 8: 1Q21 YIELD CHANGE BY MATURITY: U.S. MUNICIPAL BONDS VS. TREASURYS (BASIS POINTS)

Municipal bond rates rose, but much more modestly than taxable bonds, as economic stimulus and resilient revenues supported municipal bonds.



Source: Northern Trust Asset Management, as of March 31, 2021

Municiple Performance

- Contributors: duration, security selection
- Detractors: yield curve, higher quality credit bias

Current Positioning

Interest rate risk should typically be neutral-to-short to start the quarter. We expect supply/demand imbalances to ease during the second quarter, creating an opportunity to put cash to work and lock in higher yields.

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