FIRST QUARTER 2021

Strategic Income Commentary

March 31, 2021

MARKET REVIEW

The pro-cyclical equity rotation that began in 4Q20 continued during the first quarter as small cap stocks (Russell 2000® Index) returned 12.7% to begin the year. Small cap companies are more levered to an economic reopening when compared to their large cap brethren, partially explaining the outperformance. Further evidence of the pro-cyclical rotation was seen in the outperformance of value relative to growth. Indeed, the Russell 3000® Value Index returned 11.8% during the quarter compared to 1.2% for the Russell 3000 Growth Index. With U.S. economic growth expected to be a robust 6.2% this year according to a Bloomberg survey of economists, the market is not ascribing as much value in holding growth stocks as it once did. Finally, the commodity complex is also signaling a reflationary boom as the S&P Goldman Sachs Commodity Index returned 14.2% for the quarter.

In the fixed income universe, the Bloomberg Barclays U.S. Aggregate Bond Index began with its worst start to a year ever, posting a -3.4% total return during the first quarter. It was difficult to find much value in fixed income with interest rate risk in the market running at close to all-time highs and yields at close to all-time lows. In U.S Treasuries, almost the entire term structure finished the quarter with negative real yields, i.e., nominal yield adjusted for inflation. In fact, the only positive real yield to be found across the curve was at the 30-year tenor—and that was a meager 0.10% real yield. With all the fiscal and monetary support currently embedded in the economy, fixed income yields still have room to move higher as a post-COVID normalization continues.

As we close out the first quarter and position portfolios for the remainder of the year, we must examine the factors that could derail the post-COVID cyclical reflation trade, which favors equities, commodities, and other real assets over fixed income and cash. With financial conditions at extremely easy levels, record amounts of fiscal stimulus, and employers having difficulty in finding qualified employees, the possibility does exist that this pro-cyclical reflationary boom could morph into a slow growth, inflationary episode. As long as the economy stays in the reflationary "Goldilocks" scenario, equities should continue to perform better than fixed income. Monetary and fiscal policy authorities, however, will have their work cut out for them as they endeavor to keep robust real economic growth alive while keeping inflation and interest rates from rising at a pace that adversely impacts the price of risky assets.

PORTFOLIO REVIEW

The portfolio's duration was shorter than the benchmark during the period and was a positive contributor to performance as interest rates increased with inflation fears.

Consistent with the last several quarters and the risk-on orientation for the market, the portfolio's allocation to preferred hybrid securities continued to be a positive contributor to relative performance during the quarter.

Equities were a positive contributor to performance throughout the period.

The portfolio was underweight corporate bonds throughout the quarter as better opportunities were found in higher yielding securities, such as preferred stocks. The overall underweight to the corporate sector was a drag on performance.

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PORTFOLIO MANAGEMENT TEAM

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Joined Red Cedar: 2018

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Industry start date: 1988
Joined Red Cedar: 2018

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Industry start date: 2004
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Industry start date: 2011
Joined Red Cedar: 2019

INVESTMENT PHILOSOPHY

"Strategic Income seeks current income, across global markets, in any capital structure where we find relative value. The strategy provides reduced correlations to both stocks and bonds in a high quality portfolio."
—John Cassady

March 31, 2021

The portfolio's international exposure to emerging and developed market currencies detracted slightly from performance during the quarter.

The portfolio's exposure the $25 par securities detracted from performance during the period. The unique structure of some of these securities is not well suited for a rising rate environment.

STRATEGY POSITION & OUTLOOK

The end of the first quarter of 2021 saw President Biden's $1.9T American Rescue Plan of 2021 passed and a $2.25T infrastructure plan pitched. This stimulus combined with the continued rollout of vaccines and an emerging COVID-19-related reopening has led to inflationary fears and higher interest rates. While credit spreads remained in a narrow range during the quarter, the move higher in Treasury yields resulted in one of the worst performance quarters on record for the Bloomberg Barclays U.S. Aggregate Bond Index.

The portfolio's duration is lower than the benchmark. We anticipate reflationary trends to continue throughout the year, and with that, expect higher interest rates.

The portfolio maintained it bearish position on the U.S. dollar throughout the period because of inflationary concerns. However, the portfolio's Polish zloty position was sold during the quarter because of concern for Europe's slower COVID-19 vaccination rollout and related recovery.

The portfolio's preferred exposure was maintained at the upper level of the range. Preferred securities still can offer excellent risk adjusted yield.

The portfolio is overweight the financial, metals & mining, and energy sectors. It is positioned to take advantage of the potential global reflation that could result from the government stimulus and economic-related re-openings.

U.S. investment grade corporate bond issuance was $582B in the first quarter of 2021, up 6% year-over-year and 16% quarter-over-quarter. Issuance for 2021 is expected to be around $1.4T, similar to 2019 levels.

DISCLOSURES

* All end-of-year index data noted is as of 3/31/21.

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Index Definitions: Bloomberg Barclays U.S. Aggregate Bond Index: Broad-based, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the U.S. Russell 2000 Index: Measures the performance of the 2,000 smaller companies that are included in the Russell 3000 Index, which is made up of nearly all U.S. stocks. Russell 3000 Value Index: A market-capitalization weighted equity index based on the Russell 3000 Index which measures how U.S. stocks in the equity value segment perform by including only value stocks. Russell 3000 Growth Index: A market-capitalization weighted equity index based on the Russell 3000 Index which includes companies that display signs of above-average growth. Used to provide a gauge of the performance of growth stocks in the United States. S&P GSCI: Serves as a benchmark for investment in the commodity markets and as a measure of commodity performance over time.

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