THIRD QUARTER 2021

Strategic Income Commentary

September 30, 2021

MARKET REVIEW

3Q21 was an underwhelming quarter in the capital markets with equities drifting somewhat aimlessly during the summer months and bond yields just slightly changed from the prior quarter end. That's not to say it wasn't interesting getting from point A to point B as the S&P 500® hit an all-time high during September before retreating and eking out a positive 0.6% return for the quarter. For its part, the US Treasury (UST) curve bull flattened during the first half of the quarter before reversing course and ending up virtually unchanged. The 10-year UST yield finished just 2 basis points higher than the previous quarter at 1.49%.

There were a few catalysts for this price action during the quarter, including the Federal Reserve's (Fed) confusing messaging regarding monetary policy, supply chain and inflation issues, and China's crackdown on the private sector. By the July 28 Federal Open Market Committee Meeting, the Fed was able to re-assure markets that tapering does not mean rate hikes. Indeed, if the Fed begins tapering its asset purchases late this year, they would in all likelihood not be finished until late 2022. This would put the first rate hike on the table no earlier than late 2022. This easier-for-longer stance caused the yield curve to re-steepen as the quarter wore on. The resignation of two hawkish Federal Reserve Bank presidents over their controversial personal investment trading while setting Fed policy further emboldened the easier-for-longer narrative as new appointees would undoubtedly tilt dovish. All other things equal, these would be positive developments for equity markets.

On the inflation front, the Fed has been preaching the transitory nature of inflation for over a year now, but broad US inflation indices are running between 4% and 5.5% year-over-year. Additionally, commodity prices globally continue to rise with the S&P Goldman Sachs Commodity Index posting a hefty 36.2% increase YTD. If these inflation measures do not turn out to be transitory, then fixed income yields will have to adjust upward.

As we enter the 4th quarter, the debt ceiling, government shutdowns, and stimulus bills all seem poised to create drama in the markets. For now, the government has enough funding to remain open through December 3rd. However, unless the debt ceiling is raised by October 18, the US could default on some of its Treasury obligations. Despite the theatrics out of Washington DC, we expect these issues to be resolved allowing market participants to focus on easy monetary policy, fiscal stimulus, and corporate earnings—all of which could provide additional runway for equity market returns and be challenging for fixed income.

STRATEGIC INCOME PORTFOLIO REVIEW

The portfolio's position in preferred securities was a positive contributor to performance. The fixed income market remains starved for yield, and the preferred sector continues to satisfy that hunger.

The equity holdings in the portfolio detracted from performance during the quarter. Equity markets were essentially flat during the quarter. However, the equity holdings in the portfolio are held for their dividend paying attributes, which were not in favor during the quarter.

The portfolio's positioning on the yield curve was a detractor from performance. The yield curve flattened during the period with interest rates inside 10-years increasing. The portfolio had securities with durations concentrated inside of 10-years, contributing to the underperformance.

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PORTFOLIO MANAGEMENT TEAM

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Joined Red Cedar: 2018

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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

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The portfolio's allocation to equity REITs was a positive contributor to the performance.

The portfolio's exposure to emerging market currencies via local currency sovereign debt detracted slightly from performance.

The portfolio is overweight the energy sector, and this had a positive contribution to performance. The energy sector is one of the few areas left that offers some relative yield and will continue to be overweighted.

STRATEGIC INCOME POSITIONING & OUTLOOK

Going forward, the makeup of the Fed is likely to shift in a far more dovish direction when the Biden administration fills the vacant FOMC seats. In addition, risk assets generally continue to perform well even after the first interest rate hike of the cycle. Taken together, credit should continue to have runway for outperformance. The wildcard remains inflation and whether it causes the Fed to act in a more aggressive fashion than currently anticipated.

Credit spreads were essentially unchanged during the quarter as the search for yield remained robust. The market readily absorbed corporate bond issuance of $318 billion in the third quarter due to a seemingly insatiable appetite for yield. As long as the Fed keeps the short end of the yield curve anchored near zero, this demand for yield should remain intact, keeping credit spreads range bound. The strategy will therefore maintain its near maximum overweight to preferred securities as they provide a high-quality source of incremental yield.

The portfolio's lower duration than the benchmark will be maintained with the expectation that a dovish Fed and nascent inflation will cause bond yields to rise.

While the volatility that characterized the period at the outset of COVID-19 is not expected, there will be uncertainty as the economy continues its recovery from the pandemic and Washington DC grapples with the debt ceiling. This uncertainty could lead to increased volatility and the portfolio has accordingly implemented strategies to help mitigate the tail-risk associated with it.

The portfolio's equity holdings were increased during the quarter as the sell-off of high dividend stocks provided an attractive entry point.

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The benchmark is the Bloomberg U.S. Aggregate Bond Index. The index is a broad-based benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage-backed securities, asset-backed securities and commercial mortgage-backed securities.

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