ALTMAN INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

AUGUST, 2020

IN BRIEF: The U.S. Fixed Income Markets

Fixed income markets remain in a constructive mood, with credit at or near highs, broad commodity price benchmarks trending up, and "safe-haven" government bonds holding firm. Despite high and/or rising global and U.S. COVID-19 cases, investors continue to exhibit confidence that the economic recovery will not be unduly disrupted, and the monetary authorities will continue to provide downside protection against any capital market risks. Investors have been further bolstered by medical progress on therapies and vaccines to address the pandemic. Implicitly, markets are pricing in widespread and effective vaccine availability in 2021, although we believe that sentiment could still be boosted if/when it becomes a reality. Momentum in the bond markets remains a powerful force that may further extend recent trends in the near term.

However, we continue to conclude that the path ahead will inevitably be more challenging. Valuations for most risk asset classes are for the most part already discounting a solid recovery in fundamentals as well as perpetually supportive monetary policy. It seems counterproductive to "fight the Fed", especially as Chair Powell recently reaffirmed its commitment to lagging far behind any economic recovery. Yet it is also imprudent to assume that today's super-low interest rates are appropriate for discounting normalized prospective corporate earnings or cash flows. Our assumption is that the economic recovery will persist but will be choppier than many expect; and investors should be selective in their credit exposures rather than positioning aggressively for a continuation of recent trends. Specifically, we are overweight U.S. investment grade corporate and inflation-protected bonds.

We are also equally concerned that a weakening U.S. dollar and surging gold prices are rarely indicators of a stable investing climate. We are negative on the dollar and recognize that gold may now be a crowded trade, as both instruments appear to be signaling a diminished confidence in global monetary stability (See: *Gold Revisited: Ideology vs. Evidence - August 2020*). Prior to the pandemic, we anticipated a modest pickup in global economic growth momentum, still sluggish trade, and policy uncertainty surrounding the upcoming U.S. elections. While an economic rebound from the COVID-19 driven recession is underway, we caution that the underlying global economic backdrop is less rather than more favorable versus at the start of the year.

Policy has filled the hole the pandemic created, but even in the event of large-scale implementation of an effective vaccine by early-2021, we expect the level of global demand to remain below its end-2019 level for some time to come, especially in developed economies. Moreover, the excesses that existed before the crisis - such as, elevated U.S. corporate leverage and overblown commercial property and housing markets in select economies - are still present or in some instances intensified. Policy support for the global economy is still needed, but the increase in public and private sector debt as a result of the crisis adds to the challenges confronting investors as the economic recovery unfolds.

Euro Bond Overview:

Trends in overseas-euro debt markets have matched those in the U.S. Ten-year with Bund yields drifting slightly lower, while those of the rest of the region have declined more sharply, aided by expanded debt purchases by the ECB. As in the U.S., euro area 10-year inflation expectations continue to climb, but are still just 1%. Sharply rising government debt and the prospect of joint debt issuance by the European authorities indicate that inflation risks are to the upside in the medium- and longer-terms. We expect euro area inflation-protected bonds to continue to outperform conventional issues. Fundamentals and policy also point to continued outperformance by spread product within fixed-income portfolios, given their yield advantage versus government bonds. Global high-yield (HY) and investment-grade (IG) bonds have dramatically outperformed similar-duration Treasuries since late-March, as has EM sovereign dollar debt. In each case, there may be some modest spread narrowing given central bank policy support. Nonetheless, absolute returns will likely be very modest for IG debt, with perhaps only mid -single-digit returns for HY debt over the next 6-12 months. Of course, we can see that the absence of alternatives is bolstering demand for EM debt, but risks are higher than for corporate debt given our expectation of a subdued recovery of global trade.

CLOSE-UP:

With the Federal Reserve's foot on the gas, interest rate levels are expected to remain low for the foreseeable future. Although Treasury securities were the strongest performing fixed income sector during the first half of this year, it was noticeably front-end loaded. As the hunt for higher yields mounts, we anticipate that bond investors will look to sectors outside of U.S. Treasuries. Sectors such as high-quality corporates will likely be beneficiaries.

New issuance for Treasuries, mortgage-backed securities, and corporates remain elevated. The Fed's goal is to continue to combat the current recession by keeping interest rates near zero for an indefinite period of time. This low interest rate environment is prime for cheap debt issuance that should in essence, help to stimulate growth in the U.S. These reflationary efforts by the Fed largely are anticipatory and should at some point lead to asset inflation, building the case for risk assets going forward.

Bond Market Performance:

The U.S. Broad Market Index rose 4.6% in the first half, as measured by the BofA Corporate Gov't Bond Index. Given this move towards higher risk, the quest for yield led to lower grade bonds, such as collateralized mortgage backed securities, corporates, and emerging market debt, out-performing Treasuries. Off the market bottom in March, lower yielding Treasuries returned a mere 0.6% as compared to 6% for collateralized mortgage-backed securities and over 19% for floating rate preferreds, leveraged loans, and high-quality corporate issues.

EXHIBIT I

Fixed Income Sector Performance – Q2 2020

Fixed Income Sector Performance Q2 2020	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price	Trailing12 Month Total Return
Treasury (Intermediate)	Aaa/AAA	4.05	3.83	.28 %	N/A	$106.83	6.94 %
Agency	Aaa/AA+	4.03	2.89	.51 %	23	$107.59	5.10 %
MBS	Aaa/AAA	7.65	6.85	1.7 %	142	$102.00	-13.59 %
Municipal	Aa3/A+	4.80	3.50	.74 %	46	$113.89	3.72 %
Corporate (Intermediate)	A2/A-	6.05	5.41	1.07 %	79	$110.51	10.1 %
High Yield	B1/B	6.35	4.14	6.85 %	657	$ 94.78	-1.10 %

Source: Altman Investment Management Research and Bloomberg

Sector Close up:

➢ Government Bonds

Fixed Income markets remain subdued by aggressive central bank policies, with longer-dated government bond yields slipping lower, as the third quarter unfolds and volatility appears to be at historically-low levels. The Fed is likely to implement a yield-curve control policy by yearend aimed at the 2-3year segment of the Treasury curve, but the impact is already being felt across most maturities.

Still, we expect the 10-year Treasury yield to edge higher in the year ahead, underpinning our underweight stance on government bonds within a fixed-income portfolio. The Fed and other central banks are in firm control of government bond markets, despite the huge increases in governmental borrowing. Fed holdings of U.S. Treasuries have surged by $1.7 tn over the past five months, while holdings of other securities (primarily MBS) increased by $600 bn. The Fed has absorbed nearly 80% of the increase in Federal debt since early-March. Meanwhile, ECB purchases of securities have totaled nearly €1.6 tn over the same period, according to Morgan Stanley Research.

The underlying elements of the U.S. Treasury market are little changed in recent weeks. The U.S. 10-year CPI swap rate continues to climb and is closing in on its pre-pandemic level. This is particularly noteworthy since it has occurred even as crude oil prices have been flat over the past several months. Inflation expectations and crude oil prices have been closely correlated for much of the past decade. The combination of rising inflation expectations and modestly lower bond yields has driven the U.S. real 10-year Treasury yield into negative territory. Under this scenario, we are encouraged to begin accumulating U.S. inflation-protected bonds that serve largely as an attractively-priced hedge versus conventional Treasuries, given the reflationary policy backdrop and low level of inflation expectations.

Their recent outperformance should continue, as inflation expectations are expected to drift higher given policy and economic conditions. The U.S. 2/10 curve has flattened modestly since early-June, as the 10-year yield has drifted lower. With yield-curve control policies, there is limited attractiveness for higher longer-dated Treasury yields.

U.S. Treasuries and agencies out-performed other asset classes during the first half, led by the 30-year Treasury. The significant front end nature of the returns reflects the presence of Fed policy as the recession evolves. This realization of low interest rates for the foreseeable future will likely keep a cap on government bond returns. This was evident in second quarter returns as investors seeking yields flocked to U.S. high yield, U.S. fixed rate asset backed securities and U.S. inflation linked securities.

EXHIBIT II

The 10-Year Treasury Yield Ended the Quarter at .65%

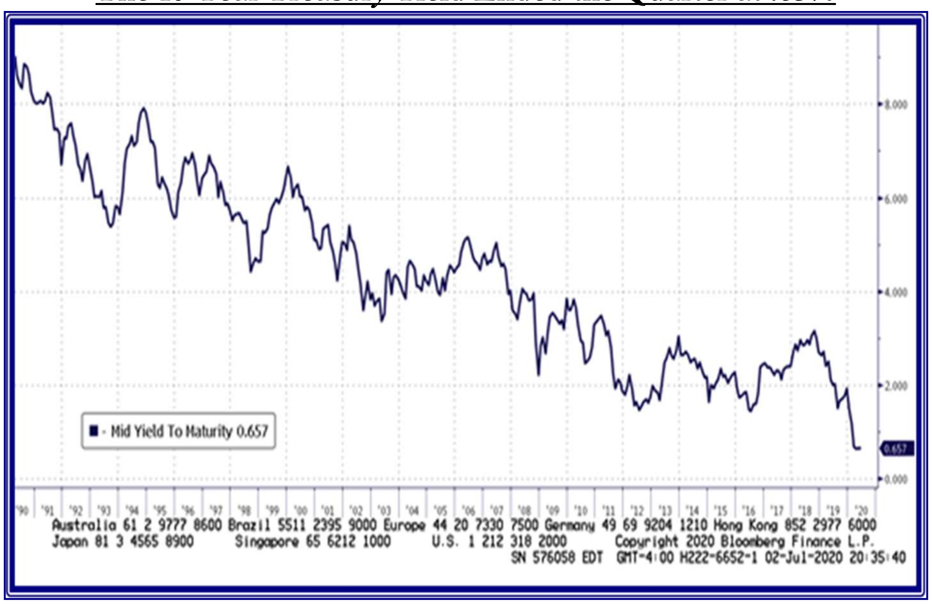
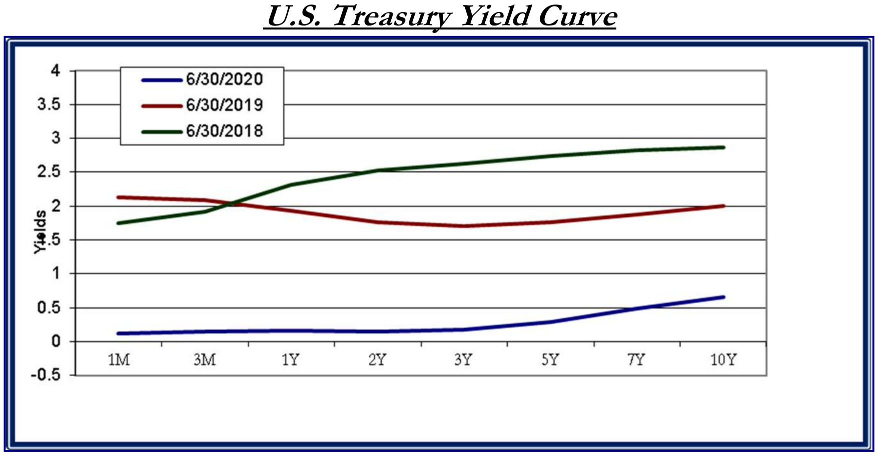


EXHIBIT III

U.S. Treasury Yield Curve



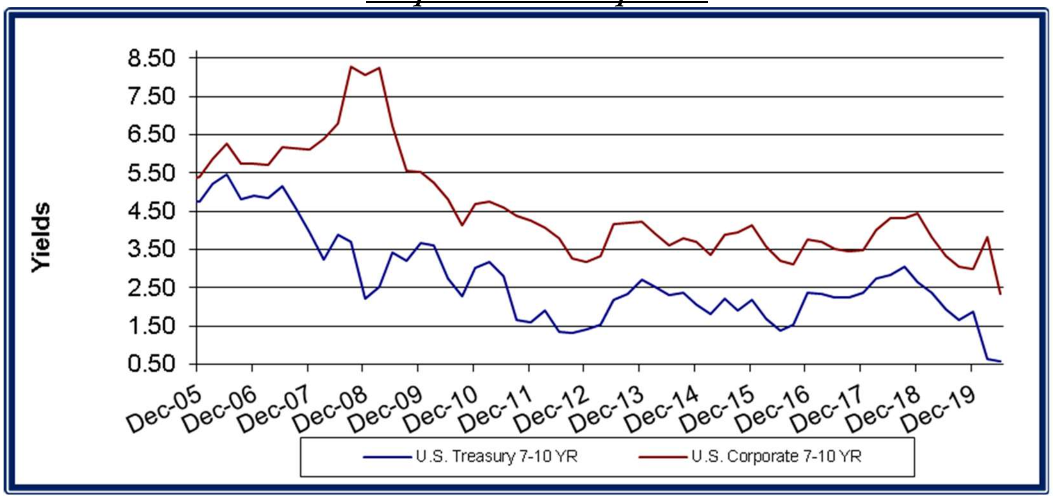
Source: Bloomberg and Altman Investment Management Research

➢ Investment-Grade Corporate Bonds

With yield on Treasuries so low, the potential exists for corporate credit spreads to narrow from here. The Fed's backstopping of the corporate bond market, through its new emergency credit facilities, mitigates some of the risk of corporate bond ownership making them more attractive investments. When the interest rate environment is relatively low, corporations have access to almost unlimited low-cost financing. This extra financing helps to support operations while navigating the current recession.

EXHIBIT IV

Corporate Credit Spreads



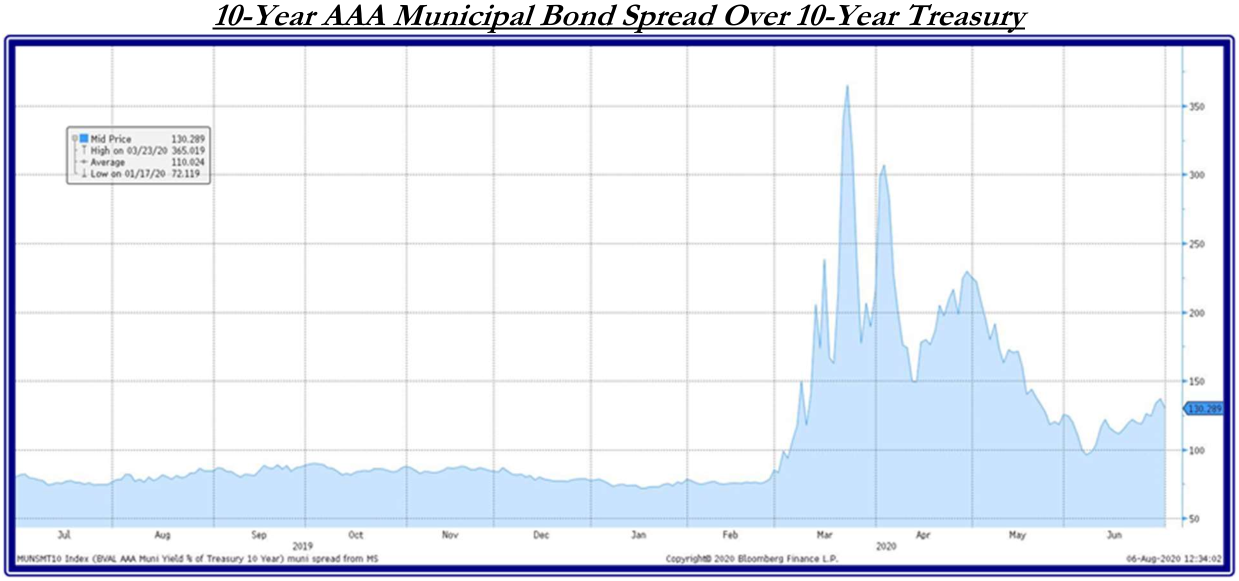
Source: Bloomberg and Altman Investment Management Research

➢ Municipal Bonds

High quality municipal bonds stayed in step with Treasuries in Q2, after trailing in the prior quarter. The shutdown led to investors pricing in contracting balance sheets for state and local governments. However, since the initial shock in March, the yield spread of municipals over Treasuries has fallen from over 350% down to 130%. At current levels this is an improvement but still remains above the longer term 10-year average rate of 85%. What this tells us is that a certain level of uncertainty remains in municipal issues due to COVID-19 related fallout.

EXHIBIT V

10-Year AAA Municipal Bond Spread Over 10-Year Treasury



Source: Bloomberg and Altman Investment Management Research

Municipals underperformed all other taxable market sectors during the first half. Fiscal conditions on the state level are deteriorating as a result of Covid-19. According to the National Association of State Budget Officers, updated revenue projections are calling for nearly double the losses experienced during the financial crisis. Additional federal aid, spending cuts, and reserve depletions are necessary to support state budgets, especially if the pandemic extends into 2021 without significant progress made on a vaccine or treatment. Therefore, in municipals, we continue to emphasis high quality debt, as the spread over Treasuries remains elevated.

IN SUMMARY:

There is little appeal for fixed income on a 6-12 month or longer-term horizon, and we recommend a mildly underweight stance within a multi-asset portfolio. We expect government bonds yields to move modestly higher in the year ahead, which will support further outperformance for spread product, especially given continued central bank policy support for corporate and other developed market issues. We are looking to add inflation-protected bonds, with inflation expectations poised to gradually drift even higher in the coming months.