PORTFOLIO PERFORMANCE
In July, the American Income Portfolio (Class A) generated positive absolute returns and outperformed (net of fees) its benchmark, the Bloomberg Barclays US Aggregate Index, which returned 1.49%. The portfolio management team would like to note that the portfolio’s strategy is benchmark agnostic, meaning that it is not constrained by its benchmark. Year to date, the portfolio increased in absolute terms but underperformed the benchmark’s return of 7.72%. (All returns are stated in US-dollar terms).

The portfolio’s high-yield holdings drove the relative outperformance during the month. An underweight in agency mortgage-backed securities also contributed.

Our holdings in commercial mortgages and credit risk-transfer securities (CRTs) detracted from returns. An underweight in duration* also hurt performance, as did an underweight in the long end of the yield curve.

GLOBAL MARKET REVIEW
Fixed-income assets rallied in July, extending gains for the fourth month in a row. Central banks kept short-term interest rates anchored, and investors continued to support risk assets in the search for yield. COVID-19 cases continued to rage across most of the globe, particularly in the US, as pharmaceutical companies raced to advance late-stage trials on numerous promising vaccines and treatments to fight the global pandemic.

The US Federal Reserve (the Fed) voted to keep short-term interest rates near zero for the foreseeable future. The Fed also extended its mostly untapped emergency lending facilities—which were originally slated to end in September—until the end of the year. Fed Chair Powell remarked, “We’ve got to hope for the best and plan for the worst.”

Global treasury returns were positive as yield curves fell and flattened in most developed-market (DM) countries. Italian 10-year bond yields fell by 25 basis points (b.p.) to 1.01% on the back of continued European Central Bank support from the Pandemic Emergency Purchase Programme and the announcement of the Next Generation European Union fund. Spanish 10-year bond yields also compressed, ending the period 12 b.p. lower at 0.34%. Ten-year German Bund rates fell by 7 b.p. to –0.53%. Japanese 10-year government bonds remained anchored near 0 at 0.01%. The yield on the 10-year US Treasury fell by 13 b.p. to 0.53% as US virus cases increased at an alarming rate, threatening the trajectory of the US economic recovery.

Performance in emerging-market (EM) bonds was positive, led by hard-currency sovereign bonds. EM hard-currency sovereigns posted returns of 3.71% in the EMBI Global Diversified Index. EM corporates were also positive, returning 2.32% in the CEMBI Broad Diversified Index. The US dollar retreated significantly against all DM and many EM currencies as market participants factored in potentially faster recoveries in Europe and Asia and as demand for US-dollar emergency reserves fell among most central banks.

Nongovernment sector returns were strong. Globally, investment-grade and high-yield corporate bonds continued to rally. The Bloomberg Barclays US Corporate High Yield Index returned 4.69%, with energy up the most, returning 6.04%, while REITS returned 2.42%.

In securitized assets, commercial mortgage-backed securities (CMBS) rose modestly, while CMBX.6 had mixed performance, depending on the tranche. CRTs were more volatile following a strong rebound in June.

Brent crude oil advanced 5.2%, even as OPEC+ began to modestly roll back production cuts. Copper prices also firmed, gaining 5.7%. Gold continued to climb, about 10%, making new highs on its ascent to nearly US$2,000 per ounce.

OUTLOOK AND POSITIONING
In the US, manufacturing is rebounding, but the labor market has stalled after recent gains. In absolute terms, the level of economic activity remains deeply depressed, and we believe the recovery is

*Duration is the measure of the sensitivity of an asset or portfolio’s price to interest rate movements.
going to be unsteady and bumpy. More than 17 million people are now out of work, and the virus continues to spread in most areas of the country. The public health policy response has been confusing and deficient. Given the current trajectory, the virus is likely to persist and cause stronger headwinds in the US than in other DM countries. The US Congress did not reach an agreement on additional stimulus in July, even as enhanced unemployment benefits expired at the end of the month. Household spending among affluent Americans remains significantly below the peak in February. On the plus side, the housing market is firmer, as home purchases and refinancing activity accelerated on lower mortgage rates. Given high unemployment and growth headwinds, we have reduced our 2020 US GDP forecast to a larger contraction of 5.4%, followed by a rebound in 2021 of 3.6%.

In this environment, we believe a well-diversified barbell approach is critical. We diversify our exposure with credit (high-yield and investment-grade corporates, securitized assets, EM) and government bonds.

We believe duration should continue to help the portfolio in periods of market stress. While we did not make active duration changes in July, in June, we added exposure in the long end of the curve, which should offer the most offset to credit if volatility spikes again.

We believe the credit cycle has come to an end due to the virus. Corporate fundamentals have deteriorated, and defaults have started to increase (the magnitude of future increases depends somewhat on how quickly and fully economies reopen). Our base-case scenario is for US high-yield defaults to increase 6%-9% over the next 9-12 months. Should a second wave of the pandemic emerge, US high-yield defaults could be higher. Global default rates will likely be somewhat lower. While valuations have compressed, they are still above 2017-2019 levels, when spreads were inside 400 b.p. Furthermore, the sector is being supported by a very strong liquidity dynamic in the form of central banks. In addition to cash bonds, we have an allocation to synthetic high yield†. Relative to high-yield cash bonds, synthetic high yield has historically delivered better returns during tail events—when high yield declines more than 5%—thus improving the portfolio’s overall tail-risk profile as well as liquidity. As valuations compressed, we took some profits on our high-yield cash positions and added high-yield credit default swap exposure†. This will allow us to more quickly take advantage of compelling opportunities as they arise.

While we still favor the banking sector, we focus on larger national champions that have strong capital and liquidity positions. Within additional Tier 1 securities (AT1s), we favor stronger structures with higher probabilities of being called. We believe any deterioration in asset quality would start from very high historical levels. Also, the significant amount of capital that banks hold should be able to absorb potential losses without triggering conversions/writedowns of the AT1s.

While we remain cautious on energy, we added modestly during the crisis via high-quality names like BBB- and BB-rated‡ credits (fallen angels that have been downgraded from investment grade to high yield) that have significant liquidity and runway to operate in a low-oil-price environment. We believe that over time, the supply-and-demand imbalance will equalize as production continues to be shut down and global demand continues to increase from extremely depressed levels. Our energy holdings have rallied but still look compelling compared with the rest of the market, and we believe they have more room for spread compression if oil prices continue to increase.

Among investment-grade corporate bonds, spreads are close to historical averages, but the sector continues to benefit from the Fed’s programs designed to improve liquidity and investors’ hunt for yield. We expect fallen angels to continue to increase, especially in sectors most impacted by the virus or those that have leveraged up for mergers and acquisitions. However, a big portion of expected downgrades have already occurred, and future downgrades may be more gradual. Many of these downgrades are already priced in, including for issuers that we expect to remain in the investment-grade universe. This represents an attractive opportunity for investors who have the flexibility to hold onto these issuers through potential downgrades. We recently took profits on some of the positions that have

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† Investments in derivatives may be illiquid, difficult to price, and leveraged so that small changes may produce disproportionate losses, and may be subject to counterparty risk to a greater degree than more traditional investments.

‡ Credit quality is a measure of the creditworthiness and risk of a bond or portfolio, based on the issuer’s financial condition. For purposes of this document, all ratings are based on ratings of S&P, Moody’s and Fitch: AAA/Aaa is highest and D is lowest.
performed extremely well and redeployed proceeds to sectors and securities that offered better relative value, including EM.

We believe EM valuations are compelling, and we are encouraged by the bilateral and multilateral support offered to EM countries. However, we recognize that an environment characterized by a severe recession, and lower trade and geopolitical tensions represents risks to the sector. In July, we added to EM corporates (including investment-grade and high-yield, BB-rated bonds), which offer attractive valuations compared with their DM counterparts. Our allocation within EM remains low and is extremely well-diversified across approximately 30 countries.

We are maintaining our conviction in securitized assets. CRTs continue to offer solid fundamentals at a time when credit metrics look stretched. The current environment is certain to impact many of the mortgage borrowers and increase the credit risk in the underlying mortgage pools. As a result, the government-sponsored enterprises’ announced forbearance plans to assist borrowers who are unable to make their monthly mortgage loan payments—as a result of a temporary hardship—should prevent defaults in the CRT pools. Also, lower rates mean increased prepayments, which will eventually shorten the life of the bonds, thus reducing their credit risk. Additionally, the housing market has held up better than anticipated during the pandemic. CRTs have rallied significantly in recent months, and we took profits on some of our holdings.

Within CMBS, we prefer deals that originated between 2010 and 2014, with tighter underwriting standards and better loan-to-value ratios. Since the crisis hit, we continue to revise our scenarios for CMBS to reflect a deep recession that is more severe than 2008–2009 for many property types. In CMBX.6†, we expect 90% of malls to default and hotels’ net operating income to decline nearly 70% this year (and expect the sector to take 2–3 years to recover). Still, the loss-adjusted yields point to mid- to high-single-digit returns. While some losses are all but certain, the credit enhancement, price appreciation and amortization in certain bonds provide a cushion. Despite the economic downturn, we continue to see opportunity in the sector, although we recognize the rebound in prices will likely take time.

We also diversify our exposure with a very small allocation to collateralized loan obligations and asset-backed securities.

The Portfolio Management Team remains committed to the American Income Portfolio’s credit barbell strategy, which has proven resilient through market dislocations and periods of stress in the over 25 years since it was incepted.

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