Hasta La Vista Baby!

2020 began with drama as the novel coronavirus spread around the world. As the year unfolded, we endured the economic fallout from the pandemic along with social isolation and unrest. Not surprisingly, the year didn’t go away quietly. In addition to the disruption of our holiday traditions, we witnessed a toxic election season culminating in a mob storming Capitol Hill shortly after year end. Is anyone sad to see 2020 come to an end? We’re with you: “Hasta La Vista, Baby!” As we look ahead to another new year, the stormy skies may be dissipating. Vaccines are being administered, fiscal and monetary stimulus continues to buoy the economy, and there’s a wave of pent up consumer demand ready to be unleashed as life normalizes. In this edition of our quarterly commentary, we will review Q4 performance in fixed income markets, share our outlook for the economy in 2021, and analyze a long-term trend in interest rates that we believe investors should consider.

Yields remain near historic lows as the 2-year and 10-year Treasuries entered the quarter yielding 0.13% and 0.69%, respectively. While near-term rates remained low and stable, longer dated maturities declined as the yield curve steepened. Treasuries across the curve were flat to down during the quarter. Corporate credit returns were positive due to credit spread compression during the quarter. Below are highlights on fixed income performance during the quarter.

### U.S. Fixed Income Market:

#### US Fixed Income Performance Through 12/31/20

<table>
<thead>
<tr>
<th>Index</th>
<th>3 M</th>
<th>6 M</th>
<th>1 Y</th>
<th>3 Y</th>
<th>5 Y</th>
<th>10 Y</th>
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<tbody>
<tr>
<td>BBg US Corp High Yield</td>
<td>6.5%</td>
<td>7.1%</td>
<td></td>
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</tr>
<tr>
<td>BBg Barc HY Muni</td>
<td>4.5%</td>
<td>4.9%</td>
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<tr>
<td>S&amp;P/LSTA US Leveraged Loan 100</td>
<td>2.8%</td>
<td></td>
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<tr>
<td>BBg Barc US Credit</td>
<td>2.8%</td>
<td>9.4%</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>BBg Barc Municipal</td>
<td>1.8%</td>
<td>5.2%</td>
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<tr>
<td>BBg Barc US Govt/Credit</td>
<td>0.8%</td>
<td>6.5%</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>BBg Barc US Agg Bond</td>
<td>0.2%</td>
<td>7.5%</td>
<td></td>
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</tr>
<tr>
<td>BBg Barc US Sctsrd MBS ABS CMBS</td>
<td>0.2%</td>
<td>4.2%</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>BBg Barc US MBS</td>
<td>0.2%</td>
<td>3.9%</td>
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<tr>
<td>BBg Barc US Treasury 1-3YR</td>
<td>0.0%</td>
<td>3.2%</td>
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<tr>
<td>BBg Barc US Treasury Government</td>
<td>0.0%</td>
<td>7.9%</td>
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<tr>
<td>BBg Barc US Treasury 20+YR</td>
<td>-3.0%</td>
<td>18.1%</td>
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#### TQT D YTD

- The 10-Year Treasury yield started the quarter at 0.69% and ended the quarter at 0.93%. Treasury prices on longer dated maturities declined as the yield curve steepened. Treasuries across the curve were flat to down during the quarter.
- High Yield and Investment Grade credit rallied in the risk-on environment as investors drove credit spreads tighter. The Bloomberg Barclays U.S. Credit index returned 2.8% while the U.S. Corporate High Yield Credit index returned 6.5%. High yield was the best performing fixed income segment as spreads tightened from 541 basis points at the beginning of the quarter to 386 basis points at the end of the quarter.
- Leveraged loans/float rate appreciated due to credit spread tightening as the S&P/LSTA U.S. Leveraged Loan 100 Index returned 3.4%.
- Municipal bonds continued to appreciate as tax exempt income increasingly looks attractive as investors anticipate changing tax rates from the new administration. The Bloomberg Barclays Municipal Bond index generated a 1.8% return for the quarter. High yield municipal bonds generated a return of 4.5%.
- Non-U.S. local currency global bonds benefited from a declining U.S. Dollar during the quarter. Emerging market debt, both dollar and non-dollar, experienced spread tightening. Just about all major developed and emerging market currencies appreciated relative to the U.S. Dollar.

#### 2021 Economic and Fixed Income Outlook

We believe the Fed deserves a round of applause for its heroic actions in 2020. The immediate rate cuts and emergency programs put in place at the outset of the pandemic quickly restored liquidity to markets and spurred a market recovery. The market ended the year as if the spring turbulence never existed. Investment grade bonds returned 7.5% per the Bloomberg Barclays US Aggregate Index and high yield bonds posted a 6.2% return per the ICE BoFA US High Yield Index. If one simply looked at the string of annualized fixed income returns over the past 5 years, 2020 would not stand out much, but the intra-year volatility will go down in the history books.

The Fed is on hold for the foreseeable future. We do not believe we will see rate increases until 2023 at the earliest. The yield curve is certainly low but is favorably sloped, suggesting we have entered a multi-year expansionary period. Given changes to the Fed’s monetary policy framework discussed in our last quarterly letter, the Fed is likely to remain on hold even longer than it has in the past.

We anticipate positive but somewhat unpredictable gross domestic product all four quarters of 2021. Much will depend on the speed at which vaccines are manufactured, distributed, and administered along with adherence to safety precautions. Look for 2021 GDP in the 3-4.0% range as we continue to pull out of the COVID-19 fog.

While a few publicized measures of inflation may intermittently suggest concern, the measure that matters to us (and the Fed) is Coreential Consumption Expenditures. We believe this metric will move back toward 2% over time from the most recent reading at 1.4% in November. We expect unemployment to decline from 6.7% currently to the 5.5% to 6.0% range in 2021. Given that the economy was not generating significant levels of inflation at pre-pandemic unemployment levels around 3.5%, we do not expect a sustained surge in inflation.

We expect modest total return to be in low single-digits for investment grade bonds as corporate spreads are near historic tights to US Treasury bonds. We still want to take advantage of the extra yield corporate bonds offer over treasury and agency bonds. On the high yield front, we anticipate a coupon clipping year with a mid-single digit total return. Our favorite ratings categories remain crossover credits; double-B’s and select single-B’s. For the most part, we are on the sidelines with triple-C credits.
The Long-term Decline in Interest Rates

Today, the federal funds rate is zero and is expected to remain at zero for at least a couple of years. The benchmark 10-year Treasury bond, as of year-end 2020, yielded 0.92% after hitting an all-time low of 0.51% in August 2020. Similarly, yields on most fixed income products are near all-time lows. Many developed economies issue debt at negative interest rates. How did we get here?

Most investors are aware that interest rates have been falling steadily in the United States since 1981 after Fed Chairman Paul Volcker raised rates to tame unacceptably high inflation. However, many might not be aware that, in January 2020, Harvard economic historian Paul Schmelzing published a paper that examined “safe asset” global real rates over the past 700 years and discovered a persistent decline. Some explanations for this phenomenon include general capital accumulation and rising life expectancies (increasing savings supply) and shorter, less destructive conflicts (reducing investment demand). Schmelzing expects real short-term rates will become permanently negative in the 2020s and long-term rates sometime after 2050. Investors can agree or disagree with this assertion. The point here is that there is little risk of cyclically higher interest rate fluctuations, but that, counterintuitively, near zero or negative real risk-free rates are not obviously at abnormal levels.

We do anticipate favorable performance from banks and finance companies on the investment grade front as they benefit from a steeper yield curve during 2021. They should also provide a safe haven for investors given prospects for leveraging across other corporate sectors. We like select retail and hospitality credits in high yield and REITs as we anticipate they will benefit from pent-up consumer demand.

As long-term investors, we continue to position portfolios to be dependable components of an overall asset allocation. We remain focused on producing income, not over-reaching for yield, and taking advantage of opportunities presented by the market.

The Long-term Decline in Interest Rates

The economic debate over the explanation of very low interest rates for the past decade or so has focused on two camps. Economist Larry Summers promotes a secular stagnation theory which focuses on a lack of investment demand. Former Fed Chairman Ben Bernanke sees a global savings glut. Their theories are more complementary than competitive.

Bernanke’s global savings glut argument focused on international trade flows; in particular, developing countries transforming from debtor to creditor nations post the 1997 Asian financial crisis and China’s rapid economic growth. These countries issued debt to their citizens and used the proceeds to build up foreign exchange reserves to insure against capital flow volatility and prevent local currency appreciation, bolstering export-led growth. Export profits helped to build up foreign currency savings, weighing on sovereign rates globally.

As we emerge from the COVID pandemic and look into the future, we should expect at least a modest cyclical rise in interest rates as growth and inflation recover from the recession. However, all of the longer-term trends driving lower interest rates remain intact.

How are we positioning portfolios at this time?

We believe markets are being supported by the prospect of declining COVID cases at a time when the federal government and central bank are still supporting the economy. Readers of this commentary should note that as long-term, value fixed income investors, we remain focused on portfolio duration and credit. We maintain our bias toward rising interest rates in the near-term and favor corporate credit. With the 10-year Treasury trading at sub 1.15% yields and the U.S. economy in recovery mode, clipping the more attractive coupon provided by U.S. corporate investments should result in superior portfolio performance over the long term. Remember, our bottom-up investment process and extensive research focus helps us identify relative value opportunities in the marketplace, giving us confidence in the risk-reward trade-offs in our portfolios. While market fluctuations can cause short-term underperformance, our long-only style of investing has delivered positive results with reduced volatility over the long term.

If you have any questions on strategy, performance or business development, please do not hesitate to contact us. development, please do not hesitate to contact us.

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Thank You

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