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No tantrums allowed for this tapering process

In May 2013, then Federal Reserve Chairman Ben Bernanke suggested in Congressional testimony that the Fed could begin to slow its pace of quantitative easing, essentially expanding its balance sheet at a slower rate in a process known as tapering. Bernanke caught the market by surprise, setting off a brief period of rising rates and stock market volatility which became known as the "Taper Tantrum." Fast forward to 2021, and we find ourselves at a similar place in terms of monetary policy but with a more favorable market response. Following its meeting in late September, the Fed signaled that a tapering of asset purchases would likely begin soon. While rates drifted higher towards the end of the quarter and stock gains leveled off a bit, there has been no tantrum related to this recent taper conversation. We believe the Fed did a better job of signaling the reduction in its bond buying program this time around. Additionally, market participants now know what to expect having weathered the Fed's tapering and subsequent tightening cycle during the period from 2013-2019. As we approach tapering this time around, we think it's important for investors to remember that tapering (lessening the pace of additional accommodation) is not the same as tightening (removing policy accommodation). Additionally, while growth slowed somewhat in the quarter, the economy continues to recover aided by the administration of Covid vaccines and some normalization in mobility. In this quarter's letter, we review performance in fixed income markets, assess the current economic situation, and offer some insights into the recent surge in oils prices from our energy analyst Matthew Burrell. We are confident that you will find his insights helpful and informative.

U.S. Fixed Income Market Performance:

After a quiet summer, some volatility has crept back into financial markets as interest rates adjust slightly higher given a more hawkish message from the Fed. Chair Powell recently signaled that a tapering of bond purchases would begin soon with an intention to conclude the buying program by the middle of next year. This timeframe would allow the Fed to begin considering rate increases in the latter part of 2022, somewhat sooner than the market had anticipated. The 10-year Treasury yield ended September at 1.49%, 18 basis points higher in the month, while the 30-year Treasury yield closed at 2.05%, 11 bps higher. It is still our view that the 10-year Treasury yield could drift higher as the labor market and the economy continue to improve. We remain generally constructive on economic fundamentals and look for above-trend GDP growth in the upcoming quarters. We reiterate that rising bond yields are a normal part of economic recovery. We also expect inflation to persist in the near term due to supply chain bottlenecks, remaining well north of the Fed's 2% target, but receding over time as economic conditions normalize.

Corporate credit has seen consistent demand from investors looking to generate income in a low yield environment. Technical support in corporate bonds remains very strong. Credit spreads were unchanged in September and corporate bonds performed in-line with Treasury bonds. Within the asset class, lower quality continued to outperform. The low absolute level of yields, strong to improving fundamentals, accommodative monetary and fiscal policy, and the economic cycle should continue to support the asset class.

Economic Update:

Economic growth continues on a strong pace but has slowed from euphoric re-opening and stimulus-fueled levels earlier in the year. Rising Covid cases and supply chain bottlenecks dampened growth in Q3. U.S. GDP growth increased 6.7% in Q2 beating a strong Q1 at 6.3%. The Bloomberg consensus estimates for the second half of 2021 look for growth to slow to 4.7% in Q3 and then pick up a little to 5.0% in Q4. Covid cases surged in the quarter but are presently on the decline. Supply chain bottlenecks continue to be a challenge due to a confluence of factors. Producers and retailers allowed inventories to fall at the onset of the pandemic and then demand surged as public health restrictions eased and governments supported consumption through stimulus measures. Meanwhile, Covid lockdowns (particularly in China) and declining labor force participation in the U.S. have disrupted normal supply chain capacity and efficiency. These factors help explain why ships and containers are piling up at U.S. ports, freight rates are surging, and parts remain in short supply. Not surprisingly, inflation is running hot as producers pass along rising costs in a strong demand environment. Core PCE YoY, the Fed's preferred inflation guide, has ramped up to the mid-3% area in recent months after struggling to reach the Fed's 2% target the last few years. We expect inflation to cool as people return to work, bottlenecks are alleviated, and growth normalizes.

On the employment front, nonfarm payrolls disappointed in September, increasing by 194,000 in September which was below the consensus estimate of 500,000 and the weakest month of job growth this year. There was some consolation in the revised figures for the prior two months, which showed an additional 169,000 jobs were added. Nevertheless, job growth slowed throughout the quarter as Covid cases related to the Delta variant spiked. The economy added over 2,000,000 jobs in June and July combined, while combined job growth in August and September slowed to 560,000. Thankfully, Covid cases peaked in mid-September and were headed down at the end of the quarter.

The unemployment rate fell another 0.4% month-over-month in September to 4.8%. For perspective, unemployment was 3.5% in February 2020 (pre-pandemic) and 7.8% a year ago in September 2020. Improvement in the unemployment rate does not tell the whole story, however. Despite record levels of job openings and signs of wage inflation, the labor force participation rate (61.6%) remains stubbornly below pre-pandemic levels (63.3%). That represents over 4,300,000 people who are not in the labor force but who theoretically could be if participation were at pre-pandemic levels. While we had expected a surge in people returning to work this fall as schools reopened, extra jobless benefits expired, and vaccination rates improved, it appears that fear and uncertainty regarding the Delta variant is keeping people on the sidelines for now delaying normalization in the job market. To sum up, job growth slowed some in Q3, but there are challenges with labor supply as well. Neither concern is likely to alter the Fed's tapering plan.

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Inflation: Energy Prices on the move...

Oil and natural gas prices have staged a strong rebound from 2020 levels. Oil and gas in the third quarter were higher by 92% and 132%, respectively from the year prior period. Domestic oil production is roughly 13% lower than the recent peak period during first quarter 2020. Domestic oil demand has been recovering as the economy emerges from Covid related lock-downs. Since demand recovery has been a little stronger than the production response, inventory levels have been coming down.

In addition to falling inventories, today's stronger oil prices reflect the view that oil and gas producers are not likely to meaningfully increase production. Investors no longer reward growth for the sake of growth and are instead focused on disciplined investment that generates excess cash. OPEC Plus recently agreed to add 400,000 b/d of previously curtailed production, but that is less than 0.5% of global demand. Moreover, U.S. oil and gas production has been hampered by damage to infrastructure in the Gulf of Mexico caused by Hurricane Ida.

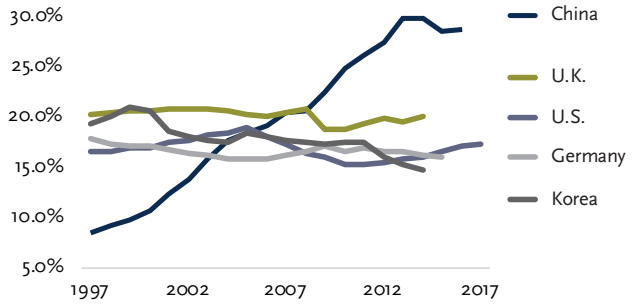
U.S. natural gas prices have become more connected to the global market by expanded LNG export capacity. The U.S. has become the third largest LNG exporter in the world. Very high prices in Asian and European markets has lifted U.S. gas prices to a level last seen in 2008.

We believe U.S. oil and gas prices will remain elevated in the near term. We do not anticipate producers to increase activity significantly despite high prices. OPEC Plus has shown they will be patient in adding additional barrels to the market. Demand should continue to strengthen as global activity continues its rebound from recent Covid induced lows. Eventually, ever higher prices will create demand destruction and/or producers will capitulate and ramp production – but we don't see this happening for the next couple of quarters.

China's reliance on real-estate activates for growth

Another risk we are keeping our eyes on is the Chinese real estate sector. For years, China's economy has relied on debt-funded investment in infrastructure and residential construction to prop up economic growth. Despite efforts to transition the economy away from investment by encouraging consumption of goods and services, real-estate related activities have continued to grow as a share of total GDP. The chart below demonstrates China's reliance on real-estate relative to other advanced economies. China is aware of this problem and late last year began limiting the amount of banks' property lending to 40% of total assets. Additionally, Beijing limited access to non-bank financing by placing leverage restrictions directly on the property developers themselves. Unfortunately, this increased developers' reliance on the one source of funding still available: deposits. China does not require deposits to be held in escrow, allowing developers to use funds generated from new property sales to pay commitments on old projects. Unfortunately, declining rates of urbanization, pandemic lockdowns, and concerns about developers' ability to deliver on their commitments have caused property sales to slow, causing funding concerns for some large developers. During Q2, bonds issued by the country's largest publically traded developer, China Evergrande, plunged to distressed levels as the Company entered the 30 day grace period on some of its interest payments. The Company was forced to sell a stake it held in a commercial bank to a state-owned enterprise in order to boost liquidity. Another developer, Fantasia Holdings Group, missed a bond payment on October 4. Given the importance of this sector to the economy in China, high debt levels, and slowing sales, China's financial system could be exposed to risks similar to those faced in the U.S. in 2008. We believe the Chinese government will intervene to prevent contagion that could destabilize the economy, but we are watching developments closely.

Impact of real-estate related activities on GDP by selected country



Source: Kenneth Rogoff, Harvard University, and Yuanchen Yang, International Monetary Fund

How we are positioning portfolios at this time?

As the US economy continues its recovery, we will remain overweight corporate securities as we believe they continue to offer the best relative value in fixed income. In addition, we will keep portfolio durations shorter than our respective benchmarks in anticipation of interest rates drifting higher later this year.

While all markets are currently trading on the latest economic releases, please remember our bottom-up investment process and extensive research focus helps to increase our understanding of our fixed income positions and helps us identify relative value opportunities. While never losing sight of the global economic environment, our long only style of investing has delivered positive results with reduced volatility. If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

Thank You

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