Reflections from 1Q 2021

Welcome to the Smith Capital Investors Reflections
(Use the links above to jump to a section)

Dear Friends,

As we worked through the difficult markets last year, we wrote about the phases we expected the markets would progress through, culminating in the confirmation phase - the phase where expectations are validated or invalidated by reality.

As we close out Q1 2021 we have even stronger conviction in our reopening and recovery thesis and see a high probability for a stronger, longer, and more durable global recovery. Safe and effective vaccines, Governments around the globe providing massive fiscal stimulus, and Global Central Banks flooding markets with liquidity via unprecedented loose monetary policy should provide great tailwinds to this thesis.

Many of the recently reported economic indicators have also validated elements of the recovery thesis. Very strong ISM numbers (close to 30-year highs), a very strong Non-farm Payroll report, and other real-time data point to great strength ahead. With very supportive financial conditions, a surge in consumer confidence, declining unemployment, and higher wages on the horizon, can you imagine what the future might bring?

The consensus, guided by the Fed, believes that we will experience a surge in economic activity followed by a reprieve. After recent adjustments, bond markets have settled down and entered a less volatile range. But equities continue their march higher, hitting new milestones. Higher equity prices and additional confirmation around the recovery have also been supportive of credit markets. We are through pre-Covid levels and in some segments of the credit markets, at the all-time tights.

Looking out on the horizon, two questions will take center stage from here:

1. What if the economic boom is longer, stronger, and more durable?

2. What if the rising inflation expectations and the adjustments to real yields prove to be too skinny and the bond market needs to go through another period of repricing?

Both questions will have significant implications for the direction of rates and the shape of the yield curve. A reminder that the front end of the curve is still anchored by high confidence around a very committed and accommodative Federal Reserve (Powell has been very firm in his commentary). And the long end of the curve is adjusting for the prospects of higher inflation on the horizon. We believe interest rates and duration continue to demand significant attention in this environment.

Stay tuned with us as these questions will be central to our discussions and debates. We look forward to sharing our thoughts and conclusions as time passes.

Please find some brief reflections from our team on the first quarter. I believe it is important to hear directly what others are thinking and give great transparency into our thinking. We will also be producing a new 5 x 5 in the near future - there is a lot to share!

In closing, we thank you for your support and appreciate your partnership.

Let’s keep talking.

1. Restoration of Value

From the Strategy Lens – Steve Zamsky, Portfolio Manager

The first quarter of 2021 saw more gyrations in fixed income valuations than we have seen in a while. While the early stages of the pandemic were a period of enormous volatility in interest rates and credit spreads, the balance of 2020 was largely subdued with both corporate and government yields constrained by economic uncertainty and interventionist policy conditions. BBB-rated credit risk tells an interesting story; yields of which reflect real interest, inflation expectations, and a moderate degree of credit risk. Those yields hit an all-time (!) low of 2.01% on December 31, 2020.

The markets have reversed that to some extent. Both inflation expectations and real yields have risen this year, driving nominal Treasury yields at the ten-year point up by around 100 bps year-over-year and over 70 bps year-to-date. Credit spreads wobbled with the interest rate volatility but have stabilized in recent weeks and are roughly unchanged so far in 2021. The net result is that those BBB yields (i.e. interest rate plus credit spread) that started the year at 2.01% have risen to 2.47% as of April 7th. That is a meaningful improvement to be sure but still low compared to a range of 3.25% to 4.25% that prevailed for most of the post-crisis, pre-pandemic period.

There has been some restoration of value in the bond market, whether one is looking at Treasury bond yields or corporate bond yields, and that has created some room for those instruments to play their traditional roles in portfolios - Treasuries as a flight-to-quality asset and corporates as an income asset. **But it will take some further pressure on markets to get to a more comfortable place, demanding nimble and careful portfolio management in the meantime.**

Back to Top

2. The Need for Yield

From the Portfolio Lens – Eric Bernum, Portfolio Manager

Entering 2021, one of the broader questions facing the investing world centered around the place for fixed income in investor profiles. With starting yields and spreads at compressed levels and significant negative real yields, many were forced to reevaluate the traditional 60/40 portfolio mix and, more broadly, fixed incomes' ability to act as a buffer to other asset allocation exposure further out the risk spectrum.

Fast forward to the end of Q1 2021 and we have seen a substantial shift in the outlook for fixed income return profiles. Longer duration U.S. Treasuries increased in yield by over 70 bps during the first quarter of the year, meanwhile the yield to worst of the Bloomberg Barclays U.S. Aggregate Bond Index rose ~50 bps. **Higher yields dramatically affect the future outlook and seem to have provided advisors and other asset allocators with much more comfort around fixed income as an allocation, as evidenced by extremely strong inflows into fixed income during Q1.**

In Q1 2021, fund inflows for investment grade set a record and overall U.S. fixed income saw very strong and consistent flows throughout the move higher in yields. It is interesting to see this acceleration in demand for the asset class coinciding with the move higher in yields; **highlighting several themes we have discussed previously including the need for yield in the current environment, the large increase in global liquidity, and the importance of real yields.**

From a portfolio perspective, the continued strong demand for fixed income resulted in a very different set of outcomes versus the last time the market underwent such a relatively quick upward move in yields. The "taper tantrum" of 2013 saw a correlated move between increasing interest rates and spiking risk asset spreads as there were large outflows from the broader asset class, exacerbating the sell-off. At least thus far in 2021, the opposite phenomena has been supportive of fixed income. **As an active manager, we were able to benefit throughout the quarter by shifting macro asset class allocations, duration positioning, and individual credit exposures to take advantage of both the significant move higher in yields as well as the opportunities these yield profiles created.** While the asset class has witnessed the benefit of inflows at a macro level, we continue to believe that risk-adjusted security selection (and avoidance) will be a key differentiator in excess portfolio returns in this type of market.

Back to Top

3. The Dilemma

From the Credit Lens – Jonathan Aal, Investor

Navigating this past quarter and looking forward, investors combat a ubiquitous dilemma: **while early cycle credit improvement is likely, in an environment awash with liquidity, investment grade credit spreads have returned to historically tight levels**. **Furthermore, the duration of the investment grade credit index remains near its all-time highs. From a valuation level alone, it suggests the dilemma represents a tightrope, with little room for error, to navigate.**

Taking these things together, the following question is a natural one: how much additional compression is reasonable, if any, and how much risk should one bear to realize it?

Without a doubt, this is a top-down line of thinking and a helpful investment process lens through which to look. It is not, however, the only lens.

Security selection and allocation are always important but in times like these, they demand a greater spotlight. In the earlier described environmental dilemma, security selection, which also crucially includes security avoidance, is likely to be the more important of the two in driving outperformance within credit going forward.

We find that a bottom-up, fundamentally driven approach focused on security selection, allows us to maximize our chances at underwriting improving risk-adjusted investment profiles, avoid those that are not, and ultimately help us turn tightropes into bridges by which to navigate the dilemma beneath.

Back to Top

4. Wave of New Issuance

From the High Yield Lens – Garrett Olson, Investor

One defining characteristic of the high yield market in the first quarter was the torrid pace of new issuance. March high yield issuance totaled $64.8bn, eclipsing the monthly record set in June of 2020. For the quarter, issuance of $158.6bn was well in excess of the prior record of $145.5bn seen in the second quarter of 2020.

While heightened primary volumes have been the norm since the market reopened following the initial onset of the pandemic, it is perhaps counterintuitive that we would see monthly and quarterly volume records after three quarters of heavy issuance and during a period in which U.S. 10-year treasury yields rose 83 bps. That said, 77% of new issuance proceeds went toward refinancing, an elevated figure relative to 66% in 2020. With the favored structure for new issuance being eight-year final maturities with a three-year non-callable period**, the impact of this heightened refinancing activity has been to extend the duration of the market,** as evidenced by the Barclays U.S. Corporate High Yield Index duration increasing from 3.58 to 3.87 over the quarter.

We see mixed implications from the huge refinancing wave in the high yield market. **The simplest implication is a dwindling supply of short duration high yield debt outstanding, at the same time we are seeing heightened demand for less interest rate sensitive debt.** We see this dynamic as lowering price volatility of short duration high yield going forward and potentially resetting yields lower for these securities. With easy access to the market and historically low borrowing costs, corporations have been able to extend their maturity runway and lower ongoing interest burdens, both of which are positive for the resiliency of corporate issuers.

On the flip side, while early in the quarter we noted how well longer duration high yield performed in the face of rising interest rates, we saw heightened volatility toward the end of the quarter, and **we would expect the rising duration of the market to result in heightened price volatility in the future.**

One thing we can be sure of, in such a dynamic environment there is no shortage of interesting opportunities available for active managers in the high yield market.

Back to Top

5. Relationships and Electronic Trading

From the Trading Desk – Zach Tucker, Investor

As with most industries, relationships matter. Finance – bond investing for our purposes here – is no different. With electronic transaction volumes increasing across many products, we find it important to highlight the nuances of the corporate bond market with respect to available options for liquidity. There are a handful of viable platforms and methods to transact in corporate bonds, with MarketAxess being perhaps the most commonly known. The uptick in electronic volumes in 2020, as well as Q1 2021, might signal to some a changing of the guard or an inflection point in how liquidity is accessed in the system. **We find these platforms to be valuable tools but by no means a panacea**.

For the longest time, transactions were effected by voice over the phone, then morphing into email-like messages, and ultimately to chatrooms with broker sales coverage. With the advent and maturation of the electronic trading platforms many investors used them as alternatives to "voice" trading, which now means everything encompassing "non-electronic execution". Taken to the extreme, many high-volume investors may use these platforms exclusively for a variety of reasons – efficiency, transparency, etc. Anecdotally for some, there is the belief that a single platform can always provide best execution.

Qualitatively for this reflection, we respectfully submit that counterparty relationships can be as important, if not more, than electronic platforms. As Q1 demonstrated fantastic periods of liquidity, it also had plenty of spurts where bid/ask spreads widened and brokers were less willing to provide aggressive levels to investor inquiry. We interacted with electronic platforms as well as voice traders during these varying times and often found better execution in working directly with counterparties than the classic "Bid/Offer Wanted In Comp". **So, as we digest data around methods to tap liquidity in the market, we are also doubling down on relationships that, in the end, do matter.**

Back to Top

6. Opening the Demand Spigot

From the Macro Lens – Lindsay Bernum, Investor

After what was another virus-related setback in 4Q 2020, we turned the calendar year with a positive outlook but aware that small setbacks would arise. With each positive announcement of support for the economy, we would take two steps forward and one step back, but **throughout the quarter the foundation for the economy was stabilizing and the pent-up demand spring was winding tighter and tighter.**

Between multiple reopening delays due to the virus and extreme weather, January and February left little to be desired. At the same time, the second round of stimulus payments lifted incomes and savings in January; this flowed into strong Retail Sales numbers, giving us a preview of what pent-up demand will look like as we move into the second quarter. Adding to the positive sentiment, vaccine distribution expanded, and Washington passed another $1.9 trillion in stimulus, bringing the total pandemic-related support to $5.3 trillion. Plus, the icing on the cake, the Fed clearly stated that they will remain accommodative until they see “real substantial progress towards maximum employment and inflation goals, not just forecasts of progress.”

Between fiscal and monetary support, the economy has stabilized and is in the process of healing. The timing of the stimulus and vaccine distribution is overlapping with the warmer weather and economic reopening. Manufacturing and housing have both been an anchor throughout the pandemic, we will start to see tourism, hospitality, and restaurants recover, further lifting economic activity and creating job opportunities.

While the recovery has been uneven and the stimulus measures work with a lag, we believe there will be a positive collision of stimulus and economic activity. Now that the foundation is set, we will be opening the demand spigot.

Back to Top

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