

FIXED INCOME MARKET UPDATE

Third Quarter 2021

QUARTER IN REVIEW

Flat Returns Obscure Large Shifts in Sentiment

The third quarter opened as fears were beginning to escalate with respect to the Delta variant and the potential negative impact on economic growth. In the beginning of July, the yield on the benchmark 10-year Treasury went from 1.45% to 1.19% as the market grappled with the latest wave of infections across the world. The weeks between the beginning and the end of the quarter were relatively quiet, but as September neared its end, Delta variant concerns were replaced by inflation fears and expectations that the Federal Reserve (Fed) would begin tapering asset purchases in the fourth quarter. In the final week of the quarter alone, the 10-year jumped a sharp 22 basis points (bps), reversing the decline and leaving rates at 1.52%, an overall change of 7 bps. As a result, returns were flattish in most fixed income markets, but the tepid returns mask the significant shifts in underlying market views that occurred along the way. Corporate bond spreads experienced much less volatility than Treasury yields but still ended the quarter modestly wider. Some of the strongest performance in the quarter came from high yield and TIPS, as the high yield default rate dropped to its lowest level since August 2019 and inflation fears mounted. Ultimately, the Bloomberg U.S. Aggregate Bond Index (Agg) eked out a small positive return. Read on for more details from the world of fixed income in the third quarter.

MARKET SUMMARY

High yield was the top-performing broad category in the third quarter and remains on top year-to-date. Treasury and Investment Grade (IG) Corporate returns were flat, and Municipal bonds finished down for the quarter but remain in positive territory year-to-date.

YIELDS & RETURNS (%)¹

	Duration (years)	Yield	Q3 Return	YTD Return
Treasuries	6.97	1.01	0.09	-2.50
Investment Grade Corporates	8.65	2.13	0.00	-1.27
High Yield Corporates	3.87	4.04	0.89	4.53
Municipal Bonds	4.85	1.12	-0.27	0.79

U.S. TREASURY MARKET

The short and long ends of the Treasury curve were essentially unchanged in the quarter while the belly of the yield curve pushed moderately higher. Intra-quarter, the 10-year Treasury hit its low point in early August at 1.17%. In the last week of September alone, the 10-year yield increased nearly 0.20%.

TREASURY YIELDS (%)¹

	Q3 Change	Year-to-Date Change	9/30/2021	8/31/2021	7/31/2021	6/30/2021
90-Day T-Bills	0.00	-0.04	0.04	0.04	0.05	0.04
2-year Treasury	0.04	0.16	0.29	0.21	0.19	0.25
5-year Treasury	0.10	0.62	0.98	0.78	0.70	0.88
10-year Treasury	0.07	0.60	1.52	1.31	1.23	1.45
30-year Treasury	0.01	0.44	2.08	1.92	1.89	2.07

Inflation fears drove outperformance of TIPS. Other Treasury maturities were mixed, with 5- and 10-year Treasuries finishing the quarter in the red.

TREASURY RETURNS (%)¹

	Duration (years)	Q3 Return	YTD Return
90-Day T-Bills	0.25	0.01	0.04
2-year Treasury	1.99	0.10	-0.03
5-year Treasury	4.90	-0.15	-1.92
10-year Treasury	9.29	-0.07	-4.24
30-year Treasury	22.50	0.39	-8.90
U.S. Treasury TIPS	7.77	1.75	3.51

BROAD INVESTMENT GRADE

The Agg produced a small gain in the quarter, with all individual components moving only slightly up or down. The biggest moves were in long-duration corporates, which lost 12 basis points (bps), and mortgage-backed securities, which earned 10 bps.

INVESTMENT GRADE INDEX & SECTOR RETURNS (%)¹

	Duration (years)	Yield	Q3 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
U.S. Aggregate	6.71	1.56	0.05	-0.05	-1.55	0.46
Treasuries	6.97	1.01	0.09		-2.50	
Agencies	4.31	0.83	0.06	-0.02	-0.74	0.24
Mortgage-Backed Securities	4.78	1.83	0.10	0.03	-0.67	-0.42
Asset-Backed Securities	2.26	0.62	0.05	0.03	0.23	0.42
Intermediate Corporates	4.50	1.48	0.08	0.06	-0.44	0.94
Long Corporates	15.18	3.14	-0.12	-0.50	-2.56	3.43

Spreads on investment grade bonds ended the quarter very close to where they began, and spreads on mortgage-backed securities widened less than 10 bps.

INVESTMENT GRADE SPREADS (basis points)¹

	Q3 Change	Year-to-Date Change	9/30/2021	8/31/2021	7/31/2021	6/30/2021
Intermediate Corporates	2	-8	60	63	62	58
Long Corporates	5	-18	122	124	122	117
MBS Current Coupon Spread	7	1	45	26	45	38

The longer-duration AAA corporate rating category lost 34 bps in the quarter; other IG buckets were slightly negative. All categories underperformed similar-duration Treasuries.

INVESTMENT GRADE CORPORATE CREDIT QUALITY RETURNS (%)¹

	Duration (years)	Yield	Q3 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
AAA	12.74	2.00	-0.34	-0.63	-3.34	1.25
AA	10.08	1.87	-0.09	-0.26	-2.04	1.40
A	8.39	1.91	-0.12	-0.27	-2.06	1.05
BBB	8.54	2.34	-0.11	-0.04	-0.45	2.66

2021's spread tightening trend stalled in the third quarter, as spreads on every IG corporate sector widened between 3 to 8 basis points. However, every sector has realized tighter spreads year-to-date.

INVESTMENT GRADE CORPORATE BOND SPREADS BY SECTOR (basis points)¹

	Q3 Change	YTD Change	9/30/2021	8/31/2021	7/31/2021	6/30/2021
Consumer Non-Cyclical	4	-8	82	84	82	78
Technology	6	-3	72	73	73	66
Energy	3	-31	105	112	109	102
Consumer Cyclical	5	-9	73	76	75	68
Transportation	3	-22	93	98	96	90
Basic Industry	8	-12	109	108	105	101
Communications	6	-10	109	111	110	103
Capital Goods	4	-18	80	83	81	76
Utilities	3	-10	96	100	97	93
Financials	4	-8	75	76	76	71

HIGH YIELD

High yield's outperformance continued in Q3, with every ratings category generating positive returns and outperforming Treasuries. Spreads were virtually unchanged in September but moved moderately wider in the quarter for all ratings buckets.

HIGH YIELD SECTOR RETURNS (%)¹

	Duration (years)	Yield	Q3 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
High Yield Corporates	3.87	4.04	0.89	0.86	4.53	5.54
BB	4.59	3.18	1.09	1.04	3.83	5.19
B	3.10	4.47	0.61	0.60	3.98	4.61
CCC	2.81	6.26	0.75	0.75	8.00	8.50

HIGH YIELD OPTION-ADJUSTED SPREADS (OAS) (basis points)¹

	Q3 Change	YTD Change	9/30/2021	8/31/2021	7/31/2021	6/30/2021
High Yield OAS	21	-71	289	288	294	268
BB OAS	3	-61	203	203	214	200
B OAS	33	-52	327	327	335	294
CCC OAS	62	-134	524	520	502	462

On an individual sector basis, spreads moved wider in all sectors other than Transportation and Utilities. Transportation (mainly airlines) remains the widest-trading sector in high yield.

HIGH YIELD CORPORATE BOND SPREADS (OAS) BY SECTOR (basis points)¹

	Q3 Change	YTD Change	9/30/2021	8/31/2021	7/31/2021	6/30/2021
Consumer Non-Cyclical	12	-26	261	256	270	249
Technology	6	-80	234	224	242	228
Energy	1	-194	343	374	389	342
Consumer Cyclical	17	-59	282	277	294	265
Transportation	-4	-302	331	350	348	335
Basic Industry	30	-70	303	287	274	273
Communications	33	-26	299	290	287	266
Capital Goods	14	-68	282	274	292	268
Utilities	-3	-7	267	261	265	270
Financials	17	-54	270	275	279	253

The high yield default rate has improved for 8 consecutive months, and at September's end sat at just 3.3%, the lowest rate since August 2019.

HIGH YIELD DEFAULT RATES²

	Q3 Change	YTD Change	9/30/21	8/31/21	7/31/21	6/30/21
Number of Issuers in Default	-19	-44	23	26	35	42
Issuer Default Rate	-2.9%	-6.1%	3.3%	3.8%	5.1%	6.2%
Number of Issuers in Default (ex commodities)	-6	-21	10	9	13	16
Issuer Default Rate (ex commodities)	-1.1%	-3.5%	1.7%	1.5%	2.2%	2.8%

MUNICIPALS & OTHER

Muni bonds were mixed in the quarter, with short duration outperforming long duration. All duration buckets have generated positive returns year-to-date.

MAJOR MUNICIPAL BOND INDEX RETURNS (%)¹

	YTW	Duration (years)	Q3 Return	YTD Return
Short Duration (1-5 Years)	0.46	2.73	0.08	0.38
Intermediate (1-15 Years)	0.84	4.23	-0.09	0.48
Long Duration (22+ Years)	1.84	6.51	-0.74	1.57

MUNICIPAL YIELDS BY RATING CATEGORY AND DURATION (%)¹

	AAA	AA	A	BBB
1 Year	0.16	0.26	0.26	0.79
5 Year	0.52	0.70	0.75	1.17
10 Year	1.12	1.31	1.39	1.76
30 Year	1.67	1.95	2.17	2.37

AA MUNICIPALS – HYPOTHETICAL AFTER-TAX YIELDS BY EFFECTIVE TAX RATE (%)³

	<u>20%</u>	<u>25%</u>	<u>30%</u>	<u>35%</u>
1 Year	0.32	0.34	0.36	0.39
5 Year	0.87	0.93	0.99	1.07
10 Year	1.64	1.75	1.88	2.02
30 Year	2.43	2.59	2.78	2.99

Leveraged loans were the top-performing "Other" sector in the quarter, while emerging market bonds, global investment grade Treasuries and U.S. Convertibles all produced negative returns.

OTHER SECTOR RETURNS (%)^{1,4}

	Duration (years)	Yield	Q3 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
Emerging Markets	5.63	6.89	-1.57	-1.59	-0.85	1.03
Global Investment Grade Treasuries (Unhedged)	8.49	0.81	-1.11	0.04	-5.67	-1.40
S&P/LSTA Leveraged Loan 100	–	3.71	1.11	–	4.42	–
U.S. Convertibles	1.76	1.07	-1.24	–	5.30	–

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¹Source: Bloomberg.

²Source: Bank of America Merrill Lynch.

³Hypothetical yields are calculated as the AA municipal yield divided by (1-tax rate). Actual tax-adjusted yields will depend on individual tax circumstances.

⁴Source: Standard & Poor's.