Global Credit Perspectives
4Q 2020

Overview

As with most fourth quarter commentary, investors will look back at the quarter and the year that was – "2020" – and look forward to the year to come – "2021". Much ink will be spilled writing about the pandemic and the global response by the medical community, scientists, central bankers, and governments around the world. This does not include a contentious presidential election in the United States nor an agreement reached in principal around BREXIT at the 24th hour. Research will be conducted on the actions taken, speculation will revolve around actions not taken, and researchers will continue to analyze the data for years to come. In short, policy response may not have been perfect, but it arrested the calamity that may have become had it not been implemented. As we close the proverbial "chapter" on a year that many will hope never to experience the likes of again, we look forward to the new year.

Given the policy responses globally, asset prices have recovered from economic despair. Looking across our traditional fixed-income valuation models (i.e., long-maturity government bonds), one does not see a significant degree of cheapness in such assets. While these instruments have been used as a hedge in the past, additional thought and analysis may be required to determine whether they will provide the same ballast as they have previously. Notwithstanding such valuations, across certain elements of the corporate and structured credit markets opportunities should continue to exist as the global economy recovers from a self-imposed lockdown during the pandemic. Crossover corporate credit (BBB/BB) with strong balance sheets and business models should benefit under the above scenarios just as assets tied to residential housing will also benefit due to a lack of supply and stronger underwriting standards. Returns from these assets should be generated from both carry as well as a small degree of spread compression over the next 12 months. Other, more esoteric assets may also provide value but will require a keen eye on valuations and underwriting standards (think collateralized loan obligations ("CLOs")).

Investing is fraught with risk as risks abound around every corner, but it also provides opportunity for those who are patient: investors must assess valuation in light of the impact on business models going forward and assign probabilities to the various outcomes. Given the uncertainty of the path of reopening the economy, quality of management, strength of business model and liquidity will be paramount for any investor as we move through 2021. Some industry sectors will benefit while others will struggle and need to adapt. We remain constructive on technology as this sector should continue to benefit as companies look to enhance margins and productivity through the deployment of more automated and efficient technology, while airlines and hotels may alter their business models to accommodate hesitant business and leisure travelers.

Another way to rehash the discussion above is through the lens of a cyclical recovery. Global fiscal stimulus coupled with accommodative monetary policy and therapeutics/vaccines to combat the virus should see a more stable and robust global growth profile which in turn allows investors the opportunity to find value by positioning portfolios for a cyclical upturn. In addition, investors with the capability to look globally should benefit through allocations away from the United States.

As we concluded last quarter, although our emotions have ridden a roller coaster through much of 2020, as we look forward to 2021 we see a very high likelihood that investors could see attractive total returns from further spread tightening due to stronger global GDP growth. To the question around the impact of a new administration in the United States, we envision a scenario where the monetary and fiscal support (discussed above) outweighs any headwinds from increased corporate tax rates and regulations.

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For Institutional Investors Only

Index Summary AS OF DECEMBER 31, 2020

INVESTMENT GRADE

- The fourth quarter of 2020 continued where the third quarter left off: continued spread compression aided by monetary stimulus and the promise of increased fiscal stimulus under the new administration.
- Spreads tightened to 103 basis points ("bps") which is within a few basis points of their January 2020 low of 99 bps. The widest U.S. investment grade ("IG") spreads reached 341 bps in March 2020, so there was a considerable range for the year. A large duration rally, however, was responsible for most of the total return (10%) as opposed to largely flat excess return (0.49%).
- Spreads versus historic levels in short duration, high quality IG paper are at record tights. There remains some room for spread tightening in longer duration paper as well as some lower quality names.
- The fourth quarter capped off a record year in terms of issuance, with over $1.9 billion of U.S. IG paper issued for the year. Most of this was used to pay back revolving credit facilities ("RCFs") drawn down in March and April, term out maturities and take advantage of historically low interest rates.
- Credit rating net downgrade action subsided in the quarter and looks set to improve over the coming quarters as credit rating agencies look forward to large scale vaccination programs, increase in fiscal support and pent-up consumer demand. This recent downgrade cycle was considerably less depressed than other cycles.

	12/31/2019		10/31/2020		11/30/2020		12/31/2020	
SPREAD/YIELD SUMMARY (bps/%)	SPREAD	YIELD	SPREAD	YIELD	SPREAD	YIELD	SPREAD	YIELD
ICE BAML Global Corporate Index	102	2.24%	131	1.62%	110	1.41%	103	1.35%
ICE BAML AA Global Corporate Index	55	1.63%	74	0.93%	63	0.83%	60	0.82%
ICE BAML A Global Corporate Index	80	2.01%	100	1.32%	85	1.17%	80	1.13%
ICE BAML BBB Global Corporate Index	130	2.54%	167	1.99%	140	1.71%	130	1.63%
ICE BAML U.S. Corporate Index	101	2.90%	134	2.08%	112	1.84%	103	1.78%

PERFORMANCE SUMMARY (%)	QTD	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR
ICE BAML Global Corporate Index	4.21%	10.33%	10.33%	5.87%	6.22%	4.54%
ICE BAML AA Global Corporate Index	3.42%	10.12%	10.12%	5.16%	5.17%	3.34%
ICE BAML A Global Corporate Index	3.44%	10.17%	10.17%	5.58%	5.68%	4.15%
ICE BAML BBB Global Corporate Index	5.01%	10.39%	10.39%	6.19%	6.93%	5.35%
ICE BAML U.S. Corporate Index	2.99%	9.81%	9.81%	7.03%	6.71%	5.62%

STRUCTURED CREDIT

- Risk markets generally rebounded over the quarter as economies gradually improved and approvals of COVID-19 vaccines offset the impact of a new spike in cases and subsequent lockdowns. The passing of new relief legislation, a strong housing market, greater clarity about the political landscape, the rollout of vaccines, and the prospect of increased fiscal stimulus create a climate for more robust economic growth which should be supportive of risk assets.
- Structured credit markets improved robustly this quarter catching up with other credit markets after previously lagging. Some segments of the market have neared their pre-COVID levels and come in close to comparable corporates.
- Remittance data showed continued abatement of residential mortgage delinquencies and a majority of borrowers exiting forbearance appear to be current in spite of the delay in stimulus checks to support struggling households. Prepayments slowed slightly over the quarter, but they remain elevated and are expected to keep their current pace as mortgage rates test new lows. Home prices continue to rise as the dynamic of tight supply and a secular shift toward home ownership seen over the prior quarter is still in place.
- Technicals in the structured credit market remain positive despite an expected increase in new issuance. We expect spreads to compress further and believe that market laggards still have room for improvement. However, there are tail risks on the horizon. These include new spikes in COVID-19 infections, problems with the vaccination rollout, extended lockdowns, persistently high unemployment, uncertainty about the scale and timing of additional fiscal support, and growing questions about how long the Federal Reserve's commitment to accommodative monetary policy will last. We remain constructive but keep a vigilant eye on these risks.

	12/31/2019		10/31/2020		11/30/2020		12/31/2020	
SPREAD/YIELD SUMMARY (bps/%)	SPREAD	YIELD	SPREAD	YIELD	SPREAD	YIELD	SPREAD	YIELD
ICE BAML U.S. Mortgage-Backed Securities Index	42	2.55%	64	1.39%	41	0.94%	28	0.85%
ICE BAML U.S. Fixed Rate CMBS Index	91	2.64%	155	1.98%	141	1.82%	126	1.68%

PERFORMANCE SUMMARY (%)	QTD	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR
ICE BAML U.S. Mortgage-Backed Securities Index	0.33%	4.09%	4.09%	3.84%	3.12%	3.03%
ICE BAML U.S. Fixed Rate CMBS Index	1.19%	6.76%	6.76%	5.30%	4.49%	4.34%

GLOBAL HIGH YIELD & LEVERAGED LOANS

- Yield-to-worst was at a low of 4.24% at the end of the 4th quarter.
- The energy sector returned over 13% for the fourth quarter, although down 6.62% for the year, versus the index's 6.48% fourth quarter return.

	12/31/2019		10/31/2020		11/30/2020		12/31/2020	
SPREAD/YIELD SUMMARY (bps/%)	SPREAD	YIELD	SPREAD	YIELD	SPREAD	YIELD	SPREAD	YIELD
ICE BAML Global High Yield Index	375	5.15%	552	5.74%	452	4.71%	410	4.28%
ICE BAML BB Global High Yield Index	232	3.64%	403	4.25%	327	3.48%	300	3.21%
ICE BAML B Global High Yield Index	414	5.65%	656	6.78%	542	5.60%	486	5.02%
ICE BAML CCC & Lower Global High Yield Index	1050	11.98%	1210	12.19%	971	9.86%	871	8.78%
ICE BAML U.S. High Yield Index	360	5.41%	532	5.75%	433	4.72%	386	4.24%
ICE BAML European High Yield Index	308	2.62%	482	4.13%	369	3.04%	355	2.88%
Credit Suisse Leveraged Loan Index	461	6.27%	583	6.08%	522	5.47%	486	5.10%

PERFORMANCE SUMMARY (%)	QTD	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR
ICE BAML Global High Yield Index	7.52%	8.03%	8.03%	5.90%	8.48%	6.63%
ICE BAML BB Global High Yield Index	7.10%	10.02%	10.02%	6.63%	8.28%	6.99%
ICE BAML B Global High Yield Index	6.75%	5.26%	5.26%	5.15%	8.04%	6.12%
ICE BAML CCC & Lower Global High Yield Index	12.70%	4.73%	4.73%	3.66%	10.14%	6.39%
ICE BAML U.S. High Yield Index	6.48%	6.17%	6.17%	5.89%	8.43%	6.62%
ICE BAML European High Yield Index	10.03%	12.01%	12.01%	3.95%	7.65%	5.44%
Credit Suisse Leveraged Loan Index	3.64%	2.78%	2.78%	3.99%	5.19%	4.47%

EMERGING MARKETS

- Restoration of confidence produced by the vaccines should turbo-charge an already expanding economy. A recovery in growth and sentiment would severely test the willingness of central banks around the world to keep the monetary floodgates wide open.
- With the yield on the GBI-EM Diversified Index falling to all-time lows at the end of 2020, the currency component will have to be a driver of performance going forward. We believe this could be the case over the course of 2021, with the vaccine rollout leading to a lifting of restrictions and gradual normalization.
- We will be closely monitoring signs of a removal of stimulus measures, taper tantrum risks and any inflationary risks that would push emerging market ("EM") central banks to hike rates faster than expectations.

	12/31/2019		10/31/2020		11/30/2020		12/31/2020	
SPREAD/YIELD SUMMARY (bps/%)	SPREAD	YIELD	SPREAD	YIELD	SPREAD	YIELD	SPREAD	YIELD
JP Morgan (JPM) CEMBI Broad	238	4.76%	326	4.41%	275	4.04%	251	3.95%
JPM EM Bond Index Global Diversified	275	4.78%	386	4.88%	348	4.46%	320	4.26%
JPM GBI-EM Broad Diversified	-	5.25%	-	4.54%	-	4.46%	-	4.33%

PERFORMANCE SUMMARY (%)	QTD	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR
JPM CEMBI Broad	4.29%	7.35%	7.35%	6.21%	7.38%	6.12%
JPM EM Bond Index Global Diversified	5.49%	5.88%	5.88%	4.94%	6.84%	5.97%
JPM GBI-EM Broad Diversified	8.71%	2.11%	2.11%	1.68%	5.92%	1.64%

Investment Grade

PERFORMANCE

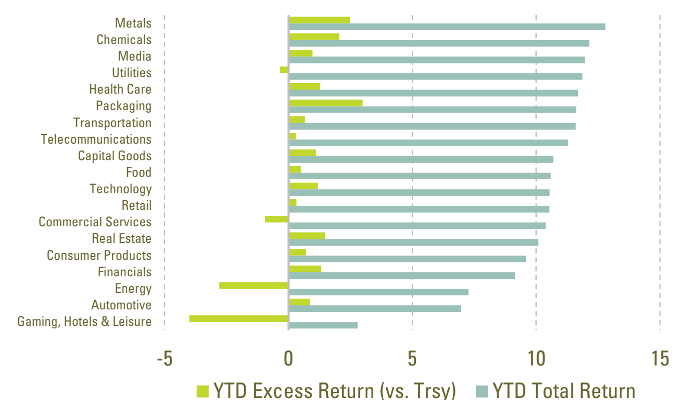
The ICE BAML Global Corporate Index returned 2.62% in the fourth quarter, while its yield tightened to 1.34% and closed the quarter with a spread of 102 bps. For the calendar year, the index returned 7.71%. Lower-quality IG bonds (BBB) returned 3.45% for the quarter and 7.79% for the calendar year, better than AA and A-rated corporate bonds, which returned 1.37% and 1.90% for the quarter and 6.67% and 7.67% for the calendar year, respectively.

While the first two quarters of 2020 were characterized by intense spread widening and then tightening following significant monetary and fiscal intervention, the third and fourth quarters were defined by spread normalization, a search for yield and politics in the U.S. This all occurred with central banks continuing their asset purchases, lending programs and other support since the second quarter. While the level of their balance sheets continued to increase, the velocity of the increase did slow somewhat.

2020 returns were dominated by a relentless bid for safe duration Treasuries as the Federal Reserve ("Fed") continued to purchase U.S. government duration as well as mortgage-backed securities ("MBS") under their quantitative easing programs. This led to impressive total returns for IG bonds since they tend to have longer duration than high yield bonds, but meager excess returns over the course of the year.

Figure 1 shows the sector return performance for IG credit over the course of 2020. It highlights not only the disparity between excess returns and total returns but also the dispersion between sectors. Packaging, health care, metals and chemicals have all benefited from robust demand, while gaming, hotels & leisure and energy have been stressed by stay-at-home orders and reduced driving miles.

Figure 1 Investment Grade Sector Returns
%, As of 12/31/2020



Source: Deutsche Bank

VALUATIONS

With such significant spread tightening over the course of the second, third and fourth quarters, valuations on a spread to historical (2003 onwards) basis appear significantly stretched. Figure 2 shows how shorter duration, higher quality names are currently trading at all-time tights in the bottom percentile. Some lower quality credits in the belly of the curve do appear to offer more potential for spread compression relative to history. Looking further out the curve, while there is potential for some spread compression, the long duration characteristics may result in losses if Treasuries sell off substantially.

Figure 2 Percentile Ranks of Current Spreads vs. History
As of 12/31/2020

	1..2	2..3	3..4	4..5	5..6	6..7	7..9	9..13	13..18
A1	0%	0%	0%	1%	3%	3%	0%	14%	17%
A2	0%	0%	0%	0%	0%	4%	2%	12%	12%
A3	0%	1%	2%	1%	9%	13%	3%	13%	14%
BBB1	0%	0%	1%	0%	3%	7%	15%	25%	28%
BBB2	1%	0%	0%	0%	4%	1%	12%	21%	25%
BBB3	9%	8%	35%	25%	19%	19%	14%	44%	

Each cell shows the current spread level relative to historic (since 2003) levels. Red shading indicates spreads trading tight to history, and green shading indicates trading wide to history.

Source: Deutsche Bank

ISSUANCE

2020 saw a record $1.91 trillion of U.S. IG bonds issued to investors. Many corporates fully drew down their revolving credit facilities ("RCFs") as a precaution in March and April. Proceeds from issuances were first used to pay back the RCFs and then term out the debt. As the year progressed, more of the issuance was used for extending maturities and share buybacks.

The fourth quarter of 2020 saw $241 billion of issuance, which is more in line with historical averages (2Q 2020 saw $761 billion of issuance). Issuance was heavily skewed to financials with over 45% of issuance in that sector. Consumer discretionary, communications and energy were around 7–10% each.

CREDIT RATING ACTION

The first two quarters of the year were dominated by persistent rating downgrades from the rating agencies across IG. However, in the third and fourth quarters it became apparent that there was sufficient liquidity and access to the capital markets for IG corporates, and the pace of rating action has since decreased significantly. Looking forward, we expect the rating agencies to consider vaccination rollouts across the developed world, continued monetary stimulus, and significant increase in fiscal stimulus under a Democratic "blue ripple" scenario. This should result in upgrades across the asset class along with rising stars entering the IG market from the high yield ("HY") market (some of which only recently downgraded to HY).

Structured Credit

OVERVIEW

Risk markets generally rebounded over the quarter as economies gradually improved and approvals of COVID-19 vaccines offset the impact of a new spike in cases and subsequent lockdowns. The passing of new relief legislation, a strong housing market, greater clarity about the political landscape, the rollout of vaccines, and the prospect of increased fiscal stimulus create a climate for more robust economic growth, which should be supportive of risk assets.

However, there are tail risks on the horizon. These include new spikes in COVID-19 infections, problems with the vaccination rollout, extended lockdowns, persistently high unemployment, uncertainty about the scale and timing of additional fiscal support, and growing questions about how long the Fed's commitment to accommodative monetary policy will last. These offsets to the favorable growth picture may cause near-term volatility and a pullback from the gains seen this quarter.

Nevertheless, with the macro economy primed for further growth and a new credit cycle in place, we maintain a constructive view. Supply-demand technicals in the structured credit market remain positive despite an expected increase in new issuance. We expect spreads to compress further and see room for more improvement from market laggards. We favor moving down in the capital stack and investing in senior tranches of lower-quality collaterals or newer off-the-run products.

U.S. RESIDENTIAL MORTGAGE-BACKED SECURITIES

New issuance of agency MBS totaled slightly over $1.0 trillion in 4Q 2020 compared to $505 billion over the same period in 2019, buoyed by continued support from Fed purchasing. Non-agency MBS issuance reached nearly $20 billion in the quarter versus $38 billion in 4Q 2019. Residential mortgage-backed securities ("RMBS") recovered further this quarter, with investor sentiment bolstered by continued improvement in collateral performance. Current-to-60-day delinquency rolls are now near pre-COVID levels and serious (90+ day) delinquencies are moderating, though they remain elevated. However, a resurgence of new COVID -19 cases, extended lockdowns and persistently high unemployment create further stress for financially vulnerable homeowners. We will continue to watch the pace of delinquencies and the outcome of non-performing loans.

In the meantime, the backdrop of high household savings, low mortgage rates, and the secular trend towards urban-to-suburban movement creates a supportive environment for U.S. RMBS. In 2021, we believe the housing market will remain firm with 3–5% appreciation, supported by a shortage of housing supply, low mortgage rates, demographic trends including buying from millennials, and the structural shift from urban renting to suburban home ownership. Household balance sheets are in solid shape with higher savings rates, less leverage, and support from forbearance and stimulus programs. We continue to view credit risk transfer ("CRT"), single-family rental, and re-performing loan/non-performing loan (RPL/NPL) securitizations as attractive investments in the housing recovery with measured borrower default risk.

COMMERCIAL MORTGAGE-BACKED SECURITIES

Issuance reached $79 billion in 4Q 2020 versus $90 billion in 4Q 2019. The quarter saw further gains across commercial mortgage-backed securities ("CMBS") with down-in-credit outperforming. Industrial was the best performing sector while office, multi-family, retail and hotel sectors were mixed. We expect commercial real estate (CRE) prices to decline gradually, mostly in retail and hotel sectors. However, this should be less severe than the 35% decline during the Global Financial Crisis (GFC) due to better underwriting, attractive cap rate spreads to Treasuries, and large amounts of private money waiting on the sidelines to buy distressed CRE properties. Absolute stress levels in CMBS will remain high in the near term. We prefer to stay up in quality (AAA through A) in conduit CMBS and single-asset/single-borrower CMBS. CRE collateralized loan obligations (CLO) offer good value due to less exposure to retail and hotel sectors. Across sectors, we continue to favor industrial, cold storage and life sciences.

ASSET-BACKED SECURITIES

Total issuance came to about $37 billion in 4Q 2020 compared to $55 billion in 4Q 2019. Consumer asset-backed securities ("ABS") markets continued to perform across the board, with single A and BBB sectors seeing better gains. We favor a shift down in quality, preferring subprime BBB/BB auto ABS, auto lease ABS, and sectors that were hit hard by COVID, e.g., container lease, timeshare, whole-business securitization, etc. We expect such credits to benefit from the economic recovery, a secular shift back to car transportation, and rising used car prices, which would indicate higher recovery values.

COLLATERALIZED LOAN OBLIGATION

U.S. collateralized loan obligation ("CLO") supply summed to $31 billion in 4Q 2020, slightly above the $29 billion issued over 4Q 2019. Quarterly performance was positive down the capital stack, with BB and below outperforming. Spread tightening in term loans helped improve CLO collateral profiles, particularly for deals holding significant amounts of CCC loans. BBB/BB tranches and middle market deals can benefit from an early credit cycle rotation. CLOs mostly weathered the market volatility of 2020 and appear poised for further growth as investors seek higher yielding assets. However, these highly levered structures remain exposed to significant credit risk.

INTERNATIONAL RMBS

UK and European RMBS new issuance picked up the pace over the quarter, with October seeing the heaviest gross issuance of last year. Distributed volume reached EUR 10.8 billion in 4Q, bringing the 2020 total to EUR 47.9 billion and -21.5% below the 2019 level. Spanish and U.K. RMBS mezzanine tranches provide attractive value given the ECB’s very accommodative stance. However, capital appreciation is key as the floating rate interest currently provides little carry.

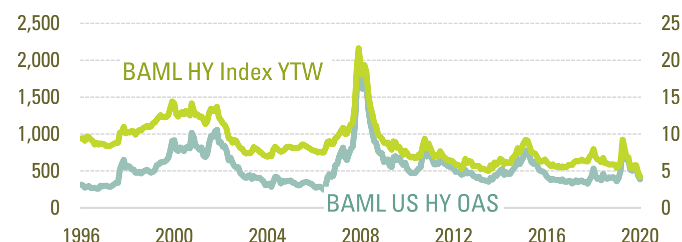
Global High Yield & Leveraged Loans

The ICE BAML U.S. HY Index returned 6.48% in the fourth quarter and finished the year up 6.17% after ending the first quarter down over 13%. While CCC-rated borrowers outperformed BB and B-rated issuers in the final quarter of the year, the higher quality segment outperformed CCCs for the full year. Index option-adjusted spreads ("OAS") ended 2019 at 360 bps, reached 877 bps at the end of the first quarter, and finished the year at 386 bps, with spreads tightening over 150 bps in the fourth quarter. The index yield-to-worst ("YTW") reached an all-time low at the end of the year (Figure 3). Despite a return of over 13% in the fourth quarter, the energy sector lagged the index and returned -6.6% for the year.

The CS Total Return Leveraged Loan Index returned 3.6% for the fourth quarter and 2.8% for the year, underperforming relative to HY bonds. Led by the energy and retail sectors, the leveraged loan issuer default rate was 4.7% for 2020 while the U.S. high yield issuer default rate was 6.4%, as indicated in Figure 4. Recovery rates were 32.1% for HY issuers (24.1% for energy) while first lien and second lien leveraged loan recoveries were 51.8% and 14.5% respectively.

The Fed remains accommodative and the U.S. Treasury continues to provide fiscal support to the economy as additional COVID-related shutdowns take place. As 2021 progresses, we anticipate a continuation of pro-cyclical outperformance, favoring companies within sectors that maintain pricing power, like metals, mining and energy. An economic re-opening combined with substantial fiscal support, in addition to loose monetary policy, should support this trade. Risks to 2021 include COVID mutations, issues with vaccination, rising rates, and rich valuations in the context of more debt outstanding. Additionally, the waning of COVID-related fiscal stimulus and slowing China credit expansion could also weigh on risk sentiment, especially among commodity producers.

Figure 3 US HY YTW and OAS
As of 12/31/2020



Source: ICE/BAML

Figure 4 CS Issuer Level Trailing 12-Month Default Rate
As of 12/31/2020

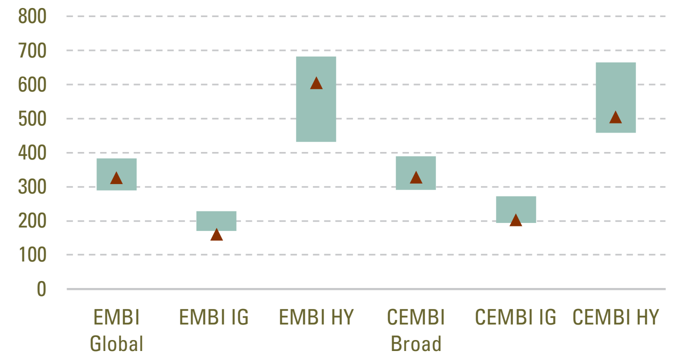
	Trailing 12-Month Default Rate
US Leveraged Loans	4.7%
Retail	24.5%
Energy	13.8%
Ex-retail and energy	3.4%
US High Yield	6.4%
Retail	12.3%
Energy	24.4%
Ex-retail and energy	3.0%

Source: Credit Suisse

Emerging Markets

The lockdowns brought on a contraction that rivaled the Great Depression. The remedial policy goal was to go big and go fast. The response has been very successful and, so far, no major central bank has blinked. Instead, the punchbowls were topped up late in the year. The Fed in mid-December provided clear guidance on its plans for another multi-trillion-dollar expansion of its balance sheet for 2021. The torrent of support has encouraged breakeven inflation rates to recover and unleashed massive gains in global equities, global corporate bonds, EMs and commodities, aided and encouraged by a falling U.S. dollar. The dollar accelerated lower following the U.S. election, leading to a strong recovery in EM currencies, which had lagged the rally of local rates and hard currency spreads until this quarter. We believe EM currencies should rally further in 2021 given attractive valuations (Figure 5) and a supportive global backdrop.

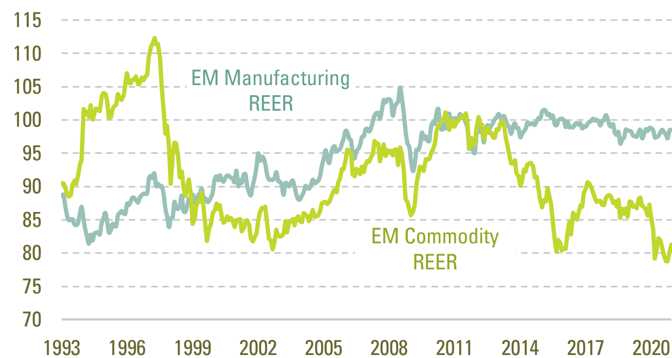
Figure 5 EM Hard Currency Valuations
As of 12/31/2020



Source: J.P. Morgan

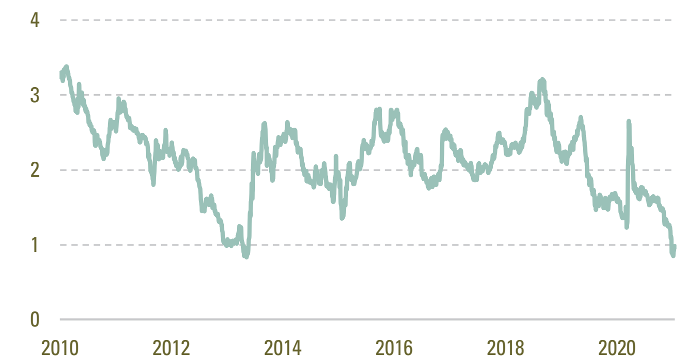
Several vaccinations were approved during the quarter, with distribution expected throughout 2021; this should lead to a lifting of restrictions and gradual reopening globally. Restoration of confidence produced by the vaccines should turbo-charge an already expanding economy. A recovery in growth and sentiment would severely test the willingness of central banks around the world to keep the monetary floodgates wide open. With valuations near all-time lows across many segments of EM fixed income (Figures 6 and 7), we will be closely monitoring signs of a removal of stimulus measures, taper tantrum risks and any inflationary risks that would push EM central banks to hike rates faster than expectations. We will also be monitoring the dynamics of the Chinese economy. Markets were caught by surprise in October and November on news that three state-owned companies defaulted on their debt, raising questions around implicit guarantees. This followed a speech earlier in the year from People's Bank of China Governor Yi Gang stating that these implicit guarantees should end. Was this a presage to the future direction of the China credit impulse?

Figure 6 EM Real Effective Exchange Rate (REER)
As of 12/31/2020



Source: J.P. Morgan

Figure 7 Local Currency EM Sovereign Forward Real Yield
As of 12/31/2020



Source: Bloomberg Finance L.P.

CORPORATES

The JP Morgan CEMBI Broad Diversified Index returned 4.4% for the quarter and 7.1% year-to-date. On a quality basis, IG and high yield returned 2.7% and 6.9% during the quarter, respectively. Year-to-date, IG was up 7.4% while the high yield index was up 6.6%. The yield-to-worst on the index rallied 60 bps during the quarter to finish at 3.4%, while spreads tightened about 76 bps to 270 bps. On an annual basis, spreads widened 2 bps year-over-year; however, intra-year they widened out 385 bps during the height of the COVID-lead sell-off. Primary markets capped off a record year with $99 billion during the quarter and $497 billion over 2020; net supply came in at $53 billion driven by Asia and ME&A. Default rates are expected to improve in 2021 following a 3.5% default rate in 2020; that's low compared to what one would've expected during a pandemic. Fiscal and monetary policy around the world opened primary markets beginning in March, providing companies with enough liquidity to manage through the shutdowns. Valuations in the CEMBI universe are at the tighter end of their historical range on a spread basis and near all-time-low yields. This valuation backdrop leaves returns going forward likely in the mid-single-digits.

SOVEREIGNS

JPM GBI-EM Global Diversified Index and the hard currency JP Morgan EMBI Global Diversified Index returned 9.62% and 5.80% during the quarter and finished the year at 2.69% and 5.26%. In local markets, currencies drove performance in the final quarter of the year, returning 6.67%, but this component was still down -5.24% for the year, leading GBI-EM to underperform hard currency markets. With the yield on the GBI-EM Diversified Index falling to all-time lows at the end of 2020, the currency component will have to be a driver of performance going forward. We believe this could be the case over the course of 2021 with the vaccine rollout leading to a lifting of restrictions and gradual normalization. Real effective exchange rates across many EMs remain close to multi-year lows. In EMBI, yields are broadly close to all-time lows, with some potential opportunities remaining in high yield countries with exposure to recovery in travel and oil prices.

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The ICE BAML U.S. Fixed Rate CMBS Index tracks the performance of U.S. dollar-denominated investment grade fixed rate commercial mortgage-backed securities publicly issued in the U.S. domestic market. The JP Morgan Corporate Emerging Market Bond Index (CEMBI) Broad is a global, liquid corporate emerging markets benchmark that tracks U.S. denominated corporate bonds issued by emerging markets entities. The JPM EM Bond Index Global Diversified is composed of U.S. dollar-denominated Brady bonds, eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities. The JPM Government Bond Index-Emerging Markets (GBI-EM) Broad Diversified is a comprehensive emerging market debt benchmark that tracks local currency bonds issued by emerging market governments. The unique diversification scheme ensures that weights among the index countries are more evenly distributed by reducing the weight of large countries and redistributing the excess to the smaller-weighted countries with a maximum weight per country of 10%. All data current as of the date at the top of the page unless otherwise noted. This information should not be considered a solicitation or an offer to provide any Brandywine Global service in any jurisdiction where it would be unlawful to do so under the laws of that jurisdiction. Past performance is no guarantee of future results.

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