MADISON INSURANCE TAXABLE BOND

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FIRST QUARTER 2021 IS ONE FOR THE HISTORY BOOKS

As 2020 ended and 2021 began, there was much celebrating that we were putting the Covid-19 pandemic behind us. While it certainly appears that the U.S. is looking at a much better year, there are still challenges both domestically and globally as the recovery moves forward. With some large U.S. states at least partially shut until the vaccine distribution reaches a much higher level, the initial pop in economic activity post shut down, will face some ongoing challenges.

Vaccine distribution and fiscal stimulus is fueling business and consumer confidence with expectations for GDP growth in the mid-to-high single digit for the quarter and high single digit growth for the full year of 2021. Whether that plays out as forecast and can continue after the fiscal fuel runs out remains to be seen. Certainly, housing and auto industries are leading the charge with continued strong auto sales and high demand for housing leading to record low inventories. Hospitality and travel continue to struggle as many are still reluctant to reengage in the day-to-day activities. Business travel seems to be pushed off at least until mid to late summer as caution prevails at least in this segment of corporate decision making.

CHALLENGES REMAIN

For the U.S. economy many small businesses are gone for good. Commercial and residential real estate are facing issues on moratoriums on evictions and foreclosures which are due to expire in June. Additionally, commercial real estate will face longer term headwinds as businesses have discovered that work from home can be done effectively, saving on expenses. One would think this will have a depressing effect on the future rate of growth in this sector of the economy.

$1.9 trillion fiscal stimulus and the associated expectations for accelerated growth steepended the yield curve over the first quarter, with the 2-year U.S. Treasury remaining essentially unchanged around 0.15%. The 10-year Treasury moved from 0.91% to 1.73% as investors voiced concern for an inflation flare up given the level of fiscal and monetary stimulus. It remains to be seen how many of the 9-10 million jobs lost over the last year are not coming back…. especially in the hard shut down state of the northeast and California. We believe this will keep the Fed rate low for longer and limit rate increases.

The bond market seems to be challenging the Fed as to how long they can keep interest rates at zero on the short end of the curve as well as continue the $120 billion in monthly purchases of U.S. Treasury bonds and agency mortgage-backed securities.

Federal Reserve Chair Powell has pushed back arguing that despite an expected jump in the inflation rate from around the current rate of 1.5%, they expect that increase will be temporary. They remain committed to keeping rates low and running the economy "hot" in order to achieve their goal of seeing the average long-run inflation increase to their desired level of 2.0%.

We do not feel the Fed would be comfortable with yields moving much higher from current levels as it could cause financial markets (both fixed income and equity) to tighten just as the economy starts to get going again. The Fed could address this by targeting purchases in the longer part of the curve and/or increasing the monthly US Treasuries

and Agency Mortgage Backed Security (MBS) purchases. We expect the Fed to stick to its guns unless we see big pick-up in inflation along with a move much closer to the full employment level from the current 6%.

Despite the steepening in the yield curve, spreads on credit remain relatively tight as demand remains high for most risk assets. The longer duration Bloomberg Barclays Aggregate Bond index returned -3.4% while the shorter Intermediate Gov/Credit Index returned -1.90%. Tax-exempt municipals, as measured by the Bloomberg Barclays Municipal Bond Index, faired better, returning -0.4%. Interestingly gold, as measured by the Bloomberg Gold Subindex Total Return, considered by many as an inflation hedge, was down -9.8%. Other commodities were up on strong liquidity and expectations of demand picks-up as the world gradually reopens.

PORTFOLIO POSITIONING

In the first quarter of 2021, we found value for our customized insurance portfolios in high quality taxable municipal bonds issued by areas of the country less severely impacted by the pandemic shut down. These bonds included general obligation bonds, school districts and water and sewer authorities. Additionally, we purchased some callable agency securities that offered attractive yields versus credit of similar duration. Some short, high quality corporate debt has been purchased to offset some of the longer duration securities. Agency MBS was unattractive for most of the quarter as prepayments accelerated due to a combination refinancing and agency buy-backs of mortgages in arrears due to the shutdown.

Demand continues to far outstrip supply in the fixed income markets. Investment-grade and below investment-grade sectors are aggressively bid, especially in the short-end, which provides principal protection from an eventual rate rise to more normal levels. This level of demand will continue keep rates in check until we see significant, sustained pick-ups in inflation and employment. For our insurance clients, Agency MBS and tax-exempts are still unattractive versus alternatives in taxable municipals and corporates. Callable and step-coupon agencies still offer occasional value.

While we have allowed durations to rise somewhat from very low levels, we will continue to be positioned cautiously, balancing the need for income (which is basically non-existent on the short end of the curve) with longer bonds in the 4-7 year range where some coupon is available, albeit very low relative to historic levels.

In the second quarter we will be closely watching the rate of reopening, both domestically and internationally and its impact on market expectations for Fed policy and the yield curve.

DISCLOSURES

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The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage backed securities, asset-backed securities and corporate securities, with maturities greater than one year.

The Bloomberg Barclays Intermediate Govt/Credit Bond Unmanaged index that tracks the performance of intermediate term US government and corporate bonds.

Bloomberg Barclays Municipal Bond Index is an unmanaged index considered representative of the tax-exempt bond market.

Bloomberg Gold Subindex Total Return Index tracks the performance of gold.

Bonds are subject to certain risks including interest-rate risk, credit risk and inflation risk. As interest rates rise, the prices of bonds fall. Long-term bonds are more exposed to interest-rate risk than short-term bonds. In a low-interest environment, there may be less opportunity for price appreciation.

Bond Spread is the difference between yields on differing debt instruments of varying maturities, credit ratings, and risk, calculated by deducting the yield of one instrument from another.