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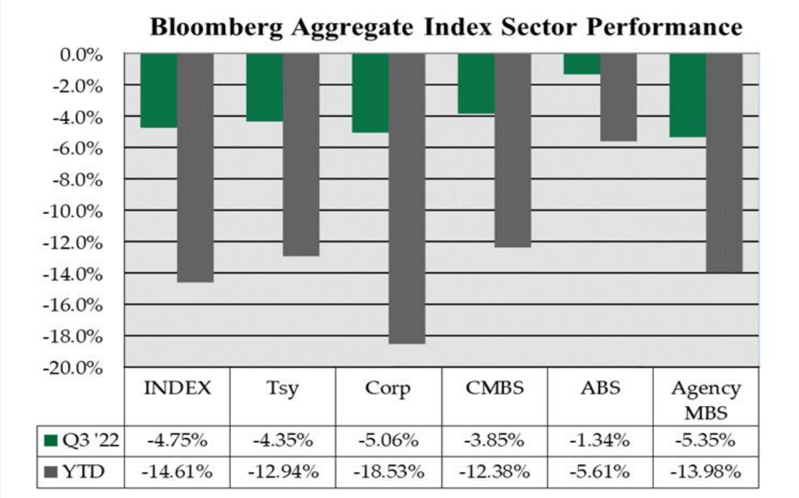
THIRD QUARTER 2022 INVESTMENT REVIEW

FIXED INCOME OVERVIEW

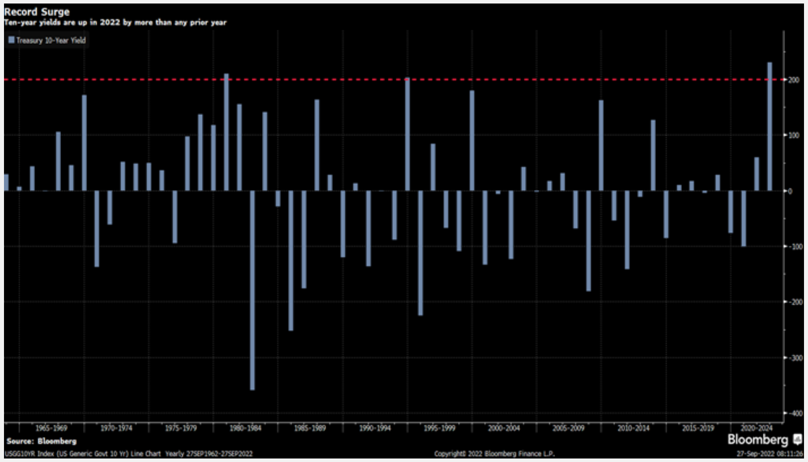
Bond yields continued their march higher as the Federal Reserve has been unrelenting in raising their target rate in their stance on wanting to curb inflation. Unfortunately, they are yet to be successful and many bond investors are choosing the sidelines versus the frontlines as monetary losses mount. The Bloomberg Aggregate Index was down about 4.75% for the quarter, bringing the year-to-date performance number down 14.61%. The less rate sensitive Bloomberg Intermediate Govt./Credit Index finished down 3.06% on the quarter. Corporate bonds and Agency MBS lost ground as worries surrounding quantitative tightening amplified angst in the agency space and economic growth concerns pressured corporates.

This has been a less than ideal year for both stocks and bonds, and calling the bottom has been a fool's errand. The move higher in the 10-yr. Treasury benchmark is actually the largest on record, but certainly not the record that anyone (unless you were short) wanted to set!



	INDEX	Tsy	Corp	CMBS	ABS	Agency MBS
🟩 Q3 '22	-4.75%	-4.35%	-5.06%	-3.85%	-1.34%	-5.35%
■ YTD	-14.61%	-12.94%	-18.53%	-12.38%	-5.61%	-13.98%

Source: Bloomberg



Source: Bloomberg

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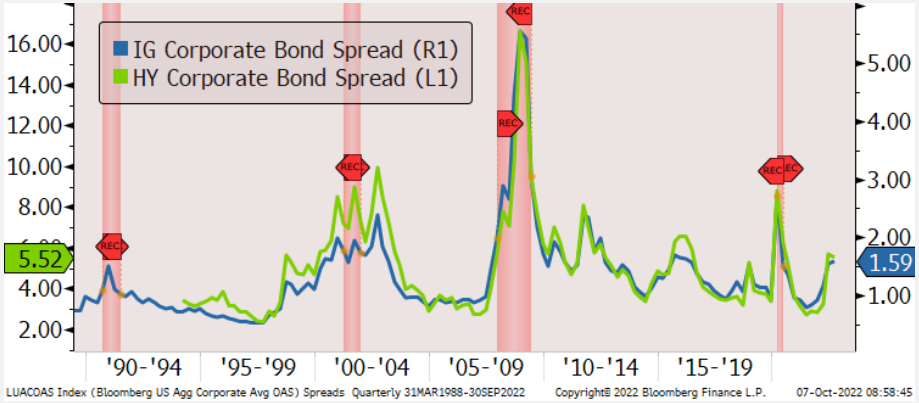
CREDIT SPREADS

Investment-grade corporate credit spreads (green line shown in graph to the right) widened just 4 bps this quarter, as market participants seemed comfortable with valuations, in the hopes this may be a sign the corporate bond market has discounted the Fed. High yield spreads rallied 17 bps for the quarter, but with the move in rates, its yield of almost 9.7% is eerily close to double digits.

While it is still tempting to proclaim this an opportunistic entry point, we note that valuations are not yet to recessionary levels (highlighted in red), so we remain underweight high yield within our DFI and Core Plus accounts. Within our investment-grade portfolios, we continue to take advantage of relatively flat credit curves in the money center banks, as we remain comfortable with their fundamentals. Additionally, we are finding opportunities in moving from senior to subordinate tranches of money center bank debt as the yield pick-up remains in the neighborhood of 50 basis points.

Credit Spreads

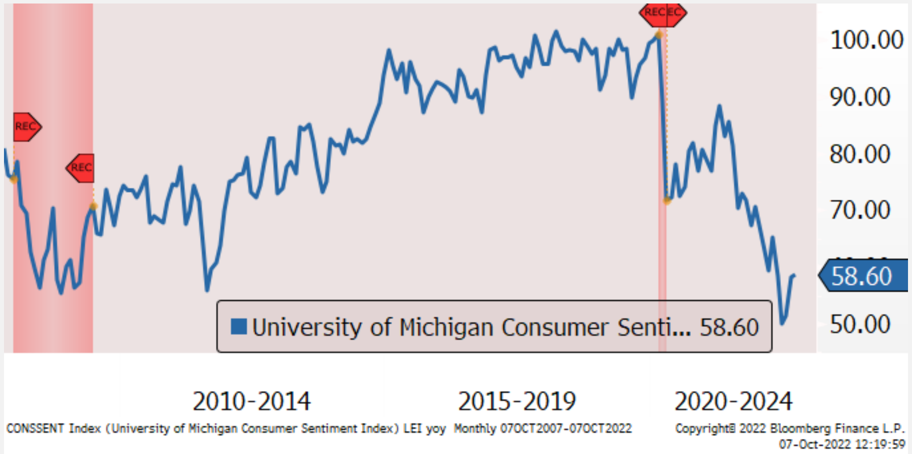


Source: Bloomberg

THE ECONOMY

The job market remains strong with the August payrolls showing over 300k jobs added. Job openings remain high but fell to a 14 month low. According to Bloomberg, the number of job openings declined by 1.1 million in August and there are 1.67 vacancies per unemployed persons, down from 1.97 in July. That is still higher than 1.15 at the end of 2019, but the adjustment process looks to be well underway. Given the reality that Fed policy tends to have a lagged effect on data, we are monitoring both the consumer and businesses for early warning signs. The consumer remains quite resilient despite 8% inflation, but we are guessing the reprieve at the pump during the quarter that benefitted many is set to turn as tensions between Russia and the West remain, and the latest production cut from OPEC seems curiously timed. Meanwhile, the dollar continues to print at extremely elevated levels making many resources even more expensive for those that can least afford it. This winter may well prove a long one. It is no surprise that sentiment readings are back at recessionary levels. (Cont.)

Consumer Sentiment



Source: Bloomberg, University of Michigan

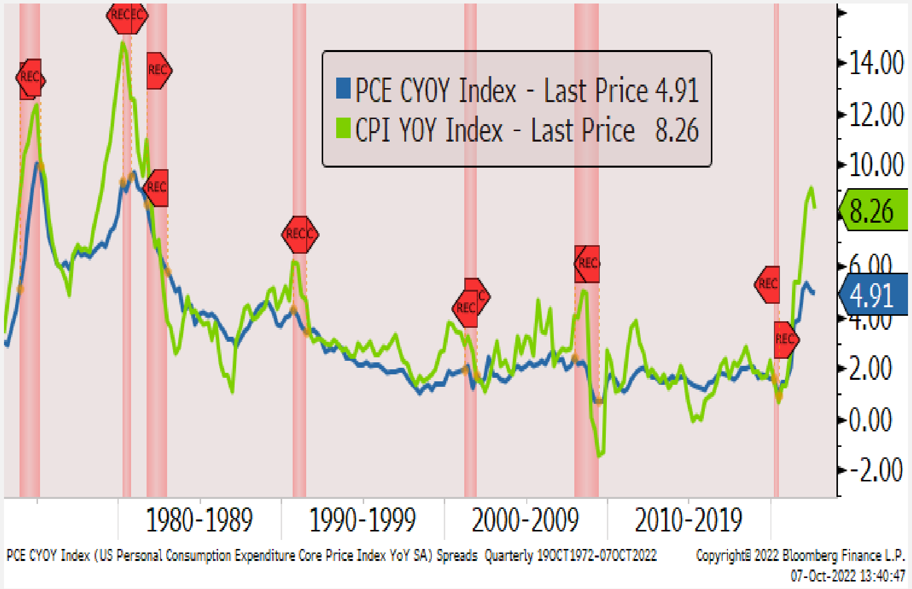
THE ECONOMY

(Cont.) Homebuyers cannot be feeling too great either as mortgage rates tick ever closer to 7%. Existing home sale prices are now up only 7.7% on a year-over-year basis after being in the 15% range for much of this year. Fortunately, many homeowners have a substantial amount of equity built up in their homes so we are not thinking there will be a disaster in the housing market, rather a cooling off. Unfortunately, for first time homebuyers the level of affordability stands near 15-yr. lows. Therefore, any economic benefits from this buying group seem to be far on the horizon. Chalk another one up for the FED!

THE FED

The Federal Open Market Committee continued on their hiking path delivering moves of 75bps in both July and September as headline inflation of 8.3% remains stubbornly high. Their preferred measure of core PCE stands at 4.9% which was 0.2% ahead of their expectations but down from 5.4% earlier this year. We are starting to see prices paid on the manufacturing side fall to almost pre-pandemic levels. However, prices paid on the services side, while falling, remain elevated. ISM New Orders are signaling a significant slowing, and we have concern with growing inventories, not to mention some earnings warnings from the likes of FedEx and Nike. The Fed seems in a very unenviable spot as they try to cool the economy without taking it down. A soft-landing will not be easy!

Inflation Remains Sticky



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Bloomberg

FOURTH QUARTER 2022 STRATEGY

Liquidity has been poor across many areas of our markets and recently the lack of liquidity within U.S. Treasuries has been a topic of discussion all the way up to the FED. New York Fed President John Williams recently acknowledged, "Market liquidity is definitely lower", but he added, "It's still functioning". It is, but that offers little comfort when adding in the fact that Treasury debt outstanding has climbed by $7 trillion dollars since the end of 2019. Also, we are all reminded that no matter what the market is, it can become saturated.

If there has been one byproduct of the general bond market weakness it has to be "all-in yields" at levels not seen since the depths of the financial crisis. The yield on the Bloomberg Aggregate Index sits at 4.75%, which is up 100bps in only 3 months. At some point, we would expect investors to be attracted to the asset class but timing this turn has so far been fruitless.

We have been adding duration across most investment mandates but remain slightly underweight relative to our indices. Additionally, we have been increasing our U.S. Treasury and Agency Mortgage exposure to maintain liquidity and upgrade overall portfolio quality. We still like the auto ABS market despite a rolling over of used car prices and an uptick in delinquencies, as recovery values remain elevated and delinquencies well under post GFC norms.

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Chief Strategy Officer

NIS

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