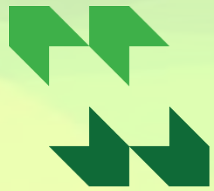

National Investment Services

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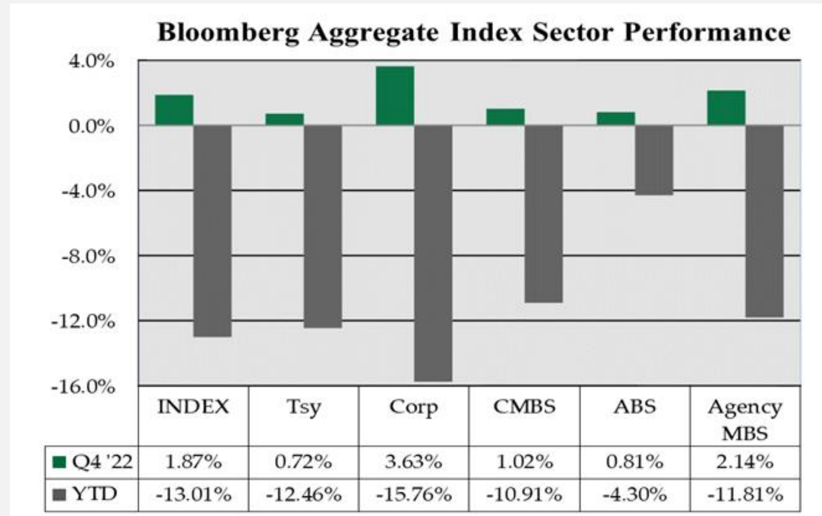
FOURTH QUARTER 2022 *INVESTMENT REVIEW*

FIXED INCOME OVERVIEW

As most investors look to put 2022 in the rearview mirror, we note that the fourth quarter ushered in positive performance across most of the fixed income landscape. Market participants are beginning to believe that the Federal Reserve and their central banking counterparts around the world might finally be doing enough to counter inflation. The answer to that puzzle will no doubt be uncovered in the New Year, so in the meantime, here is how the bond market finished a difficult year.



	INDEX	Tsy	Corp	CMBS	ABS	Agency MBS
Q4 '22	1.87%	0.72%	3.63%	1.02%	0.81%	2.14%
YTD	-13.01%	-12.46%	-15.76%	-10.91%	-4.30%	-11.81%

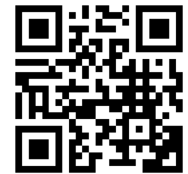
Source: Bloomberg

The Bloomberg Aggregate Index was up almost 2% in Q4 but still down 13% on the year. Duration was a large determinant of market return this quarter, but corporate bonds did well, returning over 3.5%. U.S. Treasuries, CMBS, and ABS all finished up between 0.7%-1%. Short and intermediate indices also finished in positive territory as the Bloomberg Intermediate Govt. /Credit Index rose 1.5%, and the short duration Bloomberg 1-3yr. Govt./Credit Index finished up 0.89%.

CREDIT SPREADS

Investment-grade corporate credit spreads (green line) tightened as some investors may have realized they had gotten too pessimistic with their assessment of the labor market and overall corporate health. IG spreads finished the quarter at 130bps after starting at 159bps. (Cont.)

For the latest on NIS happenings and firm updates



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CREDIT SPREADS

(Cont.) High Yield bonds also enjoyed a strong showing, as spreads in this area rallied 83bps to close at 469bps. The chart to the right highlights this rally.

Looking back to the beginning of the year, we note that the bond market was coming off very low historical spread levels (rich valuations), but as we begin 2023, corporate bond spreads are close to their post global financial crisis averages. This is a more reasonable starting point for return seeking fixed income investors and one of a few reasons to be more optimistic about the fixed income sector in the year ahead.

Credit Spreads

Source: Bloomberg

THE ECONOMY

Just as manufacturing seemed to lead us quickly out of the 2020 pandemic with the onset of de-globalization, we are keeping a close eye on the most recent and rapid slowdown for clues of a possible recession.

The December ISM® Manufacturing survey highlighted a continued drop in prices, with companies and suppliers uncertain about the economy in 2023 and lowering forecasts. While lower pricing pressure in manufacturing and services is potential evidence that the Fed's rate increases are having the desired effect, it is doubtful they are done raising rates yet. As eleven of the eighteen services industries reported growth, it was notable that real estate, rental and leasing, wholesale trade, other services, information, construction, and educational services all reported decreases.

Manufacturing and GDP

Source: Institute for Supply Management®, Bureau of Economic Analysis, Bloomberg

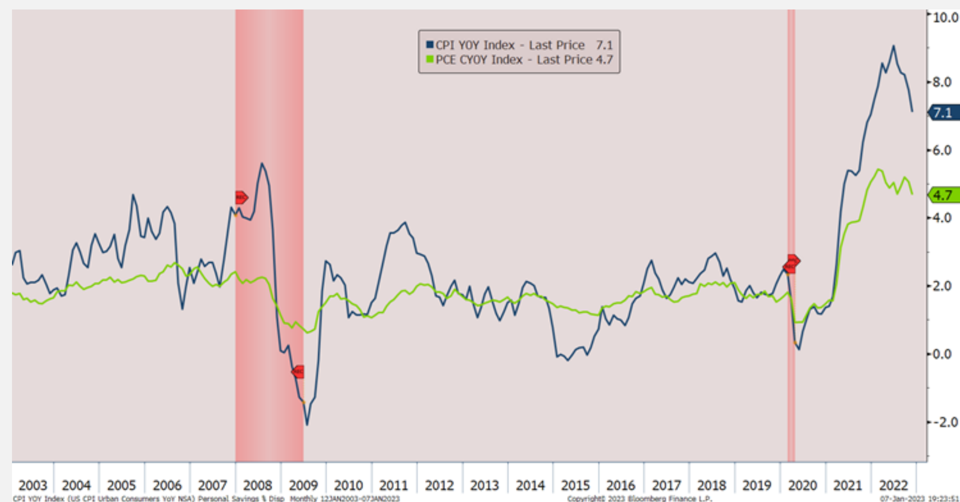
There are more than a few things to keep an eye on, but you might want to hold off a bit if you are in the market for a home. While some in the services sector were preparing for a possible recession in 2023 (finance and insurance), others were "optimistic, although concerned, about continued inflationary pressures" (real estate and rental & leasing). Go figure.

THE FED

It may seem counterintuitive that the Fed continues to raise the benchmark Fed Funds rate as inflation appears to be finally rolling over. Ironically, inflation could remain sticky due to a strong labor market, some of which is demographically driven and somewhat out of their control.

The New Year begins with the U.S. still experiencing a relatively strong jobs backdrop as the December payrolls report highlighted job creation with moderating wage growth. The Fed would probably like a bit more weakness here, and we cannot help but think they do not want to let off too early after being late to the game while believing the "transitory" story. We expect two more rate hikes of 25bps at coming meetings to a terminal rate of nearly 5% in March, and then a prolonged pause into year-end while the Fed assesses the ramifications.

Inflation Remains the Key



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

FIRST QUARTER 2023 STRATEGY

After such a rough year, it is only natural to look forward to the possibility of a more stable bond market. One of our favorite volatility measures (BofA MOVE Index), which is a yield curve weighted index of normalized volatility on 1-month Treasury options, has been showing signs of stabilizing since peaking twice in the middle of 2022. We feel it was elevated while market participants reacted to both high inflation and hawkish Fed responses.

To that end, it seems inflation is ebbing and the market is more comfortable with the policy response. We are also keeping a close watch on the health of the consumer as retail sales less autos stands at 6.6%, which is down from 10% earlier last year. In addition, debt to personal income bears some attention as it has been drifting higher. Bulls will point out that it is still much lower than even ten years ago, but having to increase debt to pay for day-to-day items is not a long-term solution.

(Cont.)

FIRST QUARTER 2023 STRATEGY

(Cont.) Therefore, our managers expect some periods of heightened market volatility as investors adjust to whether or not the Fed can orchestrate a soft landing or whether those calling for a recession are correct.

With bond spreads near historical averages and the outlook for a more stable rate environment, we are feeling more constructive on the fixed income market as a whole. Our managers want to be judicious with our capital deployment in an effort to maximize yields while paying attention to overall volatility. We recently reduced exposure to some of our hospital and muni bonds as these sectors posted a late quarter rally and appeared fairly valued.

Treasury Market Volatility

Source: ICE, Bloomberg

We still prefer money center banks to regionals and find the 3-5 year part of the curve attractive, and have been adding to our overweight here. Within Industrial credit, we continue to opportunistically move up in quality without giving up much in yield. Utility paper across the capital structure, including holding company, operating company and first mortgage bonds, has provided some opportunities to that end over the past few months. We also had the ability to add some energy exposure on the most recent downturn in commodity prices. We believe that energy companies have dramatically improved their balance sheets and as a result, some opportunities have presented themselves. Alternatively, we look to keep our exposure to cyclical sectors down, and will look for sale opportunities if credit spreads meaningfully rally into the first quarter. Fundamentals remain constructive within the auto ABS sector, where we find value in both prime and subprime deals, being selective with higher quality, more liquid issuers and tranches. Lastly, we remain of the mindset that the rates market does not yet reflect the reality of additional Fed rate increases and an ultimate steepening of the bond curve. We are therefore keeping client portfolios a bit shorter than their benchmarks with regard to duration and positioned for some curve steepening. We all wish you good health and success in the New Year!

Mark R. Anderson, CFA

Chief Strategy Officer

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