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FOURTH QUARTER 2023 *INVESTMENT REVIEW*

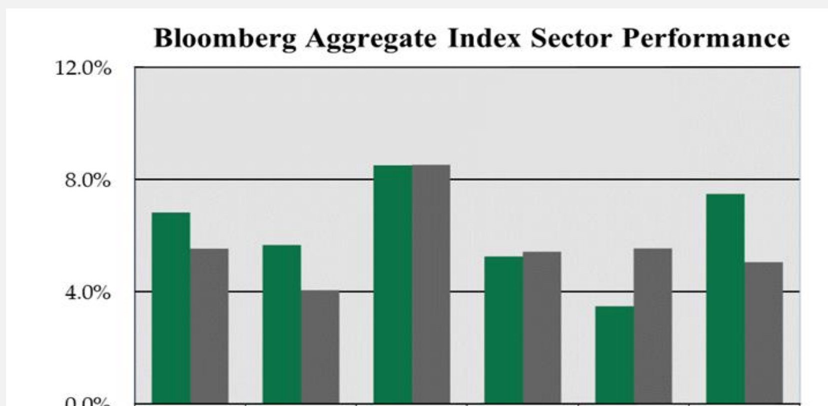
FIXED INCOME OVERVIEW

Risk markets pivoted and rocketed higher on a dovish Fed that strongly hinted at the potential for 75bps of rate cuts in 2024. Optimism reigned supreme as risk and duration were handsomely rewarded. We cannot help but wonder whether it was too far, too fast, but we suspect we will soon learn whether the Fed has really tamed inflation.

The Bloomberg Aggregate Index returned 6.82% over the fourth quarter, led by strong demand for corporate debt, long duration, and Agency MBS. Virtually every area of the fixed-income market enjoyed gains as the year drew to a close. The Bloomberg Intermediate Govt./Credit Index rose 4.56%, and the short duration Bloomberg 1-3yr. Govt./Credit Index finished up 2.69%.

ARTICLE HIGHLIGHTS

- Positive fourth quarter performance
- Credit spreads appear tight
- Interest rates have round-tripped
- Cautious to start the year



	INDEX	Tsy	Corp	CMBS	ABS	Agency MBS
Q4' 23	6.82%	5.66%	8.50%	5.25%	3.48%	7.48%
YTD	5.53%	4.05%	8.52%	5.42%	5.54%	5.05%

Source: Bloomberg

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CREDIT SPREADS

Investment-grade corporate credit spreads (green line) tightened as some investors may have realized they were too pessimistic with their assessment of the Fed, the potential for a soft landing, and the strong market technicals. IG spreads finished the quarter at 99bps after starting at 121bps. High Yield bonds also enjoyed a strong showing, as spreads in this area rallied 83bps to close at 323bps. Looking at the chart to the right shows markets that are trading close to longer-term tight levels, which seems to leave very little room for either economic weakness or higher-than-expected inflation.

Looking back to the beginning of the year, we note that the bond market was coming off an epic poor showing that left spread levels near their long-term averages. Unfortunately, we start this year well inside these averages, so we would not be surprised if there is an early dose of market volatility as investors reassess value after a holiday break.

Credit Spreads

Source: Bloomberg

RATES

In a strange twist of events, the rates market begins in 2024, exactly where it started in 2023, so at least the concept of earning the coupon was feasible last year and might be again this year. Recent market action hints at a robust demand for duration, with virtually every Treasury sell-off being quickly bought.   Inflation and the Fed will be keys to this equation, with concerns about Treasury debt issuance and budget discussions seemingly taking back seats for now.

10 Year Treasure Yield

Source: Bloomberg

THE FED

The New Year begins with the U.S. still experiencing a relatively strong jobs backdrop as the December payrolls indicated 216k jobs added vs. a consensus of 176k. Average Hourly Earnings also beat expectations, which can generally be seen as a good thing except for those looking for several rate cuts this year, with some even calling for them to start in March. We feel policymakers will be a bit more patient and would not expect any movement until summer as inflationary readings remain elevated, and the move from 3% to 2% could take a while.

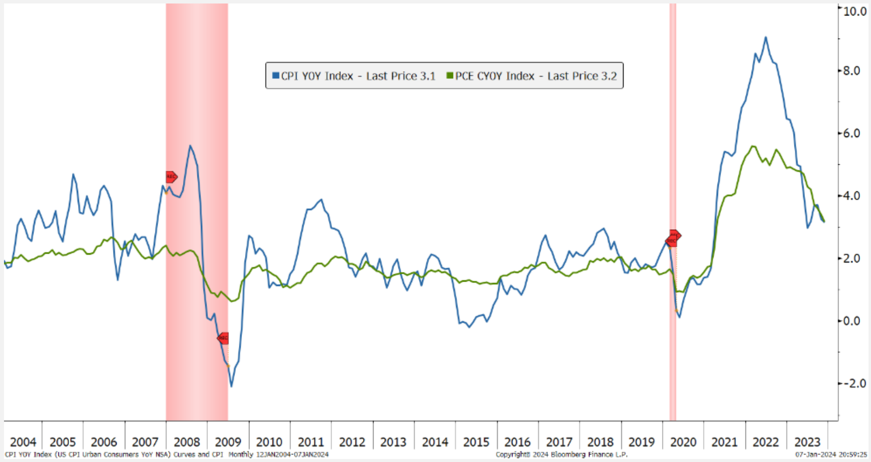
THE ECONOMY

Manufacturing data spent most of 2023 in the recessionary territory, while Services remained relatively strong, driven by buoyant consumer spending. Weak energy prices have helped to curb inflationary pressures, as has production, with companies generally able to meet customer demand. A quick look at the December ISM® manufacturing survey highlights a mixed bag of data as new orders and prices declined while production, employment, and supplier performance all improved. An uptick in manufacturing could prove a nice offset to a slowing services sector here in 2024, just what the soft-landing camp would like to see.

FIRST QUARTER 2024 STRATEGY

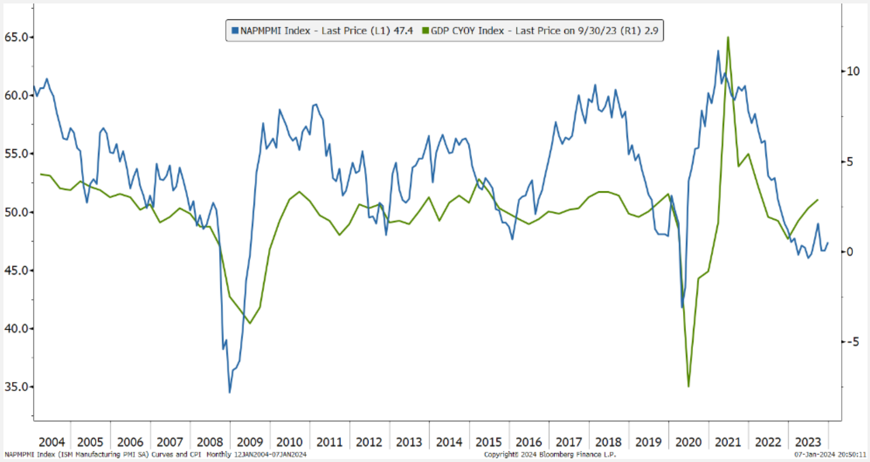
After such a strong finish in 2023, we would be remiss if we did not mention that we believe some of 2024's potential return got pulled through already, so the start of the year could be choppy. One of our favorite volatility measures (BofA MOVE Index), which is a yield curve weighted index of normalized volatility on 1-month Treasury options, remains somewhat elevated as the path towards lower yields remains uncertain much like the prospect of a soft-landing. When correlating the MOVE Index and corporate bond spreads, there appears to be a definite disconnect and one in our mind that merits a touch of caution with at least regard to credit exposure. (Cont.)

Inflation Remains the Key



Source: Bureau of Economic Analysis, Bureau of Labor Statistics

Manufacturing and GDP



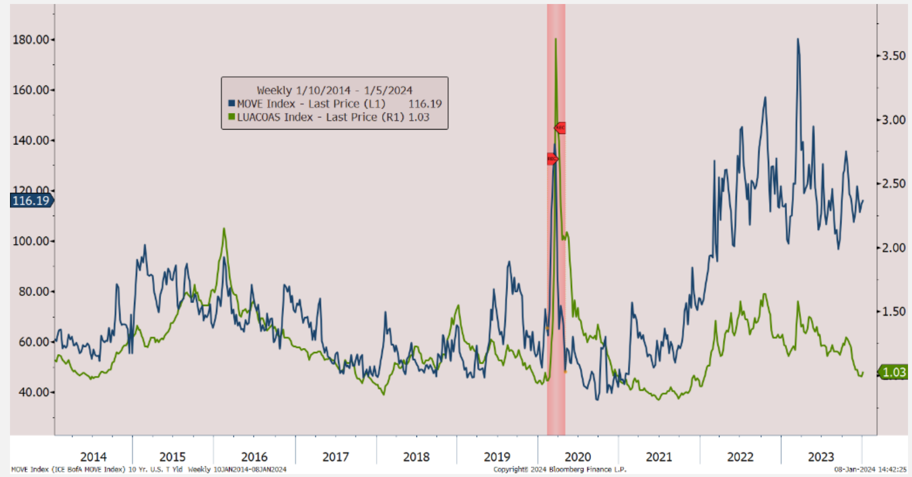
Source: Institute for Supply Management, Bureau of Economic Analysis, Bloomberg

FIRST QUARTER 2024 STRATEGY

(Cont.) 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 remained resilient through 2023 with some acceleration during the back half of the year. In addition, debt to personal income appears to be leveling out, but we have observed upticks in early delinquencies within both the credit card and auto loan spaces. While certainly not at GFC levels, these metrics merit monitoring as the pandemic stimulus monies have generally flowed through the system.

Although bond spreads are tight to historical levels, the outlook for a more stable rate environment helps balance the risks of the fixed income market. Our managers remain judicious with capital deployment in an effort to maximize yields while attempting to capitalize on volatility to make portfolio shifts.

Volatility and Spreads



Source: ICE, Bloomberg

We still prefer money center banks to regional banks, but we like the super regionals. However, we feel there has been significant spread compression here, and we are being value-sensitive. We anticipate a robust issuance calendar from US Banks in Q1, and with some regulatory changes on the horizon for 2024, banks may have to increase their issuance to boost their CET1 levels. Industrial credit spreads closed the year at or near multiyear historically tight levels. Although the economy and industrial earnings have continued to be supportive in the near term, we have started to see some cracks emerge. The most concerning is weakening top lines, as pricing power has begun to erode and overall volumes have been trending negatively - both lead to pressure at the top line. As a result, we've continued to be cautious on consumer staples and general industrial credits. We have maintained BBB exposure at or near index levels as BBBs have continued to compress relative to A credits and now stand near a 10-year historical low at only 35bps. Fundamentals remain constructive within the auto ABS sector as we continue to be selective with higher quality, more liquid issuers. Lastly, we acknowledge that much of the easy money has been made by being underweight duration and are therefore looking to move client portfolios closer to their benchmarks with regard to duration and positioning for a more normal curve. We all wish you good health and success in the New Year!

Mark R. Anderson, CFA
Chief Strategy Officer

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