Portfolio Commentary

Navigator® Fixed Income Total Return

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Credit Remains Firm Despite Market Headwinds

Market Review

The markets finished 2021 with a bang, as investors looked past the Federal Reserve's accelerated pace of tapering bond purchases, the prospects of rate hikes in 2022, and the surge in the highly contagious COVID Omicron variant, driving risk assets to new highs. Risk appetites remain elevated with expectations of continued economic and earnings growth in 2022, albeit at slower pace than the beginning of the post-pandemic period.

For the calendar year, risk assets surged, with the S&P 500 gaining 28.68% and notching 70 record highs along the way. The S&P rose more than 10% for a third consecutive year for the first time since 2012-2014 and all 11 S&P 500 sectors posted double-digit returns for the first time since 1995. The market tailwinds included unprecedented monetary stimulus, economic re-opening, and earnings growth of about 65%. U.S equities handily outperformed international stocks in 2021 and 8 of the past 10 years.

Fixed income suffered through a difficult year as the economy recovered, inflation surged to its highest level in 30-years, and interest rates rose. The Bloomberg Barclays U.S. Aggregate Bond index suffered its fourth loss ever, declining by 1.54%. Treasuries declined even more as rates across the curve rose. On the other hand, credit performed well throughout the year, with the Bloomberg Barclays U.S. Corporate High Yield Index advancing 5.28%.

It has been a remarkable recovery in the markets since the COVID-induced lows on March 23, 2020. Since then, the S&P 500 is up 119%, the Russell 2000 Index of small-cap stocks is up 128%, the MSCI ACWI ex-US Index is up 79%, and the Bloomberg Barclays U.S. Corporate High Yield Index has gained 40%.

Fourth Quarter Performance Highlights

For the quarter, Fixed Income Total Return outperformed both the Bloomberg Barclays U.S. Corporate High Yield Index and the Bloomberg Barclays U.S. Aggregate Bond Index (gross of fees). For the calendar year 2021, Fixed Income Total Return slightly underperformed the Bloomberg Barclays U.S. Corporate High Yield Index (gross of fees) and outperformed the Bloomberg Barclays U.S. Aggregate Bond Index (gross of fees).

- The strategy was invested with a risk-on bias throughout the quarter and remained fully invested in high yield bonds. In fact, it has remained allocated to high yield bonds for 17 consecutive months, since July 30, 2020. During that period, the Bloomberg Barclays U.S. Corporate High Yield Index has gained 12.18%, while the Bloomberg Barclays U.S. Aggregate Bond Index and the

Bloomberg Barclays 7-10 Year Treasury Index are down 1.69% and 4.86%, respectively. The allocation to high yield bonds has added a significant amount of alpha for the strategy compared to Treasuries.

- Credit remained firm during the quarter even as the Federal Reserve accelerated the pace of tapering and signaled three rate hikes for 2022. We see no evidence of credit stress and as a result, we remain allocated to below investment grade debt.
- Credit again outperformed duration during the quarter. Treasuries gained marginally during the quarter as the 10-year U.S. Treasury yield slipped by 2 basis points. The Bloomberg Barclays 7-10 Year Treasury Index gained 0.34% while high yield advanced 0.71%. The lower duration of high yield bonds compared to Treasuries and investment grade corporate debt has been a defensive attribute during the quarter and for the year, especially as we have seen an increase in rate volatility.

Positioning and Outlook

As we look toward 2022 and ponder what the year will hold for the markets and the economy, we think we are transitioning from a year of recovery in 2021 to a year of headwinds and mean reversion in 2022. We see 2022 continuing many of the trends that propelled the markets to new highs last year such as continued economic and earnings growth, but at a much slower pace. We believe there will be four dominant themes throughout 2022: COVID variants and the government response and economic impact, inflation, Fed policy, and the mid-term elections.

2022 is a mid-term election year and history suggests a choppy first half of the year for risk assets followed by a second half recovery. We expect to see more volatility in 2022 compared to last year, with the potential for a 10-15% equity correction in the first half of the year.

We believe economic growth will remain above trend, but not at the torrid pace we have seen since the COVID collapse. We expect the U.S. economy to grow at a pace of 3.5%- 4.0% real economic growth with tailwinds from continued economic reopening, unprecedented monetary stimulus, and inventory rebuilding.

Inflation is here and is going to remain elevated from the trend of the past 30 years. It is simply a matter of too much money chasing too few goods and services, as well as too little labor. We do expect inflation to moderate to 3.5% year-over-year in the second half of the year as COVID fears dissipate and supply chains improve.

The Federal Reserve is set to end tapering in the first quarter and will likely begin hiking rates shortly thereafter. The market is currently pricing in three rate hikes in 2022. When the Fed hikes at a measured pace, the market has historically performed well in the 12-months after the first rate hike. Yields will rise and we expect the 10-year Treasury note yield to end the year near 2.0%, but it could trade higher during the year.

We currently favor credit over duration as our credit-based risk management models continue to show no signs of credit deterioration, which potentially bodes well for additional market gains as we head into the New Year. Despite the surge in COVID cases, the economy continues to re-open and that provides a favorable macro backdrop to credit.

Continued economic re-opening has led to improved credit outlooks and an upgrade cycle that appears set to extend into 2022. The favorable macro backdrop and upgrade cycle has led to a high yield default rate of just 0.38% compared to its long-term average default rate of 3.66%.

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The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

The S&P 500 High Yield Corporate Bond Index, a subindex of the S&P 500 Bond Index, seeks to measure the performance of U.S. corporate debt issued by constituents in the S&P 500 with a high-yield rating. The S&P 500 Bond Index is designed to be a corporate-bond counterpart to the S&P 500, which is widely regarded as the best single gauge of large-cap U.S. equities.

The Bloomberg Barclays US Treasury: 7-10 Year Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with 7-9.9999 years to maturity.

The Bloomberg Barclays US Intermediate Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers that have between 1 and up to, but not including, 10 years to maturity.

The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

The 10 Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 10 year. The 10 year treasury yield is included on the longer end of the yield curve. Many analysts will use the 10 year yield as the "risk free" rate when valuing the markets or an individual security.

The MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries (excluding the US) and 26 Emerging Markets (EM) countries*. With 2,206 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

The volatility (beta) of a client's portfolio may be greater or less than its respective benchmark. It is not possible to invest in these indices. Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

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