Portfolio Commentary

Navigator® Taxable Fixed Income

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Inflation…Covid…Taper…Oh My!

Market Review

The 2 to 10-year yield curve flattened during Q4. Most of the move was seen in the 2-year Treasury, which moved from 27 basis points at the end of Q3 to 73 basis points by year end. October and November were down months for returns and December produced a year-end rally. For the quarter, the longer duration Bloomberg Barclays US Aggregate Bond Index was up 1 basis point. The Bloomberg Barclays Intermediate Corporate Total Return Index was down 56 basis points.

Here are the main headlines as we closed the year:

- **Transitory Inflation**: On November 30th, Fed chair Powell removed the word "transitory" in his description of inflation. 2-year rates were lower on Dec 1st, but then begin a steady move higher into the end of the year. The 10-year bond also rallied on December first, and moved mostly sideways during the month. The yield curve flattened.
- **Covid**: The new Omicron variant began to spread in US. Its infectious rate appears higher than Delta, but not as severe in nature. The rate market remains focused on the Fed while stocks experienced increased volatility. Buyers still appeared to be willing to invest at lower rates.
- **Taper and Rate Hikes**: The Fed started to message that they will taper bond purchases by the end of March and begin a series of rate hikes.
- **Producer Price Index (PPI) and Consumer Price Index (CPI)**: On December 10th, the Consumer Price Index (CPI) came in at 6.8% year over year, which is the fastest pace since 1982 according to the Bureau of Labor Statistics (BLS). On December 14th, the Producer Price Index (PPI) came in at 9.60% year over year, which is the largest 12-month gain since 2010 (which is also the first year the BLS kept 12-month statistics).

Fourth Quarter Performance Highlights

- Duration remained right around the benchmark at 4 years. Liquidity remained and bonds were being called during the quarter, which added some buffer to the rising yields in the 2-year area of the yield curve.
- Materials and Consumer Discretionary were the sector leaders. Information Technology was the largest underperformer in the quarter as both semiconductors and software lagged.
- Our holding in an American auto company was the best performer in the Consumer Discretionary sector. Bonds issued in the early stages of the pandemic at 8.5% in 2023 and 9% in 2025 were both tendered and the balances called at what we considered to be attractive levels.
- In Materials, our position in a mining company was upgraded by Moody's to Baa3. It was a position we started to accumulate in Q1 as we believed the increase in commodity prices was just beginning. Our view was confirmed year end by the upgrade. We expect other commodity companies we own to be upgraded in 2022 as well.
- Our positions in a cloud computing company and a computer software company were laggards during the quarter. The cloud computing company became a renewed target of private equity. The computer software company made a bid

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for Cerner in the Healthcare field. Both news events were viewed negatively, and spreads widened.

Positioning and Outlook

Is it possible that the Fed has badly misplayed its hand on inflation? That is the burning question. Based on their sudden shift to drop the term "transitory," and given the CPI and PPI numbers that followed, clearly something has changed.

We believe we are well-positioned in the Energy and Materials sectors. Companies in these sectors seem intent on not re-visiting sins of the past and expanding their balance sheet to lever-up. We are looking for continued tenders and potential upgrades within our holdings, which should provide some price stability within the portfolio. For our investment grade positions, we look to increase exposure to Financials.

Overall, we expect rates to edge higher, but we don't believe they will break out dramatically. Spreads remain range bound. The fundamentals and credit profiles of the portfolio remain positive, and we believe BB credits should continue to be upgraded. The curve may steepen a bit, but ultimately, a repeat of 2016 flattening may occur further along with tightening.

We will remain vigilant in our yield curve analysis and see if a barbell approach is warranted at some future point. The portfolio was on the green side of returns while most benchmarks were in the red in 2021, specifically among passive strategies. We have navigated these waters before, and we continue to believe that active management can help investors remain committed to their long-term financial goals.