Portfolio Commentary

Navigator® Fixed Income Total Return

Portfolio Manager

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A Volatile Start to the Year

Market Review

It was a rough quarter for the markets, which faced many headwinds. There is a lot of uncertainty in the markets pertaining to the threat of the highest inflation in 40 years, economic stagflation, geopolitical tensions, and the Federal Reserve tightening and eventually shrinking their balance sheet. On March 16th, the Federal Reserve began their first rate hike cycle since 2019 with a 0.25% hike in the overnight rate. Monetary conditions are still very accommodative with the target overnight range still very low at 0.25% - 0.50%.

However, the Fed is taking a more hawkish tone on future rate hikes and balance sheet roll-off. That hawkish tone now has the market pricing in the equivalent of nine 0.25% rate hikes this year, with a 0.50% hike likely at the May FOMC meeting. The 10-year Treasury Note yield surged to 2.49% before slipping back to 2.33% at quarter end. The middle of the Treasury yield curve flattened and the 2-year to 10-year U.S. Treasury Note spread inverted as the month ended.

Given all of the worries facing investors, the markets have been very volatile so far this year. March provided a much needed bounce higher for weary investors to end the quarter, but it was not enough to erase the losses. For the quarter, risk assets and defensive assets both suffered losses. The S&P 500 declined 4.6%, small-caps as measured by the Russell 2000 Index declined 7.53%, and international markets defined by the MSCI ACWI ex-US Index declined 5.44%.

Fixed income provided no place to hide. The Bloomberg Barclays Aggregate Bond Index sank 5.93%, its largest quarterly decline since 1980. The Bloomberg Barclays 7-10 Year U.S. Treasury Index declined 6.61%, and the Bloomberg Barclays U.S. Corporate High Yield Index lost 4.84%. Within fixed income, credit outperformed duration in the first quarter.

First 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.
- The strategy came into the year fully invested in high yield bond exposure with a risk-on bias. However, as the markets turned sour on risk assets and credit began to suffer losses, the strategy de-risked on January 31st by selling half of its high yield exposure and allocating the proceeds into cash equivalents.
- From the end of January through quarter end, the strategy was allocated 50% high yield bonds and 50% cash equivalents. The partial de-risking ended an 18-month stretch where the strategy was fully allocated to high yield bonds. During that stretch, the Bloomberg Barclays U.S. Corporate High Yield Index gained 9.11%, while the Bloomberg Barclays U.S. Aggregate Bond Index and

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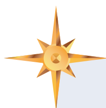

the Bloomberg Barclays 7-10 Year Treasury Index lost 3.81% and 7.10%, respectively. Since the January 31, 2022 partial de-risking through quarter end, the returns for those indices are -2.16%, -3.86%, and -4.36%.

- The primary driver of the strategy's return over time is its macro allocations that are driven by our relative strength credit-based risk management models. That remained the case in the first quarter as the alpha generated was due to the portfolio's defensive position of allocating half of the strategy into cash equivalents on January 31st.
- On a relative basis, credit held up better than duration. High yield outperformed other fixed income sectors as its duration, which is lower than investment grade corporate debt and Treasuries, proved to be a defensive quality. We believe the move lower in fixed income has been driven by rates. This has been evidenced by CCC-rated bonds outperforming broad high yield, investment grade corporate debt, and Treasuries.

Positioning and Outlook

In our Q4 2021 commentary we stated, "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 expect to see more volatility in 2022 than last year, with the potential for a 10-15% equity correction in the first half of the year." So far, that script has played out with the global equity and bonds markets under pressure.

We expect the markets to remain choppy over the near term as they digest the Fed's path of tightening monetary policy. While inflation is a massive concern, we think we may be nearing the point of peak inflation. The flattening and inversion of parts of the Treasury yield curve suggests lower economic growth in the future. We do not see a risk of immediate recession as some have called for. In fact, while parts of the curve have inverted, the difference between the 10-Year Treasury and 3-month T-bill yields, which is a more accurate recession gauge, has actually steepened to its highest levels since 2017.

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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.

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 Russell 2000 Index measures the performance of the 2000 smallest U.S. companies based on total market capitalization in the Russell 3000, which represents approximately 11% of Russell 3000 total market capitalization.

The Bloomberg Barclays U.S. Corporate High-Yield Index covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

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 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 MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries.

Treasury notes are interest-bearing securities that have a fixed maturity of not less than 1 year and not more than 10 years from date of issue. Treasury currently issues notes in 2, 3, 5, 7, and 10-year maturities. Treasury notes pay interest on a semi-annual basis. When a note matures, the investor receives the face value.

An obligation rated 'CCC' is currently vulnerable to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation.

The Consumer Price Index (CPI) measures the change in prices paid by consumers for goods and services. The CPI reflects spending patterns for each of two population groups: all urban consumers and urban wage earners and clerical workers.

Fixed income securities are subject to certain risks including, but not limited to: interest rate (changes in interest rates may cause a decline in market value or an investment), credit, prepayment, call (some bonds allow the issuer to call a bond for redemption before it matures), and extension (principal repayments may not occur as quickly as anticipated, causing the expected maturity of a security to increase).

Non-investment-grade debt securities (high-yield/junk bonds) may be subject to greater market fluctuations, risk of default or loss of income and principal than higher-rated securities.

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