Portfolio Commentary

# Navigator® MultiStrategy

## Portfolio Manager

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# Inflation Caused the Return of the Bond Vigilantes – Was it Just a Cameo?

## Market Review

Investors had not seen inflation rear its ugly head since the early 80s, so when it came charging at us as 2022 began, they were slow to adjust. The first half of the year has been challenging because both stocks and bonds have been under severe stress: the S&P 500 is down 19.97% through June 30th, and the Bloomberg Aggregate Bond Index is down 10.3%. A 60% S&P 500 and 40% Aggregate Bond portfolio is down 16.1% during the first half of the year, the second worst performance on record, topped only by 1932. It is not only investor portfolios that are suffering, the soaring inflation has driven Real Average Hourly Earnings to post its worst decline since the 1970s. Market volatility has spiked as the S&P 500 has moved up or down 1% at more than twice the normal rate. 57% of the market's 1% moves have been negative, a ratio greater than we saw in 2020 or even 2008. Large-cap growth stocks, the market's prior darlings, have been particularly crushed, and are down 27.6% year to date.

During the first quarter, interest rates and stocks declined, but by our measures, those declines were mostly because of rising interest rates, while earnings, investor confidence, and balance sheets held their own. The second quarter was different, as spiraling inflation dominated headlines, and energy prices pounded consumers.

As inflation began to be reflected in wages and there were more job openings than workers, the Fed began to change its tone. In May, Jerome Powell became more hawkish, stating that if the Fed needs to be "moving past broadly understood levels of "neutral," we won't hesitate at all to do that." June 10th's shocking report of the Consumer Price Index (CPI) up 8.6% year-over-year and 6% Core CPI growth proved that the Fed was well behind and had to adjust. As that report came just before the Fed's June meeting, both bonds and stocks suffered when a 75 basis point rate hike became baked in and expectations had to reset. The June hike finally ended rising energy prices, and broad declines across the commodity spectrum were the result of investors beginning to play defense in anticipation of a recession. As we move into the second half of the year, many investors believe the worst of inflation is over, but five more rates hikes are expected within the next year. We believe the story of the second half of the year will be determined by whether the Fed backs off its hawkishness as it sees the economy slow, or even turn south.

## Second Quarter Performance Highlights

For the quarter the S&P 500 Index was trounced, falling 16.11%, while large value was relatively better, down 11.3%. Large growth was worst among all style boxes, losing 20.8%. Small-cap value was down 12.8%, while small-cap growth declined by 15.7%.  Among factors or themes, high dividend was again the leader, falling only 5.5%, while minimum volatility down 9.2% also outperformed amidst market

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turbulence. Momentum was down 18.8%, quality down 16.7%, and high beta (down 22.7%) trailed, while buybacks down 14.0%, modestly outperformed.

- Surging inflation delivered a blow to fixed income, with the Bloomberg U.S. Aggregate Bond ETF down another 4.7%, and now down 10.2% year to date. The 7-10 Year Treasury ETF was down 4.5%, but high yield bonds experienced steeper declines of 9.5%, as credit stresses and recession fears exploded.
- MultiStrategy now devotes 2/3 of its fixed income exposure to the Navigator® Tactical Fixed Income Fund (NTBIX) and 1/3 toward the Navigator® Tactical Investment Grade Bond Fund (NTIIX). Our tactical investment grade bond position took a defensive stance during the quarter, avoiding investment grade corporates and favoring cash and Treasuries. Our Treasury positions never developed momentum and reversed, producing losses. Despite these losses, by avoiding the worst of the pain in investment grades, we were able to outperform the Bloomberg Barclays U.S. Aggregate Corporate Index, an investment grade corporate bond Index on the quarter. NTBIX, our tactical high yield strategy, was defensive in April and May, but a late May rally drove us back into high yield. Unfortunately, high yield quickly reversed, and after the June CPI report, markets catapulted lower. After an approximately 4% loss, we were forced back to cash and the sidelines.

## Positioning and Outlook

As the second quarter began, soaring inflation and an aggressively hawkish Fed influenced the equity style boxes and factors that we track within the portfolio. For years, mega-cap growth stocks were big beneficiaries of quantitative easing and persistently low interest rates. However, the tide has turned, and we perceive that the long duration and speculative assets, with their long-dated and less certain cash flows, stand to lose the most value during a Fed hiking cycle.

For most of 2022, our models have steadfastly kept us away from growth and pointed us towards large-caps and value, which tend to benefit during periods of rising rates. As the quarter began, the equity portion of MultiStrategy favored large-cap value stocks, and quickly as the quarter progressed, our models moved us into high dividend and minimum volatility ETFs. Through May many of these trends persisted, and the Energy and Materials sectors powered higher, driving value factor performance. When the June CPI number surprised everyone to the upside, the Fed was forced to deliver a dramatic 75 basis points rate hike on June 15th. Thereafter, equity markets and credit spreads cracked lower.

Within the factor environment, we saw a classic buy the rumor and sell the news situation. 10-year Treasury yields had hit nearly 3.5%, but the Fed's hawkish tone instead stirred recession fears, flipping the 10-year yield to below 3.0% by the end of the quarter. Energy and Materials cracked on a price and relative basis after a spectacular first five months of the year. With rate hikes stalled at least temporarily, growth stocks found some stability. As the decline accelerated, we moved more into the S&P 500 Index, a tactic we often employ after a major decline in an effort to increase beta, to become neutral with regard to value vs. growth, and to not avoid becoming too defensive at a market bottom. This year, the losses in the S&P 500 itself became so great that we instituted a tax loss sale of the S&P 500 ETF, moving instead into U.S. broad market ETF.

After so much pain to start the year for stocks and bonds, we believe investors should be reassured that since World War II, after stocks have declined by more than 15% in one quarter, in 100% of the cases stocks have been positive two quarters later, with an average gain of 15.1%. Many indicators point towards a bear market bottom being close, including extreme investor pessimism. Investor pessimisim is more extreme than lows in 2016, 2018, and near lows of 2011 and 2020. Technicals have become oversold, and valuations have come in dramatically, but the overvaluation in 2021 was so extreme that this year's decline has only brought us back to just above multi-decade averages.

Our asset allocation and individual equity teams have noted one major disconnect that needs to be resolved. While we have seen extreme macroeconomic volatility, corporate fundamentals (balance sheets and earnings expectations) have been stable, but now they are expected to turn south. So, while valuations have indeed come in, the all-important "E" in P/E ratios is under fire from higher input costs, rising wages, and a slowing economy. Can markets rally in the face of expected earnings struggles? To answer that question, we prefer to first look at credit markets, which in June continued to weaken despite stabilization of stock prices. High yield bond spreads have risen to over 500 basis points, but higher levels were reached at major market lows in 2011 and 2016 – to say nothing of much higher spreads seen during the recessions of 2002, 2008, and 2020.

If the economy avoids recession, while we still expect some short-term weakness, we are not too far from an important market low. If unfortunately, a recession occurs, we believe that valuations in credit and equity point towards more potential downside. The good news is that corporate balance sheets are in much better shape than during prior instances of market stress. We believe that should limit the worst of the downside we see from here, at least on the credit side. As always, we will continue to rely on our credit-based models to determine our fixed income stance. While the third quarter may continue to bring volatility, we expect to become more bullish by the fourth quarter with regards to both equity styles and factors and bonds. In our view, valuations now present a much more enticing risk-reward picture once markets demonstrate stability, but we will wait until that time before aggressively taking on risk.

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### MultiStrategy 25-75 Top Contributors as of June 30, 2022

| Company Name | Average Weight (%) | Contribution to Return (%) |
|---|---|---|
| SPDR Portfolio S&P 500 Value ETF | 0.56 | 0.31 |
| iShares Core S&P Total U.S. Stock Market ETF | 2.38 | 0.30 |
| iShares Core High Dividend ETF | 0.54 | -0.15 |

### MultiStrategy 25-75 Top Detractors as of June 30, 2022

| Company Name | Average Weight (%) | Contribution to Return (%) |
|---|---|---|
| Navigator Tactical Fixed Income Fund Class I | 49.21 | -3.00 |
| iShares Core S&P 500 ETF | 7.64 | -2.19 |
| Navigator Tactical Investment Grade Bond Fund - Class I | 24.17 | -1.30 |

*Source: Factset. For illustrative purposes only. Past performance does not guarantee future results. The holdings identified do not represent all of the securities purchased, sold or recommended for advisory clients. In the chart above, "weight" is the average percentage weight of the holding during the period, and "contribution" is the contribution to overall performance during the period. To obtain the calculation methodology and a list showing every holding's contribution to the overall composite during the period, contact: PortfolioAnalytics@ccmg.com.*

### MultiStrategy 50-50 Top Contributors as of June 30, 2022

| Company Name | Average Weight (%) | Contribution to Return (%) |
|---|---|---|
| SPDR Portfolio S&P 500 Value ETF | 1.21 | 0.67 |
| iShares Core S&P Total U.S. Stock Market ETF | 4.51 | 0.50 |
| SPDR S&P 400 Mid Cap Value ETF | 1.08 | -0.28 |

### MultiStrategy 50-50 Top Detractors as of June 30, 2022

| Company Name | Average Weight (%) | Contribution to Return (%) |
|---|---|---|
| iShares Core S&P 500 ETF | 14.21 | -4.09 |
| Schwab Fundamental US Large Co. Index ETF | 12.71 | -2.08 |
| Navigator Tactical Fixed Income Fund Class I | 32.27 | -1.95 |

*Source: Factset. For illustrative purposes only. Past performance does not guarantee future results. The holdings identified do not represent all of the securities purchased, sold or recommended for advisory clients. In the chart above, "weight" is the average percentage weight of the holding during the period, and "contribution" is the contribution to overall performance during the period. To obtain the calculation methodology and a list showing every holding's contribution to the overall composite during the period, contact: PortfolioAnalytics@ccmg.com.*

### MultiStrategy 75-25 Top Contributors as of June 30, 2022

| Company Name | Average Weight (%) | Contribution to Return (%) |
|---|---|---|
| SPDR Portfolio S&P 500 Value ETF | 1.85 | 1.02 |
| iShares Core S&P Total U.S. Stock Market ETF | 6.63 | 0.68 |
| Navigator Tactical Investment Grade Bond Fund - Class I | 7.62 | -0.40 |

### MultiStrategy 75-25 Top Detractors as of June 30, 2022

| Company Name | Average Weight (%) | Contribution to Return (%) |
|---|---|---|
| iShares Core S&P 500 ETF | 20.78 | -5.96 |
| Schwab Fundamental US Large Co. Index ETF | 19.60 | -3.22 |
| iShares S&P 500 Growth ETF | 5.01 | -1.76 |

*Source: Factset. For illustrative purposes only. Past performance does not guarantee future results. The holdings identified do not represent all of the securities purchased, sold or recommended for advisory clients. In the chart above, "weight" is the average percentage weight of the holding during the period, and "contribution" is the contribution to overall performance during the period. To obtain the calculation methodology and a list showing every holding's contribution to the overall composite during the period, contact: PortfolioAnalytics@ccmg.com.*

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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.

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 SmallCap 600® seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable.

The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollardenominated, fixed-rate taxable bond market.

The S&P 500 Value measures value stocks using three factors: the ratios of book value, earnings, and sales to price.
The S&P 500 Growth Index is a stock index administered by Standard & Poor's-Dow Jones Indices.

The 10-year Treasury note is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.

The 2 Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 2 years.
The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The price-to-earnings ratio is the ratio for valuing a company that measures its current share price relative to its earnings per share (EPS). The price-to-earnings ratio is also sometimes known as the price multiple or the earnings multiple.

The "Consumer Price Index for All Urban Consumers: All Items Less Food & Energy" is an aggregate of prices paid by urban consumers for a typical basket of goods, excluding food and energy.

Investing involves risk, including loss of principal.

Real average hourly earnings for all employees are calculated as follows: Real aggregate weekly payrolls of all employees divided by aggregate weekly hours of all employees.

The securities of mid-cap companies may be subject to more abrupt or erratic market movements and may have lower trading volumes.

One of the most effective smart beta strategies for achieving a reduction of risk are known as 'minimum volatility' strategies, which are specifically designed with this goal in mind, seeking to deliver market-like returns with less volatility by targeting lower volatility stocks.

Minimum volatility ETFs (commonly referred to as "min vol" ETFs) attempt to reduce exposure to stock market volatility. Min vol ETFs do not ensure against losses.

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