Portfolio Commentary

Navigator® Taxable Fixed Income

Portfolio Manager

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Navigating Rising Rates and Inflation

Market Review

The Federal Reserve continued to ramp up the aggressiveness in their battle to reduce inflation during the second quarter. They hiked rates twice, including a 75 basis point hike in June. They also began quantitative tightening and started to let their balance sheet mature off.

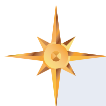
At the end of the first quarter, the market implied that the Fed Funds rate at the end of the year would be 2.395%. By the end of the second quarter, that number had jumped to 3.375%. In other words, over the course of one quarter, almost an additional 100 basis points of hikes were priced into the market. The driving factor in the aggressiveness was the continued high level of inflation, with The Consumer Price Index (CPI) coming in at 8.6% for May. This led to a very volatile market and the worst performing half in more than 40 years.

During the quarter, Treasury yields rose by approximately 65 basis points across the curve, closing at 2.95% on the 2-year and 3.01% on the 10-year. The 2-year briefly touched 3.43%, which was the highest since 2007. This interest rate move was the main driver of the Bloomberg Barclays U.S. Aggregate Bond Index returning -4.69%, while the Bloomberg Barclays Intermediate Corporate Index returned -3.92%. Overall, spreads on corporate bonds also widened with the Option-Adjusted Spread (OAS) on the index moving from 116 basis points to 155 basis points. This was reflective of the growing concern in the market that the odds of a recession had risen significantly during the quarter.

First Quarter Performance Highlights

- Duration in the portfolio remained less than the benchmark at approximately 4 years. The volatility in the market resulted in most companies slowing the pace of new debt issuance and calling old bonds, which was a reversal from the last few years.
- While credit fundamentals and company balance sheets continued to stay strong, there were some cracks that started to show, especially among large retailers that had inventory issues and missed earnings.
- The best performing sector from a total return basis was Technology, which was led by higher quality, lower beta companies. REITs were the worst performing sector, as the uncertainty around all real estate grew throughout the quarter.
- Industrials added the most value to the portfolio as the higher quality, shorter duration trade in the sector proved beneficial. Overall, the best performing holding in the portfolio was once again a bank, as the front end overweight in the portfolio helped to offset the impact from higher yields.
- A semiconductor company was the largest detractor from the portfolio; most semiconductor names turned negative as a growth slowdown and potential recession began to be priced into the market.

Past performance is not indicative of future results.
This is not a recommendation to buy or sell a particular security. Please see attached disclosures.



Positioning and Outlook

The portfolio continued to be upgraded from a credit quality perspective during the quarter. The portion of the portfolio invested in high yield was reduced, mainly by selling some of the lower quality home builders. As rates rise and the economy slows, this is a sector that could be hit especially hard. We will continue to reduce this position and only hold what we believe are the best names in the sector. The other addition to the portfolio, early in the quarter, was Energy, to take advantage of rising oil prices. During the quarter, Treasuries were also added to the portfolio to help hedge against credit spread widening while keeping duration at the desired level.

Along the yield curve, the portfolio continued to buy higher yielding short paper (1-3 year maturity) while also buying higher quality longer paper (7-10 year maturity). We continue to believe that rates will not move significantly higher and will invert more as the year progresses.

As the Fed attempts to tame inflation, risks remain that they will go too far and slow the economy more than expected. Moving the portfolio into what we believe are more liquid, higher quality bonds should, in our opinion, enable it to navigate these markets and continue to outperform the index going forward.

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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.

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).

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 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.

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 option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option. Typically, an analyst uses Treasury yields for the risk-free rate.

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 10-Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 10 years.

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.

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