Portfolio Commentary

Navigator® Fixed Income Total Return

Portfolio Manager

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Crisis Averted or Prelude to More Turmoil?

Market Review

It was an eventful first quarter with additional Fed rate hikes, inflation still higher than desirable but declining, questions about the health of the economy, and a banking crisis that threatened to roil the markets. The first quarter news flow spanned the gamut of emotions.

The year started with consensus among economists that a recession was imminent. After better-than-expected economic reports, the narrative shifted to a soft landing and higher-for-longer Fed policy. Then it shifted again in March following the second and third largest bank failures in U.S. history. Through it all, the markets have been very strong.

Unlike last year, both stocks and bonds are up on the year. During the first quarter, U.S. and broad international stock indices performed in line with each other. Growth outperformed value by over 1300 basis points, and Treasuries, high yield, investment grade corporate, and municipal bonds all posted gains. For the quarter, the S&P 500 gained 7.48%, the Russell 2000 advanced 2.73%, and the MSCI ACWI ex-US gained 6.87%. Gains were also posted in fixed income with the Bloomberg Barclays High Yield Index up 3.57%, the Aggregate Bond Index 2.96%, and the 7-10 Year Treasury Index higher by 3.53%.

The Federal Reserve hiked rates twice in the first quarter, extending the most aggressive hiking cycle in over 40 years, lifting the fed funds target range to 4.75% - 5.0%. As expected, with aggressive hiking cycles, the rate hikes have caused stresses in the system. This time, in the form of a banking crisis.

Ironically, in the aftermath of the 2008 Global Financial Crisis, authorities regulated the amount of credit risk that banks can take. Credit was not the straw that broke the camel's back this time around. Too much duration risk and bad risk management at troubled banks caused the problem this time as the Fed hiked rates. That duration risk, which was originally the trigger, turned into a credit risk issue for several banks.

First Quarter Portfolio Highlights

The primary drivers of Fixed Income Return over time are its macro allocations that are driven by our relative strength credit risk management models. Those models dictate the strategy's allocation to high yield bonds, U.S. Treasuries, and cash equivalents.

Past performance is not indicative of future results.
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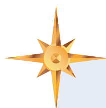

- Coming into the year, the strategy owned high yield bonds, but our models turned cautious in mid-February as interest rates moved higher. Between late February and mid-March, the strategy was maximally defensive in cash equivalents. However, by mid-March U.S. Treasury relative strength moved the strategy into U.S. Treasuries, where it ended the first quarter. Since exiting high yield bonds, we have seen very modest spread widening, and noticeably poorer liquidity after the Silicon Valley Bank failure.
- CCC and below bonds outperformed higher quality bonds for the quarter. However, all the relative outperformance occurred in January. Lower credit quality bonds underperformed in February and March.
- Fixed income volatility, measured by the ICE BofA MOVE Index, remained elevated throughout the quarter, and reached its highest level since the Global Financial Crisis in 2008.
- Yields across the U.S. Treasury curve declined during the quarter. 10-year Treasury yields declined 39 basis points. The 10-year Treasury Note ended the quarter with a 3.49% yield, down from 4.23% in October 2022.

Positioning and Outlook

Tightening cycles have been associated with a financial shock or crisis, and crisis events end after the Fed has at least paused. Ultimately, we believe the stress amongst some banks has likely led to an earlier conclusion for the Fed rate hike cycle. In our annual Market Outlook we stated, "With inflation set to continue falling, the Federal Reserve is in the late innings of rate hikes. We expect the final rate hikes to occur in Q1, then a pause." We may be at that point now, or there may be one more rate hike. We also highlighted that "bonds could easily rally before the Fed cuts, they already have done so on signs of economic slowing, which could take the 10-Year Treasury Note yield down towards 3%." We believe there will be volatility around the turmoil in the banking sector, but the end of rate hikes should be viewed positively by stocks as this headwind is removed.

Thanks to rate hikes and quantitative tightening, the Fed is draining reserves while banks are bleeding deposits. As the Fed raised rates, the opportunity cost of holding cash in banks rises for depositors. Deposits have been leaving the banking system in favor of money market funds, which pay a higher yield on cash holdings. As a result, money market fund assets have soared to $5.1 trillion, exceeding the COVID peak of $3.2 trillion. Ironically, this is aiding the Fed's objective, less deposits results in less loan growth, slower economic activity, and therefore slows down the labor market.

The S&P 500 gained over 7% in the first quarter, which bodes well for the market for the remainder of the year. When the S&P 500 gained more than 7% in the first quarter, the full year has been positive every time (16 of 16 historical cases) with an average 23.1% gain. Of course, a lot can happen given the banking crisis, Fed policy, and inflation's trajectory, but history's message is positive. In addition, in the 11 previous cases when the S&P 500 fell the previous year and rallied in the first quarter, over the last nine months of the year, the index was up every time by a median of 11.2%.

While we are optimistic, we are also aware of the many risks including the potential for a Fed policy error by overtightening into decelerating inflation and the growing potential of a recession. A new risk has emerged with the commercial real estate market. Vacant office space in the U.S. is at its highest level ever of 18.7%. No rent is being paid on about 1/5 of all U.S. office space. We believe that could be an area of additional stress across the banking sector and is something worth monitoring.

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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 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 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 US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market.

The Bloomberg 5 Year Municipal Bond Index is a capitalization weighted bond index created by Bloomberg intended to be representative of major municipal bonds of all quality ratings with an average maturity of approximately five years.

The 5 Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 5 years. The 5 Year treasury yield is used as a reference point in valuing other securities, such as corporate bonds.

The MOVE Index measures U.S. interest rate volatility. The index tracks the movement in U.S. Treasury yield volatility implied by current prices of 1-month OTC options.

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 Russell 2000 Index is a small-cap U.S. stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index.

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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