



## Portfolio Commentary

## Navigator® Taxable Fixed Income

## Portfolio Manager



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## Markets Navigate Bank Stress

## Market Review

The Federal Reserve continued to hike rates during the first quarter, raising rates a quarter point (25 basis points) in February and March. The impact of these hikes began to become more apparent as Core CPI fell to 6.0% in March, the lowest reading since September 2021. These hikes, and the market's expectations for more hikes, drove the 10-year Treasury as high as 4.06% in March. This, coupled with the 2-year Treasury moving to 5.07%, resulted in the 2/10s Treasury curve inverting by more than 100 basis points.

This steep inversion continued to put pressure on banks and the cracks began to show during March. As depositors withdrew cash from the banks to move into money market funds where they could earn 4.25-4.5%, banks were forced to sell some holdings. This stress on the banks resulted in the failure of multiple banks (Silicon Valley, Signature and Credit Suisse) during the quarter. Credit spreads for banks, especially smaller regional banks, widened, hitting multi-year highs, which forced the Federal Reserve to step in with programs to save them.

Due in large part to this stress, the market now expects the Fed to begin cutting rates in the 3rd quarter of this year. The 10-year Treasury rallied 59 basis points from its peak to close the quarter at 3.47% and the 2-year Treasury rallied 105 basis points from its peak to close at 4.03%. This quick about face sent total returns higher for the quarter with the Bloomberg Barclays US Aggregate Bond Index returning 2.96% and the Bloomberg Barclays Intermediate Corporate Index returning 2.50%. After a historically poor first 9 months of 2022, those indices have now returned 4.89% and 5.29%, respectively over the last six months.

## First Quarter Portfolio Highlights

- The duration of the portfolio remained fairly consistent throughout the quarter, staying slightly over 4 years. This kept the portfolio in line to slightly underweight the index during the quarter.
- As a result of the bank stress during the quarter, a deeper review of our holdings was undertaken and we sold bank names where we believe there was evidence of extreme credit stress. This helped to limit the impact to the portfolio from the widening of credit spreads in the Financial sector.
- The best-performing sector on a total return basis was Utilities, followed closely by the Technology sector. Once again this quarter, most of the outperformance from these sectors was due to the longer duration and higher quality in these names as rates rallied and spreads widened less than the market as a whole. The worst-performing sectors were Financials and Materials. The bank failures and stress on banks resulted in not only banks underperforming, but also other Financial sector companies like insurance companies and financial service firms.

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- Utilities and Energy added the most value as the portfolio remained overweight the Energy sector and Utilities as a defensive sector in a spread widening environment. Financials and the larger-than-average cash position were the biggest detractors during the month. The majority of this underperformance happened in the last month of the quarter, reversing the positive impact during the first month and a half.

## Positioning and Outlook

Starting the year, the main theme of the portfolio was to move more defensive and to begin shortening the duration of the portfolio as rates touched 4% and began to move higher as the Federal Reserve continued to talk of hiking rates all year. This view quickly shifted as banks began to falter and cracks began showing in the economy. The deeper review into all bank and financial holdings resulted in any names that we believe showed weakness being sold and the portfolio is now underweight and up in quality in the sector.

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This up in quality trend remains in place across all sectors in the longer end of the credit curve (7 to 10-years to maturity). On the shorter end of the credit curve (0 to 3-years), an emphasis has been placed on owning bonds inside of 1 year to maturity coupled with owning bonds that have 3 years to maturity in an attempt to maximize yield and take advantage of the extreme inversion between 1-year and 2-year Treasuries (56 basis points at quarter end).

The portfolio is currently positioned to maximize yield and income in the front end while still owning what we believe are high quality names in the longer end to ensure that positive total return can be captured with any further rally in interest rates while limiting the impact on credit spreads from a weakening economy.

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.

The Core Consumer Price Index (CPI) measures the changes in the price of goods and services, excluding food and energy. The CPI measures price change from the perspective of the consumer. It is a key way to measure changes in purchasing trends and inflation.

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 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 2 year treasury yield is included on the shorter end of the yield curve and is important when looking at the overall US economy.

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.

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