



Portfolio Commentary

Navigator® Taxable Fixed Income

Portfolio Manager

**Oliver Chambers**

*SVP, Head of Fixed Income SMA,
Senior Portfolio Manager*

Rate Cut Narrative on Pause

Market Review

The Federal Reserve remained paused throughout the first quarter and the market continued to reduce rate cut expectations. The market now has a little under three cuts priced in for 2024, which is down from just over six cuts at the end of 2023. Core PCE, the Fed's preferred inflation measure, continued to inch down towards its target level, and closed the quarter at 2.8%.

While this was welcome news, continued low unemployment, high wage inflation, and higher than expected GDP, gave the Fed reasons to pause the rate cut narrative. These lowered expectations were reflected in the rates market with the 10-year Treasury moving up 32 basis points (bps) to close the quarter at 4.20% while the 2-year Treasury also moved 32bps, ending the quarter at 4.62%.

The strong economy and earnings helped drive credit spreads lower in the first quarter. The Bloomberg Barclays Intermediate US Corporate Bond Index saw option adjusted spreads (OAS) fall 10 basis points as the default risk throughout the market lowered. Overall, this move in credit spreads helped to override the negative move in interest rates. While the broad fixed income market exhibited negative returns for the quarter (-0.78% for the Bloomberg Barclays Aggregate), the intermediate portion of the curve outperformed with positive returns (0.26% for the Bloomberg Barclays Intermediate Corporate Index). This was a continuation of outperformance for this portion of the market over the last 18 months with a 10.50% return over that timeframe.

First Quarter Portfolio Highlights

- Duration remained slightly below four years and was in line with previous quarters. The move in interest rates resulted in yield-to-worst increasing to 5.24% at quarter end, which was slightly above the index.
- The best performing sectors for the quarter on a total return basis were the Energy and Financials sectors. Financials were bolstered by banks as the performance rebound from the regional banking crisis in 2023 continued. Banks began the year trading cheaply versus other industrial names and have now reversed most of the underperformance from 2023. The worst performing sectors were Consumer Staples and Communications Services (media and entertainment). The continued cord cutting by consumers kept pressure on these media companies to recreate themselves and consolidate going forward.
- The Energy sector added the most value to the portfolio during the quarter. The portfolio was overweight the index during the quarter in Energy and carried a slightly shorter duration. This allowed the portfolio to reap the benefits of spread tightening without the interest rate move impacting performance significantly. Communications Services (media and entertainment) detracted from the portfolio as positioning in that sector was slightly longer and slightly down in credit versus the index.

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Positioning and Outlook

The main themes of the portfolio remained constant since the end of last year. The portfolio maintains an overweight position in the shorter end of the interest rate curve (0-3 years) and also added increased exposure to credit risk within this segment. This strategy aims to take advantage of the higher yields and lower overall default risk, which is relatively low in the current economy.

As bonds within this portion of the curve mature, the proceeds will be reinvested either in 3-year bonds or, if the Federal Reserve has initiated rate cuts, in 10-year bonds. This approach helps ensure that the portfolio maintains its current barbell structure, with overweight allocations in both the 0-3 years and 7-10 years segments. By adopting this barbell strategy, the portfolio can benefit from the higher short-term yields while also positioning itself for potentially lower long-term rates over the coming year.

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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 Personal consumption expenditures (PCE) is the primary measure of consumer spending on goods and services in the U.S. economy.

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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