

Intermediate & Core Fixed Income Commentary

4th Quarter 2022

Economic Overview & Interest Rate Outlook

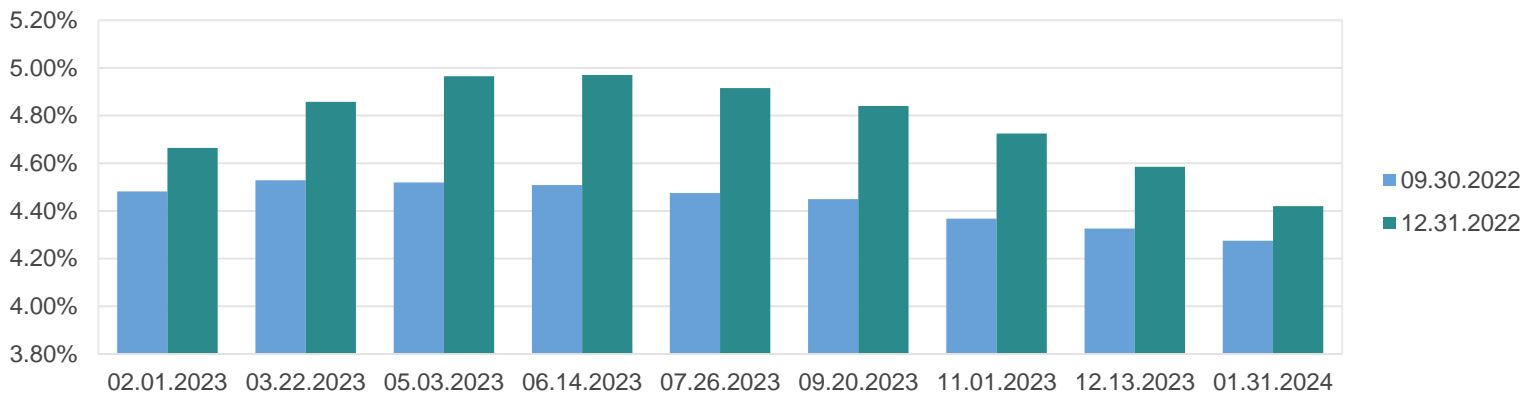
The markets staged a rally in the fourth quarter as incoming inflationary data showed some signs of slowing. The headline Consumer Price Index (CPI) decelerated to a still-elevated 7.1% on a year-over-year basis in November, while core CPI fell to 6.0% year-over-year, both slightly better than expected. However, the core Personal Consumption Expenditure (PCE) Index still registered a robust 4.7% year-over-year increase in November. The labor market continued to show strength with the unemployment rate at 3.5% in December still near a 50-year low. Additionally, labor costs continued to defy expectations, as average hourly earnings grew 5.1% on a year-over-year basis in September but slowed to 4.6% in December.

The Federal Reserve (Fed), as expected, raised rates by another 50 basis points (bps) on December 14 at their final meeting of 2022. While this was a reduction in magnitude after four consecutive 75-bp hikes, it still represented a meaningful move and left the fed funds rate in a range of 4.25-4.50%. Chair Powell reiterated the need to bring inflation down to 2.0% and stressed more work was needed on this front. He also acknowledged the danger in prematurely loosening policy and pledged to “stay the course until the job is done.”

The Federal Open Market Committee (FOMC) also released its quarterly Summary of Economic Projections (SEP). Of note, the FOMC increased its estimate of the unemployment rate to 4.60% for 2023 and lowered real growth to 0.50%. Importantly, the FOMC expects inflation to remain elevated in 2023 with the median projection for core PCE, the Fed’s preferred inflation gauge, at a still stubbornly high 3.50% rate in 2023 and only falling to 2.50% in 2024, both well above the 2.0% target.

The market clung to any news of inflation slowing and subsequently posted positive returns for the quarter. Interest rate markets responded positively to the improvement in the inflation picture and slower pace of rate hikes. After rising in October and early November to a nearly 15-year high of 4.72%, two-year Treasury yields finally began to fall, closing the quarter at 4.43%. U.S. Treasury yields on the front end of the curve spiked during the quarter, with the 6-month rate up over 100 bps. Three- and five-year yields fell slightly this quarter while yields less than one year rose again, further inverting the front end of the yield curve. Rates were relatively flat on the longer end of the curve, with the 10-year Treasury yielding 3.87%. The Bloomberg U.S. Aggregate Bond Index was up 1.87%, leaving full-year 2022 still down significantly at -13.01%. Corporate credit was the biggest beneficiary, up 3.63% for the quarter, but still a detractor for full-year performance, down 15.76%.

Fed Funds Futures - Implied Rate of Hikes



Yields are subject to market conditions and are therefore expected to fluctuate. All data referenced herein is as of 12.31.2022 unless otherwise noted. Data sources: Bloomberg L.P.; Factset. Chart source: Bloomberg L.P.



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Our View:

While signs of an economic slowdown have driven yields lower based on less aggressive Fed policy, we believe this optimism is now overstated. Wage inflation remains very sticky, and while inflation is slowing, we expect it to remain well above the Fed's target level for quite some time. We expect the Fed to raise rates early in 2023 to at least the 5.0% level. More importantly, we believe a pivot, or a cut in rates, is being priced too aggressively by the markets. The Fed's SEP released in December showed an average terminal rate for fed funds of 5.10%. Additionally, none of the FOMC members expected a cut in 2023. Conversely, the bond market is now pricing in cuts beginning in the second half of 2023. The Fed has continually pushed back on market expectations, stating that they will hold rates higher for longer. We believe sentiment has swung too far during the quarter, and a repricing will occur. This should pressure rates markets and risk assets.

We have once again lowered our growth expectations and now expect 2022 GDP growth of 0.0-0.5%, with risks skewed to the downside due to persistent inflation and increased geopolitical instability. We expect rates to remain range-bound but with increased volatility, as the market focuses on data that may indicate a pause in Fed hikes. However, we expect short-term rates to remain elevated, keeping the yield curve inverted in 2023.

Given the recent rally in risk assets, we believe recession risk is not being fully reflected in pricing. In this environment, our risk-off posture remains intact. We continue to reduce risk by selling into corporate credit strength. We prefer higher quality names and are focused on companies with stronger balance sheets to help weather a potential recession. We will look to tactically add to risk exposure in 2023 if spreads widen. We maintain our short duration bias, as we expect the Fed to keep rates higher for longer and a pivot in the direction of policy is still premature. However, for longer-term mandates, we recently reduced our underweight slightly by adding to the back end of the yield curve.

Sector Performance & Exposure

Credit

Corporate credit staged a partial recovery in the fourth quarter, despite facing continued rate hikes from the Fed and other central banks around the world. The option-adjusted spread on the Bloomberg U.S. Corporate Index tightened by 29 bps during the quarter, while the Bloomberg U.S. High Yield Corporate Index OAS tightened by 83 bps. Excess returns relative to duration-matched Treasuries for the investment grade and high yield indices were 2.89% and 3.05%, respectively. Relative Treasury yield stability also supported the asset class, with total returns of 3.63% and 4.17% for investment grade and high yield, respectively. Investment-grade spreads ended the year at 130 bps, 34 bps wider on the year, while high yield spreads widened by 185 bps to 469 bps. Technical conditions for investment grade were mixed during the quarter as the asset class saw outflows of ~\$43B, which was offset by lower primary market issuance of \$223B. Year-to-date primary market volume in investment grade ended the year down approximately 16% compared to 2021. While high yield spreads remained only slightly above the long-term average, the slowing in Fed rate hikes and high all-in yields in the mid-8% range encouraged an improvement in money flows in the fourth quarter, and the asset class took in ~\$13B during the period. Continuing a theme we have seen all year, high yield primary market issuance remained anemic, totaling just over \$15B and taking year-to-date issuance to only \$101.8B, down approximately 68% year-on-year.

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Corporate Bond Option-Adjusted Spreads (OAS)



Fundamentals for U.S. corporate issuers showed modest deterioration compared to peak levels in the quarter. Based on third quarter earnings results, EBITDA margins decreased by 0.3% compared to the previous quarter and by 0.9% year-over-year to 28.2%, while interest coverage deteriorated by 0.2 times to 15.1x. Net leverage improved slightly, by 0.1 times to 2.9x, with the largest decreases in transportation (-0.4x) and communications (-0.4x), with capital goods showing the largest increase (+0.1x). Overall, corporate credit metrics are now slightly weaker than longer-term averages. The pace of credit rating upgrades also appears to be waning as companies face higher costs and lower margins. So far, this trend is most apparent in the leveraged loan market where downgrades have exceeded upgrades for the past several months. In high yield, downgrades also exceeded upgrades in October and November this year, the first time this has occurred since late 2020. In November, S&P updated its default rate expectation for the next 12 months, which now calls for U.S. defaults to increase to 3.75% in its baseline scenario from its 2022 forecast of 1.6%. The agency expects higher interest rates and costs to push the default rate to the highest since June 2021 and above the ten-year average of 3.1%. In a downside scenario involving a deeper recession, S&P expects 6% of issuers to default. In December, Moody's also raised its global default rate forecast from 4.5% to 4.9% compared to a forecast of 2.9% at the end of 2022. Defaults could almost quadruple in Moody's most pessimistic scenario with risks to the baseline outlook including the effects of the Russia/Ukraine conflict, the slow-down in China's economy, and the impact of ongoing monetary tightening around the world.

Our View:

Our outlook for credit remains cautious given credit spreads in both investment-grade and high yield trade only slightly above long-term averages amid a deteriorating economic backdrop. We have continued to use rallies in credit spreads to cut exposure this quarter and we expect wider spreads over the intermediate term, as the lagged impact of monetary policy tightening ultimately leads to a recession in the U.S. With no industries yet showing any material signs of credit stress, we expect weakness in credit spreads to remain broad-based. While credit fundamentals have deteriorated slightly from the peak, they have done so from relatively strong levels. This and the cushion provided by high all-in yields should prevent credit spreads from approaching levels seen in previous recessions including the Great Financial Crisis of 2007-2008 and those seen during the pandemic. We would look to add back to our exposure in corporates once we feel credit spreads reflect a higher risk of recession. Our stance would change if we believed a shift in monetary policy was likely, either due to a substantial drop in inflation or extreme economic weakness, although we don't foresee either scenario in the short term.

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Securitized Products

Agency mortgage-backed securities (MBS) rebounded in the fourth quarter as investors returned in force following two months of better-than-expected inflation prints and a long-awaited downshift in the size of the Fed's interest rate hikes in December. The sector finished the quarter with excess returns of 1.06% relative to duration-matched Treasuries. Option-adjusted spreads, which peaked just under 90 bps in October, tightened back significantly to finish the quarter at 51 bps. Despite mortgage rates retreating from peak levels touched early in the quarter, average mortgage rates remained above six percent and MBS prepayment activity continued to decline as the Mortgage Bankers Association Refinance Index hit a 20-year low and helped to create a positive technical backdrop for MBS as supply remained low.

After outperforming other risk assets through the first three quarters of the year, asset-backed securities (ABS) significantly underperformed Treasuries in October, posting a -0.72% excess return for that month, representing the worst month since the Great Financial Crisis, barring the early pandemic underperformance of March 2020. Despite a strong rally in December, the sector still trailed Treasuries by 0.20% for the quarter. Spreads widened and liquidity diminished amid concerns regarding consumer credit performance as the FOMC continued to increase rates, a lack of demand from dealers or end accounts, and a decent slate of new issuance. As a result, relative value versus corporates stretched to the point that investors started to take notice and increased demand for ABS in December, just as new issue volume dried up and the lack of dealer inventories meant spreads could gap tighter into the end of the year. ABS closed 2022 down versus Treasuries, a rarity for the sector which last happened in during the Great Financial Crisis.

Non-agency commercial mortgage-backed securities (CMBS) underperformed duration-matched Treasuries by 0.3% for the quarter, despite a favorable technical backdrop with new issuance down more than 80% from the same period as last year. The underperformance was particularly notable as competing products, namely corporate bonds, staged an impressive rebound. We attribute the poor performance to more investors became cautious on the commercial real estate outlook as statistics started to show weakness and negative media coverage amplified the weakness. Additionally, the Trepp CMBS delinquency rate moved to 3.04% in December from 2.92% three months ago. Real Capital Analytics' Commercial Property Price Index fell 1.0% in November from three months ago, although it was still up by 4.9% over the last 12 months. Liquidity during the fourth quarter became challenged as increased volatility added to investor angst. In this environment our up-in-quality bias helped us weather the turbulence as high quality CMBS outperformed within the sector.

Our View:

We continued to add exposure to agency MBS during the quarter, particularly in October when valuations were historically wide. Our focus remained biased toward middle-to-higher coupon 30-year MBS, which offered a nice balance of attractive yields and limited optionality. Given the sharp outperformance of MBS in the final two months of the year, we think valuations are now back toward more normalized, fair levels and we expect to see more balanced trading going forward. Volatility should remain elevated as investors sell on further strengthening but add on any material weakness.

Despite the year-end rally, ABS still look attractive relative to corporate bonds, though not as attractive as high-quality CMBS. We expect underlying loan fundamentals to deteriorate as the economy slows and perhaps enters recession next year. However, we believe highly-rated ABS will prove sufficiently insulated from the fundamental downturn and can tighten versus Treasuries next year.



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We should see an overall lower level of issuance in 2023 given the less attractive financing for securitized issuers and lower expected level of consumer borrowing as the economy slows. Buying opportunities should emerge during the year as market technicals push spreads wider during periods of particularly heavy new issuance.

We believe high-quality short-duration CMBS are attractive at current levels. Their price volatility should be relatively low given their duration profile, and they are well-protected from a mild commercial real estate downturn, which we think is the most likely scenario, except for office properties. The office sector is facing tough headwinds as layoffs rise and the hybrid work-from-home model is stickier than expected. However, we are cognizant of the liquidity challenge the sector faces during market volatility, and thus we remain prudent in adding to our high-quality short-duration CMBS exposures.

Government-Related

The fourth quarter witnessed a sharp reversal in the relative performance of the government-related sector versus duration-matched Treasuries. Excess returns for the sector were 1.01% above duration-matched Treasuries. Given the risk-on backdrop, performance was driven primarily by the 4.98% and 1.05% excess returns of the sovereign and local authority sub-sectors, respectively. This late-inning rally saved the year-to-date performance of sovereigns and allowed them to strike the group's only positive excess return versus duration-matched Treasuries of 0.68% in 2022 despite a myriad of pitfalls. A dearth of issuance remained a consistent theme for the sector throughout 2022 and undoubtedly helped contain how much underperformance the group experienced. The impact of this theme is highlighted by the duration for the government-related basket falling from 6.05 at the beginning of 2022 to 5.17 by the end.

Our View:

The local authority sub-sector remains our primary exposure to the basket and will continue to receive an allocation as we move into 2023. Municipal issuers are fundamentally well-positioned to face the economic slowdown we expect to materialize over the next few quarters. The National Association of State Budget Officers Fall 2022 Fiscal Survey of States indicated that 49 out of 50 states reported that revenue collections exceeded budget projections in fiscal 2022, leading to the highest median rainy-day fund balance in the history of the report going back to 1988 (approximately 12% of expenditures). From a technical standpoint, supply should remain muted again in 2023. Refinitiv reported that taxable municipal bond issuance fell 56.4% year-over-year in 2023, and we do not forecast a meaningful spike back to previous levels in the near term. Contradicting the performance seen in 4Q22 in the sovereign sub-sector, we do not believe any meaningful fundamental progress was made to justify the move. Sovereign issuance was virtually non-existent in 2022 for all the wrong reasons, but ultimately was a primary driver of performance. According to data compiled by Bank of America, emerging market external debt saw a negative \$230B net issuance total in 2022, the worst year on record. While being frozen from issuing in 2022, we do not think the space will have the luxury of sitting out another year and therefore supply should pick up meaningfully as issuers are forced to tap the primary market. The U.S. agency and supranational sub-sector's solid credit ratings are attractive given our economic projections. Ultimately the yield pick-up is just not high enough to justify giving up the liquidity of Treasuries to make a major allocation to the space, but we continue to look for tactical trades when valuations and situations present themselves.



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Index Data as of 12.31.2022	3-Month Total Return	12-Month Total Return	3-Month Excess Return to Treasuries ²	12-Month Excess Return to Treasuries ²
Bloomberg U.S. Aggregate Bond Index	1.87%	-13.01%	1.00%	-14.31%
Bloomberg Intermediate Govt-Credit Index	1.54%	-8.23%	0.67%	-9.53%
ICE BofA 1-10 Year Municipal Index ¹	2.83%	-4.63%	1.97%	-5.92%
Bloomberg U.S. Treasury Index	0.87%	1.30%	0.00%	0.00%
Bloomberg U.S. Agency Index	0.70%	-7.87%	-0.17%	-9.17%
Bloomberg U.S. Government-Related Index	1.86%	-11.09%	1.00%	-12.38%
Bloomberg U.S. MBS Index	2.14%	-11.81%	1.27%	-13.11%
Bloomberg Non-Agency Investment Grade CMBS	0.67%	-10.75%	-0.19%	-12.05%
Bloomberg U.S. ABS Index	0.81%	-4.30%	-0.06%	-5.59%
Bloomberg U.S. Corporate Investment Grade Index	3.63%	-15.76%	2.77%	-17.06%
Bloomberg U.S. Corporate High Yield	4.17%	-11.19%	3.30%	-12.48%

Data is as of 12.31.2022. Sources: Bloomberg L.P., ICE BofA. ¹Municipal index returns are not tax-adjusted. Excess returns are in excess of the Aaa (Govt.) Municipal Yield. ²Excess returns to Treasuries are Treasury duration-neutral. The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index. Past performance is not indicative of future results.



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Technical Terms & Index Definitions

Technical Terms:

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. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

The **Core Personal Consumption Expenditure (PCE) Index** is a measure of prices that people living in the United States, or those buying on their behalf, pay for goods and services.

The **coupon rate** is the amount of annual interest income paid to a bondholder, based on the face value of the bond.

The **Federal Funds Rate** refers to the interest rate that depository institutions (such as banks and credit unions) charge other depository institutions for overnight lending of capital from their reserve balances on an uncollateralized basis.

Free cash flow (FCF) measures a company's financial performance. It shows the cash that a company can produce after deducting the purchase of assets such as property, equipment, and other major investments from its operating cash flow. In other words, FCF measures a company's ability to produce what investors care most about: cash that is available for distribution in a discretionary way.

Leveraged buyout (LBO) refers one company's acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. The assets of both companies may be used as collateral in the transaction.

Net leverage (also known as net debt-to-EBITDA) measures a company's ability to pay off its liabilities. It shows how much time the company needs to operate at the current debt and EBITDA levels to pay all of its debt.

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 spread is added to the fixed-income security price to make the risk-free bond price the same as the bond.

The Real Capital Analytics' Commercial Property Price Index™ (CPPI™) measures the actual price experience of property investors, based on transaction data.

Real gross domestic product (GDP) is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year, expressed in base-year prices.

The **Trepp CMBS delinquency rate** refers to the percentage of loans within a financial institution's loan portfolio whose payments are delinquent.

Technical terms are sourced from Corporate Finance Institute, the Bureau of Economic Analysis (BEA), and MSCI.

A Note on Indices: The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

The Bloomberg U.S. Aggregate Bond Index is an unmanaged index composed of securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. It is not possible to invest in the Bloomberg U.S. Aggregate Bond Index, which is unmanaged and does not incur fees and charges.

The Bloomberg U.S. Intermediate Government/Credit Bond Index measures the performance of U.S. Dollar denominated U.S. Treasuries, government-related and investment grade U.S. corporate securities that have a remaining maturity of greater than one year and less than ten years.

The ICE BofA Merrill Lynch 1-10 Year Municipal Index is a subset of the ICE BofA U.S. Municipal Securities Index including all securities with a remaining term to final maturity less than 10 years. The ICE BofA Municipal Master Index tracks the performance of the investment-grade U.S. tax-exempt bond market.

The Bloomberg U.S. Treasury Index is made up of the public obligations of the U.S. Treasury with a remaining maturity of one year or more.

The Bloomberg U.S. Agency Index is an unmanaged index composed of publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government (such as USAID securities).

The Bloomberg U.S. Government-Related Index is an unmanaged index composed of U.S. dollar obligations meeting certain criteria issued by native and non-native agencies, Local Authorities, Sovereigns, and Supranational organizations.

The Bloomberg U.S. MBS Index tracks fixed-rate agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Bloomberg Non-Agency Investment Grade CMBS Index is an unmanaged index composed of SEC-registered Commercial Mortgage Backed Securities meeting certain criteria including being rated in the investment grade category.

The Bloomberg U.S. ABS Index is the ABS component of the U.S. Aggregate Index. It has three sub-sectors: credit and charge cards, autos, and utility. The index includes pass-through, bullet, and controlled amortization structures and includes only the senior class of each ABS issue and the ERISA-eligible B and C tranche.

The Bloomberg U.S. Corporate Investment Grade Index is an unmanaged index composed of the qualifying universe of investment grade rated taxable corporate bonds. The index includes U.S.-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers.

The Bloomberg U.S. Corporate High Yield Index is an unmanaged, U.S. dollar–denominated, nonconvertible, non-investment-grade debt index. The index consists of domestic and corporate bonds rated Ba and below with a minimum outstanding amount of \$150 million.