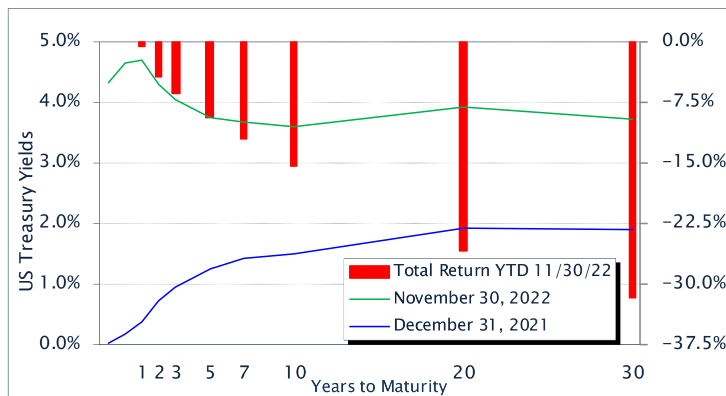
INVESTMENT UPDATE

The year's almost over—thank goodness—and as such, it's a good time to lay out what's occurred over the past few months and how that informs our outlook as we head into 2023. Let's get cracking.

First, as you are probably all too aware, 2022 will go down as the worst year ever (at least in the modern era) for high-grade bond investors, with double-digit losses for most broad bond portfolios. The reasons are equally well-established at this point: high (and potentially sticky) inflation, which impelled the Federal Reserve to move swiftly in raising interest rates in order to tamp down economic growth and ease inflationary pressures.

That summary doesn't fully describe the breadth of the damage inflicted on bond investors in 2022. Interest rates moved up rapidly in the first nine months of 2022, so rapidly, in fact, that investors earned very little income that could've helped offset the price declines that rising bond yields created. Adding insult to injury, prevailing interest rates in the post-Covid era were at rock bottom levels, leaving investors especially vulnerable to the impact of rising rates.

Investors were also caught offside by a lack of clear guidance from the Fed, which maintained, even as recently as this time last year, that only modest rate increases (75 basis points or so, as of December 2021) in the Fed funds rate would be necessary to tame inflation. With the full benefit of hindsight, bond investors were lulled into complacency after decades of low inflation, and were highly vulnerable to the hairpin U-turn in policy the Fed performed in early 2022.



The chart on this page shows the rate moves and total returns in the US Treasury market in the first eleven months of the year. Comparing the blue and green lines, we see that short Treasury rates moved from zero to more than 4% while longer rates moved up from 1.5-2.0% to 3.5-4.0%. Keep in mind that the 4% rise in short rates was more than *four times* larger than what the Fed thought it would need to do when 2022 started. The red bars, measured on the right hand scale, show just how bad Treasury returns were in the first eleven months of the year. Short-duration portfolios of two- and three-year Treasuries returned -5%, ten-year maturities returned -15%, and long duration portfolios had returns of -25% to -35% through November of 2022. Again, these numbers are unprecedented.

Is the damage over? Probably not. The Fed, after raising its overnight Fed funds rate seven times in calendar year 2022, has signaled that while it may dial back the pace and magnitude of its rate hikes, it has not finished raising rates. This is supported by the economic data, which shows that only the most interest rate-sensitive parts of the economy (e.g., housing, auto loans) are showing signs of significant slowing, as US GDP continues to grow at a decent pace, even after accounting for inflation. Likewise, our tight labor market—the primary source of wage inflation pressures—hasn't eased up, with the US unemployment rate at 3.7%, only 0.2% above the lowest levels in 50+ years. Even allowing for the fact that the Fed's tools work with significant lags, it's clear that 2022's dramatic rate hikes haven't been sufficient to cool down the US economy yet; more rate hikes will come in 2023.

The bigger question for bond investors is how much "bad news" is currently reflected in the yields available in today's bond market. Our opinion of that depends on which area of the US bond market you're looking at. We'll stick with Treasuries for the moment. Short Treasury yields are still below the Fed's projections for next year. While it's tempting to dismiss the Fed's forecast (just look at how far off their 2022 predictions were), this is the group that is responsible for carrying out the directive of bringing inflation down, and there is no indication from them that their job is nearing completion. We've seen a small decline in longer rates (in the order of 50 basis points, or 0.50%, in the past two months) as some investors are anticipating that the Fed will be done with rate hikes sooner rather than later. We're not ready to "declare victory" on that front yet. Short rates are likely to climb above 5% as the Fed slows its pace; it is not yet close to completing its rate-hiking cycle.

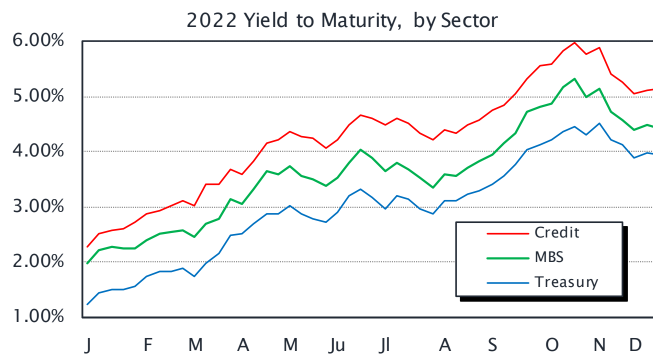
Similarly, longer rates, which are more sensitive to inflation and broader economic conditions than short rates, also continue to look vulnerable. Top line inflation has eased a bit over the past couple of months, as core CPI has dropped from a high of 6.6% in September to 6.0% in November, while the headline CPI (which includes food and energy components) has fallen even more—from a high of 9.1% in June to 7.1% in November. That's good news for the Fed, and has encouraged some investors to begin extending the average maturity and duration of their portfolios. And yet, inflation numbers of 6% (much less 7%) are still many hundreds of basis points above the Fed's 2% inflation target, reinforcing the fact that the Fed still has plenty of work to do yet.

It's also clear to see that we are much farther along the tightening cycle than we were a year ago. Yields now reflect the fact that the

Fed has pulled its big guns out and will continue to fire away until inflation is tamed. That, in itself, is encouraging to buyers of longer-maturity bonds, where there's the potential to make big gains if yields decline (and, as we've seen, suffer big losses in the other direction).

But beyond mere speculation, higher yields provide what investment Godfather Benjamin Graham called a "margin of safety." Total returns in the bond market are, ultimately, dependent on the yield on bonds, and the reinvestment of those yields. Prices move in response to changes in yield, but unless a bond defaults, or the holder is forced to sell it (due to deteriorating credit fundamentals), you will receive par value for the bond at maturity, no matter what price path that bond may take over its life. If you can buy a bond at a yield of 4% (or 5%+, in the case of non-Treasury bonds), you will earn that yield over the life of the bond.

Perhaps even more importantly, the higher bond yields available to investors today (the Bloomberg Aggregate Index's yield recently hit a 14-year high), provide an income "cushion" in case rates continue to climb and bond prices fall. As recently as a year ago, that cushion was practically non-existent, and as we've seen, provided little margin of safety against rate increases. In this higher yield environment, a modest rise in rates over the next year could be offset, at least in part, by coupon income. Without coupon income, bonds are (all things equal) a lot more vulnerable to the vicissitudes of interest rate movements.



While we're on the subject of the benefits of higher yields, we'll turn our focus to the high grade "spread sectors" in the US bond market, namely corporate credits and mortgage-backed/asset-backed securities. The corporate bond sector has performed, on average, even worse than Treasuries in 2022, as their yields rose (and prices fell) more than like-duration Treasuries this year. This makes sense, as tightening monetary policies tend to increase costs for businesses, reducing corporate profitability and squeezing free cash flow. In the first ten months of 2022, the average corporate yield spread (the difference in yield between a corporate bond and a similar maturity Treasury) widened from 90 basis points to more than 160 basis points, as investors were in no mood to take credit risk on top of the interest rate risk they had in their portfolios.

But, as is the case with the overall levels of interest rates, the wider yield spreads are for corporate bonds, the better their margin of safety in case things deteriorate. With Treasury rates in the 4.5% neighborhood and credits recently trading nearly 150 basis points higher, that 6% yield can help cushion against another big move up in rates, should that come to pass. And, as the chart on this page shows, these "all-in" yields are a significant improvement compared to those less than 12 months ago.

That margin of safety may be tested in 2023, though, particularly if the Fed is forced to keep the brakes on the economy for an extended period of time to achieve its goals. If we are indeed headed into a recession in 2023, as many believe, there will be downgrades from the ratings agencies as earnings come under pressure, particularly in economically-sensitive industries and among weaker credits. Careful security selection will be critical in a recessionary environment, and our credit team is closely following their designated industries and individual corporate credits, and will continue to recommend changes as needed, including sales of problematic credits. With all of this in mind, we have dialed back our allocation to corporate bonds since yield spreads have narrowed in recent weeks, and currently stand with a credit allocation only about 15% higher than the Aggregate Index in our Core portfolios.

Finally, the mortgage sector. Yields on US agency Mortgage Backed Securities (MBS), which includes GNMA, FNMA, and FHLMC securities, have been suppressed for years now, dating back to the global financial crisis, as MBS were included in the Fed's quantitative easing program's asset purchases. By early 2022, fully one-third of agency MBS were owned by the Fed. In the months since the buying program ended, yield spreads on MBS have widened significantly, as investors have been wary of how well all the "extra supply" would be absorbed with the Fed no longer involved.

The widening of MBS yield spreads coincided with MBS prices falling to historically low levels—another big positive for this sector. The ultra-low interest rate environment created an MBS market dominated by securities that, even more than the corporate sector, had very low (2%-3%) coupons, and even those traded at a premium to par value. From January to October of 2022, the average price of an agency MBS fell from $103 to $85. This steep discount in the average MBS price has moderated a bit (they're back to approximately $90), but remains a very attractive total return opportunity, as that ten-point discount to par provides ample headroom for MBS prices to rise in a consistent, linear path should rates eventually ease. This eliminates one of the key negatives endemic to MBS, namely, their so-called "negative convexity," which limits the upward price of MBS once they trade above par value. For more than a decade, it's been virtually impossible to find MBS with prices below 100 cents on the dollar; now they are abundant.

As a result, after years of no more than a market-neutral weight in MBS, today we have our highest allocation to the mortgage sector in recent memory. MBS are backed by the federal government, and therefore have no real credit risk, unlike even the highest rated corporate bonds—another positive for MBS should the economy tip into recession. Their yield spreads are narrower than corporates, but they are competitive with them, and have (as we've seen) plenty of upside price potential. They are our top pick for outperformance in 2023.

It's been a tough year, and we appreciate your patience and understanding. Here's to a better 2023. Happy New Year!