

Unconstrained, multi-sector focus on global risk-adjusted opportunities

Strategy overview

An unconstrained, multi-sector fixed income strategy focused on maximizing total return by seeking risk-adjusted opportunities across the globe.

Key takeaways

- Rates continued to sell-off into October as strong economic data faded hopes for a U.S. Federal Reserve “pivot”.
- In the final month of the quarter, the Fed appeared to confirm renewed market expectations that a less restrictive stance was in the near future.
- Looking forward, the outlook has improved marginally, however we still expect growth to slow below trend.

Portfolio review

For the quarter ending December 31, 2023, the Strategy underperformed the Index on a net asset value (NAV) basis. Duration and yield curve positioning depressed returns, sector allocation decisions detracted and security selection added.

Rates continued to sell-off into October as strong economic data faded hopes for a Fed “pivot”. In particular, the labor market showed significant strength, with September’s payroll data reporting an impressive pace of job gains. This was followed by the initial reading for third-quarter gross domestic product growth which exceeded already elevated expectations, coming in well above trend. By the end of October, the 10-year Treasury yield had breached 5%, a level not seen since 2007. As rates moved higher, credit spreads widened reflecting the increased risk that comes with a prolonged period of restrictive policy.

Then came November and with it, a notable turn in sentiment. Inflation data, which had already been declining for several months, continued to decline resulting in more balanced market expectations. One Fed governor even suggested the possibility of rate cuts ahead of reaching the 2% inflation target. Additionally, while payroll gains remained strong, they were more measured over the next couple of months, and September’s blockbuster gain was revised downward by a meaningful amount. As a result, rates rallied, and credit spreads tightened.

In the final month of the quarter, the Fed appeared to confirm renewed market expectations that a less restrictive stance was in the near future. The updated dot plot showed that every single participant believed the hiking cycle had concluded, and the median participant projected 75 basis points worth of cuts in 2024. This affirmation from the Fed further contributed to the tightening of credit spreads, and a fall in rates.

The experience of November and December stood out from the first 10 months of the year. Rates experienced a significant decline, and the Bloomberg US Aggregate Index rallied, resulting in a 6.82% return for the quarter, with more than 4% coming from November alone. One thing that was consistent throughout the year was that lower credit sectors produced strong excess returns however even higher quality sectors posted respectable outperformance. For example, agency mortgage-backed securities (MBS), which struggled earlier in the quarter due to inconsistent demand, rallied into falling rate volatility and ended the quarter on a high note.

Duration and yield curve positioning depressed returns, while security selection added and sector allocation detracted.

From a sector allocation perspective, the largest detractor was from investments in high yield (HY) corporates where we were underweight versus the benchmark. Our overweight to commercial mortgage-backed securities (CMBS) also detracted as commercial real estate continued to price in a recessionary outcome. Conversely, our underweight in investment grade (IG) corporates and emerging markets detracted as these sectors outperformed. Security selection contributed on net, but was mixed. Selection within emerging market corporates contributed but was offset by decisions within HY and IG. We remained roughly a tenth of a year short versus the benchmark on duration over the quarter, which detracted from performance.

Current strategy and outlook

Looking forward, the outlook has improved marginally, however we still expect growth to slow below trend. The increased cost of capital will likely curb consumption and investment, however ongoing government support measures at a global level are expected to partially offset these effects. In particular, China's growth focused investment and advanced economies efforts to enhance supply chain security are anticipated to bolster growth in the short term.

As the market focus shifts from inflation to growth concerns, duration will become an effective offset to risky asset

drawdowns. Rate volatility, though receding from recent peaks, will remain above pre-pandemic levels due to uncertainty about the timing of rate cuts and concerns about government debt levels. Elevated real rates will incent investors to increase allocations to fixed income, creating opportunities during bouts of volatility.

That said, many corners of the market appear to be priced for a soft landing. While this has become a more likely outcome, we believe the risks to this outcome materializing are being ignored. Labor markets are coming into better balance which, while good news for inflation, could cause concern among workers that a turn in the cycle is approaching. This in turn could compel workers to boost savings rates which would limit consumption and act as a challenge to growth.

With this dynamic in place, portfolios have a moderate level of risk with focus on higher quality credit, and allocations are skewed towards sectors with better relative value. For example, securitized credit markets are currently trading with wider spreads relative to comparably rated corporates bonds. Meanwhile, the dark clouds facing the sector due to concerns over CMBS appear to be fading as lower rates make refinancing existing loans less challenging. Within corporate credit, we prefer IG, however to the extent we are willing to drift into lower quality, we prefer HY over senior loans given the latter is most directly impacted by higher financing costs. Outside of credit, agency MBS remain attractive relative to Treasuries due to historically wide spreads despite minimal prepayment risk.

Disclaimers

The custom benchmark is a blend of 80% the Bloomberg US Corporate Bond 1–5 Year index and 20% the Bloomberg US High Yield index. Indexes do not reflect fees, brokerage commissions, taxes or other expenses of investing. **Investors cannot directly invest in an index.**

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The strategy employs a quantitative investment process. The process is based on a collection of proprietary computer programs, or models, that calculate expected return rankings based on variables such as earnings growth prospects, valuation, and relative strength.

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