Portfolio Managers' Quarterly

Q2 2023: Recession Probability Declines, but Risk Remains

Dear Fellow Investor:

In the second quarter of 2023, stocks led the way over bonds, as the S&P 500 rose 8.74% vs the Bloomberg Agg Bond Index' loss of -0.84% and the FTSE 10 Year US Treasury Benchmark's loss of -1.9%.

Security	April 2023	May 2023	June 2023	Q2 2023
Bloomberg Agg Bond	0.61%	-1.09%	-0.36%	-0.84%
ICE Bank of America US High Yield	0.97%	-0.95%	1.63%	1.63%
S&P 500	1.56%	0.43%	6.63%	8.74%
FTSE 10 Yr US Treasury Benchmark	0.72%	-1.46%	-1.15%	-1.90%

Source: Morningstar

In the beginning of the year, BTS saw a high probability of recession brought on by restrictive Fed policy and stubborn inflation. BTS allocated to treasuries in anticipation of a possible flight to quality trade but also hedged this view by utilizing short duration treasuries. Ultimately, the bond market began to price in higher rates in the near term, whereas risk assets began discounting lower rates 9-12 months into the future and a softer landing than originally anticipated.

BTS exited the treasury trade and made a lateral move to U.S. high yield bonds, as the high yield bond market broke out of key price resistance levels and BTS Proprietary models issued a new buy signal. The move occurred on June 15th.

Despite this move, BTS still sees considerable risk in the market, particularly if risk assets are underestimating the impact of further rate hikes later this year, as well as the time horizon for how long rates will have to be elevated in order to bring inflation back down towards the Fed's mandated goal of 2%. The reality of a mild to medium recession could still leave the door open for a flight to quality trade later this year.

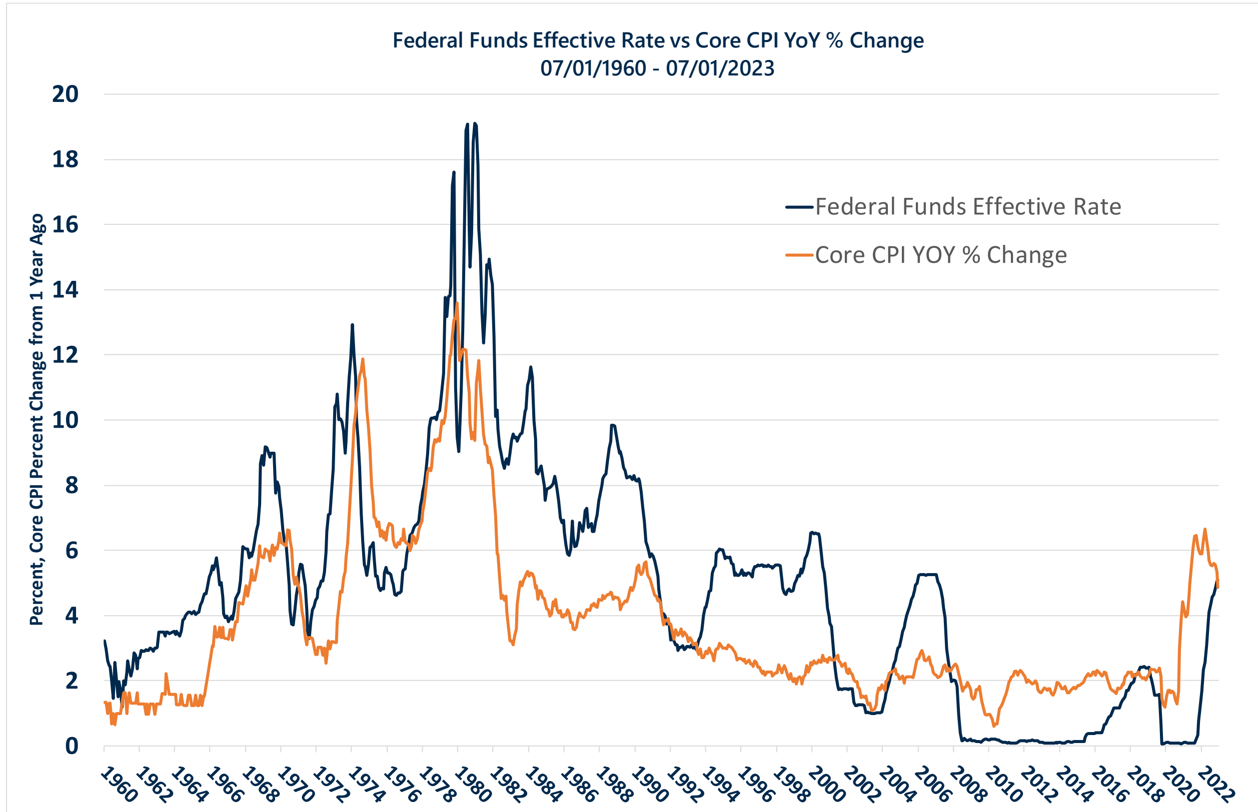
Due to these risks, BTS sees great value in Tactical Asset Allocation strategies that aim to react to price changes and allocate assets accordingly to the current market environment. Concerns remain on risk assets having extended valuations after a strong 2nd quarter and to what extent a soft landing (if a recession is avoided) would impact corporate profits moving forward.

Additionally, "in 2023, gains in the S&P 500 have been more concentrated among its largest stocks than in any six-month period since [2000]", which puts these expensive valuations on full display during the Q3 earnings season and whether such valuations are justified.[1]

Economic Considerations

The release of the June Fed minutes showed a divided vote rather than a unanimous vote to *not* raise interest rates at the June FOMC meeting. This supports our previous view that the market may be underestimating the need for further rate hikes.

Although the inflation has contracted in the last few months, the core CPI (less volatile Food and Energy components) is still running at a year-over-year rate of 4.8% from the last reading in June. One silver lining is that headline CPI that includes Food and Energy fell to 3% as of June.



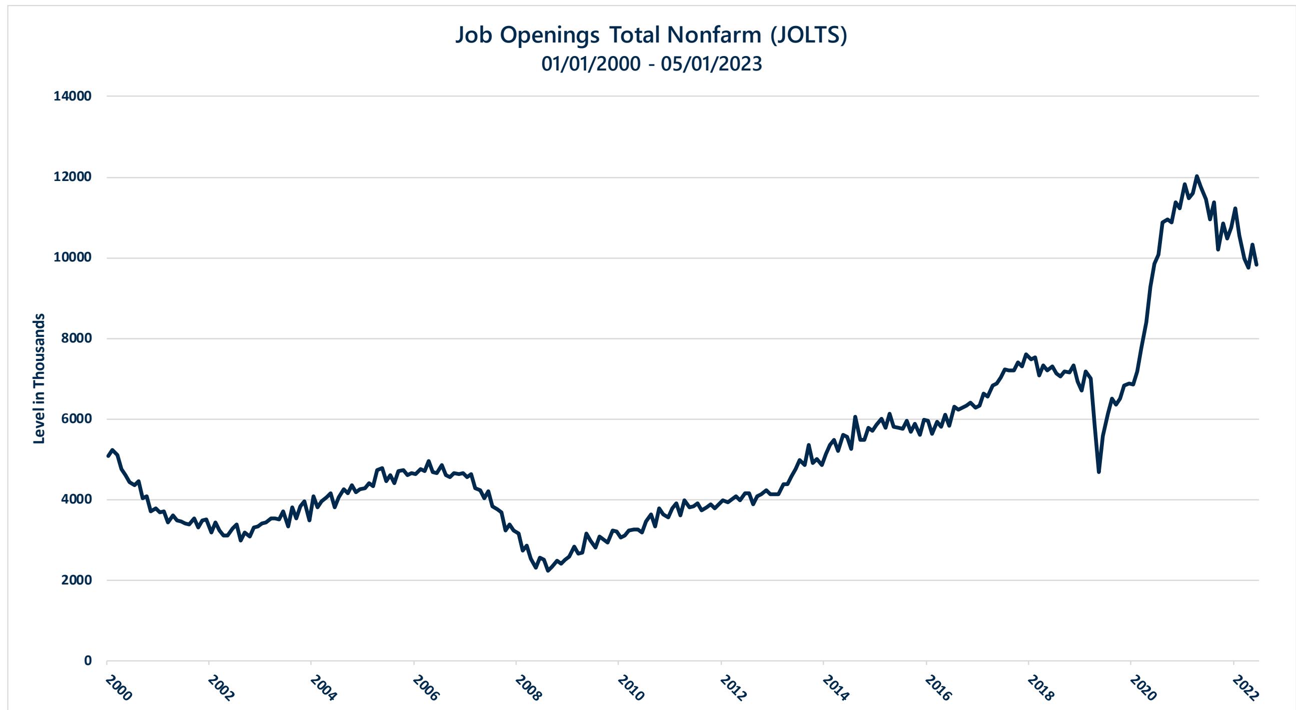
Source: Board of Governors; Atlanta Fed

The current period is most like the high inflation of the 1980s, where similar declines in inflation prompted the Fed to adjust the Federal Funds Rate. This time around, BTS believes the Fed will be less likely to repeat the mistakes of the past and only begin cutting rates once the decline in core inflation has shown enough downside momentum towards the mandated goal of 2% with confirmation from the Fed's "favorite" inflation gauge, the Personal Consumption Expenditures Core Index (PCE), which is still elevated at 4.6%, as of May.

State of the Jobs Market and Lag Effect of Rate Hikes

One impediment to the mandate is the strong jobs market, which has finally shown some signs of softening in recent months, as indicated by declining Total Nonfarm Job Openings. This serves to have two possible ramifications. On the one hand, it allows the Fed to slow its pace of rate hikes as the economy softens from the loss of jobs and inflation declines. On the other hand, it

increases the risk of a more severe recession brought on by job loss and less consumer spending, such as what occurred in 2008. It is unclear which scenario will play out.



Source: U.S. Bureau of Labor Statistics

Additionally, Fed rate hikes may have a longer time lag for their effects to be realized, which could be attributed to strong consumer balance sheets driven by wage gains, COVID-19 relief funds, home equity gains, and stock gains. Thus, consumer spending and sentiment have been harder to impact from rate hikes during this rate cycle. Eventually, effects from rate hikes may compound in short order resulting in heightened volatility.

Managing Cash and Dollar Cost Averaging into BTS Managed Income

With money market rates above 4%, many investors are enjoying returns on cash not seen since the rate hike cycles during the Dot Com bubble and the 2008 Great Recession. BTS views this as a positive in the short term but warns that investor holding cash may eventually miss out on a strong capital appreciation opportunity when rates contract.

One strategy to mitigate this risk would be to dollar cost average into the BTS Managed Income Fund (BTSAX/BTSCX/BTSIX/BTSRX) over time. The BTS Managed Income Fund aims to offer a majority exposure to a basket of income producing securities that go beyond the types of investments that are in an aggregate bond index, while also adding a 30% tactical hedge component that can allocate to cash during volatility.

Conclusion

BTS urges caution into the second half of 2023 with the main risk being an underestimation by the market as to the magnitude of a possible economic softening or recession and lagged effects of rate hikes. BTS does, however, note that positive CPI and job market developments give the Fed a little more flexibility in its need to raise rates further, which, if a recession is avoided, will result in strong gains in the high yield market.

At BTS we remain committed to adapting to ever-changing market conditions.

Thank you for the opportunity to manage your assets.

Sincerely,

Vilis Pasts
Matthew Pasts, CMT
Isaac Braley
Co-Portfolio Managers

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CITATIONS

[1] Bloomberg: Wall Street Traders Drive Stocks Higher Before CPI

IMPORTANT RISK INFORMATION

Investing, including investing in mutual funds, involves risk, including possible loss of principal. There is no assurance that any strategy will achieve its investment objective. The value of fixed income securities will fluctuate with changes in interest rates. Defaults by fixed income issuers could also harm performance. Lower quality bonds known as “high yield” or “junk” bonds, present greater risk than bonds of higher quality, including an increased risk of default. An economic downturn or period of rising interest rates could adversely affect the market for these bonds and reduce the Portfolio Manager’s ability to sell its bonds. The use of leverage within a

strategy will indirectly cause additional expenses and could potentially magnify the gains or losses.

The S&P 500 includes 500 leading companies in leading industries of the US economy and is a proxy for the total stock market.

Bloomberg Aggregate Bond Index (Bloomberg Agg Bond) - An index used by bond funds as a benchmark to measure their relative performance. The index includes government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturities of the bonds in the index are more than one year.

ICE BofAML US High Yield Index (ICE Bank of America US High Yield) tracks the performance of US dollar-denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one-year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $100 million. Also, qualifying securities must have risk exposure to countries that are members of the FX-G10, Western Europe, or territories of the US and Western Europe. The FX-G10 includes all Euro members, the US, Japan, the UK, Canada, Australia, New Zealand, Switzerland, Norway, and Sweden.

FTSE 10 Yr US Treasury Benchmark measures the performance of total returns for the current ten year on-the-run Treasuries that settle by the end of the calendar month.

Federal Fund Effective Rate is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight. (1) The rate that the borrowing institution pays to the lending institution is determined between the two banks; the weighted average rate for all of these types of negotiations is called the effective federal funds rate. (2) The effective federal funds rate is essentially determined by the market but is influenced by the Federal Reserve through open market operations to reach the federal funds rate target.

Core CPI YoY % Change is the year-over-year percent change of the Core CPI, plotted monthly, which is an aggregate of prices paid by urban consumers for a typical basket of goods, excluding food and energy. This measurement, known as "Core CPI," is widely used by economists because food and energy have very volatile prices.

Job Openings Total Nonfarm are a measure of all jobs that are not filled on the last business day of the month. A job is considered open if a specific position exists and there is work available for it, the job can be started within 30 days, and there is active recruiting for the position. Data stream is monthly.

**Index returns are for illustrative purposes only and should not be construed as BTS model performance or performance achieved by any BTS client. More specifically, any reference to index returns during isolated or defined periods in time is for reference only and is not meant to imply index returns are indicative of actual returns achieved in client portfolios. Investors cannot invest directly in an index, and index returns do not reflect management fees, custodial fees or brokerage commissions, which vary depending upon the custodian chosen.*

Source: ***Morningstar (for index returns)***

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