Portfolio Managers’ Quarterly

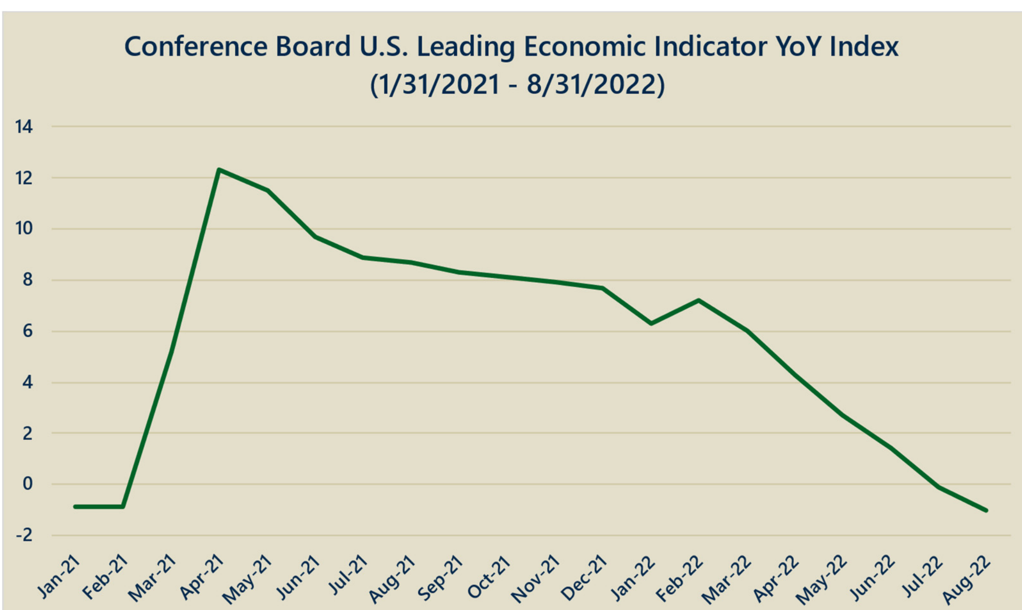
Q3 2022: More Pain Necessary to Cool Inflation

Dear Fellow Investor:

Q3 began with positive returns in equities and bonds from a perceived dovishness pivot by the Federal Reserve. The rally didn’t last, however, as the Fed reiterated a hawkish monetary policy stance in August, pledging to contain inflation and warning of the pain restrictive monetary policy may inflict on markets. The shift increased volatility and the quarter suffered net losses in equities and bonds. The S&P 500 Total Return Index ended down 4.88%, while the Bloomberg Aggregate Bond Index (AGG) finished the quarter down 4.75%. Our BTS Bond Asset Allocation/Tactical Fixed Income strategy spent much of the quarter in a defensive position, limiting losses in the strategy to just a fraction of the aggregate bond market, while our correlated BTS Managed Income strategy was still able to outperform the AGG by over 1%.

The Likely Bearish Scenario

Our previous quarterly discussions cited the Leading Economic Indicator Index (Conference Board LEI) as a barometer for discounting future downside risk to the economy, which would inevitably affect the stock and high yield bond markets. The index has now declined 6 months in a row and is continuing to discount further economic weakness. Furthermore, the IMF and other institutions have cut their global economic growth forecasts for the next 6-12 months which does not bode well for risk asset that are forward-looking and tend to discount future risk before it occurs.



Source: Bloomberg

The continued weakening of the economy has the potential to influence the Fed's monetary policy going forward, as the Fed must balance their mandate of low and stable inflation with that of maximum employment. These mandates are conflicting because if the economy dips into recession and the unemployment rate increases, the Fed will have difficulty cutting interest rates if inflation remains elevated.

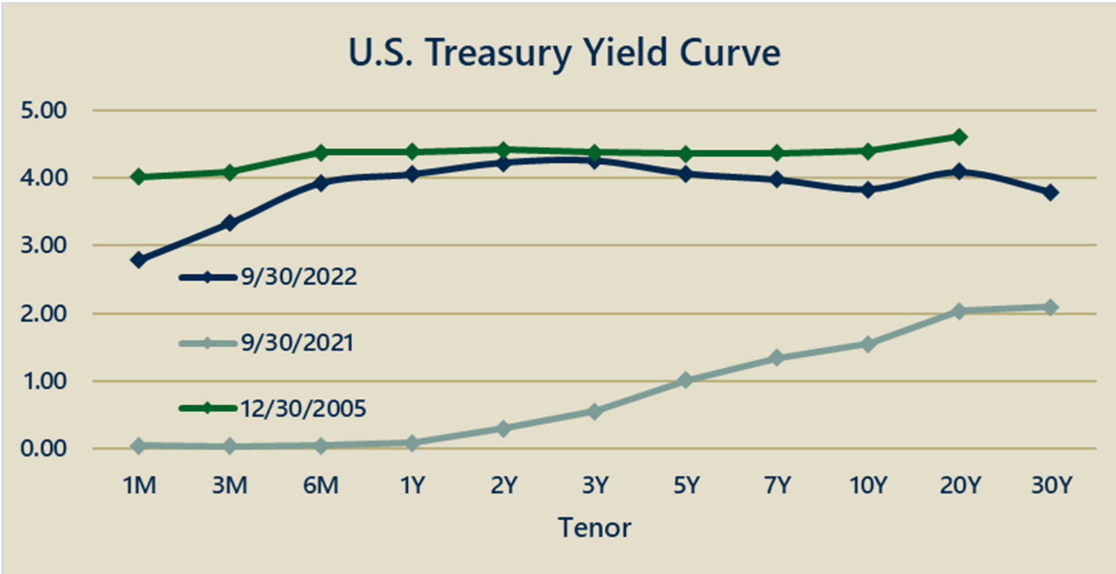
The Fed has largely been 'data-driven', which has introduced a new layer of volatility, both on the upside and downside. After the July FOMC meeting, markets discounted Fed Chair Jerome Powell's remarks as dovish, largely from an expectation of fewer and less aggressive future rate hikes, but new economic reports on inflation and the state of the job market forced the Fed to reiterate its stance as an inflation fighter during the August Jackson Hole Conference. In general, it looks like the Fed is still backed in a corner to continue to increase interest rates and/or keep interest rates higher for longer until a string of Consumer Price Index (CPI) reports confirms a new down-trend in the inflation rate. The September CPI came in worse than expected, thus reiterating the need for higher interest rates for longer to continue to depress demand-driven price increases to create price equilibrium in the economy.

Thus, we believe the likely scenario for Q4 and into 2023 is a continuation of the Fed's inability to orchestrate a 'soft-landing', which will likely push the U.S. and global economies further to recession. The depth and length of the recession will most likely be correlated to new data that comes in, which will affect the pace of Fed tightening and easing.

The Contingent Bull Case for Q4 and 2023

The bull case for the end of 2022 and 2023 would stem from a recession occurring sooner rather than later with the job market deteriorating and inflation declining. With inflation controlled, the Fed, with rates fairly high, would have the flexibility to cut interest rates in a moderate manner to gradually stimulate demand and job growth without once again increasing inflation and staying in line with their target 2% inflation rate. We believe risk assets would respond favorably to the decline in inflation and medium-term adjustment of monetary policy back to neutral from hawkish.

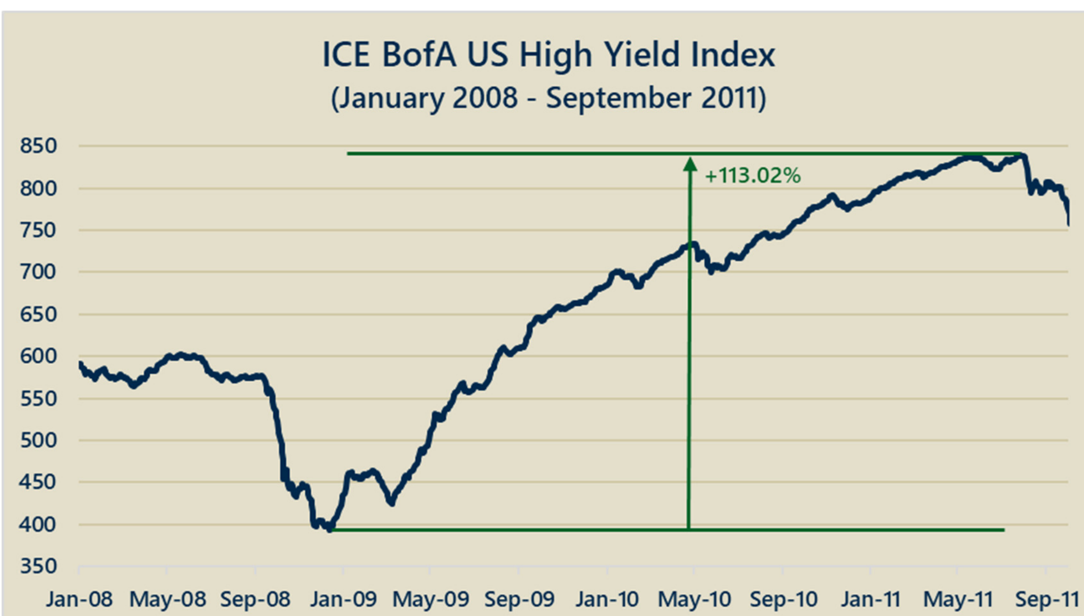
We believe this bull case is unlikely given the state of the treasury market. The spread between the 2-YR note and the 10-YR note has recently profoundly inverted for the second time this year, with the recent inversion being the steepest seen since the months preceding the 2008 financial crisis. Back then, the curve flashed its first warning sign in December 2005, 22 months ahead of the official start of the recession. While every recession has been preceded by an inversion on this part of the curve, the length of delay between inversion and recession has varied from 6 to 22 months.



Source: Bloomberg

Thus, due to the future discounting of the recession prediction of the 2YR to 10YR spread, the likelihood of a recession occurring in the near-term future is low and the exact date is uncertain.

The question now is whether the job market can stay strong in the face of heightened inflation, or if the economy slips into recession faster, creating an economic 'reset' ripe for expansion. If the latter holds true, the Fed can soon start to neutralize their policy to create an interest rate environment akin to that coming out of the 2008 Recession. This would bode well for risk assets, particularly high yield bonds, which often lead other risk assets coming out of recessions, including the stock market. The chart below shows the strong returns high yields exhibited coming off the lows of 2008.



Source: Bloomberg

Conclusion

In aggregate, BTS believes the bear case is currently more probable, but we remain ready to respond to an increased probability of the bull case, if and when our proprietary models go positive and signal the next possible economic expansion. When faced with a potential crossroads environment such as this, we see an advantageous position for actively managed portfolios such as ours.

At BTS, we remain ready to adapt 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

The material provided herein has been provided by BTS Asset Management and is for informational purposes only. BTS Asset Management serves as investment advisor to one or more mutual funds distributed through Northern Lights Distributors, LLC member FINRA/SIPC. Northern Lights Distributors, LLC and BTS Asset Management are not affiliated entities.

Investors should carefully consider the investment objectives, risks, charges, and expenses of the BTS Tactical Fixed Income Fund and the BTS Managed Income Fund before investing. This and other information about the Fund is contained in the prospectus and should be read carefully before investing. The prospectus can be obtained on our web site, www.btsfunds.com, by calling toll free 1-877-287-9820 (1-877-BTS-9820), or by calling your financial representative. The BTS Tactical Fixed Income Fund is distributed by Northern Lights Distributors, LLC, Member FINRA/SIPC. BTS Asset Management, Inc. is not affiliated with Northern Lights Distributors, LLC.

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. Complete performance information is available upon request for any strategies mentioned.

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 - 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 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.

Consumer Price Index is a measure of the average change over time in the prices paid by urban consumers for a market of consumer goods and services.

Headline inflation is the raw inflation figure reported through the Consumer Price Index (CPI) that is released monthly by the Bureau of Labor Statistics (BLS).

Core inflation is the change in the costs of goods and services, but it does not include those from the food and energy sectors.

The Composite Index of Leading Indicators, otherwise known as the Leading Economic Index (LEI), is an index published monthly by The Conference Board. It is used to predict the direction of global economic movements in future months. The index is composed of 10 economic components whose changes tend to precede changes in the overall economy. Businesses and investors can use the index to help plan their activities around the expected performance of the economy and protect themselves from economic downturns.

**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: ***Bloomberg (for index returns)***

BTS Asset Management is affiliated with BTS Securities Corporation, member FINRA/SIPC. Securities are offered through BTS Securities Corporation and other FINRA member firms. Advisory services are offered through BTS Asset Management, Inc.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS.

5853-NLD-10/12/2022