Portfolio Managers' Quarterly

Q4 2023: Restrictive for Longer Means Fed Policy is Lagging

Dear Fellow Investor:

In the third quarter of 2023, both major stock and bond markets saw declines. The S&P 500 fell -3.27%, while the Bloomberg U.S. Aggregate Bond Index fell roughly the same amount with a return of -3.23%. Notably, U.S. Treasuries plunged in the third quarter, as the FTSE 10 Year US Treasury Benchmark declined by -5.12%. The High Yield bond market was a bright spot during this quarter, as the ICE Bank of America US High Yield Index returned +0.51%.

BTS navigated this period mostly invested in High Yield bonds with positions in high quality Equities, High Yield Municipals, and Convertible Bonds.

September reaffirmed its reputation as the worst month for risk assets. The primary catalyst for these widespread losses was a growing market consensus that Federal Reserve policy would remain restrictive for longer than initially anticipated at the beginning of this year. Although most market participants believe that the Fed is unlikely to raise rates much higher than the current target range of 5.25% to 5.50%, maybe only one further hike of 25bps, the Fed's commitment to doing whatever it takes to bring inflation back towards its mandated goal of 2% seems to finally be solidified in Wall Street's psychology.

BTS held the view earlier this year that markets may be underestimating how long the Fed would keep interest rates high, and this view may be materializing. This could result in the market pricing in a mild to medium severity recession into 2024. In that scenario, BTS would position to participate in a flight to quality trade.

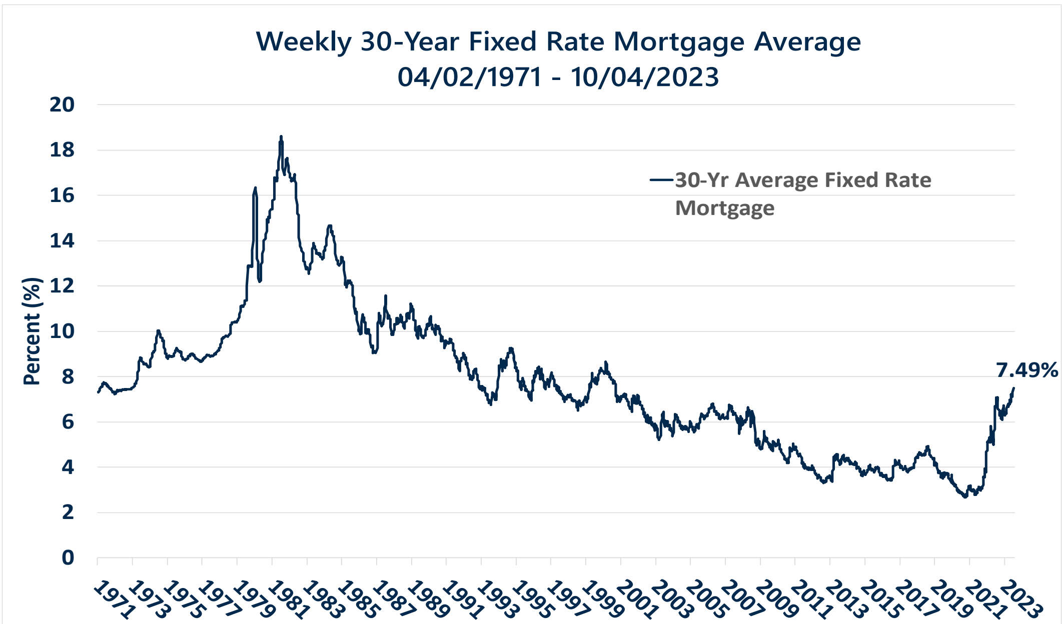
A soft landing is still a possibility, and rates would eventually decline as the Fed begins to cut at the end of its current rate cycle. Either way, the outlook for bonds has increased, but the following negative headwinds may increase volatility before the definitive decline in interest rates is clear.

Q4 Outlook: Many Negative Headwinds Ahead

As we head into year end, many developments may cause headwinds for the Fed's plan for monetary tightening, as well as the outlook for risk assets. These include mortgage rates, oil prices and geopolitical tensions, strong employment, and the slow realization of lagging effects of hawkish interest rate policy.

Mortgage Rates

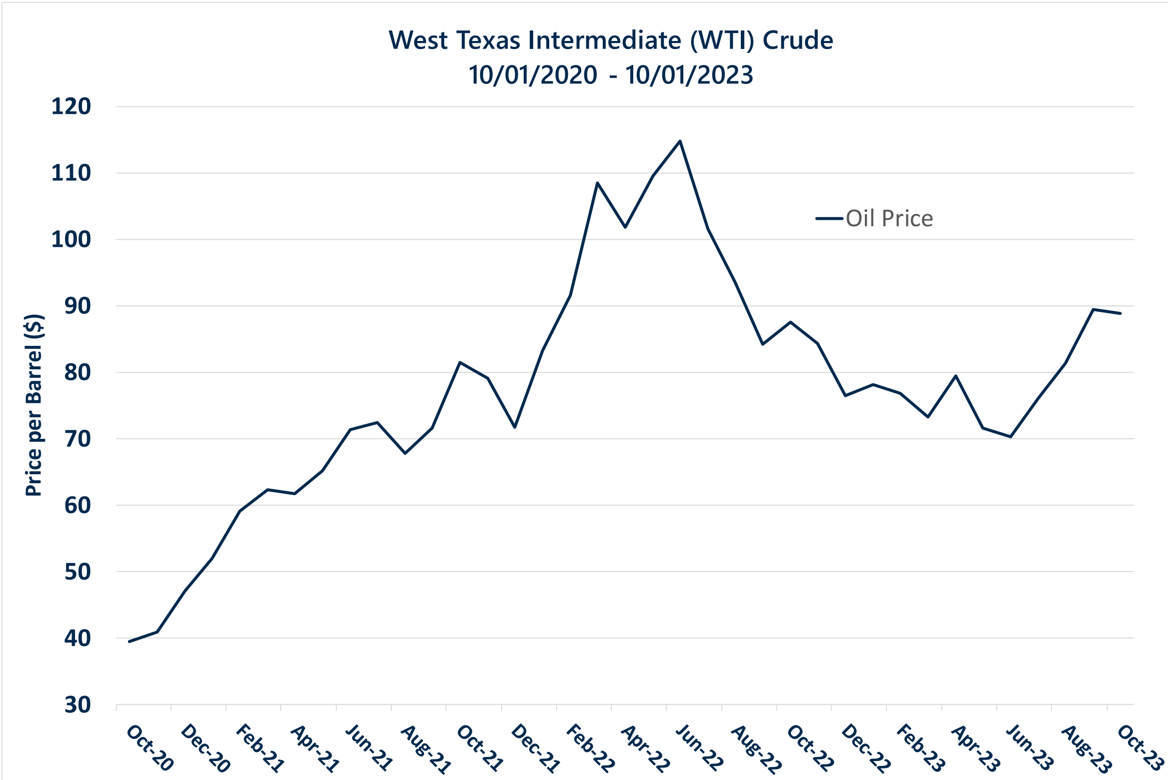
With mortgage rates topping over 7%, a 20-year high, the housing market has come to a standstill. The mindset of home buyers has been to hold off until lower rates are realized. If this is a prolonged expectation, and mortgage rates remain elevated in line with the 10-year treasury yield, it could affect homebuilder sentiment and potentially cause the number of housing starts to soften. It would also decrease money spent on home renovations and general housing expenditures that come with new home sales.



Source: Federal Reserve Bank of St. Louis [1]

Oil Prices and Geopolitical Conflict

Recent militarization near Israel is also a cause for concern because a prolonged geopolitical conflict in the Middle East will have widespread political and economic ramifications. Tensions could cause U.S. interventions and the proximity of the conflict to major oil producers may send shocks to oil prices in the short to medium run. This would most likely increasing headline CPI and give the Fed more reasons to hold off on announcing its timeline for eventual rate cut decisions. Oil price increases in the past few months may fuel these concerns.



Source: U.S. Energy Information Administration [2]

Strong Employment

The September Jobs Report shocked estimates when U.S. Employment remained resilient despite high interest rates and inflation. September added about twice the jobs as expected and the unemployment rate remained at 3.8%. The strong jobs market has impacted the Fed's policy, often being one justification for raising rates earlier this year. In the September FOMC meeting, Fed Chair Jerome Powell said he did not expect a large increase in unemployment over the next year, which has contributed to the consensus of a longer timeline for restrictive policy. The Fed could cut rates sooner if cracks in the jobs market appear since lower unemployment would correlate to lower wages and subsequent consumption, a deflationary force.

Rates could also decline if a modest decrease in unemployment is realized, which would increase the likelihood of the soft-landing scenario.

Lagging Policy

BTS views that Fed policy has lagged, partly due to low rates secured during the pandemic. In the medium-term, into the middle of 2024, BTS sees a high probability of the economy beginning to rapidly experience the negative economic effects of the Fed's rate hikes.

This is plausible because higher rates have only affected about 10-15% debt in most markets. Corporations have yet to make spending decisions to take on new debt to fund operations and corporate development initiatives. The High Yield market, for instance, has only seen 10% of its debt reset to today's higher interest rates. The investment grade bond market has seen about 14% of its debt rolled over to higher rates.[3] In short, we have yet to see the impacts to high yield defaults and corporate profits in the new paradigm of higher rates, which will begin to materialize itself over the next year.

It is uncertain how severe the economy will be affected by this repricing of debt. A softish landing is still a possibility in the next few years if corporate profits remain robust. The negative headwinds ahead, however, call for a strict reliance on tactical asset allocation with a commitment to capital preservation.

Conclusion

In summary, BTS sees continued risk that has the potential to further disrupt economic and risk asset outlooks. BTS sees a more uncertain, gradual shift by the Fed in the direction of their rate policy decisions, which may cause volatility into the end of this year and into 2024. Risk assets could find it challenging to overcome overly hawkish policy if it stays in place for more than 6-9 months, which is the current baseline projection.

It is with this view that BTS aims to find opportunity in the right market given the economic and price backdrop. BTS will not hesitate to position defensively into cash or participate in intermediate rallies in risk assets to add value during this period. A flight to quality trade in short-duration treasuries is becoming more likely, especially if economic data points weaken or the Fed cuts rates sooner than expected. BTS also sees this as an opportunity to add value because treasury yields are extended above their recent averages and have room to move back lower.

At BTS we remain committed to adapting to ever-changing market and economic conditions in order to best serve our clients.

We thank you for the opportunity to manage your assets.

Sincerely,

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

CITATIONS

[1] Freddie Mac, 30-Year Fixed Rate Mortgage Average in the United States [MORTGAGE30US], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MORTGAGE30US.

[2] U.S. Energy Information Administration, Crude Oil Prices: West Texas Intermediate (WTI) - Cushing, Oklahoma [DCOILWTICO], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DCOILWTICO.

[3] An 'iceberg' awaits with only 10% of the junk-bond market feeling the pinch of higher rates, says BofA Global

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.

CPI is Consumer Price Index, which is the aggregate price paid by urban consumers for a typical basket of goods, including food and energy. This measurement, known as "CPI," is widely used by economists.

**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 and Bloomberg (for index returns)***

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS.

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