THIRD QUARTER 2022

Core Plus Fixed Income Commentary

September 30, 2022

MARKET REVIEW

The Federal Reserve (Fed) continued with its aggressive tightening cycle by increasing the Fed Funds target rate by another 75 basis points (bps) at its September meeting. This brings the lower band of the target to 3%, after beginning the year at zero, making it the fastest pace of rate hikes since the 1980s. Additionally, the Central Bank continues to shrink its bloated balance sheet by nearly $100 billion per month. These actions were necessitated by the fact that U.S. inflation remains stubbornly sticky as measured by the unexpectedly high August year-over-year Consumer Price Index (YoY CPI) reading of 8.3%. Across the Atlantic, Germany and the United Kingdom experienced August YoY CPI readings of 10.0% and 9.9%, respectively.

Unsurprisingly, the government bond markets did not take these events lightly. 10-year U.S. Treasury yields increased by 84 bps during the quarter, ending at a 3.83% yield to maturity (YTM). 10-year German bunds, which began the year with negative yields, increased by 74 bps during the quarter to end with a 2.07% YTM. Meanwhile, as the UK made plans to cut taxes and spend approximately 5% of GDP to subsidize this winter's heating bills, 10-year Gilt yields exploded by 186 bps to the upside, ending the quarter at 4.09%. Europe's more dire circumstances relative to the U.S. provided the spark for the counter-cyclical U.S. Dollar Index (DXY) to increase an astounding 7.1% for the quarter. After trying to rally earlier in the quarter, the government funding issues and stronger U.S. dollar proved to be too much for equity markets to handle as the S&P 500® ultimately finished down 4.89% for the quarter. With risk-free interest rates increasing at a quickened pace, it was somewhat surprising that growth stocks outperformed value stocks on a relative basis.

As we enter the final quarter of the year, Chairman Jerome Powell and the Fed seem determined to follow the Paul Volcker model rather than the Arthur Burns model on fighting inflation. This, along with U.S. companies' earnings being negatively impacted by a strong dollar, could make for a challenging 3Q earnings season and a continued bear market for stocks.

CORE PLUS PORTFOLIO REVIEW

The Core Plus Composite (Composite) returned -3.71%, net of fees, for the quarter ending September 30, 2022, outperforming the Composite's benchmark, the Bloomberg U.S. Aggregate Bond Index, which returned -4.75%. Year-to-date, the Composite is outperforming its benchmark by 27 bps.

The strategy's performance benefited by maintaining a shorter duration than the benchmark as 10-year Treasury yields increased 81 bps during the quarter. The period started with Treasury yields declining in July, continuing the end of the second quarter trend, as markets hoped for a change in Fed messaging, to an earlier-than-expected pause and perhaps even a pivot. Any change in messaging did not occur, as inflation continued to run too hot for the Fed to do anything but continue its aggressive tightening cycle. This disappointed markets, and Treasury yields increased during August and September.

Higher yielding corporate and preferred securities were positive contributors to the strategy's performance as credit spreads were essentially unchanged for the quarter. Credit markets experienced the same volatility as the Treasury market during the period. They initially tightened in response to the risk-on environment, then sold off in August and September. Ultimately, spreads ended the period only 3 bps wider.

While the allocation to securitized products was a drag, it was more than offset by security selection within the asset class, making the overall effect positive. The Composite's underweight to agency mortgage-backed-securities (MBS) was additive as that market experienced the worst returns on record due to fears of quantitative tightening and rising interest rates. Therefore, agency MBS was the worst performing sector in the benchmark during the period. In addition, prepayment penalties on the Ginnie Mae project loan interest-only tranches generated strong positive alpha during the period.

Performance was negatively impacted by the strategy's exposure to municipal securities and its underweight position to Treasury bonds.

CORE PLUS POSITIONING AND OUTLOOK

The third quarter started with financial markets anticipating there would be a change in Fed Chairman Powell's monetary policy of continuing its aggressive rate tightening. The financial markets quickly changed their position as July's payroll report was much higher than expected, Chairman Powell called the Federal Open Market Committee's (FOMC's) inflation fight "unconditional" and "will bring some pain," and the Fed hiked the Fed Funds rate by 75 bps twice during the quarter and charted a hawkish course of slowing labor

STRATEGY INFORMATION

Benchmark	Bloomberg U.S. Aggregate Index
Business Minimum	$15M
Number of Holdings	207
Assets	$87.10M

PORTFOLIO MANAGEMENT TEAM

John L. Cassady III, CFA
Chief Investment Officer
Industry start date: 1987
Joined Red Cedar: 2018

Jason M. Schwartz, CFA
Senior Portfolio Manager
Industry start date: 2004
Joined Red Cedar: 2018

David L. Withrow, CFA
Director of Portfolio Management
Industry start date: 1988
Joined Red Cedar: 2018

Michael J. Martin, CFA
Senior Portfolio Manager
Industry start date: 1994
Joined Red Cedar: 2018

INVESTMENT PHILOSOPHY

"We seek income producing opportunities in the capital structure, in a variety of risk profiles where we find relative value in an effort to reduce correlation to traditional bonds."
—David Withrow

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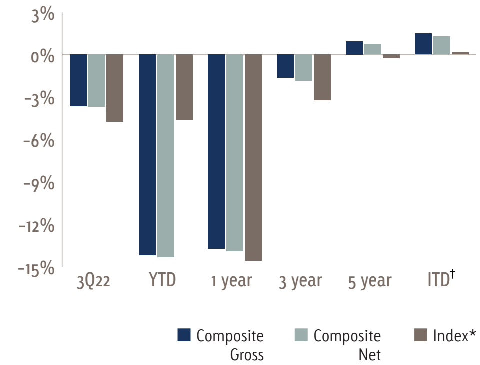
demand. Global recessionary fears continue to be stoked by the strong U.S. dollar, higher energy prices, and most countries' central bankers fighting their own inflationary issues. Given this, the strategy remains defensively positioned to higher rates.

Investment grade corporate bond spreads ended the quarter essentially unchanged from where they started, but that doesn't reflect the sector's volatility. The corporate bond market had the same roller coaster experience as other risk markets, tightening during the month of July, then widening in August and September. Credit spreads started the quarter at +164 bps, tightened to +139 bps by mid-August, then widened back out to end September at a level of +167 bps, only 3 bps wider for the period. While credit spreads are perhaps starting to represent value, there is concern the economy could dip into a recession and negatively impact corporate earnings. For now, the corporate credit exposure in the strategy is defensively positioned, and this stance will be maintained until market conditions are better defined. The financial sector (an overweight in the portfolio) outperformed during the quarter. Given the global uncertainty, the strategy has reduced its exposure to the international financial sector. For now, the emphasis will continue to be on high quality companies with strong balance sheets.

Preferred securities had a total return of -0.95% (as measured by the ICE BofA Fixed Rate Preferred Securities Index) for the quarter, compared to -4.75% for the strategy's benchmark. Throughout the quarter, we transitioned the strategy's preferred holding into more favorable structures and geographic exposure. Non-domestic bank exposure was sold, replaced with domestic banks. Security structures that have a mismatch between call dates and reset indices have been reduced. The strategy maintains a bias toward $1,000 hybrid securities, which are less sensitive to increasing interest rates compared to more retail oriented $25 preferred stock.

Within securitized products, the strategy is focused on defensive cashflows with an emphasis on low spread duration, high quality, and liquidity. To that end, the team continued to add agency-guaranteed commercial MBS backed by multi-family properties that benefit from prepayments. Also in multi-family, the strategy favors interest-only securities given their short spread duration, attractive yields, and accelerated return of capital that can be reinvested in a rising rate environment. Finally, the agency MBS underweight was maintained due to the ongoing risk that the Fed could choose to reduce the size of MBS holdings on its balance sheet.

PERFORMANCE



	Composite Gross	Composite Net	Index*
3Q22	-3.66%	-3.71%	-4.75%
YTD	-14.20%	-14.34%	-4.61%
1 year	-13.73%	-13.91%	-14.60%
3 year	-1.66%	-1.86%	-3.25%
5 year	0.92%	0.72%	-0.27%
ITD†	1.47%	1.27%	0.15%

†Inception Date 5/1/2016
Periods greater than 12 months are annualized
*Bloomberg U.S. Aggregate Index
Source: Bloomberg, Clearwater Analytics

DISCLOSURES

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