THIRD QUARTER 2023

# Strategic Income Commentary

Spetember 30, 2023

## 3Q MARKET REVIEW

During the third quarter of 2023, U.S. Treasury investors were beginning to wake up to the sobering reality that the Federal Reserve (Fed) just might hold short-term interest rates higher than previously anticipated. From a bigger picture perspective, it can no longer be ignored that the United States fiscal profligacy is unsustainable, and investors are demanding higher yields to hold U.S. Treasuries. Running 7% budget deficits in times of peace and full employment will only add to the already bloated 113% debt-to-GDP ratio. In August, Fitch Credit Ratings downgraded U.S. Government debt from AAA to AA+. It cited the lack of political will to deal with these deficits in any meaningful way along with the political dysfunction in Washington. These issues, along with a Fed still fighting inflation, were instrumental in 10-year Treasury yields rising from 3.84% to 4.57% during the quarter. The Bloomberg U.S. Aggregate Bond Index returned -3.2% for the quarter, bringing its year-to-date (YTD) return to -1.2%. Despite these less-than-ideal fundamentals and lackluster returns, fixed income has become an interesting asset class once again. As the quarter ended, real yields across the maturity spectrum¬—as measured by Treasury inflation-protected securities (TIPs)—are now all above 2%. These levels have not been seen across the curve since prior to the Global Financial Crisis (GFC).

The equity market turned in negative returns for the quarter as the Fed's higher-for-longer messaging was cause for concern. The S&P 500® Index returned -3.3% for 3Q but is still up YTD at 13.1%. The more interest-rate-sensitive small cap Russell 2000® Index was the laggard and returned -5.1% for the quarter and is up just 2.5% YTD. Commodities were a bright spot for investors as the S&P Goldman Sachs Commodity Index returned 12.8% for the quarter, primarily on the strength of the crude oil market.

Heading into the final quarter of the year, investors will be looking for evidence that the long-awaited corporate earnings growth will reassert itself during 4Q. Investors will also want to know if the rate of inflation will continue to moderate or whether it will be sticky as some suspect. A strong U.S. economy with moderation of inflation and a return to corporate earnings growth would go a long way to offset some of the fiscal challenges and slowing global growth picture.

## PORTFOLIO REVIEW

The Red Cedar Strategic Income Composite (Composite) outperformed its benchmark by 289 basis points (bps), net of fees, in the third quarter of 2023. As key investment themes have begun to unfold according to expectations, the YTD outperformance relative to the benchmark has increased to 95 bps. Relative performance was led by the maximum exposure to preferred securities of 50%. While exceptional returns were broad based across the asset class, notable results were on display amongst regional banks and additional tier 1 (AT1) securities. Regionals benefited from the market coming around to the view that the bank failures in March were idiosyncratic and not systemic. Meanwhile, the AT1 market was given evidence that the failure of Credit Suisse wasn't a death to the asset class as evidenced by a restart of the new issue market with multiple banks raising capital.

The second major theme that continued to progress is a market coming to terms with the notion that the Fed may not be cutting rates anytime soon. This reset long-term government bond yields as investors suspect that the equilibrium interest rate might now be higher than originally anticipated. The 10-year U.S. Treasury yield reached its highest level since 2007 at 4.57%. Not coincidentally, this was just prior to the GFC when quantitative easing by the Fed began to distort government bond yields. The strategy benefited from both the increase in the level of rates via a short duration posture and from a steepening of the yield curve.

Equities within the portfolio bolstered performance with returns driven mostly by energy. Specifically, oil field services outperformed on the thesis that the world is in an oil deficit and will require more "picks and shovels" to increase capacity down the road. Metals and mining positions were a drag and partially offset results. Volatility trading also added to the Composite's

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## PORTFOLIO MANAGEMENT TEAM

**Brandon F. Bajema, CFA, CPA, MSA**
Co-Chief Investment Officer
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Joined Red Cedar: 2021

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Industry start date: 2011
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**John L. Cassady III, CFA**
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Industry start date: 1987
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**Michael J. Martin, CFA**
Senior Portfolio Manager
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**Jason M. Schwartz, CFA**
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**David L. Withrow, CFA**
Senior Market Analyst
Industry start date: 1988
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### INVESTMENT PHILOSOPHY

"Strategic Income seeks current income, across global markets, in any capital structure where we find relative value. The strategy provides reduced correlations to both stocks and bonds in a high quality portfolio."
—John Cassady

performance where active management played a key role. Upon touching a post-COVID low of 12.68 on the VIX Index, the strategy meaningfully increased exposure to volatility just prior to the late quarter surge when it briefly touched 19.

The performance of securitized products contributed to overall results, primarily due to the strength of investments in agency guaranteed issues. Within the agency mortgage-backed securities (MBS) book, the team strategically employed a barbell strategy that had a notable positive impact via security selection. Furthermore, the tightening of interest-only tranches extracted from agency commercial MBS proved beneficial, resulting in favorable excess returns during the period.

## PERFORMANCE

| ANNUAL PERFORMANCE (%) | 2022 | 2021 | 2020† |
|---|---|---|---|
| Composite Net | -7.90 | 5.85 | 14.46 |
| Index* | -13.01 | -1.54 | 4.23 |

| | 3Q23 | YTD | 1 Year | 3 Year | ITD† |
|---|---|---|---|---|---|
| Composite Net (%) | -0.34 | -0.26 | 2.28 | 0.50 | 3.10 |
| Index* (%) | -3.23 | -1.21 | 0.64 | -5.21 | -3.53 |
| **Outperformance** (%)** | **2.89** | **0.95** | **1.64** | **5.71** | **6.63** |

*Bloomberg U.S. Aggregate Bond Index
**Outperformance=Composite Net-Index
†Performance calculated from inception date 4/1/2020

Periods greater than 12 months are annualized
Source: Bloomberg, Clearwater Analytics

## PORTFOLIO OUTLOOK AND POSITIONING

The market is contending with substantial structural shifts unfolding within both the domestic and global economies, and the strategy is positioned to capitalize on these changes. It is becoming increasingly evident that the global pandemic may have altered the economic landscape, potentially hastening the transition to a period of elevated energy prices, inflation, and equilibrium interest rates. The investment team recognizes that yields now cushion the blow of a further bond market sell-off, particularly in shorter dated maturities. Consequently, the portfolio duration was extended from 4.4 to 5.0 years by adding an overweight to the front and middle part of the yield curve. The portfolio duration is now toward the upper end of the historical trading range for the strategy. However, the team views the long end of the yield curve as mispriced relative to the short end. Accordingly, the strategy further shed long maturity securities and ended the quarter with very little exposure to bonds maturing beyond 10 years. This results in a significant underweight relative to the benchmark. A yield curve steepening bias also serves as a portfolio hedge, given that it is expected to align with a potential tightening of financial conditions should it continue.

The equity allocation was increased to near the maximum of 10% primarily by adding to energy while also increasing metals and mining. The transition to clean energy is likely to be a challenging one that limits the world's effective means to expand oil capacity. The increased allocation therefore acts as a commodity-related inflation hedge. Additionally, the volatility hedge position was decreased tactically in response to the significant pickup in equity volatility at the close of the quarter. Active management is of the utmost importance for the trade, and the team anticipates increasing the exposure given any subsequent drop in volatility.

Against the backdrop of elevated oil prices, rising interest rates, and the persistent strength of the U.S. economy compared to its developed counterparts, the U.S. dollar is poised to strengthen. To capitalize on this trend, short positions have been initiated in both the euro and British pound, aligning with the outlook for the diverging economies.

The portfolio maintains its maximum exposure to the hybrid securities market as the process of normalization and recovery has begun but remains in the early stages with ample upside remaining. The securities the portfolio owns tend to trade at deep discounts to par, reflecting the market's misplaced belief that the vast majority of these securities will not be called and replaced in the medium term. These securities generally yield in the 7.5-8.5% range, but given the discounted prices, could yield much higher in the event they are called. All of these securities are variable rate, and many of them float over short rates. Consequently, they have low interest rate sensitivity.

The securitized products allocation was increased to 35% predominantly through an addition to agency MBS where the allocation was doubled to 13%. A barbell strategy was implemented by overweighting low coupons with deeply discounted prices into the low $70s. On the opposing side of the barbell, higher coupon mortgages were purchased near the current level of prevailing interest rates. The former targets bonds with unique prepay upside in the Ginnie Mae space where high levels of delinquencies could translate into faster prepayments at par. The latter high coupon mortgages target elevated levels of implied rate volatility that could increase in value should that situation normalize as the Fed ends its tightening cycle.

## DISCLOSURES

Red Cedar Investment Management, LLC (RCIM) is an investment adviser registered under the Investment Advisers Act of 1940, founded in 2013. Registration as an investment adviser does not imply any level of skill or training. The oral and written communications of an adviser provide you with information about which you determine to hire or retain an adviser. For more information please visit: www.adviserinfo.sec.gov and search for our firm name. Neither the information nor any opinion expressed herein should be construed as personalized investment, tax, or legal advice, or a recommendation of any particular security or strategy.

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All information and performance are reported in U.S. dollars.

The "Net" returns presented are net of fees. Investing involves the risk of loss and investors should be prepared to bear potential losses. Past performance is not indicative of future results.

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The Strategic Income Composite (Composite) includes a broad distribution pooled fund (North Square Strategic Income Fund) that invests in Treasury and agency bonds, investment grade and non-investment grade corporate bonds, municipal bonds, asset-backed securities, agency, and non-agency mortgage-backed securities, collateralized mortgage obligations, preferred securities, equity REITS and equity securities. The strategy may use derivatives, including forward contracts, futures contracts, swap contracts and options in implementing its strategy. The use of derivative instruments allows the strategy to achieve its investment objectives, reduce risks, or manage the strategy more efficiently. The strategy also invests in international securities, foreign exchange, and non-U.S. dollar denominated securities. The Strategic Income Composite was created on April 1, 2020. The inception date of the Composite was April 1, 2020.

The benchmark is the Bloomberg U.S. Aggregate Bond Index. The index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage backed securities, asset-backed securities and commercial mortgage-backed securities.

**Benchmark Definitions:**

- The S&P 500 is widely regarded as the best single gauge of the U.S. equities market. The index includes a representative sample of 500 leading companies in industries of the U.S. economy.
- The VIX Index is a financial benchmark designed to be an up-to-the-minute market estimate of the expected volatility of the S&P 500 Index, and is calculated by using the midpoint of real-time S&P 500 Index (SPX) option bid/ask quotes.
- The Russell 2000 (Small Cap) measures the performance of the 2,000 smallest
- companies in the Russell 3000 Index. It is generally representative of US Equity Small
- and Mid-Cap Performance.
- The S&P GSCI is widely recognized as a leading measure of general price movements and inflation in the world economy. It provides investors with a reliable and publicly available benchmark for investment performance in the commodity markets.

An index is an unmanaged portfolio of specific securities, the performance of which is often used as a benchmark in judging the relative performance of certain asset classes. Investors cannot invest directly in an index. An index does not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown.

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