RED CEDAR INVESTMENT MANAGEMENT

FOURTH QUARTER 2023

# Core Fixed Income Commentary

December 31, 2023

## MARKET REVIEW

During the fourth quarter of 2023, investors completely changed their view on the direction of U.S. interest rates, causing both stock and bond prices to rally into year end. The Federal Reserve's (Fed) decision on November 1 to leave the targeted Fed funds rate unchanged for the second consecutive meeting convinced investors that rate cuts were imminent. This was despite Federal Open Market Committee (FOMC) Chairman Jerome Powell's insistence that the Fed still had work to do on inflation and would remain vigilant. Investors would have none of it, however, as the S&P 500® Index returned +11.7% for the quarter and +26.3% for the year. Domestic investment grade bonds, which had spent much of the year flirting with their third consecutive year of negative returns, managed to return an impressive +6.8% for the quarter, bringing the total return for the year to +5.5% as represented by the Bloomberg U.S. Aggregate Bond Index.

In contrast to the first three quarters of the year, the rally in stocks was broad-based with the small cap Russell 2000® Index returning +14.0% for the quarter. This eclipsed the NASDAQ Composite Index, which returned +13.8% for the quarter. For the entire year, however, the NASDAQ beat all of the major stock indices with a +44.7% return while the broad S&P 500 Index returned +26.3%.

As interest rates fell globally, most fixed income markets showed impressive returns. The Bloomberg Global Aggregate Index (ex-USD) returned +9.2% for the quarter, while the Bloomberg U.S. Corporate High Yield Bond Index returned +7.2%. Commodities struggled during the quarter with the S&P/Goldman Sachs Commodity Index returning -12.1% based on slow growth in Europe and China. At the December 13 Fed meeting, Powell and the FOMC delivered a "dovish hold," sending the 10-year Treasury yield tumbling an additional 32 basis points (bps) to end the year at 3.88%.

As 2024 unfolds, we are left to question whether the market has gotten ahead of itself in projecting nearly six interest rate cuts from the Fed. Both the market and the Fed should be concerned with inflation still running above the Fed's target. Additionally, the U.S. government continues to run unsustainable deficits and must bring $816 billion in new Treasury issuance to market during the first quarter. With no obvious recession looming on the horizon, the Fed does not need to cut rates. While some may question valuations in the equity markets, the Street consensus forecast for earnings growth in 2024 is a robust 11%. This should help buoy the equity market as the year progresses.

## CORE FIXED INCOME PORTFOLIO REVIEW

The Core Composite (Composite) outperformed its benchmark, the Bloomberg U.S. Aggregate Bond Index, by 6 bps on a gross-of-fees basis. For the full year 2023, the Composite outperformed by 33 bps.

Most of the Composite's relative outperformance can be attributed to the allocation to corporate bonds, specifically within the banking sector. The positive impact on performance stems from the Composite's strategic allocation within the sector to U.S. regional and super-regional banks, which consistently outperformed other corporate bond sectors over the quarter. Following the banking turmoil in March 2023, these bonds traded at a discount and are steadily regaining their market value.

The Composite's allocation to commercial mortgage-backed securities (CMBS) was also a contributing factor to its outperformance over the quarter. Within the sector, most of the outperformance can be attributed to non-agency CMBS bonds. In particular, the Composite held a single-asset, single-borrower bond that was valued at a discount price in the portfolio. Despite the low valuation, the team saw a high probability that it would pay off in full at maturity. Upon reaching maturity, the bond did pay off in full and returned the principal at par, boosting performance.

Agency CMBS also contributed positively to outperformance. These bonds are fully guaranteed by the U.S. government and pay interest monthly, boosting the yield of the Composite and contributing positively to relative outperformance.

Agency mortgage-backed securities (MBS) had a negative impact on relative performance, due to the Composite being slightly underweight the sector. Mortgages performed well, outperforming other sectors, and any underweight allocation was a drag on performance.

The Composite maintained a slightly short duration position over the quarter, which marginally hurt performance as the yields dropped across the curve and bonds rallied.

## STRATEGY INFORMATION

| | |
|---|---|
| Benchmark | Bloomberg U.S. Aggregate Bond Index |
| Business Minimum | $10M |
| Number of Holdings | 229 |
| Assets | $205.53M |

## PORTFOLIO MANAGEMENT TEAM

**David L. Withrow, CFA**
Senior Market Strategist
Industry start date: 1988
Joined Red Cedar: 2018

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

**Jason M. Schwartz, CFA**
Director of Portfolio Management
Industry start date: 2004
Joined Red Cedar: 2018

### INVESTMENT PHILOSOPHY

"We seek consistent income across the capital structure and in high quality companies."
—Jason Schwartz

continued on page 2

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## CORE FIXED INCOME POSITIONING & OUTLOOK

After hiking a total of 525 bps since the beginning of the tightening cycle, the Fed has held the policy rate steady since July 2023. Investment sentiment remained wary at the start of the fourth quarter with investors questioning the resilience of the U.S. labor market and greater economy amid higher rates. Throughout the quarter, labor market data, consumer spending, and economic growth came in strong. This, coupled with softening inflation data, caused yields to fall across the curve. At a meeting in December, the Fed communicated a dovish sentiment. As we go into 2024, the market is pricing in falling inflation, a resilient economy, and a series of rate cuts. The team is unconvinced these expectations are realistic and views the timing of rate cuts to be highly uncertain.

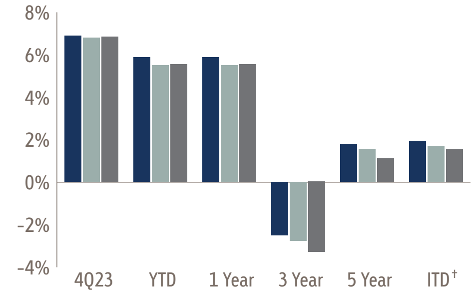
During the last quarter, the Composite maintained a consistent positioning, aligning with the team's market views established at the quarter's outset when yields were elevated. The most notable strategic decisions during the quarter were long U.S. banks, holding high quality non-agency CMBS with little extension risk, and exposure to agency fixed rate securities. These strategic decisions contributed to the Composite's strong performance, capitalizing on the bond rally that persisted until the year end.

Going into 2024, the team expects bank corporates to continue to outperform, and the Composite is positioned to maintain an overweight in the sector. Discounted securities in the space represent an opportunity to outperform as banks continue to regain the market's confidence.

The team maintains a positive outlook on agency MBS and expects the sector to perform well going forward. The Composite currently is mostly neutral across the coupon stack, with a slight overweight in low coupons. The low-coupon bonds, priced at a discount, offer an opportunity to recover the principal at par in the event of prepayment, a scenario the team deems likely based on specific prepayment and default narratives held in the Composite. High-coupon bonds should also perform well in 2024 as they will benefit as implied volatility falls, which is likely as the Fed ends its tightening cycle.

The Composite maintains a slightly short duration position. The team would consider adding duration if rate cuts become more imminent, though, it is the opinion of the team that the market may be overly optimistic on the timing of Fed tightening.

## PERFORMANCE




| | Composite Gross (%) | Composite Net (%) | Index (%)* |
|---|---|---|---|
| 4Q23 | 6.88 | 6.78 | 6.82 |
| YTD | 5.86 | 5.48 | 5.53 |
| 1 year | 5.86 | 5.48 | 5.53 |
| 3 year | -2.52 | -2.78 | -3.31 |
| 5 year | 1.75 | 1.51 | 1.10 |
| ITD† | 1.93 | 1.68 | 1.53 |

†Inception Date 8/1/2014
Periods greater than 12 months are annualized
*Bloomberg U.S. Aggregate Bond Index
Source: Bloomberg, Clearwater Analytics

## DISCLOSURES

Red Cedar Investment Management, LLC (RCIM) is an investment adviser registered under the Investment Advisers Act of 1940, founded in 2014. 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.

The securities discussed do not represent the Composite's entire portfolio. Actual holdings will vary depending on the size of the account, cash flows, and restrictions. It should not be assumed that any of the securities transactions or holdings discussed will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.

The information presented in this material is general in nature and not designed to address your investment objectives, financial situation, or particular needs. Prior to making any investment decision, you should assess, or seek advice from a professional regarding whether any particular transaction is relevant or appropriate to your individual circumstances. The mention of specific securities and sectors illustrates the application of our investment approach only and is not considered a recommendation by RCIM. There is no assurance that the securities purchased remain in the portfolio or that securities sold have not been repurchased. The opinions expressed herein are those of RCIM and may not actually come to pass.

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.

The "Gross" returns presented are gross of fees. The results do not reflect the deduction of investment management fees. The client's return will be reduced by the management fees and any other expenses incurred in the management of the account. For example, a U.S. $100 million account, paying a 0.50% annual fee, with a given rate of 10% compounded over a 10-year period would result in a net of fee return of 9.5%. Management fees are described in Part 2A of RCIM's Form ADV Part 2A. Investing involves the risk of loss and investors should be prepared to bear potential losses. Past performance is not indicative of future results.

The information herein was obtained from various sources. RCIM does not guarantee the accuracy or completeness of information provided by third parties. The information in this report is given as of the date indicated and believed to be reliable. RCIM assumes no obligation to update this information, or to advise on further developments relating to it.

The Core Composite includes all fully discretionary institutional portfolios that invest in Treasury and agency bonds, U.S. dollar denominated investment grade corporate bonds, municipal bonds, asset-backed securities, agency, and non-agency mortgage-backed securities, collateralized mortgage obligations and preferred securities. The Composite also invests in derivatives such as Treasury futures and CDX for hedging purposes. The Composite was created January 1, 2019. The inception date of the Composite was August 1, 2014.

**Benchmark Definition:** The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, US 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.

**Index 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 Russell 2000 Index (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 NASDAQ Composite Index is a market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System. The Bloomberg Global Aggregate ex USD Index is a measure of Investment grade debt from 24 local currency markets. This multi-currency benchmark includes treasury, government-related, corporate, and securitized fixed-rate bond from developed and emerging markets issuers. The Bloomberg U.S. Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond markets. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. The S&P Goldman Sachs Commodity Index 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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