FIXED INCOME INSIGHTS / 1Q 2022

Navigating Turbulent Times

Weitz | INVESTMENT MANAGEMENT

TOM CARNEY, CFA
Director of Fixed Income Research
& Portfolio Manager

NOLAN ANDERSON
Portfolio Manager
& Research Analyst

The difficult market conditions fixed income investors experienced last year heated up in the first quarter. Heightened inflation risk produced a surge in interest rate and cross-asset volatility (volatility across multiple asset classes, including stocks, bonds, commodities, and currencies). Treasury yields rising (and periodically falling) by more than 10 basis points (0.10%) per day quickly shifted from what would otherwise seem unusual to ordinary. Bouts of positive correlation (returns moving in the same direction, up or down) between U.S. Treasuries and stocks served as a good reminder of how damaging inflation can be to investors.

As shown in the Bloomberg Index returns table here, the first quarter produced no safe havens. Longer duration indexes were the worst performers given their higher sensitivity to what remain low longer-term nominal levels of interest rates (rates before accounting for inflation) and deeply negative levels of real interest rates (rates adjusted for inflation). Given this backdrop, while negative returns are never welcome, we are quite pleased with the relative results that our investment process and flexible approach have yielded. For detail regarding individual fund performance and analysis, see our funds' quarterly commentaries.

Q1 2022 | Fixed Income Returns, Bloomberg Indexes as of 03.31.2022

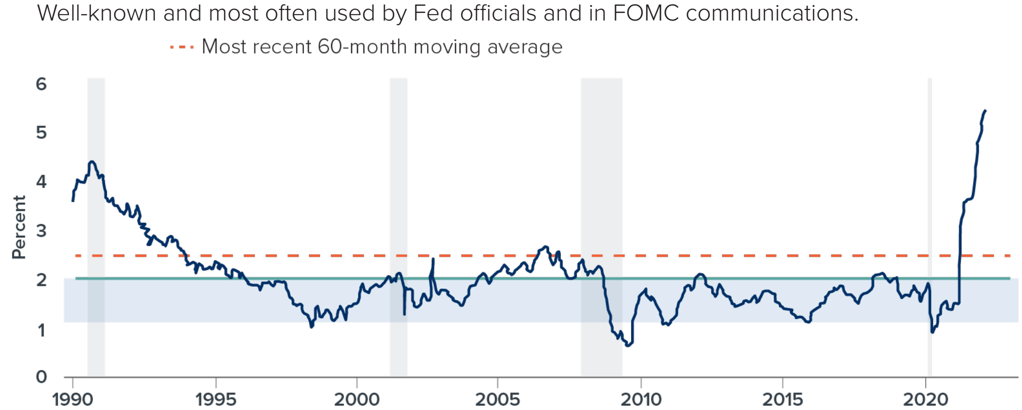
	YTD Performance	Duration
U.S. Corporate	-7.69%	8.0
U.S. Agg	-5.93%	6.5
U.S. Treasury	-5.58%	6.7
U.S. Securitized	-4.99%	5.0
U.S. MBS	-4.97%	5.1
U.S. High Yield	-4.84%	4.0

Inflation, Inflation, Inflation

By now, everyone has realized that inflation is high and spreading. Inflation is pervasive; it affects every corner of the U.S. economy – commodities, food, energy, housing/shelter, and wages. Even the Fed's preferred measure of inflation, the Core Personal Consumption Expenditures (Core PCE) price index, which had a difficult time reaching 2% after the Great Financial Crisis, soared to 5.4% in February 2022.

Core PCE

Well-known and most often used by Fed officials and in FOMC communications.

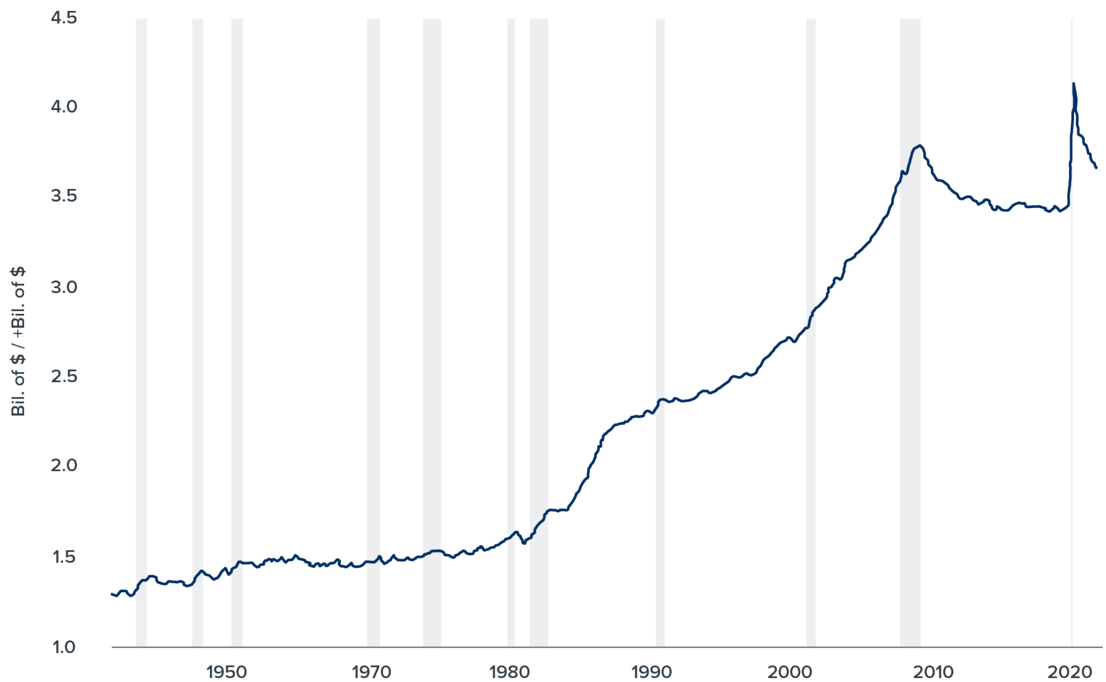


Note: Shaded blue range indicates 25th to 75th percentile of the 1-month growth rates computed over the past 10 full calendar years. Gray bars indicate recession periods.
Source: Bureau of Economic Analysis

What matters from here is how persistent inflation will be and how its ripple effect will be felt through the economy and financial markets. With pricing pressures broad-based and spread throughout a tight labor market, inflation is likely to remain well above the Fed's long-term goal of 2% for quite some time. However, there is an old saying that the cure for high inflation is high inflation. In other words, high inflation may eventually result in demand destruction. The logic is simple: the more money spent on goods and services today, the less discretionary money there is to spend in the future. And the longer inflation remains elevated, the more likely the Fed is to tackle inflation rather than focusing on the risk of lower economic growth or recession.

A decisive policy response from central banks may result in a further hit to demand by raising the cost of capital (potentially abruptly) on consumers and businesses. Bigger picture, the U.S. economy remains highly leveraged, with total debt-to-GDP (gross domestic product) at an all-time high of over 350%. On the fiscal side, materially higher interest rates could lead to a higher portion of tax revenue being allotted to government bondholders, thereby squeezing the federal government's budget and spending programs. It is a tough balancing act, but at some point, the focus may shift from coping with today's high inflation to the consequences of much weaker economic growth in the future.

All Sectors; Debt Securities and Loans; Liability, Level/+Gross Domestic Product.



Shaded areas indicate U.S. recessions. | Source: Board of Governors; BEA
Federal Reserve Economic Data (FRED) - St. Louis Fed | fred.stlouisfed.org

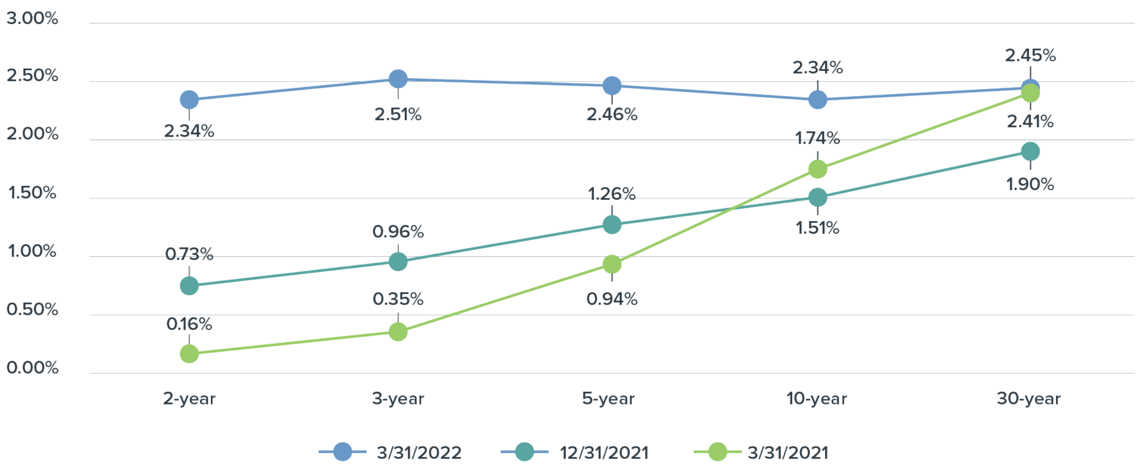
The Fed and The Yield Curve

While no one knows what the new equilibrium for interest rates will be, the Fed is at the start of what may be one of the fastest hiking cycles in decades. Markets expect up to an additional 8 or 9 interest rate hikes in 2022, with the potential for the first 50 bps rate increase since 2000. If current expectations hold, the Fed Funds rate may end the year at 2.25-2.50%, matching the peak of the Fed's last tightening cycle in 2016-2019. In the here and now, the Fed's hawkish rhetoric has already created a material upward shift in the front end of the yield curve.

March 31, 2021, to March 31, 2022, the yield on the 2-year U.S. Treasury rose 218 basis points from 0.16% to 2.34% – a nearly 15-fold increase. On the other hand, the yields on the 10-year U.S. Treasury increased 60 basis points from 1.74% to 2.34% and the 30-year Treasury increased 4 basis points from 2.41% to 2.45%. This has resulted in a much flatter yield curve than is typical at the start of a rate hiking cycle. According to Deutsche Bank, since 1955 it has taken 23 months on average for the 2-year vs. 10-year U.S. Treasury to invert. Yet we experienced a brief 2-year vs. 10-year U.S. Treasury curve inversion in early April 2022 before reversing as longer-term yields rose.

Some Fed officials have been vocal about the need to set policy at restrictive levels (levels that are expected to inhibit economic growth). While one can argue the yield curve doesn't represent true market pricing given the enormous presence of central banks, every recession in the last 70 years has only happened after the 2-year vs. 10-year U.S. Treasury curve inverted. While one can also argue about yield curve signaling, what is clear given the tightness of spreads is that credit markets are not currently concerned about potential negative effects from high inflation and/or tighter monetary policy.

U.S. Treasury Yields (%)

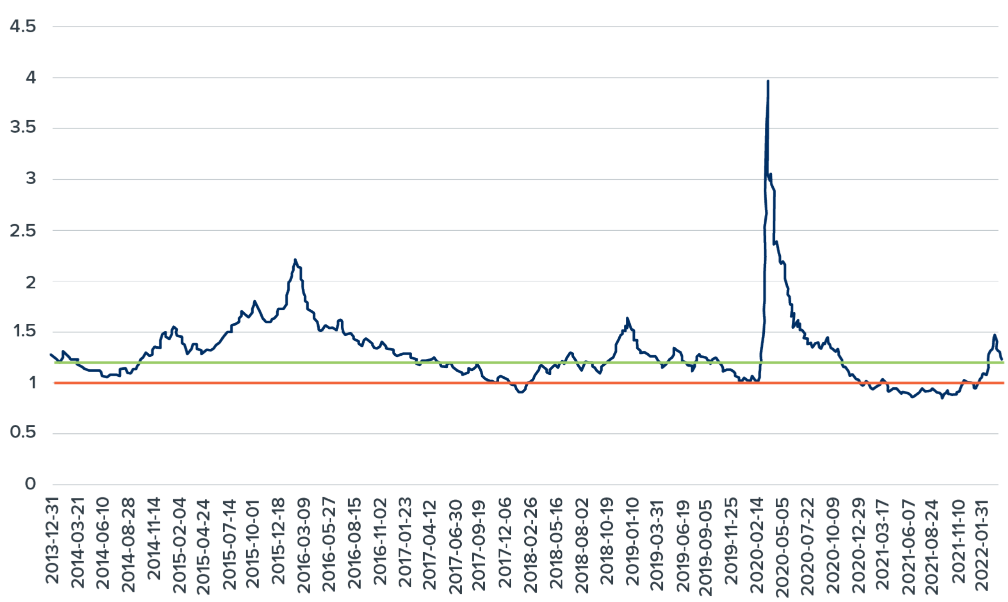


Credit Spreads

Today, credit spreads reflect strong corporate liquidity positions and minimal concern about future credit weakness and defaults. While we agree fundamentals remain generally solid, there are plenty of reasons to be cautious. Fed tightening, high inflation, rising geopolitical tensions, removal of fiscal support, and tight labor markets are just some of the risk factors we see. While credit spreads widened during the first quarter, they remain below long-term averages. A broad measure of investment-grade corporate bond spreads, compiled by ICE BofA, increased to 122 basis points on March 31, 2022, from 98 basis points on December 31, 2021. The chart below depicts the path of investment-grade credit spreads for the past five years (blue line) against the one-year (orange) and five-year (green) averages.

High yield credit spreads experienced similar movement during the first quarter. A broad measure of U.S. high yield corporate bond spreads, compiled by ICE BofA, touched a high of 421 basis points before finishing at 343 basis points on March 31, 2022, up from 310 basis points on December 31, 2021.

Investment Grade



Source: Federal Reserve Economic Data (FRED) - St. Louis Fed

Outlook

The first quarter was a good reminder that the future is not set in stone. As always, much can happen over the next nine months that may require a different path than what appears most conceivable today. Our overarching investment approach is to remain patient while utilizing our flexible mandate to seek out the best risk/reward opportunities available in the market. As the year progresses, the risk of a monetary policy error (too tight or too loose) is high, resulting in wider credit spreads. In the meantime, a disciplined approach of adding Treasuries, high-quality securitized products, and selective corporate bonds has enhanced the coupon income of our portfolios, which we hope will pave the way for better returns in the future.

IMPORTANT DISLCOSURES

The opinions expressed are those of Weitz Investment Management and are not meant as investment advice or to predict or project the future performance of any investment product. The opinions are current through 04/15/2022, are subject to change at any time based on market and other current conditions, and no forecasts can be guaranteed. This commentary is being provided as a general source of information and is not intended as a recommendation to purchase, sell, or hold any specific security or to engage in any investment strategy. Investment decisions should always be made based on an investor's specific objectives, financial needs, risk tolerance and time horizon.

One basis point is equal to 0.01 percent.

Portfolio composition is subject to change at any time. Current and future portfolio holdings are subject to risk.

Definitions: Investment Grade Bonds are those securities rated at least BBB- by one or more credit ratings agencies. **Non-Investment Grade Bonds** are those securities (commonly referred to as “high yield” or “junk” bonds) rated BB+ and below by one or more credit ratings agencies.

Consider these risks before investing: All investments involve risks, including possible loss of principal. Market risk includes political, regulatory, economic, social and health risks (including the risks presented by the spread of infectious diseases). Changing interest rates may have sudden and unpredictable effects in the markets and on the Fund’s investments. The Fund may purchase lower-rated and unrated fixed-income securities, which involve an increased possibility that the issuers of these may not be able to make payments of interest and principal. See the Fund’s prospectus for a further discussion of risks.

Investors should consider carefully the investment objectives, risks, and charges and expenses of the Funds before investing. This and other important information is contained in the prospectus and summary prospectus, which may be obtained at weitzinvestments.com.

Weitz Securities, Inc. is the distributor of the Weitz Funds.