FIXED INCOME INSIGHTS / 1Q 2023

With Uncertainty Now the Norm, Bonds Remain Attractive

Weitz | INVESTMENT MANAGEMENT

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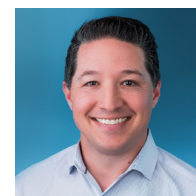

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The first quarter was a rollercoaster ride. Bond and equity markets enjoyed a steep climb in January, only to fall in February on renewed inflation concerns and Federal Reserve hawkishness. March brought sudden fears of a banking crisis and, counterintuitively, ended with a strong rally in risk assets. While bank failures like Silicon Valley Bank (SVB) and Signature Bank are very unlikely to result in systemic risks, they create uncertainty around bank lending/credit availability and potential implications for the broader economy.

Stepping back, loan standards at banks have been tightening since last fall and tightened further in January. This was largely driven by slower repayments on existing loans due to rapidly rising interest rates. When interest rates increase rapidly, there is little incentive for refinance activity, and the lack of loan repayments, all else equal, reduces the availability of capital to make new loans.

Anecdotal evidence suggests loan standards are tightening even more briskly after recent bank failures prompted increased deposit risk. This makes sense. When banks face higher funding costs (and now the risk of tighter regulation and higher capital requirements), loans will become more expensive and harder to get. It remains to be seen how slower bank loan growth will impact the real economy, but at a minimum, it may add additional pressure on consumer and business spending already impacted by high inflation.

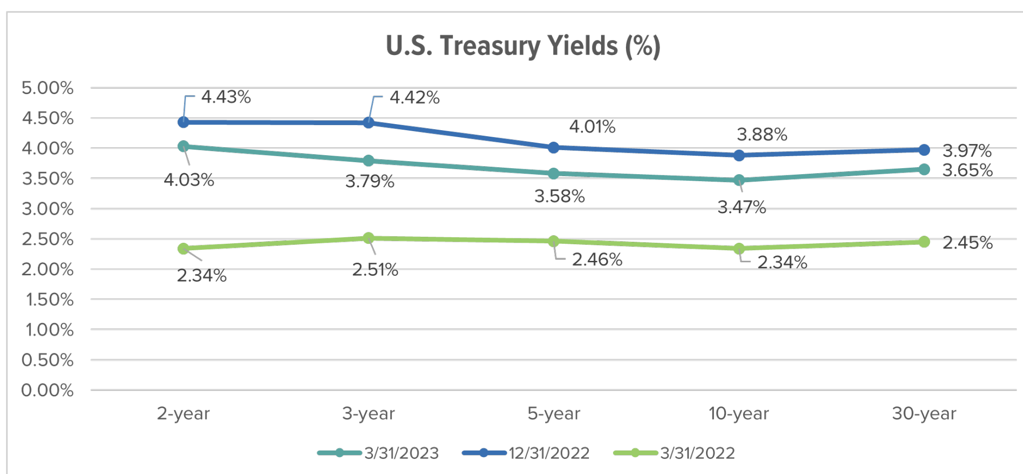
Zooming in on U.S. fixed income markets, the table below provides return data for select Bloomberg U.S. bond indexes for the first quarter. Longer duration and credit-sensitive indexes led the way as interest rates declined and credit performed well. Despite our lower duration profiles, we are pleased with the relative results that our investment process and flexible approach have yielded. For details regarding individual fund performance and analysis, see our funds' quarterly commentaries.

Q1 2023 | Fixed Income Returns
Bloomberg Indices

	Performance	Duration
Bloomberg US T-Bill Index	1.11%	0.3
Bloomberg US Aggregate Bond	2.96%	6.3
Bloomberg US Treasury	3.01%	6.3
Bloomberg US MBS (Mortgage-Backed)	2.53%	5.9
Bloomberg US Corporate Invest Grade	3.50%	7.3
Bloomberg US Corporate High Yield	3.57%	3.7
Bloomberg US Securitized	2.47%	5.8

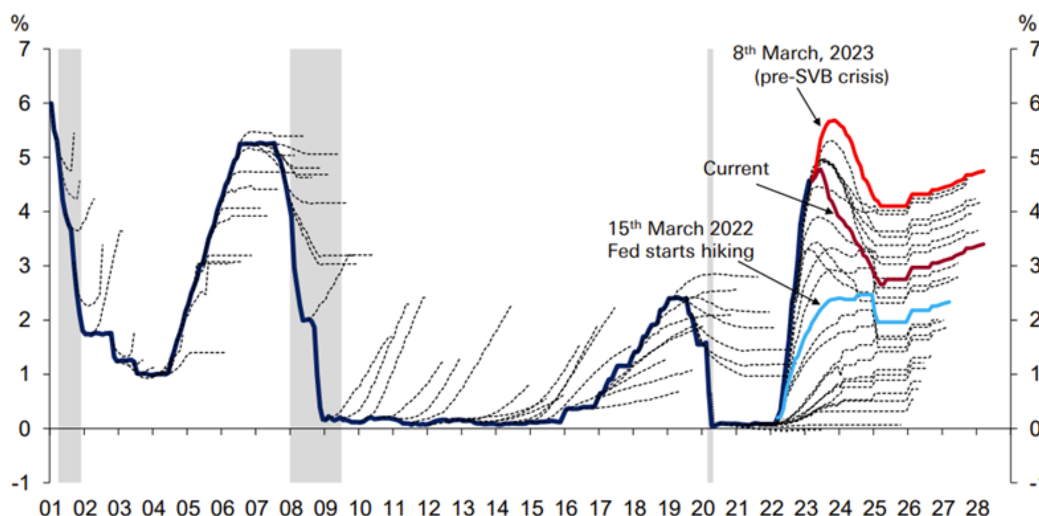
As of 3/31/2023

After calmer conditions to start the year, interest rate volatility, as measured by the ICE BofA MOVE Index, reached its highest level since the Great Financial Crisis in October 2008. This played out with extreme movement in the shape of the yield curve. The table below highlights movements in U.S. Treasury yields over a broad spectrum of maturities. While the 2-year Treasury ended the first quarter down 40 bps, it fell 100 bps over three days following the SVB failure, the biggest move since 1982. Overall, yields across the maturity spectrum shifted down and flattened during the first quarter.



Interest rate volatility has also led to rapidly evolving views on the forward path of the Fed's interest rate policy. The chart below highlights the pre-SVB expected path of Fed Funds (red line) and the current (as of March 20th) expected path (maroon line), which equates to an approximately 200 bps shift down in the Fed funds rate.

As a result, a great divide has emerged between market expectations and the Fed, which expects short-term interest rates to remain elevated for some time. We believe it is unlikely that a deeply inverted yield curve, along with expectations of significant Fed cuts, herald an environment of lower, yet sturdy economic growth and inflation returning to a long-run rate of 2%.

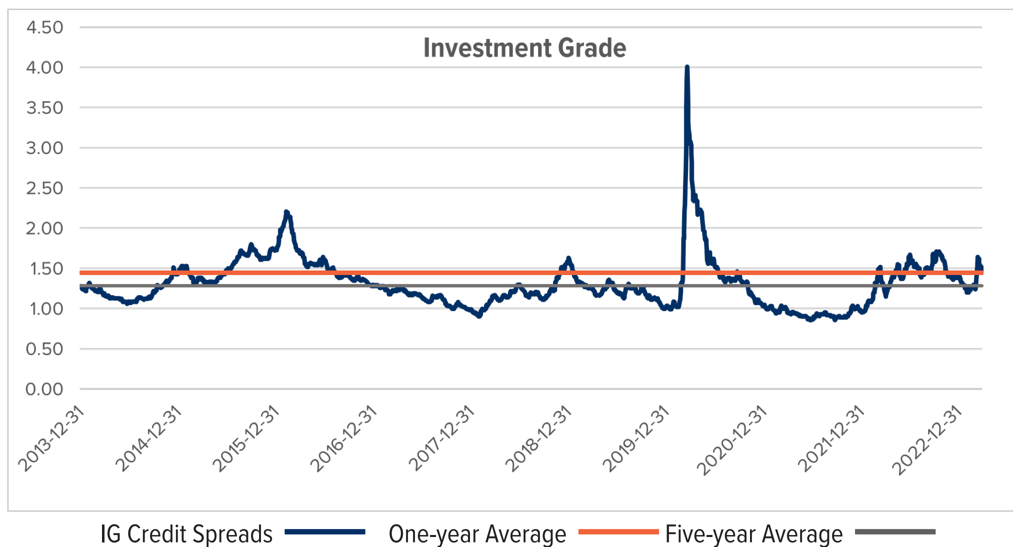


Source: Bloomberg Finance LP, Deutsche Bank, (Last update March 20, 2023)

The amount of Fed easing that investors expect also matters. History would suggest that it is ill-advised to place risky bets on expectations of significant interest rate cuts. According to Morgan Stanley, since 1980 there have been six Fed easing cycles of 150 bps or more. Five of those six easing cycles were associated with recessions, or 83% of the time.

U.S. economic resiliency largely lies at the feet of the strong labor market and consumer spending. With the March 2023 unemployment rate near an all-time low of 3.5%, all eyes will remain on the jobs market. Since 1949, every time the unemployment rate has risen by 1% or more over a 12-month period, a recession has always happened.

Rate volatility aside, credit markets broadly are not signaling much in the way of potentially hazardous conditions down the road. After a brief spike up to 164 bps in early March, broad investment grade credit spreads finished the first quarter at 145 bps, up from 138 bps at year-end. However, dispersion in credit spreads by sector and issuer has increased, which may present compelling opportunities. The high yield market faired even better. After rising to 522 bps (up from 481 bps at year-end), high yield spreads finished the first quarter at 458 bps.



IG Credit Spreads — One-year Average — Five-year Average

Outlook

We expect the path forward will be bumpy and the range of outcomes will remain wide. However, we continue to add attractive investments to our portfolios across a diverse array of sectors within corporate credit and securitized products. We also maintain sizable Treasury holdings to provide ballast and enable us to take advantage of opportunities brought on by market turbulence. We remain highly focused on the credit performance of our underlying investments and, overall, we remain pleased with the quality and performance of our portfolios. Coupling our differentiated investment approach with the potential for forward returns that haven't been this good in many, many years leaves us very encouraged by future return possibilities.

IMPORTANT DISCLOSURES

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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.

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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.

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