FIXED INCOME INSIGHTS / 1Q 2024

Great Expectations

Weitz | INVESTMENT MANAGEMENT

After a stunning "everything rally" in the fourth quarter, U.S. fixed income markets took a breather to start 2024. As illustrated in the chart below, interest rates increased across the yield curve, as investors dialed back expectations of significant Federal Reserve interest rate cuts in 2024. The result was modest gains for shorter-duration and more credit-sensitive sectors of the market and small to moderate losses for intermediate and longer-duration bonds.

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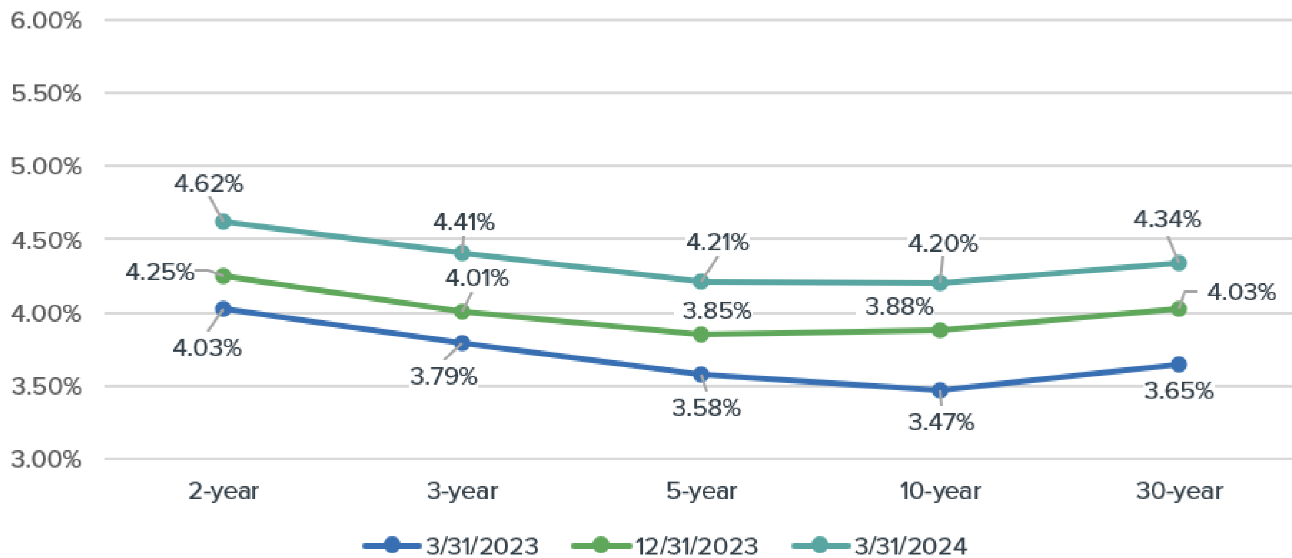


Source: Bloomberg

While interest rates increased during the first quarter, risk assets continued their torrid rally. In hindsight, last November's long-awaited Fed 'pivot' or pause in its monetary tightening policy, was akin to the Fed announcing the "all-clear" signal, giving investors confidence that everything is (finally) just right. The U.S. Treasury added to the excitement by aggressively shifting the expected mix of government funding toward T-Bills, and away from longer-term coupon issuance (lower-than-expected coupon issuance may provide technical support for longer-term yields). Interestingly, the announcement coincided with 10-year and 30-year Treasury bond rates briefly eclipsing 5% for the first time in more than 16 years.

High Yield Rally Continues in Q1

Q1 2024 Fixed Income Returns | Bloomberg Indices

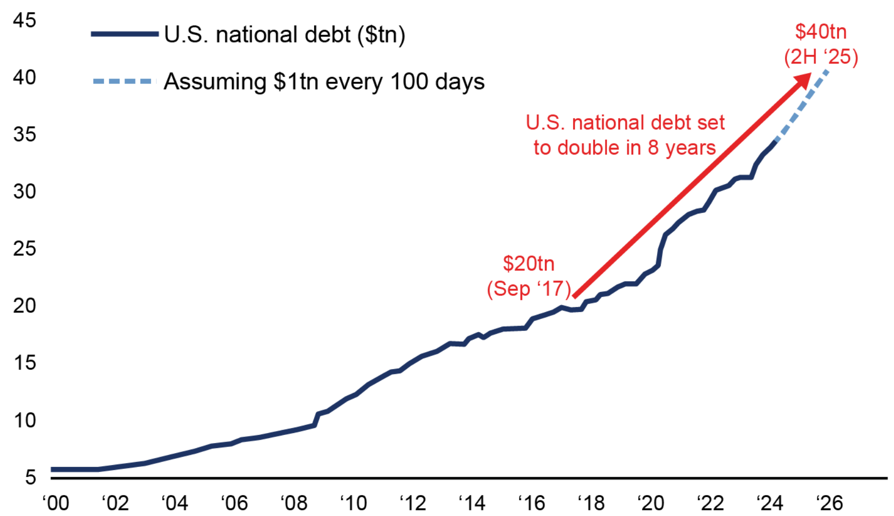
	Q1 Returns (%)	Duration (Years)
U.S. T-Bill Index	+1.29	0.26
U.S. Aggregate Bond	-0.78	6.21
U.S. Treasury	-0.96	6.04
U.S. MBS (Mortgage-Backed)	-1.04	6.08
U.S. Corporate Invest Grade	-0.40	7.01
U.S. Corporate High Yield	+1.47	3.15
U.S. Securitized	-0.91	5.92

Source: Bloomberg

While we remain optimistic about forward-looking return prospects in fixed income, as credit spreads continue to rachet tighter the amount of coupon income or yield available in the marketplace is increasingly a function of today's relatively high levels of U.S. Treasury, or "risk-free," rates. As we look at credit markets broadly, investor sentiment today largely reflects a high level of certainty in the future path of the economy, the painless disappearance of inflation, and Fed rate cuts. In other words, credit markets are discounting little room for error. As Warren Buffett famously said, "The future is never clear; you pay a very high price in the stock market for a cheery consensus." In reality, the future path of the U.S. economy, inflation, fiscal policy, and geopolitics remains highly uncertain. As a stark example, since the Fed's pivot, we have seen significant increases in the price of a wide range of commodities including oil and gasoline, which may feed into higher inflation down the road.

More concerning and less discussed is the impact of U.S. fiscal policy. Years of huge government deficits are, by nature, inflationary. Extraordinary levels of government spending without commensurate increases in tax revenue have resulted in government deficits once reserved for only war-time periods, averaging 9% of GDP over the last four years. This deficit spending may be the primary reason that the Federal Reserve's rapid increase in interest rates has yet to buckle the U.S. economy. Per Bank of America, the U.S. national debt is rising by $1 trillion every 100 days; it is set to hit $37 trillion by the election, $40 trillion by mid-2025, and could double in eight years. To say we may be borrowing growth from the future could prove to be an understatement.

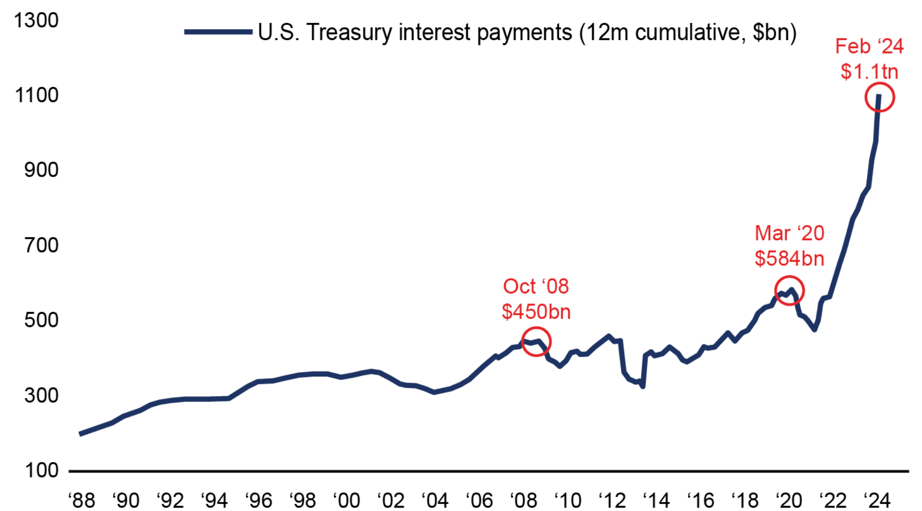
U.S. national debt ($tn) and projection assuming $1tn increase every 100 days



Source: BofA Global Investment Strategy, Bloomberg

Increasing government deficits accompanied by high interest rates creates a more challenging interest burden the U.S. must absorb. Spending an increasing amount of government tax revenue to pay interest crowds out spending for otherwise more productive uses. Per Bank of America, interest costs are set to rise to $1.6 trillion based on current spending trends and as U.S. debt is refinanced at higher current rates. This dynamic could result in increasing amounts of Treasury issuance as deficits increase further. Fiscal policy has and may continue to play a critical role in the evolution of the post COVID economic and inflation dynamics.

U.S. Treasury interest payments ($bn, 12-month cumulative)



Source: BofA Global Investment Strategy, Haver

As previously mentioned, credit spreads continued their descent in the first quarter and now sit near 10-year lows. Broad investment-grade spreads declined from 106 basis points to 93 basis points. High yield spreads declined from 339 basis points to 312 basis points. Investor behavior in both the primary and secondary markets suggest there is simply not enough supply of credit to keep up with demand. We are witnessing signs of investor complacency with indiscriminate buying, record levels of new issue subscription (both in corporate bonds and securitized products), and significant flattening in credit curves (i.e., the extra compensation you receive to lend further out the interest rate curve). Given market conditions that appear priced for perfection, we ask ourselves: what happens to risk assets and the economy if the Fed doesn't cut rates at all or as much as expected? Or if the Fed does cut rates, will that spur another rally in risk assets, commodities and therefore, further fuel inflation? We believe the answer to either question warrants caution regarding duration exposure and current levels of credit spreads.

The Value of Diversification in Fixed Income

Our investment approach focuses on casting a wider net across the fixed income landscape, seeking out the most attractive risk-adjusted opportunities both within and outside the benchmark categories. Today, we believe a diversified portfolio encompassing broad market exposure, including benchmark and non-benchmark, fixed and floating rate, is a competitive advantage in today's environment. How so? Our current asset allocation reflects not only our efforts to focus on sector and security selection, investing in assets one at a time in those areas that we believe have the most favorable risk/reward outcomes, but to weather different macro environments.

For example, if continued economic strength results in a steepening yield curve/increase in term premiums and higher longer-term yields, allocations to newer vintage agency and non-agency mortgages (our coupon stack consists of newer vintage 4.5% to 6.5% coupons) should benefit from attractive coupon income and slower prepayment speeds. Moreover, these MBS investments differ from what is broadly represented in the benchmark indices like the Agg, which largely consists of low coupon (2-3%), lower dollar price MBS that was originated during the post COVID/Fed QE 2020-2022 period. A scenario where inflation remains stickier than expected, forcing the Federal Reserve to hold short-term interest rates higher than what is discounted in the front end of the Treasury curve, may benefit floating rate securities (commercial mortgage-backed securities, corporate and infrastructure CLOs). Higher for longer short-term rates may also benefit shorter duration asset-backed securities (auto, consumer, equipment) given their 1-2 year weighted average life profile and amortization feature, allowing for the reinvestment of monthly interest and principal payments. Conversely, should the U.S. economy suffer unexpected weakness or experience an exogenous shock, U.S. Treasuries may provide downside protection, serve as a natural hedge to MBS exposures, and provide a key source of liquidity to take advantage of market opportunities that may arise from unexpected economic turbulence. Regardless of the macro environment to come, we believe our active, flexible approach will allow us to deliver value to shareholders.

IMPORTANT DISCLOSURES

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 04/10/2024, 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.

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

Definitions: Basis point (BPS) refers to a unit of measurement that is equal to 1/100th of 1%, or 0.01%. Spreads are measured by **ICE BofA** which is a group of indexes that track the performance of U.S. dollar-denominated debt issued in the U.S. domestic market. The **Bloomberg U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The **Bloomberg U.S. Corporate High Yield Bond Index** measures the U.S. dollar-denominated, high yield, fixed-rate corporate bond market. The **Bloomberg U.S. Corporate Investment Grade Index** is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market. The **Bloomberg U.S. Mortgage-Backed Securities (MBS) Index** tracks fixed-rate agency mortgage-backed pass-through securities guaranteed by Ginnie Mae, Fannie Mae, and Freddie Mac. The **Bloomberg U.S. Securitized Index** is a subset of the Bloomberg U.S. Aggregate Bond Index that includes MBS Pass-through, ABS, CMBS and covered assets. The **Bloomberg U.S. Treasury Index** measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. The **Bloomberg U.S. Treasury Bill (T-Bill) Index** tracks the market for treasury bills issued by the U.S. government. U.S. Treasury bills are issued in fixed maturity terms of 4, 8, 13, 17, 26 and 52 weeks. **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. Effective yield is the return on a bond that has its interest payments (or coupons) reinvested at the same rate by the bondholder. **Effective yield** is the total yield an investor receives, in contrast to the nominal yield—which is the stated interest rate of the bond's coupon. **Option Adjusted Spread**: A “spread” compares the interest rate on a particular bond against a “base line” bond (typically a U.S. Treasury bond). When a bond issuer (or bondholder) has the option to exercise a right (for example, if the issuer can call a bond before its stated maturity date), then the “Option Adjusted Spread” takes into account the possibility that this option might be exercised—so a bond's Option Adjusted Spread may be more (or less) than its regular spread.

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.