High Uncertainty, Great Opportunity

Weitz | INVESTMENT MANAGEMENT

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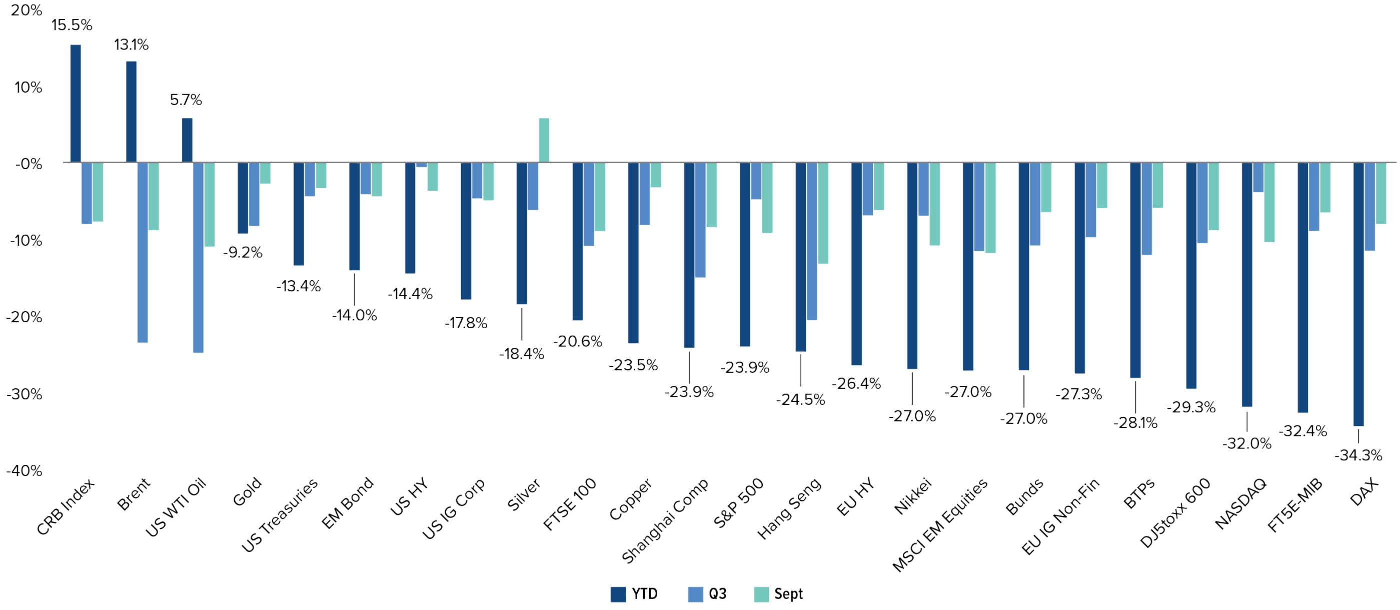
The third quarter was a continuation of the "nowhere to hide" mantra that has dominated almost all global assets in 2022. Here in the U.S., the strong start for both credit and equities came to a crashing halt after Federal Reserve Chairman Jerome Powell delivered a simple, yet stark, message at the Jackson Hole Economic Symposium in late August: taming inflation will require more financial and economic pain. The higher-than-expected August inflation report threw more fuel on the fire, creating severe risk-off conditions (investors reducing their exposure to risk and focusing on protecting capital) and extreme cross asset volatility (volatility across multiple asset classes, including stocks, bonds, commodities, and currencies).

2022 YTD, Q3, and September Total Returns (in USD) for a Selection of Global Assets



Source: Deutsche Bank, Bloomberg Finance LP

Zooming in on U.S. fixed income markets, the table to the right provides return data for select Bloomberg U.S. bond indexes for the third quarter and year-to-date. Large negative returns are the norm except for ultra-short securities (such as Treasury bills) and cash. Given this backdrop, while negative returns are never welcome, 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.

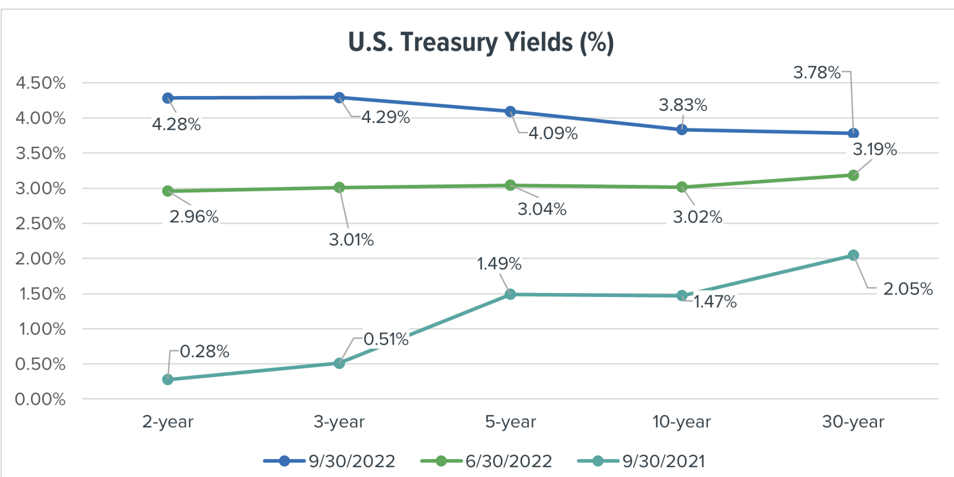
Q3 2022 | Fixed Income Returns
Bloomberg Indexes

	Q3 Return (%)	YTD Return (%)
Bloomberg US T-Bill Index	0.40	0.43
Bloomberg US Aggregate Bond	-4.75	-14.61
Bloomberg US Treasury	-4.35	-13.09
Bloomberg US MBS (Mortgage-Backed)	-5.35	-13.66
Bloomberg Municipal	-3.46	-12.13
Bloomberg US Corporate Invest Grade	-5.06	-18.72
Bloomberg US Corporate High Yield	-0.65	-14.74

As of 9/30/2022

U.S. Treasury yields surged to multi-decade highs as the Fed's resolve to keep monetary policy more restrictive for longer took markets by surprise. In other words, ANY hope for a Fed pivot was crushed. Contrary to such hope, the Fed delivered a third consecutive super-sized 0.75% interest rate hike in September and set the stage to increase interest rates by an additional 1.00-1.25% this year, resulting in expectations for a 4.00-4.25% target rate by year-end. In addition, the Fed's quantitative tightening (QT) program is now in full effect with up to $90 billion of roll-off per month from the Fed's balance sheet.

The Fed's intent to keep raising interest rates and sustain them at an elevated level is explicitly seen in the upward shift of the entire yield curve during the third quarter. As illustrated to the left, the Fed's expected path of interest rate hikes is largely priced into the market today, with 2-yr and 3-yr Treasuries yielding above 4.25%. Incredibly, the yield on 2-yr Treasuries has increased more than fifteen-fold over the past year. In addition, the 10-year Treasury briefly traded above 4% for the first time since 2010.

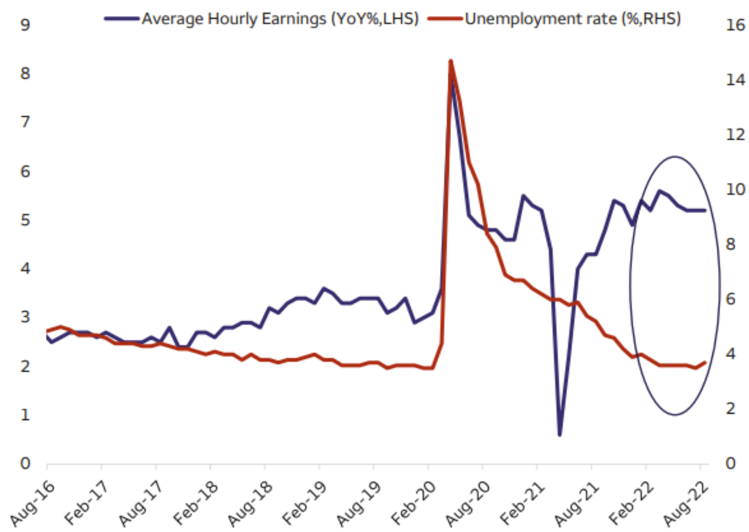


Source: U.S. Federal Reserve

Federal Reserve - No (Easy) Way Out

After decades of accommodative monetary policy, the Federal Reserve is dusting off the restrictive policy playbook. And while they believe a softish landing is still the most likely outcome, whereby inflation recedes toward its 2% target and unemployment gently rises, the history books contain few reasons to be optimistic when it comes to high inflationary environments. Since World War II, only two of the prior thirteen Fed hiking cycles ended without a recession (1965-66 and 1994-1995). However, in neither case was inflation at or above 5%, let alone over 8%. The U.S. also has much higher leverage (i.e., debt-to-GDP) in the overall economy than we did in the 1960s or 1990s.

Monetary policy is a blunt policy tool and one that operates with a significant economic lag, leading to both intended and unintended consequences. As a result, no one knows what economic impact the Fed's aggressive interest rate hikes will have on the economy over the next six to twelve months. In the here and now, the Fed remains focused on inflation and employment trends, and the data is not encouraging. The strong labor market is a key reason inflation remains stubbornly high. As illustrated in the chart to the right, there remains a large gap between wages and the unemployment rate. Even with the tick down in the year-over-year growth rate of average hourly earnings from 5.2% in August to 5.0% in September, wage pressures remain elevated. In addition, the unemployment rate fell back to a 50+ year low of 3.5% in September, from 3.7% in August.

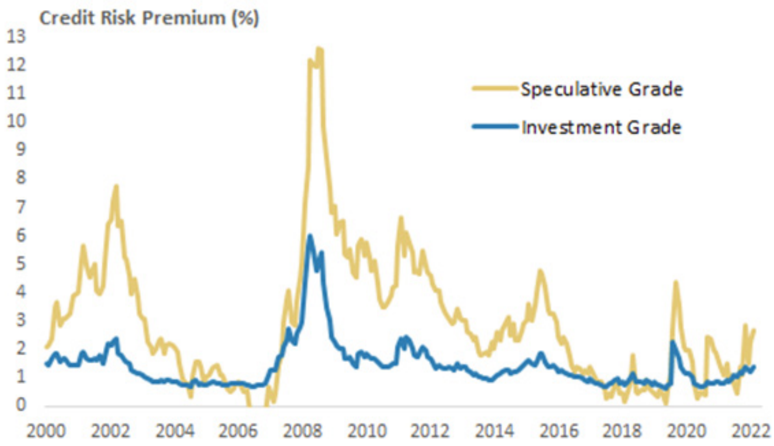


Source: Wells Fargo Securities, Bureau of Labor Statistics, Bureau of Economic Analysis

Even though employment is considered a coincident or lagging indicator, these labor market statistics are in stark opposition to the Fed's goal of increasing unemployment. Again, history is not on the Fed's side. According to Deutsche Bank, twelve months following the first interest hike in all previous thirteen Fed hiking cycles going back to the mid-1950s, the unemployment rate declined in twelve instances and was flat in the other. Moreover, per Bank of America, the average unemployment rate when the Fed hiked rates for the last time in the past sixteen rate-hiking cycles was 5.7%. This historical context, and the latest data, seem to suggest the Fed may have difficulty making significant progress on nudging the unemployment rate up and, therefore, has plenty of work to do per its policy objectives. Ultimately, no one knows what the longer-term economic impact will be, but we are preparing for a much weaker economy in 2023.

No Canary in the Credit Coal Mine

While investors have witnessed extreme interest rate and equity market volatility, such fear has yet to spill over to credit markets. The chart to the right shows how credit risk premiums have widened in both investment grade and high yield, but not to levels consistent with market stress or recession. As such, market participants banking on a Fed pivot due to "stress" in financial market conditions may be disappointed. While new debt issuance is becoming more costly for issuers, financial intermediation is alive and well. New financing transactions are getting done, albeit with better pricing and terms for investors. Secondary markets have gotten choppier, and liquidity is harder to come by, but we welcome these conditions and are taking advantage.

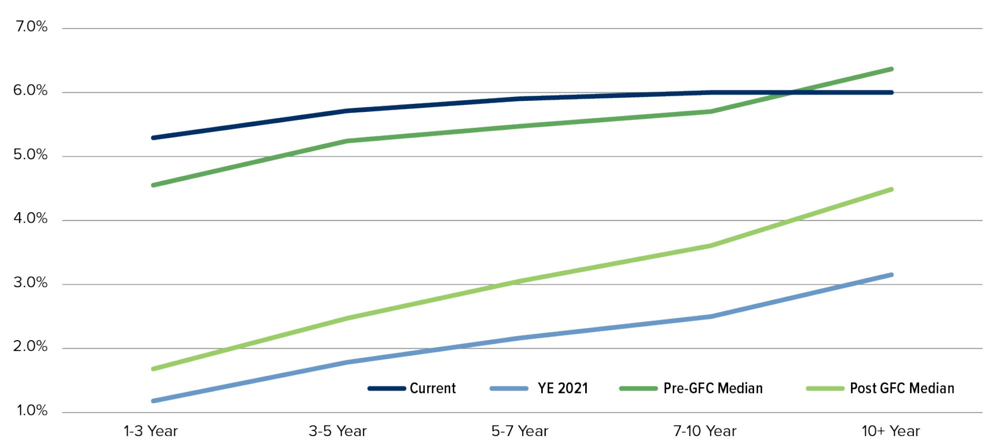


Source: Morgan Stanley Research

Finally, The Presence of Higher Income/Yields

Over the past few years, we repeatedly warned about low forward-looking returns across fixed income markets given historically low yields during and after the COVID pandemic. While uncertainty remains the dominant force, there is a bright spot for fixed income investors: forward return prospects continue to improve on the back of higher current income/yields. Interest rates are adjusting to higher inflation, and credit spreads reflect an uncertain economic environment. **As a result, we are finding the best risk-adjusted return opportunities since the COVID pandemic. We are proceeding with caution, but with Treasury yields at or above 4% and higher-quality, investment-grade yields on offer at 5-7%, we believe that now may be a good time for investors to consider adding to their fixed income allocation.**

To illustrate the attractive yields on offer today, CreditSights assembled the following investment-grade yield curve across various duration segments. The key takeaway is that current investment-grade yields (dark-blue line) are now **mostly above the pre-Great Financial Crisis (GFC) median** (dark-green line). In other words, the post-GFC environment of zero-interest-rate policy – reflected by the post-GFC median (light-green line) and, at its most extreme, year-end 2021 (light-blue line) – have been fully retraced by today's fixed income environment.



Source: CreditSights

As we often say, we would never "call" a bottom in price or a peak in yields. Our overarching investment approach is to remain patient while utilizing our flexible mandate to achieve our long-term investment goals. Namely (a) preserve capital, (b) maintain a strong liquidity position, (c) understand evolving risks and opportunities, (d) conduct consistent/thorough credit surveillance, and (e) selectively take advantage of favorable risk/reward opportunities.

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 10/12/2022, 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.

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.