FIXED INCOME INSIGHTS / 4Q 2022

Bonds are Back / Return of Income

Weitz | INVESTMENT MANAGEMENT

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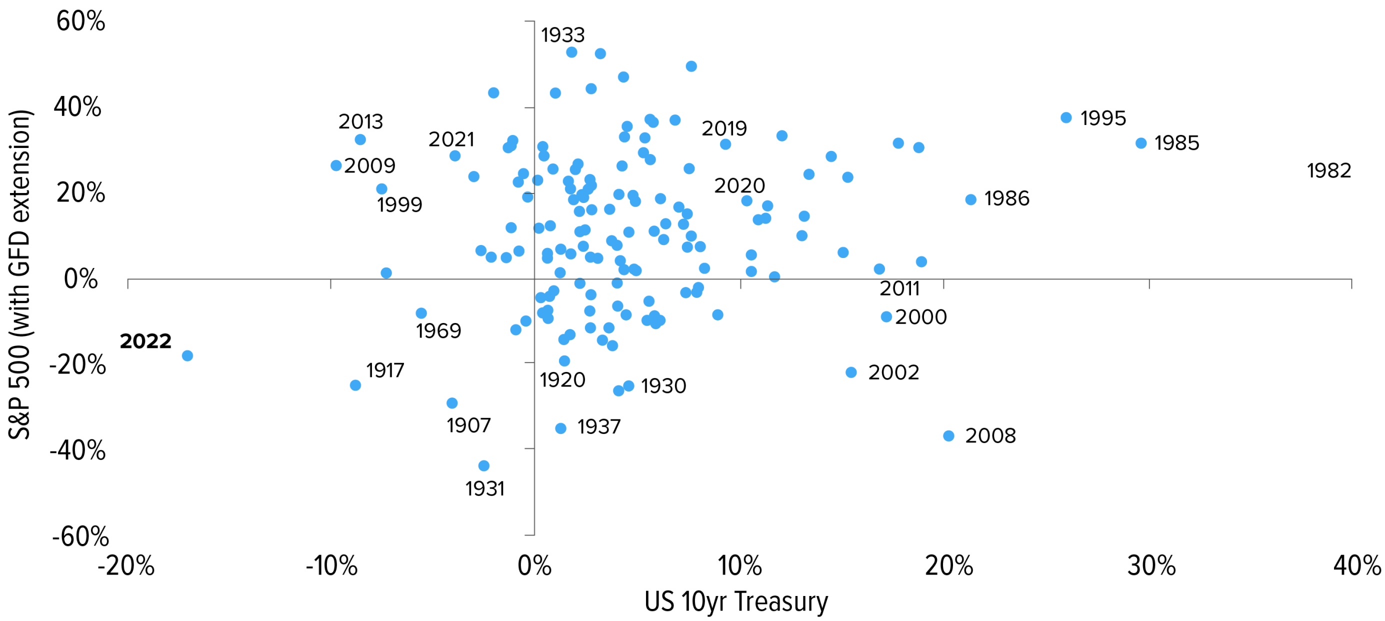
Signs of easing inflationary pressures in the fourth quarter and, with that, hope that the Federal Reserve will slow or pause tightening monetary policy, provided some respite from an otherwise brutal year for fixed-income investors.

Despite the rebound in the last three months of the year, 2022 set a historic precedent for both bond and equity returns. As the chart below highlights, 2022 was the first year since the origin of this data series (in 1872!) that **both** the 10-year Treasury and S&P 500 lost more than 10% on a total return basis for a full calendar year (actual results were -17.0% and -18.1% respectively).



Source: Deutsche Bank, GFD (Global Financial Data)

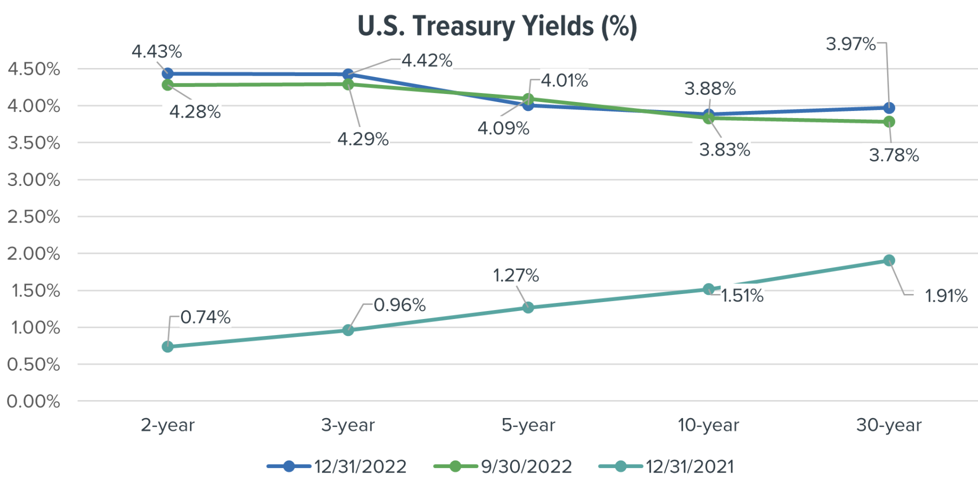
Zooming in on U.S. fixed income markets, the table to the right provides return data for select Bloomberg U.S. bond indexes for the fourth quarter and full year 2022. Except for ultra-short securities (such as Treasury bills) and cash, historically large negative returns were widespread across various fixed-income asset classes. Given this backdrop, while negative returns are never welcome, we continue to be 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.

2022 | Fixed Income Returns Bloomberg Indexes		
	Q4 Return (%)	2022 Return (%)
Bloomberg US T-Bill Index	+0.89	+1.46
Bloomberg US Aggregate Bond	+1.87	-13.01
Bloomberg US Treasury	+0.72	-12.46
Bloomberg US MBS (Mortgage-Backed)	+2.14	-11.81
Bloomberg Municipal	+4.10	-8.53
Bloomberg US Corporate Invest Grade	+3.63	-15.76
Bloomberg US Corporate High Yield	+4.17	-11.19

As of 12/31/2022

The Federal Reserve delivered a fourth-consecutive super-sized 0.75% interest rate hike to the federal funds rate in November before slowing its pace to an increase of 0.50% in December, resulting in a 4.25-4.50% target rate by year-end. In the minutes released from the Fed's December 2022 meeting, Federal Open Market Committee (FOMC) members' projections (known as the 'dot plot') showed a median year-end 2023 estimate for the federal funds rate target of 5.125%, with an upward skew to that median (17 of the 19 committee member estimates were above 5%).

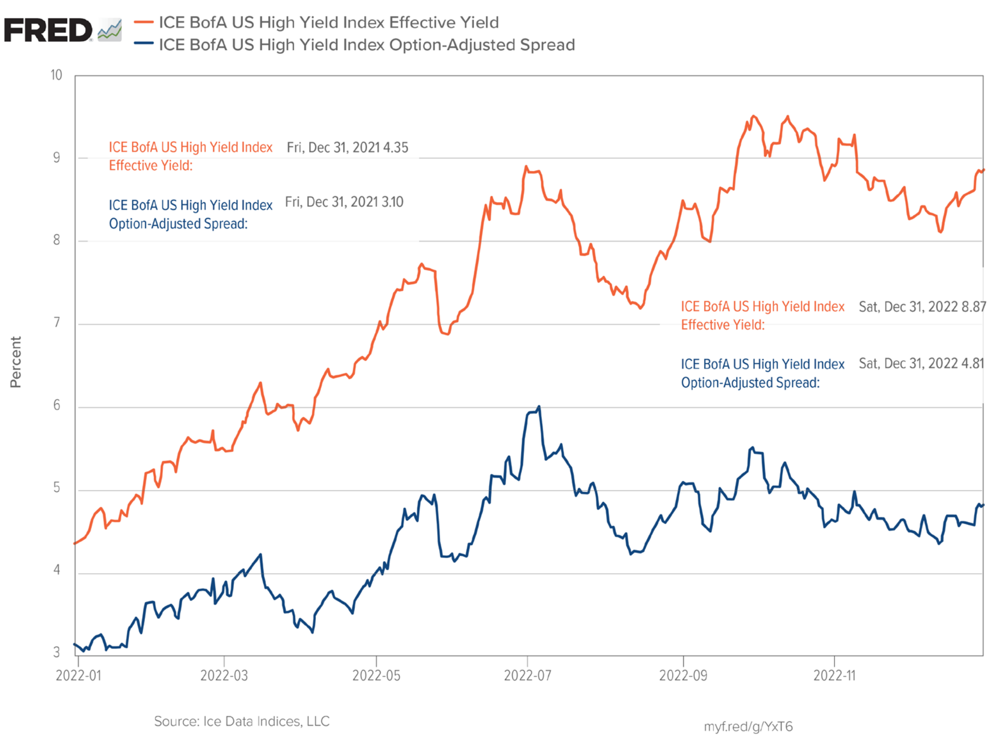
It's worth noting that despite the economic data at the Fed's disposal (arguably vastly superior to all market participants), their 'crystal ball' is as cloudy as everyone else's. Case in point, in the Fed minutes from December 2021, 16 of 18 FOMC members had projected end-of-year 2022 'dots' **below 1%** (with a median dot for end-of-year 2024 of 2.1%). There were even a number of people still thinking inflation would prove 'transitory.' So much for forecasts. More evidence of why we eschew making too many (if any).

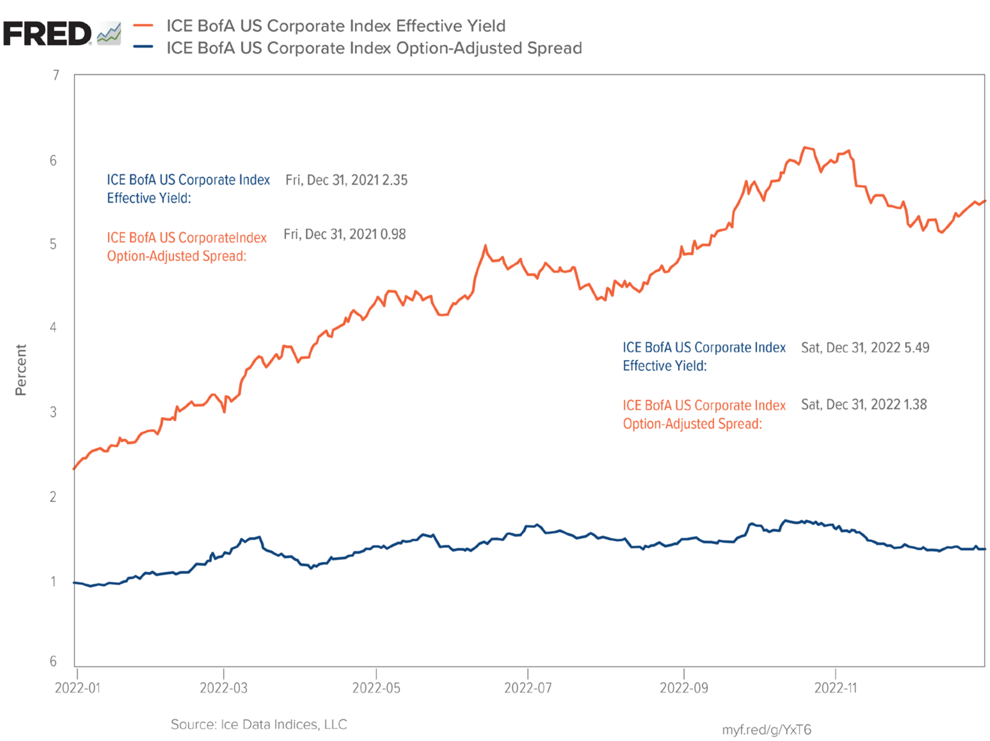


Source: U.S. Federal Reserve

As illustrated in the chart to the left, and given market expectations of a terminal Federal Funds Rate nearing 5%, 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 4.40% at year-end.

Corporate credit spreads widened (increased) during 2022 but are off the peak reached in the second and third quarters. The charts below combine the changes in credit spread (red lines) with changes in effective yield (blue lines) for the broad investment grade corporate and high yield bond indexes. While overall spread levels (red) have not meaningfully increased, the effective yields (blue) have more than doubled from where they began the year as the rise in base (Treasury) rates have improved forward return prospects, a topic we've highlighted in previous correspondence.





Bonds' 'Great Reset' and the Return of Income

Many investors might have been happy to turn the calendar and say good riddance to 2022 as bonds experienced a painful version of 'The Great Reset' (a term originally coined to describe the World Economic Forum's Covid recovery plan). After wandering the investment 'desert' and suffering through nearly 10 years of the Fed's zero interest-rate policy (ZIRP), the view of the investment landscape at the beginning of 2023 may not be 'a land flowing with milk and honey,' but the ability to generate income from a portfolio of fixed income securities is a welcome relief from the 'return-free risk' environment that plagued most of the last decade.

While uncertainty is a constant companion for investors, we remain encouraged by the scope and breadth of some of the best risk-adjusted return opportunities in many years. Borrowing part of the title from The Angels' 1963 hit "My Boyfriend's Back," we think it's more than fair to claim that "Bonds are Back." Caution is and will remain our calling card, but we continue to believe now is a good time for investors to consider adding to their fixed income allocation.