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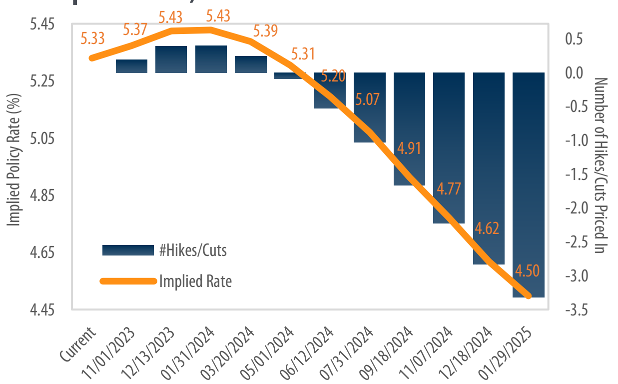
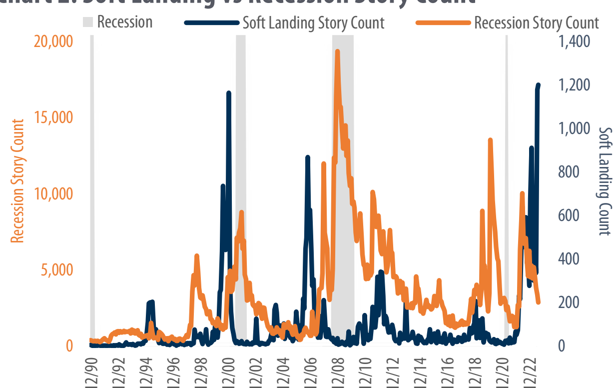
Chart 1: Implied Federal Funds Rate & Number of Hikes/Cuts as of September 30, 2023



Source: Bloomberg, as of 9/30/2023. The assumed rate movement for one rate hike or cut is equivalent to +/- 0.25%. There is no assurance forecasts will be achieved.

Chart 2: Soft Landing vs Recession Story Count



Source: Bloomberg. Data from 1/1/1991-9/1/2023. Past performance is no guarantee of future results.

Finally! The market drumbeat of higher interest rates for longer has reached the loudest in this cycle. What a stark contrast from where we've been for most of this rate-hiking cycle. After all, for much of this cycle, Chairman Powell has repeatedly reminded markets of the Federal Reserve's ("Fed") commitment to achieve a 2% inflation rate. However, despite the consistent reminders, the market has largely been betting that the Fed would cut rates aggressively in the not-too-distant future. Well, much has changed since the last Fed meeting in September. The rate pendulum has now swung a great distance to the other side. Much of the recent change in interest rates has stemmed not from expectations for a higher terminal Fed Funds rate, but rather expectations that the Fed will hold rates at these much higher levels further into the future (Chart 1).

While the recent interest rate volatility may seem as though the bond market is coming unhinged, we believe much of the rate volatility can be tied back to current economic data and the markets perception that a "soft landing" is imminent. Last quarter, we wrote about how convinced the market was that the economy will "soft land" (in other words, no imminent recession). As one can see in Chart 2, the number of Bloomberg, L.P. news stories highlighting a soft landing is near an all-time peak. What does all of this have to do with interest rates? Well, if the market believes a soft landing is on the horizon, that suggests the potential for stronger economic growth and higher inflation for a longer period of time, resulting in higher interest rates for a longer period of time. However, we'd caution readers to observe that, it would not be out of context with history to have a surge in soft landing conviction shortly before the economy begins to weaken. While there's no way to perfectly time such a downturn, the historical context can prove useful.

We believe the Fed will continue to "leak" an additional rate hike or two into the market from here. This is supported not only by how high interest rates are relative to trends in the economy, but, how high real (inflation adjusted) rates are, as well. The real 10-year U.S. Treasury yield was 2.23% at the end of the third quarter. Prior to the Global Financial Crisis in 2008/2009, the real 10-year U.S. Treasury yield peaked at 2.82%. Higher real rates have historically resulted in drags on the overall business cycle. As such, we believe we are much closer to this hiking cycle's finish line than we are to its beginning. Moreover, with interest rates at these levels, the bond math is much more supportive of future positive returns than it has been for some 15 years. A stronger case can be made today relative to any point in this cycle for the asymmetrical payoff available to bond investors given a 100 basis point (bps) change in interest rates in either direction (Chart 3). Said differently, the higher interest rates in the market, or "carry," when coupled with the convexity, or non-linear relationship between interest rates and bond prices, we believe they are at a level where they once again offer protection to investors. Consequently, given the long and variable lags between higher real rates and the economy, we believe the reinvestment risk inherent in owning short-term securities likely poses a greater risk than owning duration. Our duration target is 100% of the Bloomberg U.S. Aggregate Bond Index's duration. We continue to closely monitor interest rates and the health of the labor market to gauge the timing of further duration extension. Finally, we continue to favor more defensive areas of fixed income (investment grade) over higher risk bond allocations.

Chart 3: Bond Convexity is Back: Asymmetrical Return Profile

Treasury Maturity	Current Yield	12-month Total Return if Rates Increase +100bps	12-month Total Return if Rates Decrease -100bps
Two-Year	5.05%	3.20%	6.94%
Five-Year	4.60%	0.14%	8.81%
10-Year	4.58%	-3.85%	12.17%
30-Year	4.70%	-11.68%	20.92%

Source: Bloomberg, as of 9/30/2023. Past performance is no guarantee of future results. Two-Year treasuries are represented by the ICE BofA Current 2-Year US Treasury Index. Five-Year treasuries are represented by the ICE BofA Current 5-Year US Treasury Index. 10-Year treasuries are represented by the ICE BofA Current 10-Year US Treasury Index. 30-Year treasuries are represented by the ICE BofA Current 30-Year US Treasury Index. Total return profiles in the above illustration assume an investor purchases the specified treasury maturity on the date listed below and sells the investment 12-months later. A basis point is a common unit of measure for interest rates and is equal to 1/100th of 1% or 0.01%. A 1% change is equal to 100 basis points. Yield for ICE BofA Current 2-Year US Treasury Index was 5.05% on 9/30/2023. Yield for ICE BofA Current Five-Year US Treasury Index was 4.60% on 9/30/2023. Yield for ICE BofA Current 10-Year US Treasury Index was 4.58% on 9/30/2023. Yield for ICE BofA Current 30-Year US Treasury Index was 4.70% on 9/30/2023.

SECTOR POSITIONING

Ultra-Short Maturity

In the past year and a half, the Fed has raised the Federal Funds Rate by more than 500 bps. As a result, the income potential from ultra-short securities, such as commercial paper and short-term corporate notes has significantly increased. Some additional hikes may be forthcoming, but we believe that the Fed is near the end of its hiking cycle but will keep rates elevated well into 2024 to bring inflation to its target. We believe ultra-short securities offer investors attractive yields with a high-quality bias.

Mortgage-Backed Securities

We hold a positive outlook on agency mortgage-backed securities given the historically attractive valuation levels of mortgage-backed securities and may prove defensive should the market experience a harder landing than is priced in today. Finally, given the interest rate increases that have occurred, we believe most of the mortgage bond market appears to be fully extended.

U.S. Treasury Securities

Given the broad increase in rates, we like U.S. Treasuries to limit credit risk and extend duration. While we anticipate upward pressure on rates, we believe the bond market is more balanced today between income and duration. We believe the durability of U.S. Treasuries provides an attractive complement to our credit positions.

High-Yield Bonds

Our outlook for high-yield bonds remains cautious. We believe that the risk of a recession in 2024 is increasing, which is not fully reflected in high-yield bond spreads that we feel are priced for a 'soft landing' scenario. We estimate that default rates will rise in 2024, surpassing the long-term average of 3.2%. Nevertheless, as of September 25, 2023, the average price is near 88 with an average yield of approximately 8.9%, which provides some buffer to total return expectations. Accordingly, we anticipate modestly positive total returns for high-yield bonds over the next twelve months, as higher yields should help mitigate the negative price impact associated with wider credit spreads.

Emerging Market Bonds

Emerging Market bonds offer attractive levels of income and the potential for capital appreciation driven by the expectation of yield compression as several central banks have initiated rate cutting cycles following peak inflation. A key risk to that view would be a broad global risk-off event, which in the past has negatively impacted Emerging Market currencies due to the strengthening of the U.S. dollar. Nevertheless, we believe this could be partially mitigated because the U.S. dollar is currently at elevated levels relative to many Emerging Market currencies. The volatility in Emerging Markets continues to be influenced by uncertainty surrounding the terminal rate of the Fed, although consensus is leaning towards one more rate hike or a pause. We view the fundamental backdrop as neutral, with multiple countries experiencing expansionary manufacturing PMIs and a peak in inflations. Despite China's relatively lackluster levels of stimulus and easing, we expect the policies to contribute positively while attention remains focused on the Chinese domestic real estate and mortgage market. Consequently, we anticipate the return outlook will be shaped by the appealing income levels and the potential for yield compression as Emerging Market countries lower rates, with currency movements in relation to the U.S. dollar serving as the wildcard.

Senior Loans

We find the yields in the bank loan market to be attractive, given they are floating rate and the yield advantage of loans compared to high-yield bonds is currently near record highs. However, it is important to note that the senior loan market has been tilted towards weaker and lower-rated companies, which we believe are likely to face more difficulties as financial conditions tighten. Typically, a rapid increase in interest rates puts a heavier interest burden on highly leveraged companies, leading to reduced cash flow at a time when recession risk is rising. We anticipate that the refinancing schedule will remain manageable through next year, but it is expected to significantly increase in 2025 and 2026. Therefore, even considering the valuation metrics, we would look for a more opportune time to add to senior loan exposure given the unique risk factors facing the sector.

Investment Grade Corporate Bonds

We are constructive on investment grade corporate debt due to high yields, partially offset by the potential for modest spread widening in a weakening macroeconomic environment. Currently, all-in yields are near their highest levels in over a decade, while credit spreads remain below the historical average. Given this environment, we believe there will be a divergence in valuations between cyclical and non-cyclical sectors, highlighting the importance of active management and credit selection. Consequently, we maintain a favorable view on short and intermediate duration, where spreads are closer to long-term averages compared to longer duration spreads, which we believe are expensive from a historical perspective and carry higher risks of negative returns due to their heightened price sensitivity to wider credit spreads.

Preferred Securities

Preferred securities are expected to generate returns primarily through income in the near-term, as limited price appreciation is anticipated due to the lack of fund inflows and volatility in interest rates. Despite this, valuations remain attractive on a historical basis, with yields above 7% and discounted prices at 88% compared to par, as of September 5, 2023. However, we believe tighter financial conditions and an evolving economy may put pressure on some smaller issuers, particularly smaller regional banks concentrated in commercial real estate.

Municipal Fixed Income

We anticipate positive total returns for municipal securities over the next year, primarily driven by our interest rate outlook, which suggests the completion of the Fed's rate hiking cycle and a gradual decline in longer-term rates driven by lower forecast economic growth. However, we consider valuations, as indicated by the muni-treasury ratio, to be on the richer side of fair value in the 5 and 10-year portion of the curve compared to the past three years while 20+ year to maturity municipal bonds appear closer to fair value. We specifically see value in the A and BBB rated revenue sectors, such as airports, health care, toll roads, and gas bonds, within the 11-20 year maturity range, as such we believe this is an area where active management adds value vs passive index investing. While credit fundamentals have remained relatively stable this year, we anticipate a gradual deterioration as the U.S. economy weakens, with subdued revenues and a gradual rise in unemployment. Federal funding will continue to support credit this year, but funds are being expended and will not be replenished. While credit ratings upgrades have exceeded downgrades this year, there is an increasing number of negative outlook changes, which we expect to continue.

Definitions:

The **Federal Funds Rate** is the interbank overnight lending rate for commercial banks' excess reserves. The **Implied Federal Funds Rate** for the U.S. is the estimated forward rate for the United States and is derived from Federal Funds Futures contracts to determine the probability of the Federal Reserve changing monetary policy at a particular meeting.

The **Bloomberg US Aggregate Bond Index** measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS, ABS and CMBS. The **ICE BofA Current 2-Year U.S. Treasury Index** is a one-security index comprised of the most recently issued 2-year U.S. Treasury note. The **ICE BofA Current 5-Year U.S. Treasury Index** is a one-security index comprised of the most recently issued 5-year U.S. Treasury note. The **ICE BofA Current 10-Year U.S. Treasury Index** is a one-security index comprised of the most recently issued 10-year U.S. Treasury note. The **ICE BofA Current 30-Year U.S. Treasury Index** is a one-security index comprised of the most recently issued 30-year U.S. Treasury note. Indexes are unmanaged and investors cannot invest directly in an index.