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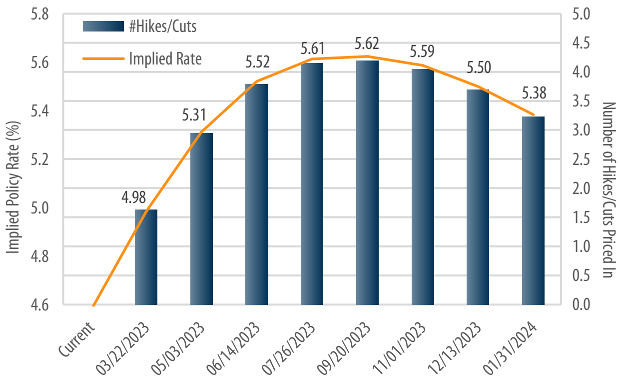
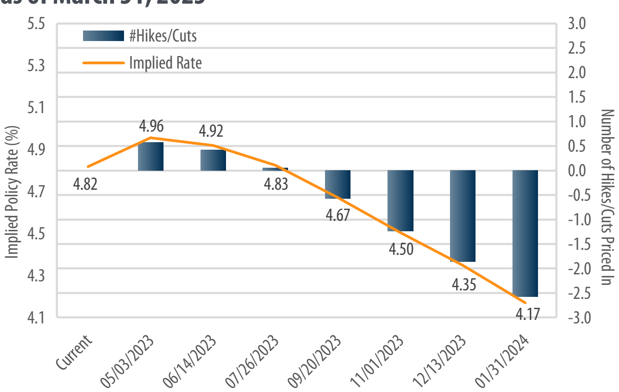
Chart 1: Implied Federal Funds Rate & Number of Hikes/Cuts as of March 7, 2023



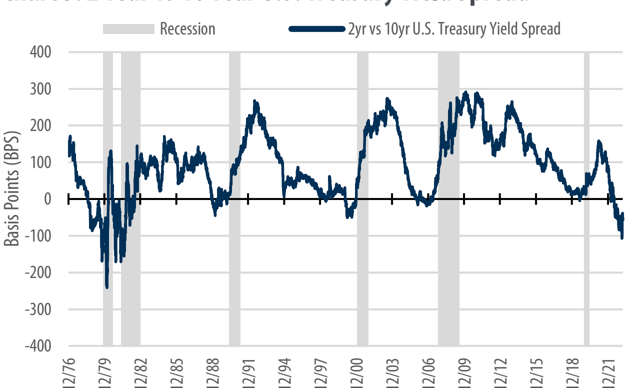
Source: Bloomberg, as of 3/7/2023. The assumed rate movement for one rate hike or cut is equivalent to +/- 0.25%. There is no assurance forecasts will be achieved.

Chart 2: Implied Federal Funds Rate & Number of Hikes/Cuts as of March 31, 2023



Source: Bloomberg, as of 3/31/2023. The assumed rate movement for one rate hike or cut is equivalent to +/- 0.25%. There is no assurance forecasts will be achieved.

Chart 3: 2 Year vs 10 Year U.S. Treasury Yield Spread



Source: Bloomberg, as of 03/31/2023. **Past performance is no guarantee of future results.** The yield spread is the difference between yields on the varying Treasury maturities. 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.

In the first quarter, inflation remained stubbornly elevated as the 6% Consumer Price Index reading in February (reported in March) proved significantly hotter than the Federal Reserve's ("Fed") 2% target. For those keeping tabs, the Fed has now delivered the equivalent of nineteen 25 basis point rate hikes in a span of 13 months. Despite this, inflation's deceleration remains slow.

At the Fed's March meeting, they maintained their December 2022 forecast of a 5.00-5.25% terminal Federal Funds rate; this compares to the current Federal Funds rate of 4.75-5.00%, implying one more rate hike in 2023. While the Fed has consistently reiterated its commitment to fighting persistently high inflation, investors continue to question their resolve, as evidenced by the extreme volatility in rate markets.

While the Fed remains steadfast in both their interest rate policy and commitment to fighting inflation, the market continues to question: (1) the ultimate Federal Funds rate, and (2) how quickly rates will fall once the Fed achieves said terminal rate. The market's interpretation of these two variables proved remarkably fickle in the first quarter, particularly in the final weeks of March. In early March, after a strong labor market report, the bond market expected a terminal Federal Funds rate of 5.50-5.75%, higher than the Fed's own "dot plot" projection. In fact, at one point, the market expected the Fed to raise the Federal Funds rate by 50bps at its March meeting, believing the Fed would hold rates higher throughout the course of the year (see Chart 1). These expectations seemed adequate, and in line with our own expectations. However, by quarter-end, investors had rapidly slashed rate expectations amid chaos in the banking sector, pricing in a terminal Fed Funds rate of 4.75-5.00% and no further hikes in 2023. In effect, the market went from expecting as many as three rate hikes in 2023, to pricing in as many as four interest rate cuts by January 2024 (see Chart 2).

In our view, the bond market, at least in the near-term, has mispriced the Fed's willingness to ensure its battle with inflation is undoubtedly won. Further, the market has likely overestimated the immediate impact of the recent banking sector turmoil on the overall economy. The implications of tighter bank lending standards will likely take time to manifest in overall economic data. Given the Fed "only" delivered a 25bps rate hike in March (instead of 50bps), they seem less interested in the speed at which they reach their target, and most interested in simply making it to that target. As such, we expect interest rates to snap back to the reality of higher for longer, perhaps again reaching a terminal range of 5.50-5.75%. Such repricing of Fed expectations would send U.S. Treasury yields higher, likely resulting in a steeper inversion between the 2-year/10-year U.S. Treasury yield curve. (see Chart 3).

As for the economy, recall that the Fed's policy tools operate with a "long and variable lag." In other words, we have yet to observe the true impact of recent (or future) rate hikes on the overall economy. Higher rates will eventually result in demand destruction, leading to lower corporate earnings, while opening the door to a hard landing for the U.S. economy. The Fed's dual mandate centers on price stability and employment, both of which are typically lagging indicators of overall economic activity; as such, the risks of (1) Fed policy error and (2) a 2023 recession have escalated significantly, in our view.

As we enter the second quarter, we believe that much will hinge on the resilience of the U.S. economy and its ability to withstand the current interest rate environment. We continue to favor extending duration at this point in the cycle, particularly as rate expectations reset higher, providing an opportunity to lock in higher rates for longer. We currently target 85%-90% of the Bloomberg US Aggregate Bond Index's duration in our traditional fixed income model portfolio. We continue to closely monitor the health of the labor market to gauge the timing of further duration extension.

Despite our expectation for rates to reset somewhat higher from here, we believe that we are undoubtedly much closer to the finish line of the Fed's hiking cycle; consequently, the reinvestment risk inherent to owning short-term securities likely poses a greater risk than owning more duration. Said differently, there may be an opportunity cost associated with shorter dated holdings if, after a hard landing, these investments mature into a lower rate environment.

As we proceed further into 2023, we anticipate high levels of volatility, as is typical in bear markets, to persist. Moreover, given our expectation for a recession in late 2023 or early 2024, we continue to favor a higher quality fixed income allocation. In recent years, investors have been forced into unconventional, and often times riskier, avenues to secure income. However, the rate reset over the past year has effectively resurrected the traditional 60/40 portfolio. In fact, given our expectation of a hard landing, and subsequent recession, a 50/50 portfolio may be warranted as investors de-risk equities to take advantage of discounts, and income, in the bond market today.

SECTOR POSITIONING

Ultra-Short Maturity

The Fed slowed the pace of interest rate increases, increasing rates by 25 basis points in February and March. Short-term rates rose for the majority of the quarter before falling in March as investors fled to safety amid the banking turmoil. We anticipate that short-term interest rates will continue to rise as the market refocuses on inflation while pricing in the risk of Fed rate cuts later this year.

Mortgage-Backed Securities

We prefer mortage-backed securities because we believe the asset class is less susceptible to recession risk and continues to trade at historically attractive spreads. We expect housing prices will continue to fall on muted sales volume, as affordability and a lack of supply caused by rate lock-in prove primary headwinds. We prefer hedged structures and defensive positions, with selective exposure to yield enhancement opportunities in commercial and non-agency securitized sectors as a complement to a discounted agency portfolio in times of increased volatility.

U.S. Treasury Securities

Interest rates declined through February, rose into March and steeply declined when the banking crisis erupted in March, as the market flocked to safety. The market believes the Fed will cut rates later this year. We anticipate that once the market stabilizes, investors will refocus on inflation and price out the possibility of significant Fed cuts, putting pressure on U.S. Treasury prices until the economy deteriorates further and we approach recession.

High-Yield Bonds

High yield bond valuations appear appealing, but as we approach a recession, we anticipate higher default rates and deteriorating corporate fundamentals to further weigh on the asset class. We seek to increase our allocation at more attractive valuations as spreads widen further, potentially later this year. Rising input and labor costs are expected to put pressure on corporate margins, while lower sales and earnings are beginning to price in weaker demand.

Senior Loans

Bank loan valuations are at historically attractive levels, but given our outlook for rising recession risk, we expect better opportunities ahead to allocate at more attractive valuation levels. Defaults are expected to rise to 5.5% by 2024, compared to a long-term average of just over 3% for high yield bonds and loans. We anticipate that margins will contract due to higher labor and input costs, and that earnings estimates will be revised lower. As the economy worsens, we anticipate that the opportunity to add to the asset class will arise as early as later this year.

Investment Grade Corporate Bonds

As financial conditions tighten, we expect investment grade fundamentals to deteriorate. We anticipate labor and other input cost inflation will become increasingly difficult to pass on to consumers, thereby pressuring corporate profit margins. Consequently, we favor non-cyclical sector positioning with a continued emphasis on credit selection via active management. We see more opportunity in the front-end of the investment grade yield curve, as spreads widened disproportionally in March, providing a level of protection against rate volatility.

Preferred Securities

In March, the preferred and hybrid securities markets experienced significant volatility. Both U.S. and European financial institutions tend to dominate this market. The write-down of Credit Suisse's contingent convertible securities caused concern in this market segment, and a series of events in the United States, including the failures of Silicon Valley Bank and Signature Bank, brought the system into the public eye. Despite attractive valuations, we believe deteriorating economic conditions may restrict loan growth and earnings in the sector; as such, risks remain elevated.

Emerging Market Bonds

Emerging Market bonds have performed well as the U.S. dollar has fallen in value, benefiting local currency bondholders, and China's reopening has shifted from a risk factor to a positive global fundamental driver. Fundamentals are neutral, with many Emerging Market countries' Purchasing Managers' Indexes exceeding 50, indicating expansion. Interest rate volatility is a risk, and we expect global risk-aversion, which typically drives safe-haven seekers, to support U.S. dollar strength while undermining Emerging Market bonds.

Municipal Fixed Income

We anticipate that as the Fed completes its rate hikes, potentially by June, fund flows will be a primary driver of municipal bond performance along with muted new issue supply. With higher short-term rates on the front part of the municipal curve, we anticipate break-even total returns will look more appealing even if rates continue to rise. We believe that municipal bonds may produce positive total returns over both short and longer maturities, as we expect U.S. Treasury rates to become rangebound and municipal bonds have never experienced two consecutive years of negative total returns. Muni-Treasury ratios are generally rich to 3-year historical averages, but higher absolute yields typically stimulate demand at the front end of the curve. Given employment trends, GDP growth, and significantly improved revenues year-over-year, we believe most municipal bond sectors' credit fundamentals have been stable or improved. In 2022, rating upgrades outnumbered downgrades. Year-to-date as of 3/31/23, municipal defaults are lower year-over-year.

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.