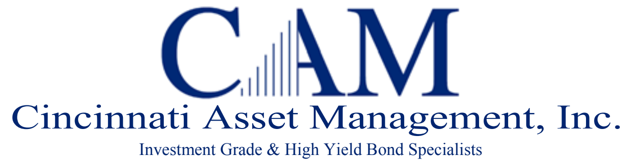
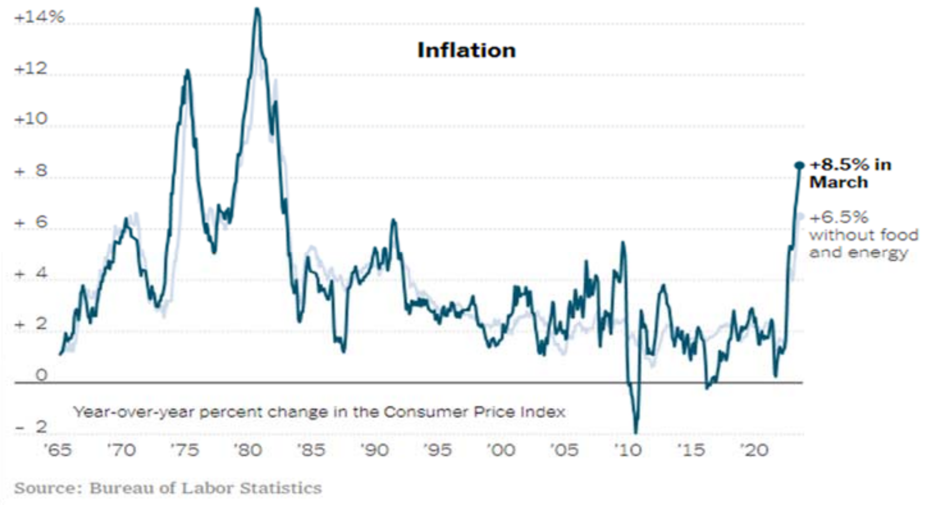
First Quarter 2022 Bond Market Review and Outlook



"The FED predicts the rate of inflation will slow to 4.3% by year end using its preferred PCE price barometer. And then drop to 2.3% by the end of 2024" (*MarketWatch* 4/13/2022)



"This is not the kind of inflation from the 1960s and 70s" (Chicago FED president, Charles Evans 4/11/22). During that event before the Detroit Economic Club, Evans contended that the current spurt in prices is temporary, rather than sustaining and that inflation will revert back to pre-pandemic levels in a year or two (source: *MarketWatch 4/13/22).* The chart on page three shows the longer period, five to ten year inflation expectations of surveys by the University of Michigan remain subdued at about three percent.

Federal Reserve Chairman, Jerome Powell, cited the Russia/Ukraine war disruption of commodities, pandemic related supply chain disruptions, pandemic related labor shortages and pandemic relief funds leaving many flush with money to spend on goods and services as the primary drivers of the rise in inflation (source: Jerome Powell speech at 38th Annual Economic Policy Conference National Association for Business Economics 3/21/22).

The Consumer Price Index rose to 8.5% for the twelve months ending March 31, the fastest pace since 1981 (source: *New York Times* 4/12/22). However, FED officials noted that a large portion of the March increase was the result of a spike in oil prices blamed on the outbreak of the Russia/Ukraine war (source: ibid).

The Core Price Index, which strips out more volatile food and fuel fell in March from February to 0.3%, compared to 0.5% the prior month. Economists took that as a sign the price increases for goods might have peaked and will continue to moderate and even recede in the months ahead. One major contributor to the rise in the price of goods, such as cars, are pandemic driven supply chain bottlenecks, which are expected to continue to ease.

The other element driving prices, demand for goods is expected to ease as consumers burn through the unprecedented $2 trillion plus of savings accumulated as a result of the governments massive covid relief packages.

The FED has taken its first step in March to address inflation by raising the Fed funds rate to 0.25%-0.5% and signaled it intends to raise it higher. Charles Evans thinks a "neutral"

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Yields* on 03/31/2022	Yield*
CAM Broad Market (corporate core plus) Strategy (7.6 year maturity; 6.2 duration)	**3.98%**
CAM Investment Grade (100% corporate bonds) Strategy (7.5 year maturity; 6.4 duration)	**3.27%**
CAM High-Yield Strategy (only BA & B rated purchased) (7.5 year maturity; 5.7 duration)	**5.46%**
CAM Short Duration Strategy (4.1 year maturity; 3.4 duration; 50% IG & 50% HY)	**4.17%**
CAM Short Duration Investment Grade Strategy (3.7 year maturity; 3.3 duration)	**3.02%**
U.S. Treasury** (10 year maturity)	**2.34%**
U.S. Treasury** (5 year maturity)	**2.46%**
U.S. Treasury** (2 year maturity)	**2.34%**

* The lower of yield to maturity or yield to worst call date ** Source: Bloomberg

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CAM's Key Strategic Elements

- Bottom-up credit analysis determines value and risk.
- Primary objective is preservation of capital.
- Larger, more liquid issues preferred.
- Target is always intermediate maturity.
- No interest rate forecasting.
- All clients benefit from institutional trading platform and multi-firm competitive bids and offers.

CAM returns are after CAM's average management fee & all transaction costs but before any broker, custody or consulting fees. **The indices are unmanaged and do not take into account fees, expenses, and transaction costs.**	Total Return (%)	Annualized Returns (%)			
	1Q '22	1-YEAR	3-YEARS	5-YEARS	10-YEARS
CAM Broad Market Strategy—Net 1/3 high yield, 2/3 investment grade	-6.53	-3.89	2.93	3.13	3.30
CAM High Yield "Upper Tier" Strategy—Net only purchase BB and B; no purchases of CCC & lower	-6.11	-2.24	4.25	4.08	3.61
Bloomberg US Corporate High Yield Index	-4.84	-0.66	4.58	4.69	5.75
CAM Investment Grade Strategy—Net 100% corporate bonds	-6.75	-4.65	2.29	2.73	3.14
Bloomberg US Corporate Index	-7.69	-4.20	3.03	3.34	3.65
CAM Short Duration Strategy—Net 1/2 investment grade, 1/2 high yield	-4.17	-2.64	2.88	2.87	2.43
CAM Short Duration Investment Grade Strategy—Net 100% corporate bonds	-4.38	-4.43	1.25	1.64	2.01

Relative Performance Review 03/31/2022

CAM's **Investment Grade Strategy** ("**IG**") produced a gross total return of -6.69% in the quarter ended March 31, 2022, compared to -7.69% for the Bloomberg U.S. Corporate Index. CAM always positions a majority of the portfolio within intermediate maturities of 5-10 years. Longer dated securities (10+ years) returned -11.61% for the period, dramatically underperforming the broader index. CAM's zero weighting in this duration bucket produced a +142 basis point contribution to excess return. The LTM return for the CAM IG strategy was -4.43% compared to the Index return of -4.20%. Over this period shorter-dated securities (1-3 years) returned -2.91%, widely outperforming the broader index. CAM's underweight and positioning within that duration bucket produced a -21 basis point contribution to excess return.

The **High Yield Strategy** ("**HY**") delivered a gross total return of -6.04% in Q1 while the Bloomberg US Corporate High Yield Index returned -4.84%. The modified duration of CAM's portfolio was 5.7 while that of the index was 3.9. The allocation effect of CAM's maturity profile served as a -130 basis point impact to CAM's portfolio relative to the index during the quarter. The HY LTM return was -1.95% while the Bloomberg US Corporate High Yield Index returned -0.66%. In this period, the allocation effect of CAM's maturity profile was a -123 basis point contribution to excess return.

Our **Broad Market Strategy ("BM")** – a 67%-33% blend of IG-HY bonds – produced a gross total return of -6.46% for the quarter compared to -6.75% for the Bloomberg blended Index. Our BM strategy invests in intermediate maturities between 5-10 years, and currently less than 1% of assets are allocated to maturities 10 years and longer. The allocation effect of not investing in longer dated maturities (10+ years) was a +118 basis point contribution to excess return. The LTM return for the CAM Broad Market strategy was -3.63% compared to blended Index return -3.02%. For this period, the allocation effect of our structural avoidance of Caa and lower rated credit produced a -11 basis point contribution to excess return.

The CAM **Short Duration Strategy** ("**SD**") blends equal weights of IG and HY bonds with a target duration of 3 years. The strategy's gross total return for the quarter was -4.11% while the Index, a similar blend of the intermediate components of Bloomberg IG and HY corporates, returned -4.07%. CAM's positioning within the Consumer Cyclical Services and Automotive industries had the largest positive impacts, generating +14 and +12 basis point contributions to excess return, respectively. The LTM gross total return was -2.38% compared to the blended Index return of -2.15%. CAA credit returns were mixed during the period, with CAA outperforming the broader index, while CA dramatically underperformed. CAM's avoidance of these lower quality tiers produced a combined -12 basis point contribution to excess return during the period.

The **Short Duration Investment Grade Strategy** ("**SD-IG**") delivered a gross total return of -4.32% for Q1 while the Bloomberg U.S. Corporate 1-5 Index returned -3.73%. CAM's selection and weighting within the Banking and Technology industries drove -17 and -10 basis point contributions to excess return, respectively. Over the LTM period, SD-IG underperformed the Index, by delivering -4.19% gross total return versus an Index return of -3.61%. Given the move in interest rates, longer duration credit underperformed during the period, and CAM's positioning within the 3-5 and 5-7 year duration buckets produced a combined -17 basis point contribution to excess return versus the index.

Bloomberg Bond Indices Returns vs. CAM Gross (annualized %)

Periods ended 03/31/2022	10-yrs	20-yrs
U.S. Aggregate	2.24	4.00
U.S. Corporate	3.65	5.12
CAM Investment Grade Strategy	5.80	5.02

Better Asset Allocation Might Result from More Exacting Analysis

The chart to the right shows that BA and B rated bonds have outperformed the Bloomberg US Aggregate Index for all periods shown. Even inclusive of the annualized double digit S&P 500 returns over the past 10-years, they modestly underperformed the S&P 500 for the 20-year period. Notably, they have done so with about half the volatility of that Index (Ibbotson), suggesting that better credit quality high yield bonds deserve consideration as a core holding in an investor's portfolio allocation over a complete market cycle.

The chart also indicates that CAA rated securities outperformed B rated and BA rated bonds for all periods. However, not shown in the table is the pronounced volatility that has characterized the CAA subsector. For example, during 2008, when the High Yield Index was down 26%, CAA rated bonds were down 44%, and during 2009, the Index was up 58% while CAA bonds were up 91%. In each calendar year since 1997, CAA rated bonds ranked either best or worst in Credit Sights Annual Excess Return Rankings for US corporate credit tiers, a trend that was finally upset in 2019, although it returned in 2020 and 2021.

Total Return of High-Yield Bonds by Credit Quality

(periods ended 03/31/2022) Source: Credit Suisse First Boston

(annualized %)

High-Yield Bond Sectors	5-years	10-years	20-years
BA-rated bonds	4.76	5.58	7.21
B-rated bonds	4.56	5.32	6.87
CAA-rated bonds	6.19	6.67	8.24
CA & D-rated bonds	-12.22	-9.62	-3.49

Performance of Other Asset Classes

(periods ended 03/31/2022) Source: Bloomberg & Lipper

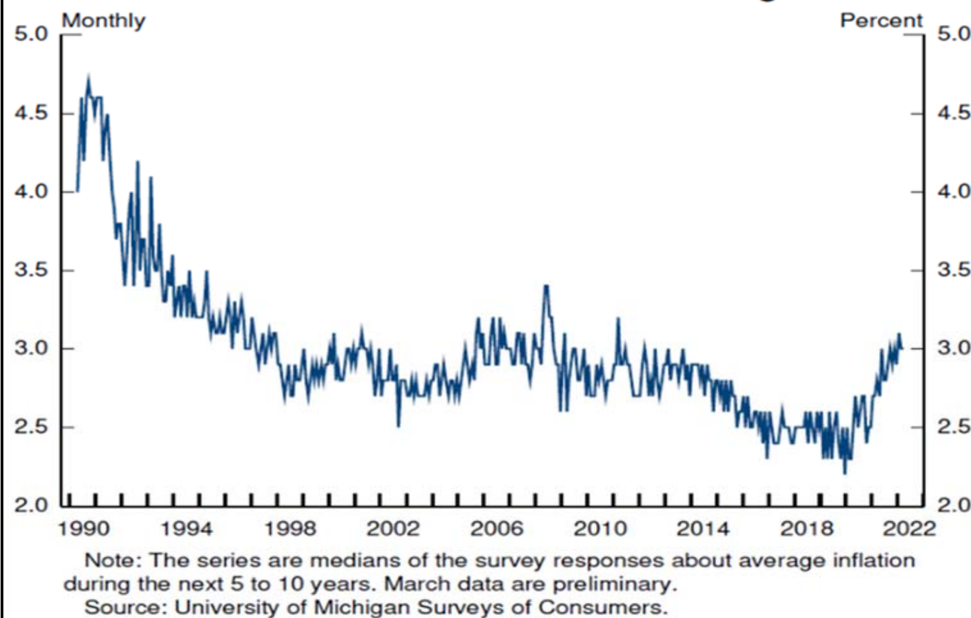
	5-years	10-years	20-years
S & P 500 Stocks	15.99	14.64	9.22
Bloomberg U.S. Aggregate	2.14	2.24	4.00

The March 31 spread levels (shown at the right) enhance the value of corporate bonds versus U.S. Treasuries. As of 3/31/2022 spreads widened for credit quality of all stripes reflecting investors' uncertainty about growth and inflation. The 10-year U.S. Treasury ended Q1 2022 at 2.34% compared to 1.51% at Q4 2021. The 10-year yield has been rising since the low point of 0.52% on August 4, 2020.

Widening spreads and higher Treasury yields combine to provide a more compelling entry point into corporate bonds than has existed since the spring of 2019.

Credit Rating	20-Year Average Spread	03/31/22	12/31/21	12/31/20	12/31/19	12/31/18	Tightest This Decade
A	1.20%	0.94%	0.74%	0.73%	0.70%	1.18%	0.63%
BAA	1.87%	1.42%	1.13%	1.21%	1.20%	1.97%	1.00%
BA	3.67%	2.32%	1.94%	2.64%	1.82%	3.54%	1.82%
B	5.09%	3.42%	3.13%	3.79%	3.24%	5.31%	2.94%
CAA	8.95%	6.78%	5.96%	7.15%	9.20%	9.89%	4.91%

Figure 7. Longer-run expectations remain well-anchored in their historical ranges



Note: The series are medians of the survey responses about average inflation during the next 5 to 10 years. March data are preliminary.
Source: University of Michigan Surveys of Consumers.

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Fed funds rate that doesn't boost inflation is 2.25%-2.5% (source: *MarketWatch* 4/11/22).

Another pandemic driven anomaly involves the workforce. The tight labor market is driving wages higher, contributing to inflationary pressures. The FED reported in March that there were a "record 1.7 posted job openings for each person who is looking for work" (source: Jerome Powell Federal Reserve System Chairman 3/21/22). He also notes that nominal wages are growing at their fastest pace in decades. He attributes the labor shortage to two factors. The first is the "strong financial position of households", obviously the result of all that pandemic welfare aid given out. They expect this factor to fade away over time.

The second factor cited is the labor participation rate, which has only partially recovered from its "sharp drop in the pandemic". The labor force supply and total demand for labor (total employment plus posted job openings) can be seem on the chart on page four. Factors include retirements, caregiving needs and fear of contracting covid.

While retirees won't return to the workforce, Powell notes that the participation rate of "prime age" workers remains well below pre-pandemic levels, so there is a source to grow the labor force.

So, inflation is largely being driven by three transitory factors: the pandemic disruptions, the Russia/Ukraine war and pandemic welfare payments by the Federal Government. We believe that is why the longer-run inflation expectations shown in the chart on page three remain much lower than the recently reported inflation rates.

In the first quarter U.S. bond prices fell more sharply than investors have seen in many years. The Bloomberg U.S. Government bond index returned –5.5%, its worst

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Footnotes and disclosure

Cincinnati Asset Management, Inc., ("CAM") an independent privately held corporation established in 1989, is registered with the United States Securities and Exchange Commission as an investment advisor. The CAM High Yield, Investment Grade, Broad Market, Short Duration, and Short Duration-Investment Grade composites consist of all discretionary portfolios under management, including all securities and cash held in the portfolios, and have been appropriately weighted for the size of the account. All accounts are included after they are substantially invested.

Returns are calculated monthly in U.S. dollars and include reinvestment of dividends and interest. Figures for periods of less than one year are cumulative returns. All other figures represent average annual returns. Past performance is no guarantee of future results.

When compared to indices' performance, CAM results are after deduction of all transaction costs and CAM advisory fees. CAM advisory fees used are the composite averages. Accounts managed through brokerage firm programs usually will include additional fees. "Net of fees" herein refers only to CAM's management fee. Returns audited annually. Most recent audit available upon request. S&P 500 averages are published quarterly in Barron's as supplied by Lipper Analytics. The indices and information shown for comparative purposes are based on or derived from information generally available to the public from sources believed to be reliable. No representation is made to its accuracy or completeness.

High yield bonds may not be suitable investments for all individuals. Before investing a thorough reading of all materials and consultation with an independent third party financial consultant may be appropriate. Fixed Income securities may be sensitive to changes in prevailing interest rates. When rates rise the value generally declines. For example, a bond's price drops as interest rates rise. For a depository institution, there is also risk that spread income will suffer because of a change in interest rates. The Indices are referred to for informational purposes only and the composition of the Index is different from the composition of the accounts included in the performance shown above. Index returns do not reflect the deduction of fees, trading costs or other expenses.

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performance since 1980 (source: *Wall Street Journal* 4/17/22). As of Tuesday 4/19/22 the 10-year U.S. Treasury note yield was 2.897% (source: *Bloomberg* 4/19/22) up from 1.496% at year end 2021 (source: *Wall Street Journal* 4/17/22). The abrupt move may portend yields nearing a peak and prices moderating as we move into the summer.

The FED increases rates to drive down demand and lower inflation through higher borrowing costs. Now, the 30-year mortgage rate is over 5%, for the first time since 2011 (source: *Wall Street Journal* 4/17/22).

Also, Federal Reserve presidents' statements are hawkish and more aggressive. Previous talk of six 25 basis point (Bps) increases through March 2023 has now toughened to reaching that 2.25%-2.5% target by December with a 50 Bps increase in May. Most recently, St. Louis FED president, James Bullard said a 75 Bps increase was possible (source: *Bloomberg* 4/19/22).

The same macroeconomic conditions are prevalent worldwide. The IMF lowered GDP growth to 3.6% from 4.4% for 2022. German and U.K.10-year yields rose to their highest since 2015 (Source: *Bloomberg* 4/19/22). The U.K. and the E.U also recognize that while inflation must be lowered with interest rate increases, GDP forecasts are weakening due to higher energy and commodity prices and borrowing costs.

As of 4/19/22 the Bloomberg survey median forecast of U.S. GDP is now 1% for the first quarter of 2022, 3.2% for 2022 and 2.1% for 2023. This outlook and a recession probability of 25% in the U.S. and 33% globally according to Citigroup's Nathan Sheets (source: *Bloomberg* 3/31/22) may put a floor under bond prices, sooner. Lawrence Summers, former Treasury Secretary observed that "recession in the next couple of years is clearly more likely than not" He pointed out that "the U.S has never experienced inflation above 4% and unemployment below 4% without that being followed by an economic slump within two years" (source: *Bloomberg* 4/8/22).

Sharpe Ratios (risk & reward relative value) Inception-Q1 2022

CAM Investment Grade Strategy 0.42
Bloomberg U.S. Corp Bonds 0.40

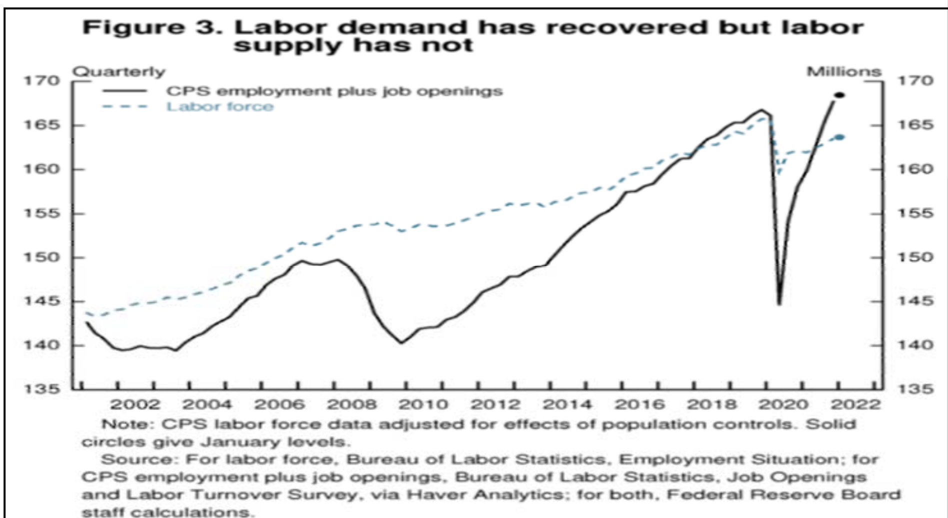
CAM High Yield Strategy 0.52
Bloomberg High Yield Corp Bonds 0.49

CAM Short Duration 0.49
Bloomberg Weighted Benchmark
(1/2 Interm. HY & 1/2 U.S. Corporate 1-5) 0.58

CAM Short Duration IG Strategy 0.94
Bloomberg U.S. Corporate 1-5 Yr 0.95

CAM Broad Market Strategy 0.68
Bloomberg Weighted Benchmark
(2/3 Corporate and 1/3 High Yield) 0.68

An important objective for all Cincinnati Asset Management investment strategies is to deliver superior risk-weighted returns. A quantitative indication of our success is the Sharpe Ratio that calculates total return per unit of risk. The data on the left indicates we have largely been successful. Sharpe Ratios of the Investment Grade and High Yield Strategies exceeded their respective benchmarks by approximately 5% and 6%, respectively. The Short Duration Investment Grade and Broad Market strategies approximated their benchmarks. The Short Duration Strategy's Sharpe Ratio trailed the benchmark primarily due to total return underperformance in the 5-year and older periods.



Rating	BA	B	CAA
Avg Spread	364	521	946
Std. Dev.	169	226	427
03/31/2022	**232**	**342**	**678**
Lowest Spread	151	228	378

Spreads to Treasuries by Credit Rating show significantly lower risk of BA and B rated bonds. Source: Bloomberg, Barclays Research (12/31/99 to 03/31/22)