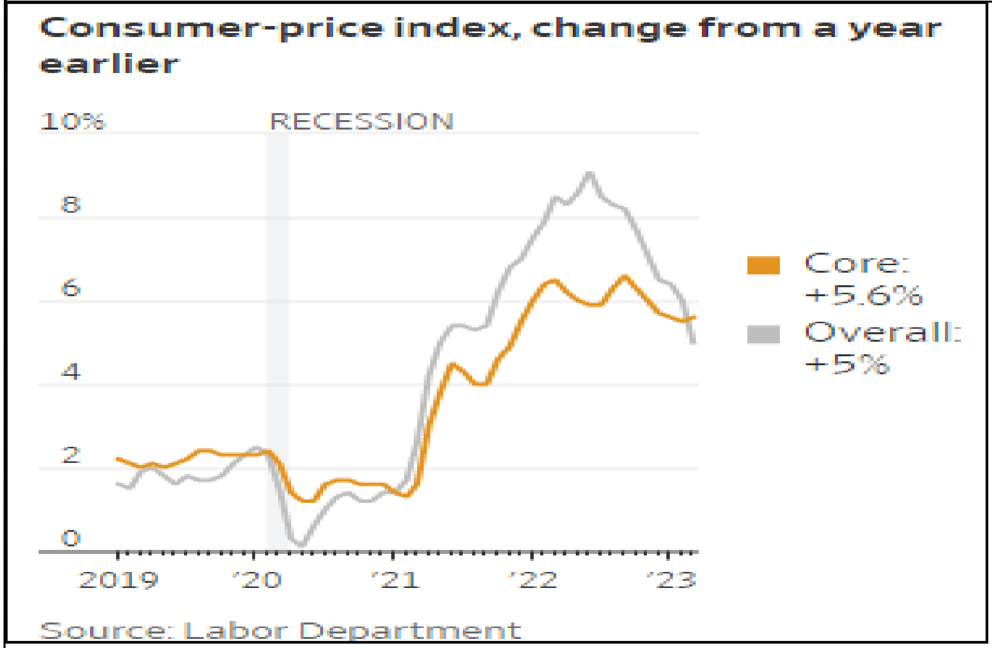
First Quarter 2023 Bond Market Review and Outlook

Cincinnati Asset Management, Inc.
Investment Grade & High Yield Bond Specialists

"Since the full impact of monetary policy actions can take as much as 18 months to work its way through the economy, we will continue to look closely at available data to determine what, if any additional actions we may need to take." (Patrick Harker, Philadelphia Fed 4/11/23 source: *Bloomberg*)



The chart above goes a long way in explaining the rally in Treasury bonds since late 2022. The survey of economists forecasts CPI falling to 3.4% by December 2023 (source: *Bloomberg* 4/12/23). More encouraging is the forecast of CPI falling further to 2.6% by the end of 2024 (source: ibid).

So at 2.6% the inflation rate as measured by CPI will be back down into its recent, acceptable range, around the Federal Reserve's 2% target.

The impact on bonds has been significant. The 10-year Treasury yield has plummeted from 3.88% at the end of 2022 to 3.39% as of 4/12/23 (source: *Bloomberg* 4/12/23). The rally's inception was around 10/24/22, when the 10-year Treasury yield was 4.24%, the year's high point (source: ibid).

Baked into investor's outlooks and the bond market's behavior is the Federal Reserve's repeatedly communicated preference for raising rates too much to be certain it has lowered inflation and expectations of future inflation to its stated target of 2%.

However, that FED posture is softening due to financial stress that appears to be developing in the wake of the bank failures of Silicon Valley Bank and Signature Bank along with declines in securities values and loan asset values at many other banks. The impact has been immediate with bank lending contracting at a record rate in the last two weeks in March (source: *Bloomberg* 4/7/23). This continued in April with lending falling more than $45 billion primarily driven by decreased lending by small banks (source: ibid).

On Thursday, April 4, the American Bankers Association index of credit conditions fell to the lowest level since the pandemic began, reflecting bank economists forecasting deteriorating credit conditions over the next six months. The result will be stricter lending requirements (source: ibid).

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Yields* on 03/31/2023	Yield*
CAM Broad Market (corporate core plus) Strategy (6.6 year maturity; 5.5 duration)	**5.54%**
CAM Investment Grade (100% corporate bonds) Strategy (6.8 year maturity; 5.8 duration)	**5.00%**
CAM High-Yield Strategy (only BA & B rated purchased) (6.3 year maturity; 4.9 duration)	**6.90%**
CAM Short Duration Strategy (3.4 year maturity; 2.9 duration; 50% IG & 50% HY)	**6.42%**
CAM Short Duration Investment Grade Strategy (2.8 year maturity; 2.6 duration)	**4.77%**
U.S. Treasury** (10 year maturity)	**3.47%**
U.S. Treasury** (5 year maturity)	**3.58%**
U.S. Treasury** (2 year maturity)	**4.03%**

* 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.
- <u>All</u> 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 '23	YTD	1-YEAR	3-YEARS	5-YEARS	10-YEARS
CAM Broad Market Strategy—Net 1/3 high yield, 2/3 investment grade	3.68	3.68	-3.91	0.93	2.02	2.10
CAM High Yield "Upper Tier" Strategy—Net only purchase BB and B; no purchases of CCC & lower	3.99	3.99	-3.83	3.82	2.74	2.23
Bloomberg US Corporate High Yield Index	3.57	3.57	-3.35	5.91	3.21	4.10
CAM Investment Grade Strategy—Net 100% corporate bonds	3.41	3.41	-4.10	-0.41	1.68	2.00
Bloomberg US Corporate Index	3.50	3.50	-5.56	-0.54	1.62	2.32
CAM Short Duration Strategy—Net 1/2 investment grade, 1/2 high yield	2.09	2.09	-1.21	2.65	2.34	1.64
CAM Short Duration Investment Grade Strategy—Net 100% corporate bonds	1.94	1.94	-0.84	0.44	1.41	1.43

Relative Performance Review 03/31/2022

CAM's **Investment Grade Strategy** ("**IG**") produced a gross total return of 3.47% in the quarter ended March 31, 2023, compared to 3.50% 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 5.62% for the period, outperforming the broader index. CAM's zero weighting in this duration bucket produced a -63 basis point contribution to excess return. The RTM return for the CAM IG strategy was -3.87% compared to the Index return of -5.56%. Over this period longer-dated securities returned -12.24%, widely underperforming the broader index. CAM's zero weight within that duration bucket produced a 207 basis point contribution to excess return. This highlights the potential benefit that can be provided by staying invested over a full market cycle.

The **High Yield Strategy ("HY")** delivered a gross total return of 4.06% in Q1 while the Bloomberg US Corporate High Yield Index returned 3.57%. CAM's weighting and positioning in Food and Beverage, Wirelines, and Airlines had the biggest positive impact on performance relative to the index with a +25, +20, and +12 basis point contributions to excess return during the quarter, respectively. Conversely, CAM's exposure to Cable Satellite and Retailers produced a -27 and -22 basis point contribution to excess return, respectively. The HY RTM return was -3.54% while the Bloomberg US Corporate High Yield Index returned -3.35%. At 3/31/2023 the modified duration of CAM's portfolio was 4.9 while the modified duration of the index was 3.6. In this period, the allocation effect of CAM's intermediate maturity profile was a -182 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 3.75% for the quarter compared to 3.53% for the Bloomberg blended Index. Our BM strategy invests in intermediate maturities between 5-10 years. The allocation effect of not investing in longer dated maturities (10+ years) was a -42 basis point contribution to excess return. The RTM return for the CAM Broad Market strategy was -3.66% compared to a blended Index return -4.76%. For this period, the allocation effect of not investing in longer dated maturities was a +155 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 2.16% while the Index, a similar blend of the intermediate components of Bloomberg IG and HY corporates, returned 2.62%. CAM's duration profile is very similar to that of the blended index, but with an underweight to the 5+ year maturity bucket. The effect of this underweight was a -10 basis point contribution to excess return. The RTM gross total return was -0.95% compared to the blended Index return of -1.61%. Longer dated paper (5+ years) dramatically underperformed the broader index during the period, And CAM's underweight of those duration buckets generated a +66 basis point contribution to excess return.

The **Short Duration Investment Grade Strategy** ("**SD-IG**") delivered a gross total return of 2.00% for Q1 while the Bloomberg U.S. Corporate 1-5 Index returned 1.68%. CAM's selection and weighting within the Banking and Independent Energy industry groups provided +5 and +3 basis point contributions to excess return, respectively. Conversely, our average cash position of 2.42% in a period of positive performance produced a -4 basis point contribution to excess return. Over the RTM period, SD-IG underperformed the Index, by delivering -0.59% gross total return versus an Index return of -0.32%. CAM's selection and weighting within the Media Entertainment and Airlines industry groups each provided a +5 basis point contributions to excess return, respectively. Conversely, our selection and weighting in the banking and electric utility industry groups produced a -16 and -8 basis point contribution to excess return, respectively.

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

Periods ended 03/31/2023	**10-yrs**	**20-yrs**
U.S. Aggregate	**1.36**	**3.18**
U.S. Corporate	**2.32**	**4.17**
CAM Investment Grade Strategy (gross)	**2.25**	**4.17**
CAM Investment Grade Strategy (net)	**2.00**	**3.94**

Better Asset Allocation Might Result from More Exacting Analysis

CAM looks to minimize the overall volatility of our High Yield strategy by focusing on the upper tier of High Yield credit (BA-B), as well as the conservative portion of a firm's capital structure. The chart to the right indicates that CAA rated securities outperformed B rated and BA rated bonds over a 20-year period as of 3/31/2023, but underperformed over the 5-year period. 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%.

Further, BA and B rated bonds have outperformed the Bloomberg US Aggregate Index (the "Agg") for all periods shown. Interestingly, the Agg printed a modest 5-year annualized return, largely a function of 2022's rising rate environment. This connotes that BA and B rated credit quality stripes have kept better pace with inflation than the Agg for all periods. These points in aggregate suggest that better credit quality high yield bonds deserve consideration as a core holding in an investor's portfolio allocation over a complete market cycle.

Total Return of High-Yield Bonds by Credit Quality

(periods ended 03/31/2023) Source: Credit Suisse First Boston

(annualized %)

High-Yield Bond Sectors	**5-years**	**10-years**	**20-years**
BA-rated bonds	**3.74**	**4.29**	**6.65**
B-rated bonds	**3.24**	**3.72**	**6.29**
CAA-rated bonds	**2.75**	**4.17**	**7.70**
CA & D-rated bonds	**-13.09**	**-11.23**	**-3.70**

Performance of Other Asset Classes

(periods ended 03/31/2023) Source: Bloomberg & Lipper

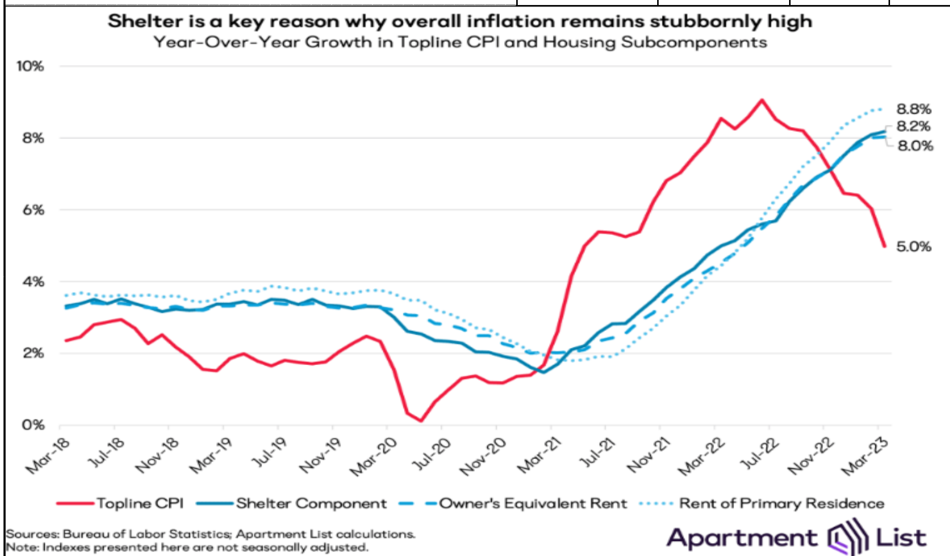
S & P 500 Stocks	**11.19**	**12.24**	**10.34**
Bloomberg U.S. Aggregate	**0.91**	**1.36**	**3.18**

Yield Spreads Over U.S. Treasuries:

The March 31 spread levels (shown at the right) enhance the value of corporate bonds versus U.S. Treasuries. As of 3/31/2023 spreads widened for all credit quality stripes versus 12/31/21, reflecting investors' uncertainty about growth and inflation. The 10-year U.S. Treasury ended Q1 2023 at 3.47% compared to 3.88% at Q4 2022. For context, the 10-year yield's low point was 0.52% on August 4, 2020.

While CPI slowly trends lower, wider corporate spreads and higher Treasury yields provide a more compelling outlook for corporate bonds than has existed since the spring of 2019.

Credit Rating	20-Year Average Spread	03/31/23	12/31/22	12/31/21	12/31/20	12/31/19	Tightest This Decade
A	1.20%	1.18%	1.09%	0.74%	0.73%	0.70%	0.63%
BAA	1.84%	1.68%	1.59%	1.13%	1.21%	1.20%	1.00%
BA	3.53%	2.83%	2.95%	1.94%	2.64%	1.82%	1.82%
B	4.91%	4.65%	4.89%	3.13%	3.79%	3.24%	2.94%
CAA	8.75%	11.44%	11.54%	5.96%	7.15%	9.20%	4.91%



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Jamie Dimon of JP Morgan Chase stated in his annual letter that the bank failures have "provoked lots of jitters in the market and will clearly cause some tightening of financial conditions as banks and other lenders become more conservative (source: ibid).

This appears to relax the Federal Reserve's monetary policy outlook. Austin Goolsbee, Chicago Fed President was the first official to state that the Fed may need to delay or halt further rate increases. He stated that "I think we need to be cautious. We should gather further data and be careful about raising rates too aggressively until we see how much work the headwinds are doing for us in getting inflation down" (source: *Bloomberg* 4/11/23).

The chart above shows that the shelter component of CPI is exerting upward pressure. It is the single largest component of CPI. For instance, the shelter component represented 32.5% of CPI in September 2022 (source: *Economics Uncovered, "Shelter and the CPI: everything you need to know"* 10/26/22). There is a significant lag in the shelter component, because part of the measure is from leasing costs, which generally roll over annually. A more current value of shelter costs is found in a measure of price changes for only new leases: the "Apartment List National Rent Index". That index posted an increase of just 2.6% in March 2023 (source: *Apartment List, "Rent CPI is finally peaking"* 4/12/23), versus the shelter component of CPI of 8.2% (source: ibid). The FED is aware of the lag and recently concluded that the Apartment List National Rent Index is an effective leading indicator for the rent component of CPI (source: ibid).

Another sign of a slowing economy is economic activity in the manufacturing sector. The Manufacturing Purchasing Manager's Index contracted for the fifth straight month in March (source: Institute for Supply Management). New orders, employment and backlogs are declining at a faster pace from the previous month and prices charged have reversed course from increasing to decreasing (source: ibid).

Minutes of the Federal Reserve's March meeting released April 12 show moderation in needed interest rate increases. Now most board members-

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feel just one more interest rate increase of 25 basis points at the May meeting may be sufficient . That would bring the Federal Funds rate to 5.0%-5.25% up from just 0.25% in March 2022, where it had been since March 2020 (source: *Bloomberg FDTR Index*). *This increase represents the most aggressive rate increases by the Federal Reserve since the early 1980s.*

Following the May increase, most officials expect to hold rates at that level (source: *Wall Street Journal* 4/12/23). However, rate cuts may come before year end, since Federal Reserve officials now forecast a recession would start later this year, due to credit tightening by banks (source: *Wall Street Journal* 4/12/23).

Warren Buffet predicts more bank failures will occur (source: *Bloomberg* 4/12/23). To date, the problems at the banks largely centered on the declining market value of banks' securities below that of deposits held for their customers. That resulted on a run on the bank by depositors.

Buffet cites commercial real estate loans as a growing problem. Office vacancies are on the rise, driven by new hybrid and remote work models used by businesses. The Bloomberg REIT office property index is down more than 50% since the end of 2021, so investors are pricing in significant problems (source: *Bloomberg* 4/13/23). Vacancy rates are rising and are now over 20%. With values down about 20% refinancing becomes even more difficult for the $92 billion of debt for offices comes due in 2023 and $58 Billion more in 2024. We have seen PIMCO's Columbia Property Trust and Brookfield recently defaulted on debt on large office properties. Steven Roth, Chairman of Vornado Realty Trust observed that "We are now approaching the eye of the economic storm, and I expect it will get even worse." (source: *Bloomberg* 4/13/23).

All this data appears to support a slowing of the economy, soon.

Sharpe Ratios (risk & reward relative value) Inception-Q1 2023

CAM Investment Grade Strategy 0.36
Bloomberg U.S. Corp Bonds 0.32

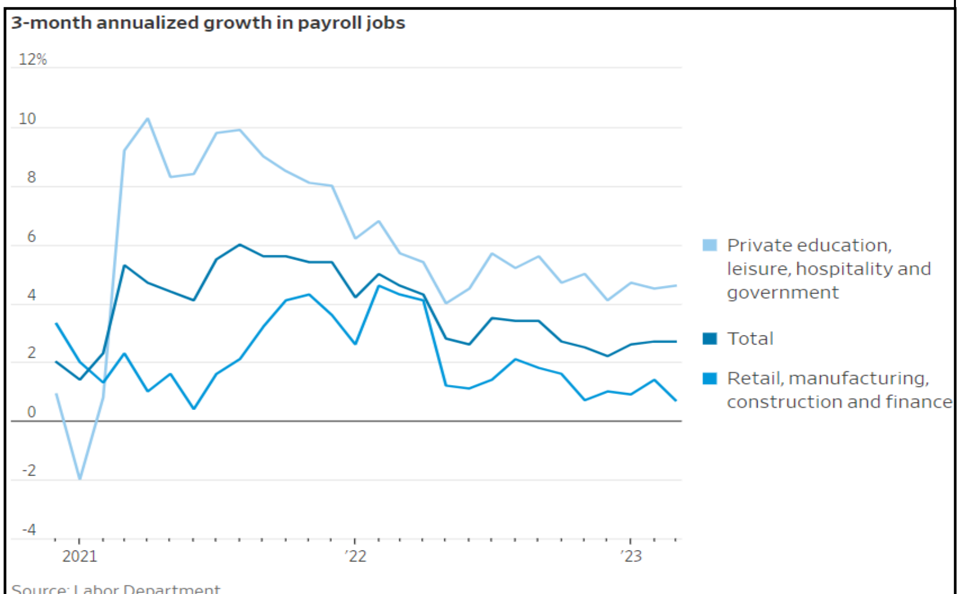
CAM High Yield Strategy 0.47
Bloomberg High Yield Corp Bonds 0.46

CAM Short Duration 0.43
Bloomberg Weighted Benchmark
(1/2 Interm. HY & 1/2 U.S. Corporate 1-5) 0.51

CAM Short Duration IG Strategy 0.82
Bloomberg U.S. Corporate 1-5 Yr 0.81

CAM Broad Market Strategy 0.56
Bloomberg Weighted Benchmark
(2/3 Corporate and 1/3 High Yield) 0.58

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. The Sharpe Ratio of the Investment Grade Strategy exceeded its respective benchmark by approximately 13%. The High Yield, 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	361	520	951
Std. Dev.	166	222	419
03/31/2023	**283**	**465**	**1144**
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 03/31/2023)