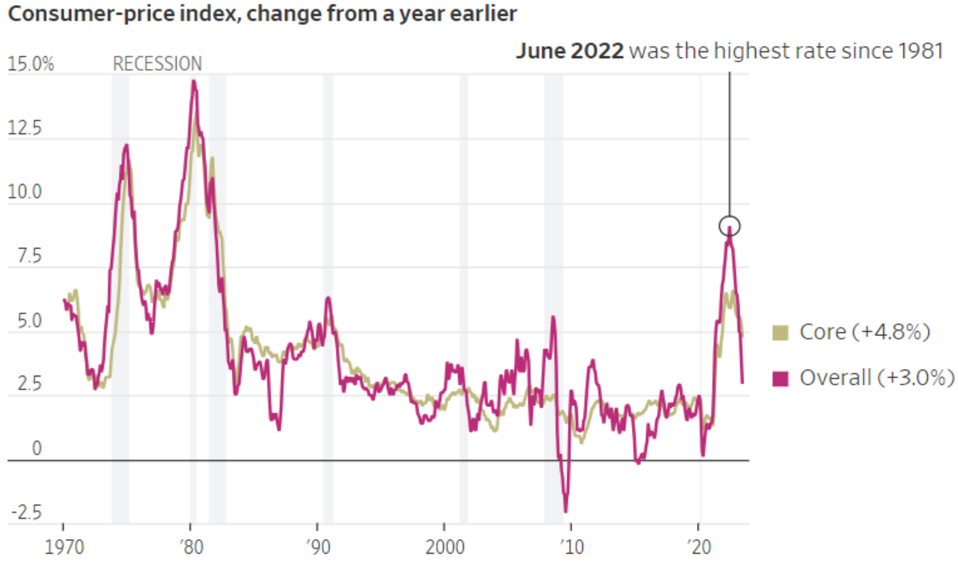
Second Quarter 2023 Bond Market Review and Outlook

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

"You cannot get in the way of the soft landing narrative—that narrative is building momentum" (source: Mohammed El-Erian quote in *Bloomberg* 7/16/23)

"We are closer to the end of our tightening phase than the beginning" (source: Cleveland Federal Reserve President Loretta Mester's July 10 speech as reported in Bloomberg 7/16/23)



Source: Labor Department

The chart above illustrates the dramatic decline in inflation as measured by the change in the Consumer Price Index and the Core Consumer Price Index, which excludes food and energy. The Federal Reserve's aggressive campaign to reduce inflation to its acceptable target of 2% is clearly bearing fruit. Earlier in July, on 7/7/23, the Bureau of Labor Statistics reported declining job growth with nonfarm payrolls increasing 209,000, below consensus estimates. Job gains for the prior two months were revised lower. This was the smallest increase since the end of 2020, but still above Powell's target of 100,000 (source: *Bloomberg* 7/16/23).

Consumer prices rose 3% from a year ago in June falling from May's 4% reading (source: Bureau of Labor Statistics 7/12/23). That was the smallest year over year increase in the monthly report in more than two years and significantly below the 9.1% increase reported a year ago (source: ibid).

The CPI report has reversed a move to higher rates that began in late June on higher than expected first quarter 2023 GDP and ADP's National Employment Report for June.

The 2-year Treasury yield, considered one of the better gauges of market sentiment regarding Federal Reserve future interest rate policy gyrated with these reports. The yield tumbled from 4.985% on July 6th to 4.635% on July 13.

The economic strength and sticky wage growth of 4.4% leads most forecasters to predict the Fed will increase short term rates another 25 basis points at the meeting in late July.

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Yields* on 06/30/2023	**Yield***
CAM Broad Market (corporate core plus) Strategy (6.4 year maturity; 5.3 duration)	**5.77%**
CAM Investment Grade (100% corporate bonds) Strategy (6.6 year maturity; 5.7 duration)	**5.17%**
CAM High-Yield Strategy (only BA & B rated purchased) (5.8 year maturity; 4.6 duration)	**7.01%**
CAM Short Duration Strategy (3.3 year maturity; 2.8 duration; 50% IG & 50% HY)	**6.41%**
CAM Short Duration Investment Grade Strategy (2.8 year maturity; 2.5 duration)	**5.33%**
U.S. Treasury** (10 year maturity)	**3.84%**
U.S. Treasury** (5 year maturity)	**4.16%**
U.S. Treasury** (2 year maturity)	**4.90%**

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

Contact us: Artie Awe, Mike Lynch, & Bill Sloneker are always available to assist.
Phone: (513) 554-8500 — Website: www.cambonds.com
Email: aawe@cambonds.com, mlynch@cambonds.com, & wsloneker@cambonds.com

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 (%)				
	2Q '23	YTD	1-YEAR	3-YEARS	5-YEARS	10-YEARS
CAM Broad Market Strategy—Net 1/3 high yield, 2/3 investment grade	-0.16	3.52	3.67	-1.81	2.07	2.44
CAM High Yield "Upper Tier" Strategy—Net only purchase BB and B; no purchases of CCC & lower	0.56	4.57	7.98	1.07	2.92	2.53
Bloomberg US Corporate High Yield Index	1.75	5.38	9.06	3.13	3.35	4.43
CAM Investment Grade Strategy—Net 100% corporate bonds	-0.33	3.06	1.70	-3.09	1.71	2.38
Bloomberg US Corporate Index	-0.28	3.21	1.55	-3.44	1.76	2.63
CAM Short Duration Strategy—Net 1/2 investment grade, 1/2 high yield	0.45	2.55	4.65	0.62	2.38	1.88
CAM Short Duration Investment Grade Strategy—Net 100% corporate bonds	-0.33	1.60	1.21	-1.51	1.33	1.61

Relative Performance Review 6/30/2023

CAM's **Investment Grade Strategy** ("**IG**") produced a gross total return of -0.28% in the quarter ended June 30, 2023, compared to -0.28% for the Bloomberg U.S. Corporate Index. CAM's weighting and positioning within the Retail industry group had the largest positive impact on performance with a 33 basis point contribution to excess return. Our exposure to Banking had the largest negative impact with a -14 basis point contribution to excess return. Of note is the direct reversal of the outperformance in Banking and underperformance in Retail experienced in Q1. The YTD return for the CAM IG strategy was 3.18% compared to the Index return of 3.21%. Over this period the Airlines and Retail industry groups had the largest positive impacts to excess return with 9 and 5 basis point contributions, respectively. Electric Utilities and the P&C Insurance industry groups had the largest negative impact, each printing a -5 basis point contribution to excess return.

The **High Yield Strategy ("HY")** delivered a gross total return of 0.64% in Q2 while the Bloomberg US Corporate High Yield Index returned 1.75%. CAM focuses on the upper tier of the high yield credit curve (BA-B) and does not purchase securities rated CAA and lower. There was mostly a risk-on tone this quarter resulting in the CAA-rated and CA-rated segments outperforming the index as a whole. The allocation effect of CAM's strategic underweight in lower quality credit was a -28 basis point contribution to excess return. The HY YTD return was 4.72% while the Bloomberg US Corporate High Yield Index returned 5.38%. Similar to the quarter, the CAA-rated and CA-rated credit quality segments outperformed the index as a whole. The allocation effect of CAM's underweight was a -31 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 -0.09% for the quarter compared to 0.39% for the Bloomberg blended Index. Our BM strategy is underweight the BAA credit subsector and achieves its BAA average credit quality via a barbell approach of higher and lower rated securities. The net effect of this structural allocation accounted for a -17 basis point contribution to excess return versus the index. The YTD return for the CAM Broad Market strategy was 3.66% compared to a blended Index return of 3.93%. For this period, the allocation effect of our barbell approach to credit quality was a -13 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 0.51% while the Index, a similar blend of the intermediate components of Bloomberg IG and HY corporates, returned 0.92%. The Leisure and Wirelines industry groups each printed a 14 basis point contribution to excess return while the Cable Satellite and Wireless industry groups posted -47 and -8 basis point contributions to excess return, respectively. The strategy's YTD gross total return was 2.68% compared to the blended Index return of 3.57%. The Cable Satellite and Retail industry groups printed -79 and -29 basis point contributions to excess return while the Leisure and Food and Beverage industry groups posted 26 and 30 basis point contributions to excess return, respectively.

The **Short Duration Investment Grade Strategy** ("**SD-IG**") delivered a gross total return of -0.27% for Q2 while the Bloomberg U.S. Corporate 1-5 Index returned 0.08%. CAM's selection and weighting within the Banking industry group provided -5 basis point contribution to excess return, reversing the outperformance seen in Q1. Our exposure to the Chemicals industry group printed a 3 basis point contribution to excess return while all other industry groups had a negligible impact. Over the YTD period, SD-IG approximated the Index, by delivering 1.73% gross total return versus an Index return of 1.75%. CAM's selection and weighting within the Chemicals and Independent Energy industry groups provided +4 and +2 basis point contributions to excess return, respectively. Conversely, our selection and weighting in the Electric Utility industry group produced the largest negative contribution to excess return of -3 basis points.

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

Periods ended 06/30/2023	10-yrs	20-yrs
U.S. Aggregate	1.52	3.01
U.S. Corporate	2.63	3.90
CAM Investment Grade Strategy (gross)	2.63	3.92
CAM Investment Grade Strategy (net)	2.38	3.68

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. Interestingly, the chart to the right indicates that CAA-rated securities only approximated or modestly outperformed B-rated and BA-rated bonds for all periods shown as of 6/30/2023. The lowest rated cohorts (CA & D) have produced negative returns for all periods shown. Not shown in the table is the pronounced volatility that has characterized the CAA-rated and lower subsectors. 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%. More recently, CAA bonds returned -17.9% in calendar year 2022 when the Bloomberg US Corporate HY Index was down -11.1%. Thus, investors may not be rewarded for the additional risk of the CAA-rated and lower subsectors.

Further, BA and B rated bonds have outperformed the Bloomberg US Aggregate Index (the "Agg") for all periods shown. The Agg printed a modest annualized returns for the 5-year and 10-year periods, 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.

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 06/30/2023) Source: Credit Suisse First Boston
(annualized %)

High-Yield Bond Sectors	5-years	10-years	20-years
BA-rated bonds	3.85	4.58	6.37
B-rated bonds	3.43	4.07	5.98
CAA-rated bonds	3.32	4.82	7.04
CA & D-rated bonds	-12.13	-10.46	-4.33

Performance of Other Asset Classes
(periods ended 06/30/2023) Source: Bloomberg & Lipper

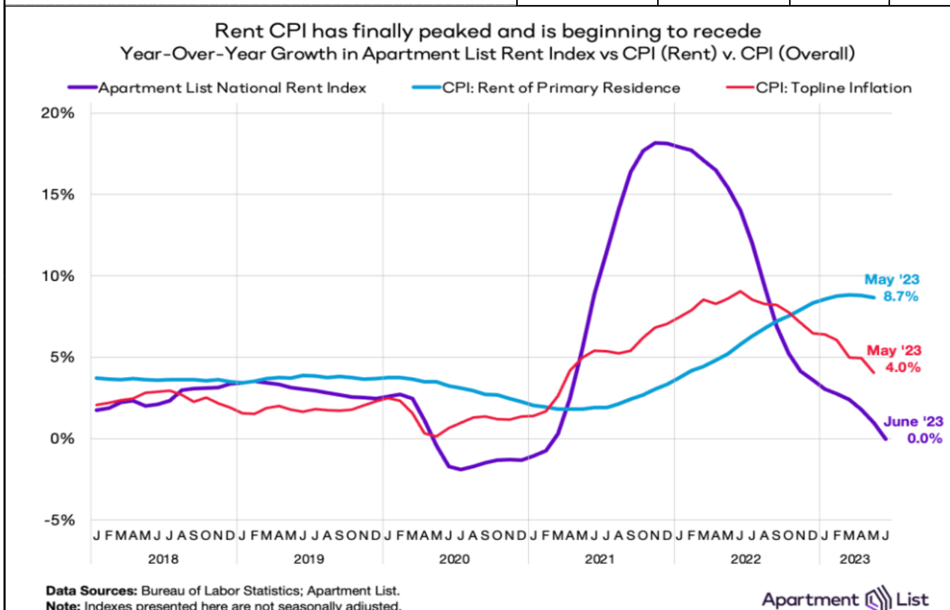
S & P 500 Stocks	12.31	12.86	10.01
Bloomberg U.S. Aggregate	0.77	1.52	3.01

Yield Spreads Over U.S. Treasuries:

The June 30 spread levels (shown at the right) enhance the value of corporate bonds versus U.S. Treasuries. As of 6/30/2023 spreads meaningfully widened for all credit quality stripes versus 12/31/2021, reflecting investors' uncertainty about growth and inflation over the past 18-months. The 10-year U.S. Treasury ended Q2 2023 at 3.84% compared to 3.88% at Q4 2022 and 1.51% at Q4 2021. For context, the 10-year yield's low point was 0.52% on August 4, 2020.

While CPI slowly grinds 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	06/30/23	12/31/22	12/31/21	12/31/20	12/31/19	Tightest This Decade
A	1.20%	1.04%	1.09%	0.74%	0.73%	0.70%	0.63%
BAA	1.84%	1.52%	1.59%	1.13%	1.21%	1.20%	1.00%
BA	3.53%	2.52%	2.95%	1.94%	2.64%	1.82%	1.82%
B	4.91%	3.98%	4.89%	3.13%	3.79%	3.24%	2.94%
CAA	8.75%	9.09%	11.54%	5.96%	7.15%	9.20%	4.91%



Empire State Manufacturing. The New York Federal Reserve Bank's measure of the region's general business conditions decreased from 6.6 in May to 1.1 in June. The forward looking measures of demand and expenditures also deteriorated.

The chart to the left documents the steady and sizable decline in the increases in housing costs. The CPI rent data is a 12-month average and is included in the CPI figure and represents the largest single component of the CPI. Rent of primary residence (i.e. owner's equivalent rent) accounts for 22.3% and all shelter accounts for nearly a third of the index (source: Pew research Center 1/24/22). However the Apartment List National Rent Index is comprised of only current data. Therefore it is a more accurate measure of current inflation.

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However, after that increase there is growing conviction that the Fed will hold rates and begin cutting rates in 2024. In addition to the declining inflation and employment gains mentioned above, corporate profits fell 4.1% in the first quarter of 2023, shrinking more than the 2% decline reported in the fourth quarter of 2022 (source: Bureau of Economic Analysis 6/29/23).

Federal Reserve Chairman, Powell's favored inflation gauge, U.S. services prices excluding housing and energy increased 4% in June from a year ago. This was its slowest increase over the past 18 months (source: *Bloomberg* 7/12/23). On a monthly basis they were flat; the first time since September 2021 that they haven't risen (source: ibid).

Additional evidence of slowing inflation is seen in 7/17/23's report on

The Apartment List index has fallen significantly since December of 2021, coincident with the Fed's March 16, 2022 initiation of this round of rate increases. The index now shows no increase in rents from a year ago. This appears to be a forward indicator of the largest element in the BLS's CPI.

So all this data would seem to confirm that the Federal Reserve's fight against inflation is being won. If so,

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Footnotes and Disclosure

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longer term bonds may represent an opportunity. For decades Treasuries with 10-year and longer maturities have consistently outperformed shorter dated maturities immediately after the peak in the Federal Funds Rate (source: *Bloomberg* 7/15/23). Surveys by Bank of America and JPMorgan Chase & Co. have found investors have increased their exposure to long-dated bonds (source: ibid). Also, historically yields tend to decline between the last Fed rate hike and the first rate cut (source: ibid).

The 10-year Treasury yield (see chart to the right) has reached three successively lower peaks over the past 8-months. We may have seen the peak in 10-year yields and possibly for a large portion of the curve for this credit tightening cycle.

The yield curve inversion is moderating. In June the yield difference favoring the 2-year Treasury over the 10-year note was 1.1 percentage points, the largest since 1981 (source: *Wall Street Journal 7/13/23).* On 7/17/23 it was 0.93 percentage points. Yield curve inversions historically have been good predictors of recession. So as the inversion recedes, so does the forecast of recession. Others find the 3-month Treasury bill comparison to the 10-year note more reliable. The inversion peaked in April 2023 at 1.9 percentage points. Today, 7/17 it is 1.6 percentage points.

Powell has underscored the importance of the "near term forward spread", which is the difference between today's 3-month Treasury bill rate and the expected rate in 18 months (source: *Wall Street Journal* 7/13/23). He feels that is the most reliable indicator of recession. The inversion has fallen from 2.1 percentage points in April to 0.9 percentage points as of 7/7/23 (source: ibid).

So the moderating yield curve inversion might be signaling a better possibility of a soft landing, especially in light of the continuing resilient GDP, payrolls and unemployment reports.

While Bloomberg models show a 60% probability of recession (down from 65%) their survey of economists shows positive GDP for 2023, 2024 and 2025. The survey shows unemployment peaking at 4.6% in 2024 (source: *Bloomberg* 7/17/23).

Therefore, High-yield bonds may represent a favorable allocation for a portion of investors' bond allocations. This might be particularly the case for the better quality "junk bonds" with single-B and double-B credit ratings.

We appreciate your interest. Please contact our team anytime for more information and discussion.

Sharpe Ratios (risk & reward relative value) Inception-Q2 2023

CAM Investment Grade Strategy 0.35
Bloomberg U.S. Corp Bonds 0.31

CAM High Yield Strategy 0.46
Bloomberg High Yield Corp Bonds 0.46

CAM Short Duration 0.42
Bloomberg Weighted Benchmark
(1/2 Interm. HY & 1/2 U.S. Corporate 1-5) 0.50

CAM Short Duration IG Strategy 0.78
Bloomberg U.S. Corporate 1-5 Yr 0.78

CAM Broad Market Strategy 0.55
Bloomberg Weighted Benchmark
(2/3 Corporate and 1/3 High Yield) 0.57

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.

Spreads to Treasuries by Credit Rating show significantly lower risk of BA and B rated bonds. Source: Bloomberg, Barclays Research (12/31/99 to 06/30/2023)

Rating	BA	B	CAA
Avg Spread	360	519	951
Std. Dev.	165	221	417
06/30/2023	**252**	**398**	**909**
Lowest Spread	151	228	378