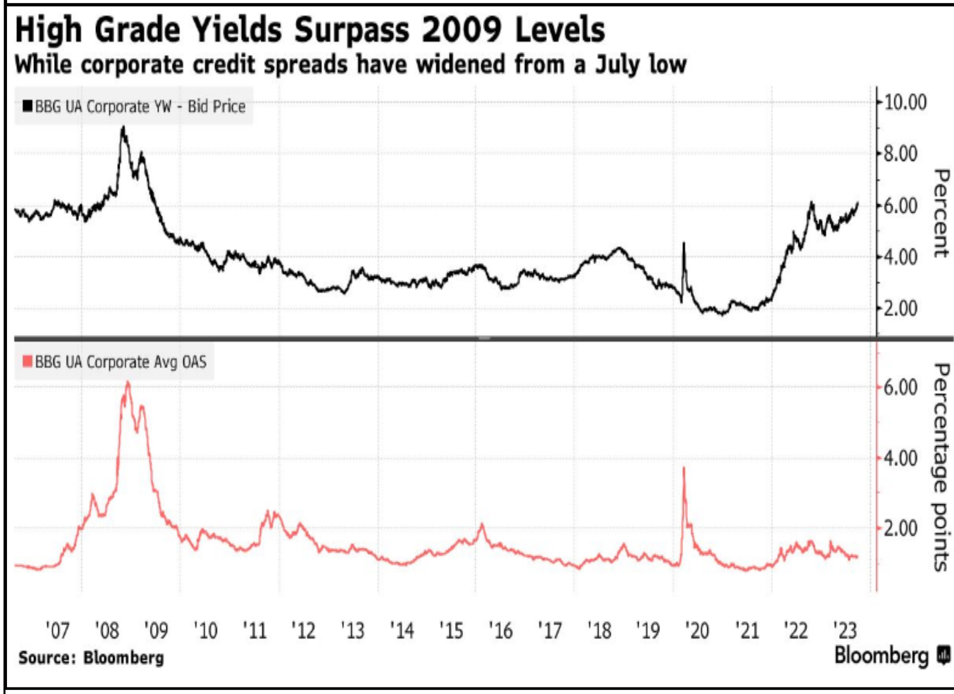
Third Quarter 2023 Bond Market Review and Outlook

Cincinnati Asset Management, Inc.

Investment Grade & High Yield Bond Specialists

"Monetary policy operates with long and variable lags." (Milton Freidman as quoted in *Bloomberg* 10/16/23)



With interest rates reaching levels not seen since since 2007, divergent outlooks are increasing. On the one hand, a recent article noted that some money managers are betting against the corporate and high-yield bond markets by shorting the larger and more liquid exchange traded funds (source: *Bloomberg* 10/16/23). The number of shares sold short of LQD, the investment grade corporate bond ETF has risen by over 50% since mid-June to about $7.2 billion (note the market cap for LQD is about $28 billion). Similarly, short interest in the high yield bond ETF, HYG has grown to over $7 billion (note the market cap for HYG is about $12 billion). This camp cites prices should reflect much wider yield spreads, given their forecast of a recession, increased financing costs, banks' tightening lending standards and higher corporate bankruptcies, up about 40% this year. The bottom graph to the left shows investment grade corporate spreads are about at their long term average (source: ibid).

The graph on page three supports their outlook of a recession developing. The graph depicts the results of a regular survey by The Federal Reserve of Senior Bank Loan Officers' lending standards. These standards have grown more restrictive this year.

The other camp finds good value in bonds, given the meteoric rise in yields over the past 18 months. The top graph to the left illustrates the tripling of investment grade corporate bond yields over this time. Also, the graph on page four shows the junk bond index (aka high yield bonds) are priced to yield over 9%.

This camp is focused on the high yields offered in today's markets and recession risk. Should the economy slow, the Federal Reserve will reverse

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Yields* on 09/30/2023	Yield*
CAM Broad Market (corporate core plus) Strategy (6.2 year maturity; 5.1 duration)	**6.41%**
CAM Investment Grade (100% corporate bonds) Strategy (6.5 year maturity; 5.5 duration)	**5.84%**
CAM High-Yield Strategy (only BA & B rated purchased) (5.5 year maturity; 4.4 duration)	**7.60%**
CAM Short Duration Strategy (3.0 year maturity; 2.6 duration; 50% IG & 50% HY)	**6.83%**
CAM Short Duration Investment Grade Strategy (2.6 year maturity; 2.3 duration)	**5.74%**
U.S. Treasury** (10 year maturity)	**4.57%**
U.S. Treasury** (5 year maturity)	**4.61%**
U.S. Treasury** (2 year maturity)	**5.05%**

* 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 (%)** 3Q '23	**Annualized Returns (%)** YTD	1-YEAR	3-YEARS	5-YEARS	10-YEARS
CAM Broad Market Strategy—Net 1/3 high yield, 2/3 investment grade	-1.84	1.61	5.22	-3.23	1.46	2.19
CAM High Yield "Upper Tier" Strategy—Net only purchase BB and B; no purchases of CCC & lower	-0.74	3.79	8.68	-0.64	2.36	2.35
Bloomberg US Corporate High Yield Index	0.46	5.86	10.28	1.76	2.96	4.24
CAM Investment Grade Strategy—Net 100% corporate bonds	-2.36	0.63	3.57	-4.40	1.07	2.08
Bloomberg US Corporate Index	-3.09	0.02	3.65	-4.93	0.93	2.23
CAM Short Duration Strategy—Net 1/2 investment grade, 1/2 high yield	0.34	2.91	5.77	-0.03	2.22	1.68
CAM Short Duration Investment Grade Strategy—Net 100% corporate bonds	0.25	1.86	3.55	-1.68	1.26	1.52

Relative Performance Review 9/30/2023

CAM's **Investment Grade Strategy** (**"IG"**) produced a gross total return of -2.30% in the quarter ended September 30, 2023, compared to -3.09% for the Bloomberg U.S. Corporate Index. CAM's weighting and positioning within the Electric Utility industry group had the largest positive impact on performance with a +17 basis point contribution to excess return. Our exposure to Banking had the largest negative impact with a -28 basis point contribution to excess return. The YTD return for the CAM IG strategy was 0.81% compared to the Index return of 0.02%. Over this period the Airlines and Electric Utility industry groups had the largest positive impacts to excess return with +18 and +13 basis point contributions, respectively. The Banking industry group, which has been volatile in 2023, had the largest negative impact, printing a -26 basis point contribution to excess return.

The **High Yield Strategy ("HY")** delivered a gross total return of -0.67% in Q3 while the Bloomberg US Corporate High Yield Index returned 0.46%. CAM focuses on the upper tier of the high yield credit curve (BA-B) and does not purchase securities rated CAA and lower. The CAA-rated and lower credit quality segments dramatically outperformed the index as a whole this quarter. The overall allocation effect of CAM's strategic average credit quality target of B1 generated a -30 basis point contribution to excess return. The HY YTD return was 4.02% while the Bloomberg US Corporate High Yield Index returned 5.86%. Similar to the quarter, the CAA-rated and CA-rated credit quality segments outperformed the index as a whole, while the C-rated segment dramatically underperformed. The overall allocation effect of CAM's average credit quality of B1 was a -96 basis point contribution to excess return.

Our **Broad Market Strategy ("BM")** – a 67%/33% blend of the IG and HY strategies above – produced a gross total return of -1.78% for the quarter compared to -1.92% for the Bloomberg blended Index. Our BM strategy is underweight the BAA credit subsector and achieves its BAA2 average credit quality via a barbell approach of higher and lower rated securities. The net effect of this structural allocation accounted for a -33 basis point contribution to excess return versus the index. The YTD return for the CAM Broad Market strategy was 1.81% compared to a blended Index return of 1.94%. For this period, the allocation effect of our barbell approach to credit quality was a -47 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 0.41% while the Index, a similar blend of the intermediate components of Bloomberg IG and HY corporates, returned 0.38%. The Media & Entertainment industry group printed the single largest positive impact to performance, with a +14 basis point contribution to excess return while the Wirelines and Automotive industry groups each posted -6 basis point contributions to excess return. The strategy's YTD gross total return was 3.10% compared to the blended Index return of 3.96%. The Leisure and Media & Entertainment industry groups each printed +30 basis point contributions to excess return while the Cable Satellite industry group posted a -84 basis point contributions to excess return, largely due to a ransomware attack at a core holding last spring.

The **Short Duration Investment Grade Strategy** ("**SD-IG**") delivered a gross total return of 0.31% for Q3 while the Bloomberg U.S. Corporate 1-5 Index returned 0.25%. Notably, CAM's selection and weighting within the Banking industry group provided a +4 basis point contribution to excess return. All other industry groups had a negligible impact. Over the YTD period, SD-IG approximated the Index, by delivering 2.04% gross total return versus an Index return of 2.01%. CAM's selection and weighting within the Chemicals and Banking industry groups provided +7 and +5 basis point contributions to excess return, respectively. Conversely, holding cash in a market with positive returns produced a cash drag contribution of -8 basis points towards excess return.

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

Periods ended 09/30/2023	**10-yrs**	**20-yrs**
U.S. Aggregate	**1.13**	**2.85**
U.S. Corporate	**2.23**	**3.74**
CAM Investment Grade Strategy (gross)	**2.33**	**3.84**
CAM Investment Grade Strategy (net)	**2.08**	**3.60**

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 underperformed BA-rated bonds for all periods shown, and significantly underperformed both BA and B-rated bonds for the 5-year period shown as of 9/30/2023. The lowest rated cohorts (CA & D) have produced negative returns over the past 5- and 10-years. Not shown in the table is the pronounced volatility that has characterized the CAA-rated and lower subsectors. For example, the standard deviation of the CAA credit tier has been nearly 50% higher than the broader Bloomberg US Corporate HY Index over the 10-year period (12.18% versus 8.32%). 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 also kept better pace with inflation.

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 09/30/2023) Source: Bloomberg US Corporate Indices **(annualized %)**

High-Yield Bond Sectors	**5-years**	**10-years**	**20-years**
BA-rated bonds	**3.68**	**4.60**	**6.55**
B-rated bonds	**2.81**	**3.89**	**5.81**
CAA-rated bonds	**0.70**	**3.73**	**6.32**
CA & D-rated bonds	**-2.80**	**-3.59**	**3.02**

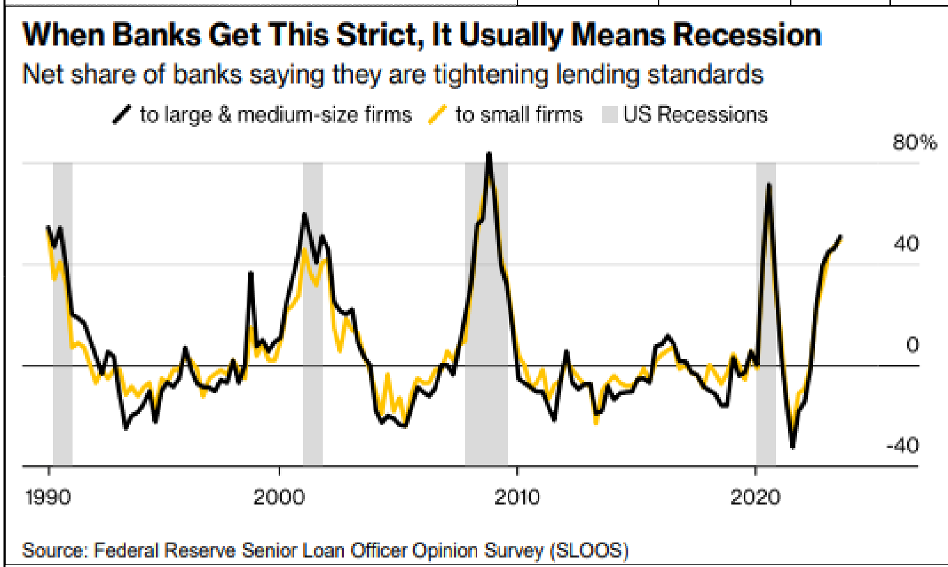
Performance of Other Asset Classes
(periods ended 09/30/2023) Source: Bloomberg & Lipper

S & P 500 Stocks	**9.92**	**11.91**	**9.68**
Bloomberg U.S. Aggregate	**0.10**	**1.13**	**2.85**

The September 30 spread levels (shown at the right) enhance the value of corporate bonds versus U.S. Treasuries. As of 9/30/2023 spreads have modestly tightened on a YTD basis but are meaningfully wider versus 12/31/2021, continuing to reflect investors' uncertainty about growth and inflation. The 10-year U.S. Treasury ended Q3 2023 at 4.57% 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 compelling outlook for corporate bonds.

Credit Rating	20-Year Average Spread	09/30/23	12/31/22	12/31/21	12/31/20	12/31/19	Tightest This Decade
A	1.20%	1.05%	1.09%	0.74%	0.73%	0.70%	0.63%
BAA	1.84%	1.47%	1.59%	1.13%	1.21%	1.20%	1.00%
BA	3.53%	2.64%	2.95%	1.94%	2.64%	1.82%	1.82%
B	4.91%	3.99%	4.89%	3.13%	3.79%	3.24%	2.94%
CAA	8.75%	8.89%	11.54%	5.96%	7.15%	9.20%	4.91%



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course and initiate interest rate cuts. Those cuts will probably spur investors to sell shorter maturity debt subject to more reinvestment risk as yields fall, so they can lock in attractive yields in longer maturity bonds.

It is extremely difficult to time the shift in the longer term trends to lock in the highest yield. Investors must rely on all sorts of market data to make that definitive call. So, perhaps averaging in to longer maturities over then next few months is a cautious course to avoid the inevitable "cash trap" of historically lower yielding short maturity bonds and money markets.

The signals now are very conflicting. That's probably the case when the economy is nearing a shift. Recently, the two year and 10-year bonds reached a new highs on 10/17/23 of 5.19% and 4.83% respectively (source; *Bloomberg* 10/17/23 at 4 PM). This followed data for the month of September which included retail sales figures that were stronger than expected and Consumer Price Index data that came in slightly above forecasts. Of note is that at 4.1% we remain above the Federal Reserve's 2% target, however over 50% of the rise in CPI is attributable to shelter costs, which have a significant lag (source: CNBC 10/12/23).

In response to the retail sales data, a number of economists revised upward their third quarter GDP estimates. Morgan Stanley increased their GDP estimate to 4.9%, JP Morgan forecasts 4.3% and Goldman Sachs raised their estimate to 4%. The Atlanta Federal Reserve's GDPNow forecast was increased to an annual rate of 5.4% in the third quarter, which would be the strongest reading since 2021 (source: *Bloomberg* 10/17/23).

Low unemployment and steady wage gains continue to fuel the consumer. The result is a shift in the outlook by economists. The latest quarterly Wall Street Journal survey of economists lowered the probability of a recession to 48% in October's release from 54% in July. The factors driving the optimism are declining inflation, a strong labor market, rising real incomes, economic growth that has exceeded expectations and the Federal Reserve on the apex of its interest rate cycle. Almost 60% of economists surveyed feel the Fed won't raise rates

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Footnotes and Disclosure

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further and will initiate cuts in the second quarter of 2024 (source: *Wall Street Journal* 10/15/23).

However, employment historically lags Fed interest rate actions by about 18 to 24-months. So the impact would start in the beginning of 2024 (source: *Bloomberg* 10/16/23)

GDP forecasts in the survey now show fourth quarter growth of 2.2% up from 1% in the July survey and 1% in 2024, slightly lower than the previous survey of 1.3% (source: ibid).

There are some other forces that may push GDP lower. One is the commercial real estate market. Nearly $2 trillion of existing loans are set to mature over the next five years (source: *Bloomberg* 10/17/23). Another report states $1.5 trillion in loans are set to mature by the end of 2025 (source: *NY Post* 4/10/23). Most recently a joint venture tied to a PIMCO fund surrendered a portfolio of 20 hotels with a $240 million mortgage. Earlier this year they defaulted on a portfolio of office buildings with $1.7 billion of debt (source: ibid). This follows Brookfield's default on two Los Angeles office towers' debt of $775 million and Vornado Realty's default on an NYC retail building's $450 million debt (source: *S&P Global Market Intelligence* 2/17/23). These are just the high profile defaults by savvy investors that jettison assets declining in value.

As real estate values continue to decline driven by higher vacancy rates and lower prices, refinancing becomes even more difficult. The valuations also feed in to local governments' tax receipts, lowering collections and resulting expenditures which boost GDP. The cycle could lower GDP, contributing to a recession. However, it would probably be deflationary, motivating the Fed to cut rates.

Global issues have an impact. China's economic boom for three decades has contributed to GDP growth in many countries from which China sourced material, technology and expertise. But a major engine of that growth, housing development is stalling. Aggressive overbuilding with mountains of debt is resulting in a collapse in property values. Local governments largely funded themselves through land sales to developers. The addiction to this revenue source lead to overbuilding. Housing for 3 billion people was built for a population of 1.4 billion (source: *Business Insider* 10/15/23).

Also, exports are struggling as many corporations seek to diversify their supply chains. The result is deflation in the world's second largest economy (source: ibid).

The outlook is cloudy, so, diversification across asset classes is key.

Sharpe Ratios (risk & reward relative value) Inception-Q3 2023

CAM Investment Grade Strategy 0.32
Bloomberg U.S. Corp Bonds 0.28

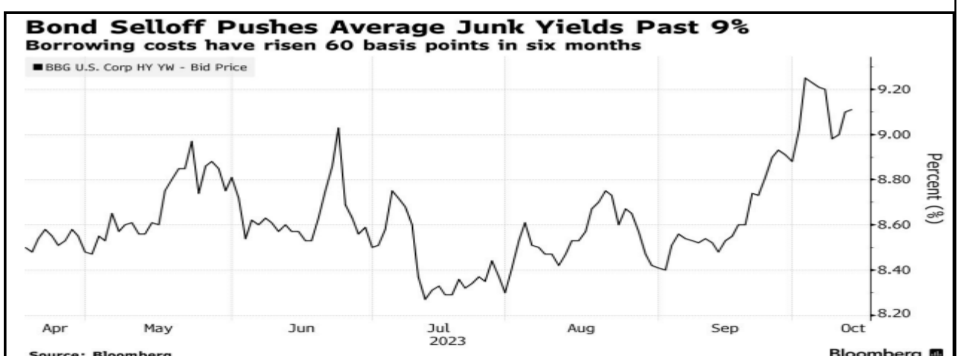
CAM High Yield Strategy 0.45
Bloomberg High Yield Corp Bonds 0.45

CAM Short Duration 0.41
Bloomberg Weighted Benchmark
(1/2 Interm. HY & 1/2 U.S. Corporate 1-5) 0.49

CAM Short Duration IG Strategy 0.75
Bloomberg U.S. Corporate 1-5 Yr 0.74

CAM Broad Market Strategy 0.51
Bloomberg Weighted Benchmark
(2/3 Corporate and 1/3 High Yield) 0.53

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 14%. 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	359	517	951
Std. Dev.	165	220	415
09/30/2023	**264**	**399**	**889**
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 09/30/2023)