INVESTMENT PERSPECTIVE

Quarterly Report

30 June 2022

During Q2, the S&P 500 Index rose 8.74% while the Russell 2000 Value Index increased 3.18%. International equity markets moved higher with the MSCI EAFE rising 3.22%.

Global growth continues to deteriorate as the impact of aggressive rate increases impact economic fundamentals. In the U.S., the manufacturing and transport sectors are in a recession and the service sector is set to slow further. Employment conditions continue to loosen and increases in the unemployment rate will be a key indicator as to the depth and breadth of the economic slowdown. Offsetting the deteriorating economic environment is continued liquidity injections by the major non-U.S. central banks and the U.S. Federal Reserve’s reverse repo facility, which has become the primary source of liquidity for rebuilding the U.S. Treasury’s general account. This flood of liquidity has boosted equity markets and dampened fixed income volatility compressing fixed income spreads.

Interest rate increases impact the economy on a long and variable lag of 12 months or more. A year ago, the Fed Funds rate stood at 1.75% compared to today’s rate of 5.25%. The economy is still very early in absorbing the higher interest rate environment. Stress in the banking system continues to build and without a cut in interest rates or suspension of quantitative tightening, we expect further troubled banks and tightening credit availability. To cut interest rates or suspend quantitative tightening, the Federal Reserve will need a better line of sight to reach their 2% inflation target. Inflation is set to stabilize at approximately 3.5% to 4.0% in the next few months, but the disinflationary conditions that have rapidly reduced inflation are abating with leading inflation indicators signaling the possibility of rising inflation in early 2024. We expect the Federal Reserve to maintain the current tight monetary conditions until there is a material decline in financial conditions or the inflationary trend breaks through 3% with visibility to reaching the inflation objective.

The Bloomberg Aggregate Index returned -0.84% for the quarter and the ICE BofA 1-10 AAA-A Municipal Index returned -0.57%. During the quarter, the Federal Reserve raised the Fed Funds rate by 25 basis points in May but elected to pause raising rates further at the June meeting. The market is pricing in at least one additional 25 basis point rate increase this year implying a terminal rate of 5.50%.

During the quarter, investment grade credit spreads tightened 15 basis points to +114 basis points over Treasuries after Congress passed legislation to raise the debt ceiling. Credit spreads are essentially unchanged year-to-date. We expect the markets to be volatile in the second half of the year, which should provide opportunities to generate alpha within spread sectors. We reduced our allocation to corporate bonds in 2022 but anticipate adding to corporates in 2023 if spreads widen materially due to a weaker economic backdrop.

We maintained a shorter average duration relative to the benchmarks across our fixed income strategies during this tightening cycle to reduce the impact on returns from rising interest rates. Now that inflation has peaked and with the Fed near the end of its tightening cycle, we are actively increasing duration to take advantage of the more favorable interest rate environment.

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