INVESTMENT PERSPECTIVE

VAUGHAN NELSON

Quarterly Report

30 September 2022

U.S. equity markets remained volatile during the third quarter, with the S&P 500 falling 4.9% and the Russell 2000 Value down 4.6%. International equity markets declined with the MSCI EAFE decreasing 9.3%. Driving equity markets was the exceptional U.S. dollar strength as the Federal Reserve dramatically tightened financial conditions by increasing interest rates and aggressively shrinking their balance sheet. The strong U.S. dollar accelerated the exportation of U.S. inflation to the rest of the world, forcing nearly all global central banks to follow the U.S. Federal Reserve in raising interest rates. Tighter financial conditions forced global equity and fixed income markets to reduce investment positions and leverage, driving nearly all asset classes lower. Ultimately, this led to a Lehman-like event, which forced the Bank of England to step in as the lender of last resort to prevent an uncontrolled systemic event. To date, equity markets have repriced valuation multiples in line with the higher cost of capital but have not yet priced a potential earnings recession.

Over the short to medium-term, markets will continue to be heavily influenced by the ongoing energy and capital shortages dominating realpolitik. Given the nature of the challenges, there are no short-term solutions, but only tradeoffs driven by the political calendar and responses to crises as they flare up. As these twin crises confront a developing global recession with all major central banks continuing to tighten financial conditions, equity investors' underlying premise must be that countries do not choose bankruptcy via austerity. We have witnessed pivots by the Bank of England, the European Union Bank, the Bank of Japan, and the Bank of Korea supporting this premise as they have reimplemented forms of liquidity support. Given that the current level of U.S. interest rates would result in the bankruptcy of the U.S Treasury over the medium-term, it will not surprise us to see the U.S. Federal Reserve also pivot as they are forced to deal with the reality of ensuring the U.S. Treasury's solvency.

The Bloomberg Aggregate Index finished the quarter down 4.8% and the ICE BofA 1-10 AAA-A Municipal Index declined 2.2%. During the quarter, the Federal Reserve raised the federal funds rate by 150 basis points (75 bps in July and 75 bps in September) to 3.25%. The market is forecasting at least four additional 25 bps interest rate increases in 2022, implying a 4.25% federal funds rate at year-end. We have maintained a shorter average duration relative to the benchmarks across our fixed income strategies all year but are selectively adding to duration to take advantage of the more favorable yield environment.

Investment grade credit spreads were volatile during the quarter, but only widened 4 basis points to +147 basis points over Treasury yields. Credit spreads have widened from last year's historically tight levels as the market started to price in an economic slowdown. With the Fed reducing its monthly bond purchases and raising short-term interest rates, liquidity conditions have tightened leading to elevated interest rate volatility and wider spreads.

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While the adjustment to higher interest rates negatively impacts bond returns, long-term total returns should improve compared to when federal funds rates were 0%. For instance, the yield-to-maturity (YTM) on the 2-Year Treasury was 0.3% last September versus 4.3% today and the YTM on U.S. investment grade corporate bonds was 2.1% last September versus 5.7% today. As a result, for long- term buy-and-hold investors, these higher yields have presented an opportunity to significantly increase the reinvestment rate bond portfolios across all major sectors of the fixed income market.

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