CONGRESS ASSET MANAGEMENT COMPANY, LLP

Fixed Income Outlook

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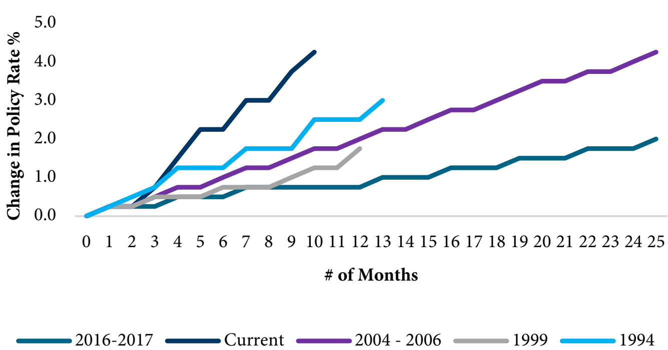
First Quarter 2023

2022 will be remembered as the worst year in the bond market for total returns since fixed income benchmarks were introduced in the early 1970's. A series of aggressive interest rate hikes by the Federal Reserve (Fed) pummeled bonds across the U.S. Treasury yield curve, decimating bond returns. The past year will be seen as a normalization of yields following an extended period of near zero interest rates. While this reset period for yields was painful, it serves up an enticing opportunity for both current fixed income investors and investors previously sidelined by the prospect of low yields.

The Fed was clearly the culprit behind this past year's lagging returns. In total, the Fed hiked rates seven times for a sum of 425 basis points in just 10 months, the fastest pace in the last thirty years. The last time the Fed hiked rates by this amount, the actions were spread out over 26 months, a much more digestible pace for markets to absorb. There was never any doubt that the Fed would fight inflation, yet they displayed a level of aggression that surprised the markets.

Figure 1 Federal Reserve Rate Hikes Over Time (Months)



Source: Bloomberg.

The pace and size of the increases proved to be difficult for a vast swath of the fixed income marketplace. Longer maturity issues, which are most sensitive to interest rate moves, were the hardest hit. But even shorter maturity issues, less sensitive to changes in yields, fared better but still declined over the year. Despite having a yield advantage to buffer returns, high yield issues suffered as well, dropping nearly as much as long duration, investment grade issues. Even inflation adjusted issues performed poorly, ironically doing so in the exact environment most investors would have expected the opposite result, underlining the complexity of these ill-understood securities.

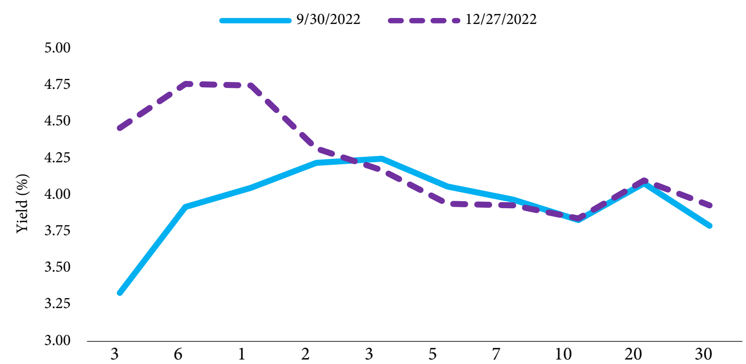
Figure 2 2022 Fixed Income Market Segment Total Returns

Market Segment	Representative Index	2022 Return %
Long Maturity	Bloomberg US Aggregate	-13.01
Intermediate Maturity	Bloomberg Intermediate US Govt/ Credit	-8.23
Short Maturity	Bloomberg 1-5 Yr Gov/Credit	-5.50
High Yield	Bloomberg US Corporate High Yield	-11.19
Inflation Adjusted	Bloomberg US TIPS	-11.85
Floating Rate	Bloomberg US Floating Rate Notes	1.34
Money Market	Bloomberg U.S. Treasury 3 Month Bill	1.51

Source: Bloomberg.

As for monetary policy, the Fed's ultimate endgame is manifest. They are seeking to slow the pace of inflation and return it to a more docile and manageable rate, closer to its 2% long-term target. Towards this goal, the policy and verbiage from the Fed have been incredibly focused on that objective. Market participants have been fixated on finding deviations in their dialog, searching for signs that the Fed may pause or slow its pace of hikes. Investors have been disappointed on both counts as the Fed has plowed ahead on its mission with seeming abandon.

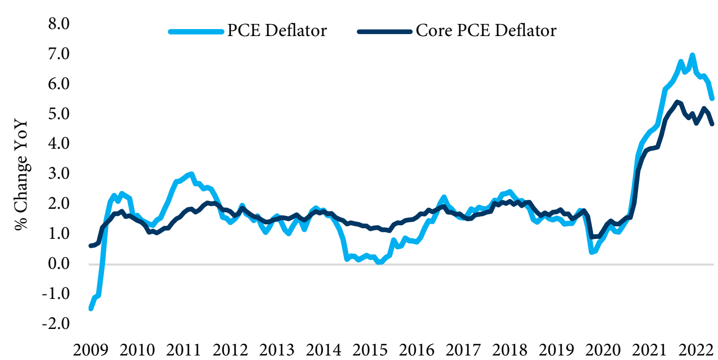
Figure 3 US Treasury Yield Curve at September 30, 2022 & December 31, 2022



Source: FactSet.

Over the quarter, yields rose on the short end of the Treasury curve while the longer end of the curve was largely stationary. The Fed was clearly the primary driver of the action in the curve movements over the last three months. Inflation continued to abate, as witnessed in economic data released over the fourth quarter. The diminution in inflation measures has been slow, with many consumers only recently realizing the slowdowns in rising prices. Until these metrics improve more substantially, we expect the Fed to abide by its chosen path to tighten monetary policy.

Figure 4 Inflation measures PCE Deflator and Core PCE Deflator
(2009 - 2022)



Source: FactSet.

Examining performance more closely for the past quarter, U.S. Government guaranteed debt underperformed Corporate bonds. In a similar trend to the previous quarter, both market segments showed modestly positive returns, near +2.0% for the quarter, with prices buoyed by falling interest rates and shrinking credit spreads. For the calendar year, Corporate bonds were edged by U.S. Government guaranteed debt for best returns. Within Corporate bonds, it should come as no surprise in these volatile times that lower quality issues underperformed higher quality issues over the year.

Looking forward, we expect the Fed to hike the federal funds rate another 50 to 75 basis points in the first quarter of the year and then step back to assess their position. We harbor concerns that the Fed's rapid pace of rate hikes may ultimately push the economy into a recession. This worry is buttressed by the fact that the full brunt of their hikes won't be fully digested by the economy until the second half of 2023 at the earliest. Given all of this, we expect yields to rise only slightly at the short end of the curve while the longer end will be volatile as the markets resolve their recession anxieties.

High quality, investment grade bonds offer an attractive opportunity as we look towards 2023. It is easy to be very bullish on bonds today, with three primary factors pointing to positive prospects. First, the Fed is near the end of their tightening cycle and the market should be able to easily digest even another 100 basis points of hikes should the Fed go that far. Second, inflation is trending down, broadening the appeal of bonds as a source of reliable income with real purchasing power. Third, yields have not been at this high level since the last quarter of 2007, perhaps the best curb appeal of all for bonds.

We continue to purchase liquid, high-quality bonds for our client's portfolios. Our adherence to our long-term strategy of thoughtful portfolio construction and measured security selection should be viewed as a benefit to our clients, both old and new. It is our desire for our client's portfolios to have safety, liquidity, and quality as primary qualities. Simply put, now is the time to consider investing in, or making additional investments in, your fixed income portfolio.

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