CONGRESS ASSET MANAGEMENT COMPANY

Fixed Income Outlook

John Beaver, CFA | Jeffrey R. Porter, CFA

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Fixed income markets have witnessed higher volatility than usual this year. The heightened activity stems from the Federal Reserve (the Fed) springing into action to combat inflation. Markets have presaged much of the interest rate hikes to come, pushing up yields. This has left bond market investors with negative returns since the new year, but also with expectations for higher yields down the road.

Recently, U.S. domestic economic data has been bifurcated. There are multiple areas of growth and strength, notably including business fixed investment, housing and consumer activity. Alternatively, prices are higher for many goods and services, in part due to supply chain issues and higher energy prices. The combination of these two factors is a healthy, growing economy that may be undone by persistent inflation. Fear of inflation is a strong motivator, despite the now distant memories of sky-high inflation that plagued the economy back in the late 1970's and early 1980's.

In response to this economic situation, the Fed increased the fed funds rate in March for the first time since December of 2018. That hike was the last move of a pre-pandemic tightening cycle, where the Fed sought to dampen growth despite a lack of inflation. Now, the Fed is explicitly targeting inflation despite reasonably good growth data. One can attribute this "good but not great" growth to supply chain issues, geopolitical strife, and global pandemic hot spots. But there can be no mistaking the prevalence of inflation in the domestic economy.

Figure 1 Inflation measures PCE Deflator and Core PCE Deflator

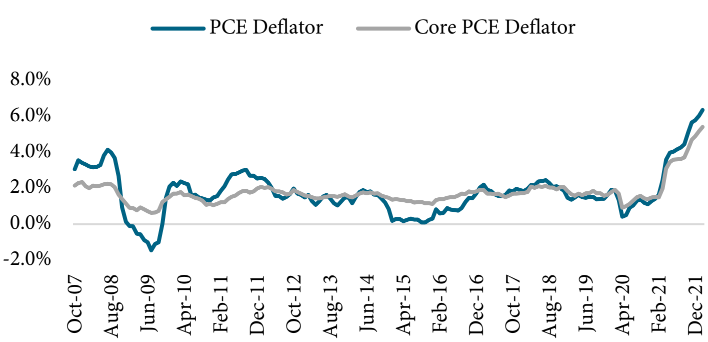

Figure 1 - Personal Consumption Expenditure Price Indices. Source: FactSet.

Inflation figures remain elevated and have a sustained, dramatic upward trajectory. Years of tame data points have given way to a strong indication of inflation, no doubt exacerbated by the recovery from pandemic economic lows. The effects have been felt across goods and services, impacting consumers not only in the normally volatile food and fuel categories, but also in a wider array of goods as well. This breadth of impacts has spurred the Fed to act quickly and also to set expectations for a long series of rate hikes to follow.

Figure 2 US Treasury Yield Curve at Year End 2021 & March 31, 2022

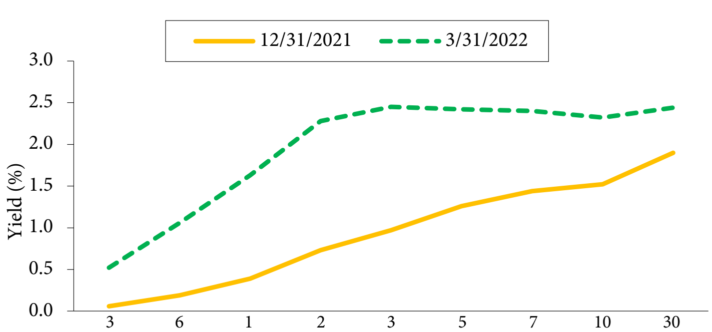

Figure 2 - U.S. Treasury Yield Curve at Year End 2021 and March 31, 2022. Source: FactSet.

The markets reacted quickly and anticipated multiple rate hikes from the Fed. In doing so, the yield curve has pushed up and become flatter. Yields on bonds with maturities longer than two years ended the quarter all within a range of 2.3% to 2.6%, a very narrow and flat range of yields. This flat shape of the curve denotes market expectations of higher short-term rates in the future and the economic growth trajectory in the long term. If the curve were to invert (short maturity yields higher than long maturity yields), then the market would be expecting a recession.

Most realistically, any prognostications today about a looming recession are presumptuous and purely speculative. First, there are many confounding and confluent factors contributing to the character of the economy that make such a forecast supremely difficult to model effectively. Second, several of these factors are evolving quickly, such as regional COVID-19 spikes and the shifting geopolitical landscape. With all of this in mind, it is most prudent to categorize a recession as plausible but not probable given what we know today.

Figure 3 Intermediate Corporate Bond Spreads by Credit Quality

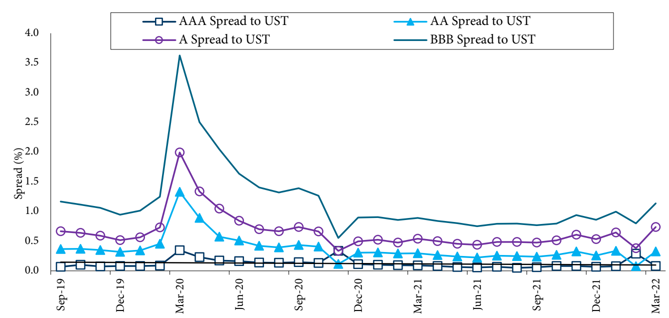

Figure 3 - Intermediate Investment Grade Credit Spreads (OAS) September 2019 to March 2022. Source: Bloomberg.

Fixed income markets have reacted to all of this primarily through higher interest rates. Credit markets have moved only a small amount since the beginning of the year. Credit spreads, or the additional yield investors require to compensate for default risk, are only marginally higher now that the Fed has begun its new tightening cycle. Over time, we would expect these spreads to move higher, but as yet the action has been muted. We still find spreads to be rich when viewed within a broader historical context.

Performance for the year-to-date period has been negative, as previously referenced. Rising yields have pushed down prices (yields move inversely to prices), dragging down returns for most instruments, save for the very short end of the curve. The negative impact of higher rates fell most heavily on longer dated issues across the bond spectrum.

Corporate bonds suffered more than U.S. Government guaranteed debt over the past three months on a total return basis. They were impacted by the increase in rates as well as the tepid increase in credit spreads. Lower quality paper underperformed higher quality as low-rated issues saw their credit spreads increase more than high-rated issues. In general, shorter maturity issues outperformed longer dated issues.

As we look ahead, we see no reason for the Fed to deviate from its pledge to raise interest rates. Within that strategic thrust, we expect tactical maneuvers to arise as they navigate the road ahead. The most likely scenario would be a hike of 50 basis points, instead of the now "normal" 25 basis points, if the Fed seeks to expedite the process. A least likely event would be a pause in hikes due a change in the global economy emanating from geopolitical causes or another sweeping wave of COVID-19 infections. Inflation must be addressed via monetary policy by the Fed if it is to be halted.

In the long run, the Fed's actions will mean higher yields in the future. The route to these higher yields may mean some near-term discomfort, but ultimately will lead to greater income for our clients. If credit spreads increase as we expect, Corporate bonds will look more attractive and would very likely be given a larger allocation in our clients' portfolios. That would supplement the yields on Government guaranteed issues and further boost the income stream provided by the portfolios.

For our clients' portfolios, we will maintain our high-quality bias within intermediate maturity bonds. Liquidity to date has not been an issue but we still are vigilant on that front. Current levels of credit spreads are not enticing, which means our weightings between Corporate bonds and U.S. Government guaranteed issues are highly unlikely to change. Most importantly the duration neutral positioning within the portfolios we manage will remain unchanged. The recent volatility and variability of interest rates has underscored the difficulty in accurately and repeatedly forecasting the path of future rates.

We hope that you all are safe and healthy in these unpredictable times.

Congress Asset Management Company

Two Seaport Lane ▪ Boston, MA 02210 ▪ 800.234.4516 ▪ www.congressasset.com