CONGRESS ASSET MANAGEMENT COMPANY

Fixed Income Outlook

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Investors were treated to a volatile ride by the fixed income markets in the last quarter. Yields have continued to shift upwards, pushing down prices, as investors nervously watch the Federal Reserve (the Fed) adjust monetary policy. Inflation fighting has moved front and center for the Fed, dominating newsprint, screentime, and mindshare for the markets. This has manifested in market expectations repeatedly increasing forecasted policy changes, moving longer-term yields in tandem. We foresee market makers continuing to fine tune their forecasts for the ending point for interest rates as the calendar year moves forward.

A check on the domestic economy leads directly to unmistakably elevated measures of inflation. Most consumers only need to review their grocery bills or the cost at the gas pump to register the impact. Economists also see inflation, even in their favored measures that exclude the more volatile food and fuel components. Core inflation has been running near 5% while inflation including all goods has been over 6% in recent figures. It is significant to note that the subcomponents of these measures are broadly elevated, suggesting that sustained inflation is likely.

Figure 1 Inflation measures PCE Deflator and Core PCE Deflator
(% Change Year Over Year - 2007 2022)

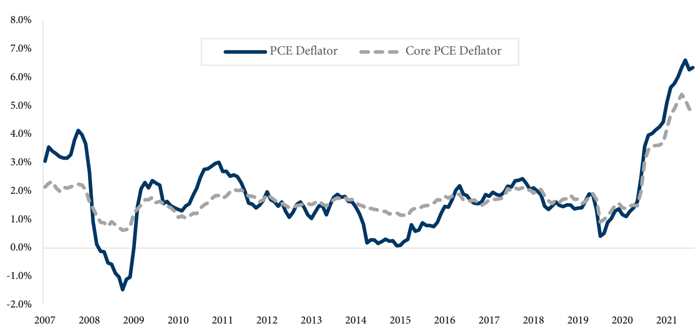

Figure 1 - Personal Consumption Expenditure Price Indices. Source: FactSet.

Taming inflation will surely take the better part of this year and some of the next, but the Fed has loudly broadcast its objectives in the fight. Fed Chairman Jerome Powell and his peers have repeatedly asserted that they are "acutely focused" on returning inflation to its 2% objective. The Fed's actions have backed up their words as they increased short-term rates once for 50 basis points in May and again in June for 75 basis points, the first 75 basis point increase since 1994. Further, Powell indicated that the group is prepared to "front load" hikes, acting aggressively and quickly to halt inflation's harmful effects on the economy.

The Fed's newfound transparency via communication and explanation has enabled better market-based predictive views. Members of the Federal Reserve Open Market Committee (FOMC) that set overnight rates are frequent speakers and have gotten adept at regularly messaging the greater markets. This transparency is in stark relief to the days when market expectations were sometimes fostered by the heft of Allen Greenspan's briefcase. Market forecasted rates have improved since that time and are now a useful tool in forward planning for both lenders and borrowers.

Bond market makers have assimilated the "Fed Speak" and the initial hikes of this tightening cycle, pushing up long-term yields as a consequence. At the same time, futures markets have presaged the end point for yields at the conclusion of the tightening cycle. This "terminal rate," currently implied at around 3.50% to 3.75%, suggests that multiple rate hikes are to follow. Long-term U.S. Treasury yields and this terminal rate are not too far apart, signaling that there is reasonable agreement between different areas of the fixed income marketplace as to the future path of interest rates.

Figure 2 US Treasury Yield Curve at March 31, 2022 & June 30, 2022

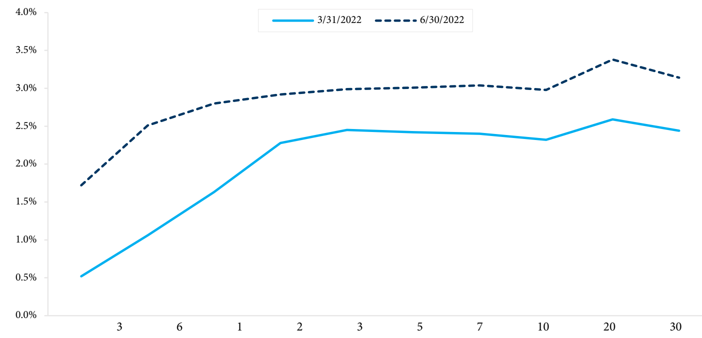

Figure 2 - U.S. Treasury Yield Curve March 31, 2022 and June 30, 2022. Source: FactSet.

The U.S. Treasury curve shifted upward over the last quarter, propelled by higher yields at every maturity point. Longer dated maturities remain quite flat across the curve and have yields that are within basis points of one another. The flat shape of the curve is unusual and can be interpreted as expressing two important market sentiments. First, the higher yields communicate the presumed levels for yields in the future when the Fed concludes its tightening actions. In this case the market unmistakably forecasts yields in excess of 3.25%, given the height of the curve. Second, the flatness of the curve suggests how successful the Fed will be at curbing inflation. Here, the Fed is judged to be an adequate tamer of inflation as the curve is not upward sloping at the long end.

We should pause here to caution that these market-based measures are continuously in flux and may not be 100% correct. Directionally, all of the data points reviewed here do share an amount of reasonableness and are more probable than not. However, these measures are based on real dollars at work and are expressing views of real people, which make them both changeable and fallible. Indeed, they are subject to change and may change quickly based on new information or events. For example, the terminal rate for fed funds has moved back and forth between 4.3% and 3.5% in just a few weeks' time towards the end of the quarter.

Figure 3 Intermediate Corporate Bond Spreads by Credit Quality

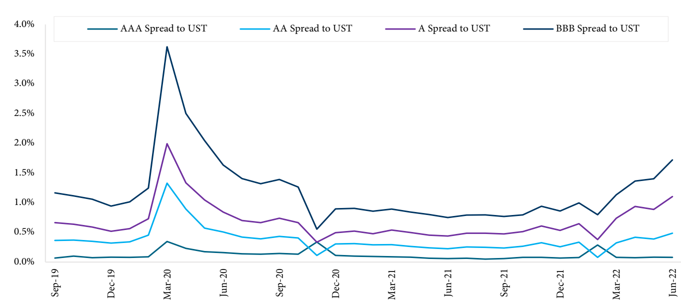

Figure 3 - Intermediate Investment Grade Credit Spreads (OAS) September 2019 to June 2022. Source: Bloomberg.

Credit spreads, or the additional yield investors require to compensate for default risk, increased over the second quarter. Investors have been slow to push spreads higher despite the risk of a slowing economy. The moves seen so far have been modest, reflecting only a mildly heightened concern over the liquidity of Corporate bonds and worthiness of their issuers. Lower quality securities did see a larger move than higher quality issues, a trend we have seen in prior quarters. Spreads still remain small when compared to their historical averages and much smaller than the peaks last seen in 2008.

Bond market performance in the second quarter of 2022 fully reflected the rise in interest rates. The size and the speed of the increase pushed most corners of the market into negative territory for the quarter. Shorter maturity issues outperformed longer maturity issues as these issues have less sensitivity to changes in yields. This led U.S. Government guaranteed debt, which collectively were slightly shorter in maturity, to outperform Corporate bonds, which were slightly longer in maturity. Corporate bonds also lost value as credit spreads increased over the quarter.

Looking forward, we expect the Fed to forcefully continue to raise interest rates as they have so pledged. The pace at which they do so remains clearly in debate, yet we can easily envision the ending point being around the 3.50% bogey suggested by market measures. There would be no surprise here if the Fed paused later this year to assess the impacts of their actions. History has shown that it can take six months for the effects of a rate hike to be fully integrated into the economy, so a timeout to review the process would make a lot of sense.

Even though we are undecided as to whether the Fed's actions will precipitate a recession, the pace and magnitude of the recent hikes will significantly increase that likelihood. Specifically, the quick pace of hikes could mean businesses and consumers may fail to adjust quickly with the rapid changes to monetary policy, leading to economic imbalances with negative outcomes. Some prognosticators suggest the odds of a recession could be as high as 50%, but these premonitions seem premature given the complexity of the current global economic environment.

At the very least, we know that short term yields are headed higher. This would mean an even flatter U.S. Treasury curve across its maturity spectrum. Where the curve goes from there will depend on how well the economy adjusts to higher rates and how well inflation can be tamped down. If there is a poor adjustment period that leads to a recession the curve might invert, pushing down long-term rates below short-term rates. Alternatively, if the inflation fight goes well, the curve could steepen and return to its more normal upward sloping shape.

Investors have been clamoring for higher yields from their bond portfolios for some time. We recognize that the time has now arrived, and we expect renewed interest in fixed income portfolios. This might be as standalone vehicles or as products that are paired with riskier assets such as equities. In this light we do urge caution for investors to choose their products carefully and maintain an eye towards high quality and good liquidity, especially as the economy continues to adjust to the new higher interest rate environment.

In these uncertain and volatile times, we continue to appreciate the value of purchasing high quality, liquid bonds for our client's portfolios. Our duration neutral posture for our clients' portfolios focuses our investment process on individual security selection and asset allocation among Corporate and U.S. Government guaranteed issues. Now is not the time to ramp up risk unnecessarily to chase higher returns. Instead, we suggest pursuing an investment portfolio that will provide returns that balance risk and return within a long-term perspective.

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

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