CONGRESS ASSET MANAGEMENT COMPANY

Fixed Income Outlook

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Volatility continued in the fixed income marketplace as yields moved higher during the third quarter. The Federal Reserve (the Fed) has steadfastly continued its fight against inflation with interest rate hikes, a shrinking balance sheet, and a plethora of verbiage. Market participants' focus remains on economic reports on inflation, hopeful that the Fed's repeated actions can gain some meaningful traction. Despite the tumult in the market, today's yields are quite appealing to investors who are long since accustomed to much, much lower levels.

The major driver behind the changes in yields has been the Fed activity. We saw two more fed funds rate hikes during the quarter, 75 basis points in July and 75 basis points in September. For the year so far, there have been six hikes amounting to a total of 300 basis points. This policy cycle has also included the Fed shrinking its balance sheet as it allows its portfolio of U.S. Treasuries and Mortgage-backed securities to mature off without reinvestment. Words have also followed these aggressive actions in what seems to be an unprecedented chorus of Fed officials broadcasting their objective to head off inflation.

While there is no mystery about the Fed's intent or methods, the result of the execution is still a question. The so-called "terminal rate," or the fed funds rate at the end of the tightening cycle as expected by markets, is still a moving target. It currently resides around 4.50%, suggesting that another 150 basis points of rate hikes could follow, but this is a moving target that has changed by the week. There is also a small expectation that the Fed overshoots its bogey and is forced to cut rates in 2023 if the economy slows too much. This thinking stems from the decreasing probability of the Fed achieving a "soft landing" as the length of this policy cycle extends through time.

Figure 1 Inflation measures PCE Deflator and Core PCE Deflator

(% Change Year Over Year - 2007 - 2022)

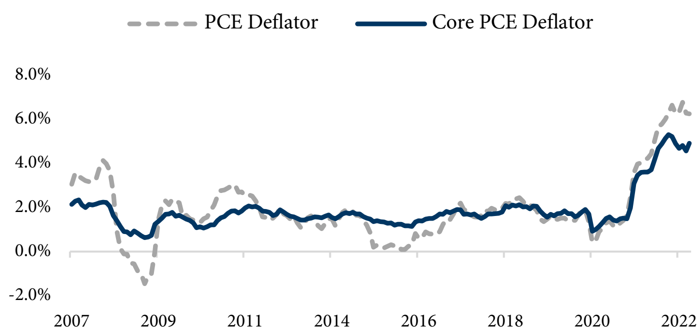

Figure 1 - Personal Consumption Expenditure Price Indices. Source: FactSet.

Data points from economic releases have not shown any dramatic curtailment of inflation in the face of these measures. While the rates hikes appear to have slowed the recent rapid spike in monthly inflation, year-over-year inflation measures remain elevated. Consumers are still feeling the bite of higher prices at the gas pump, at the grocery store, and in housing/rent prices, just to name a few areas of concern. The pervasive and broad nature of these price increases is fueling the ferocity of the Fed's policy measures. Simply put, the Fed is compelled to corral price increases quickly and without compunction.

Major policy changes do not come without a major market reaction. The U.S. Treasury yield curve moved higher and flatter over the past quarter, with short end yields moving faster than long end yields. Shorter maturity bonds tend to be more policy sensitive while longer maturity bonds are more inflation sensitive. Compared to the end of the second quarter, the curve is even flatter now and sports a slight inversion between 2-year yields and 30-year yields. As we mentioned in our previous missive, the shape of the yield curve communicates market sentiment and expectations.

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

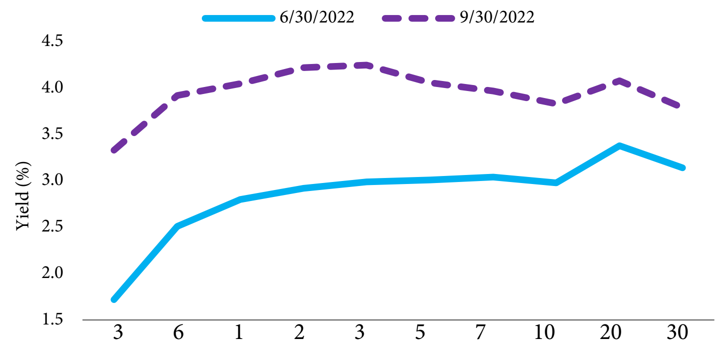

Figure 2 - U.S. Treasury Yield Curve June 30, 2022 and September 30, 2022. Source: FactSet.

There are two notable messages in the shape of the yield curve, one from the overall flatness of the curve and the other from the slight inversion of the curve. The flatness of the curve continues to speak to the market's expectations that the Fed will ultimately be successful in defeating inflation. Otherwise, the curve would take an upward sloping shape as inflation expectations would cause investors to demand more yield as compensation. The slight inversion of the curve hints at market suspicions that the "soft landing" will be hard to stick. Where a fully inverted curve is an obvious signal that the market expects a recession, today's shape points to brewing expectations of one coming to fruition.

Figure 3 Intermediate Corporate Bond Spreads by Credit Quality

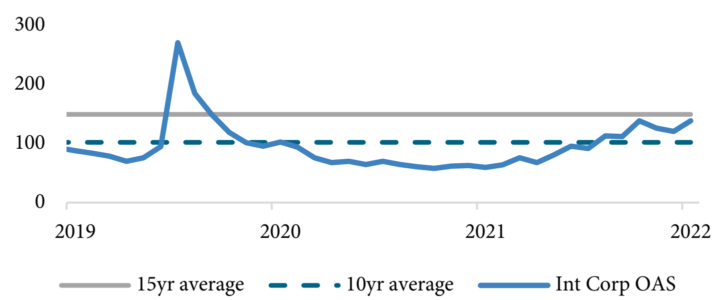

Figure 3 - Intermediate Investment Grade Credit Spreads (OAS) September 2019 to September 2022. Source: Bloomberg.

Investors continue to show little fear of credit events, as demonstrated by the overall low level of credit spreads. Credit spreads are the additional yield investors require to compensate for default risk. Investment grade spreads in general are above recent average levels that date back to before the beginning of the pandemic. However, when viewed against a longer-term history, one that includes the great financial crisis of 2007-2008, spreads remain below those average levels. Overall, the fixed income markets are not demanding enough compensation for the potential risks facing corporate bond issuers.

Most issuers appear to be financially stable and maintain adequate liquidity on their balance sheets today. But with the Fed's actions, they all face a trio of pressures yet to be fully realized. First, a slowing domestic economy will challenge revenue growth as consumers curtail spending. Second, rising interest rates will increase borrowing costs, especially for those already in the lower credit quality cohort or are borrowing on a short-term basis. Finally, inflationary pressures on costs related to raw materials, transportation, and labor will begin to squeeze margins and reduce profits. Combined, the forces will impact growth and profitability, ultimately constricting cash flows and impinging debt issuers' ability and flexibility to pay interest and principal.

Our concern is that while the vast majority of issuers will contend and surmount these financial pressures, there will be issuers who struggle to adapt, and a couple may go so far as to fail to adapt. These will likely be highly levered companies, toiling in declining industries rather than mainstream, high-quality issuers. To be clear, this would be part of the normal path in the end of a credit cycle, not a cataclysmic event such as the great financial crisis. Nevertheless, their struggles could serve as a wakeup call to the markets, pushing all spreads much, much wider.

Given all of the above, we continue to position our client's portfolios accordingly. We remain leery of narrow credit spread levels and are content with the current allocation to corporate bonds, most recently hovering around 50% of portfolio holdings. U.S. Treasuries remain susceptible to additional Fed interest rate hikes yet offer improved yields and unmatched liquidity. Trading government guaranteed debt serves as an excellent method for adjusting the portfolio's duration, or the yield sensitivity of the portfolio, which we continue to match to the duration of our index.

Performance in the fixed income markets has been dismal from a total return standpoint. The third quarter marks the fourth straight quarter of negative returns for bonds, a highly unusual occurrence. In fact, this string of four consecutive quarters of losses was the first seen since our benchmark's inception in 1973. For investors also invested in stocks in a traditional Balanced strategy, these returns on top of losses in equities may seem punitive. The last time both stocks (as measured by the S&P 500 Index) and bonds (measured by the Bloomberg Intermediate Gov't Credit Index) had negative returns over a calendar year was 1994, further showing the rarity of this current market situation.

We expect that the end of the present series of Fed interest rate hikes will mark the resumption of more normal market performance. This transition away from very low yields points to an ultimate market reset and an end to this very uncommon situation. Bonds, due to their structure, have mean reverting return properties. So, over the long run we expect bonds to have returns that roughly equate to their yield to maturity, pushing results back into positive territory.

For the quarter, both U.S. Government guaranteed debt and Corporate bonds performed equally poorly. Both market segments posted returns near -3.0% for the quarter, driven down by rising interest rates. On a year-to-date basis, Corporate issues have suffered more than government guaranteed issues. We should note that higher-quality Corporate bonds have outperformed their lower-quality counterparts over this time frame as well. Our disdain for lower-quality issues has been buttressed by this weaker performance.

Looking forward, we expect the Fed to continue to raise interest rates until macroeconomic data signals lower inflation. So far, we have seen slowing growth rates of inflation (i.e., smaller increases) but nothing that would qualify as contractionary. At the same time, given the multiple 75 basis point hikes instituted by the Fed, we would not be surprised if the Fed took a timeout to allow their policies to become fully integrated into the economy. Yet in the aggregate, we see little reason for the Fed to deviate from its well documented and broadcast mission to tamp down inflation.

Yields today are over 350 basis points higher than they were one year ago, presenting a much more enticing picture for investors. The desire to chase yield can be strong, so we do advise choosing your investment vehicle wisely. Above market yields are not given away freely, there are tradeoffs that come in the form of credit risk and liquidity risk. Fixed income investments should be made in places of stability, not volatility.

In times where uncertainty seems to be the watchword, we especially appreciate the value of purchasing high-quality, liquid bonds. Moderate yields from a moderate risk profile seems a better alternative than a "shoot out the lights" approach. Our long-term strategy of thoughtful portfolio construction and measured security selection is centered on safety, liquidity, and quality. We believe our strategy will best serve our clients over time, especially when markets are not always heading up.

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

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