CONGRESS ASSET MANAGEMENT COMPANY, LLP

Fixed Income Outlook

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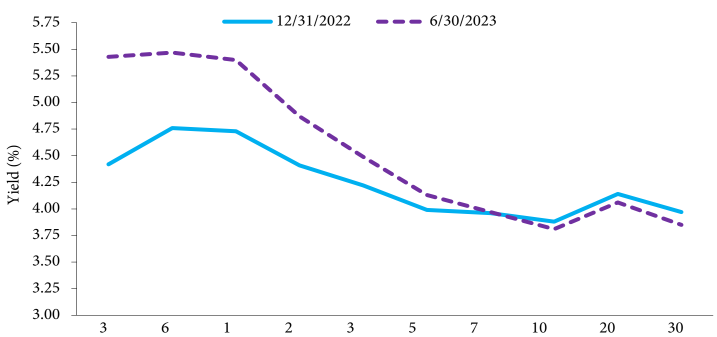
Yields rose along most of the U.S. Treasury yield curve as the Federal Reserve Board ("the Fed") continued its fight against inflation in the second quarter. The Fed has more work to do as inflation has been slow to recede despite their repeated efforts and copious verbiage. While fixed income investors are grateful for the higher yields, they are eager for the Fed to conclude its campaign. Economic data points amply indicate that the battle against inflation will endure for the foreseeable future.

Short-term yields moved higher over the last quarter while long-term yields remained relatively stationary. This movement in interest rates reflected the market's expectation that the Fed is not yet done hiking interest rates and is resolved to keep them at restrictive levels for the foreseeable future. Indeed, a review of economic data points shows that inflation is stubbornly subsiding at only a plodding rate. The pace of change is regrettably slow but is nonetheless heading in the right direction.

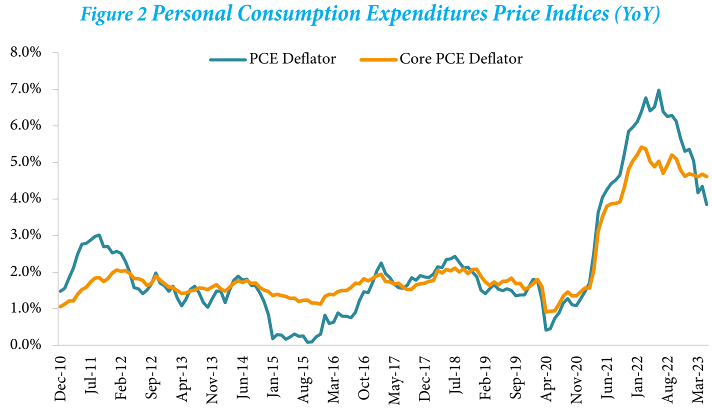
Figure 1 US Treasury Yield Curve at December 31, 2022 & June 30, 2023



Source: FactSet

The widely watched inflation metric, the Personal Consumption Expenditures Price Index ("PCE"), has fallen from a recent high of 7.0% to 3.8% in its last measurement. At the same time, the Core PCE, which ignores volatile food and energy prices, has also decreased over time from a high of 5.4% to the latest reading of 4.6%. Both of these measures rest well above the Fed's stated target of 2%. The pace of change in the price index is disconcerting when compared to the pace of interest rate hikes executed by the Fed, which has been a total of 10 actions for 5.00% of cumulative increases so far in this current cycle.

Figure 2 Personal Consumption Expenditures Price Indices (YoY)



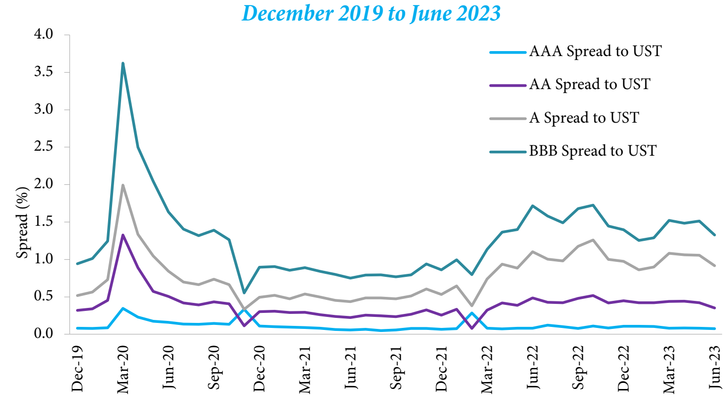
Source: FactSet.

Several macroeconomic factors come to mind when reviewing the reason for the slow decline in the PCE data. First, the demand for housing remains strong against a backdrop of constrained supply, which sustains the current high level of both home prices and rent equivalents. Second, the unabating strength of the consumer has also prolonged higher prices across a wide variety of both goods and services. Finally, a tight labor market has supported both purchasing power and consumer confidence in the post-pandemic environment. One or more of these factors will need to ease or decline before inflation falls significantly.

The present economic situation will likely require the Fed to continue to hike rates as we move ahead, perhaps with additional pauses built into their plan. Estimates by the Fed's own board members of the future state of the economy have been repeatedly revised and lack predictive strength. Overall, this suggests an open-ended timetable for the Fed until the group feels satisfied that they have adequately met their goal of lowering inflation.

Credit spreads, or the additional yield required by investors to compensate for default risk, shrank over the second quarter. There were no additional or knock-on impacts following the banking problems seen in the first part of the year. New issuance of bonds by Corporate issuers is still met with broad investor appeal, as the total of investment grade bonds sold is just 3% below last year's totals at the calendar midpoint. In general, the bond market has high confidence in the credit worthiness of borrowers.

Figure 3 Intermediate Investment Grade Credit Spreads (OAS) by Rating Cohort December 2019 to June 2023



Source: Bloomberg.

Performance for the fixed income markets was a negative for the quarter, despite shrinking credit spreads. The higher yields pushed returns for the quarter into the red, while year-to-date returns were still firmly positive. Corporate bonds outpaced U.S. Government guaranteed issues for the quarter, largely on an improved outlook for the banking sector. Lower quality issues generally outperformed higher quality issues over the same time period.

Investment grade bonds present an attractive opportunity today. Yields may rise as we move ahead, but very likely not at the same pace we have witnessed so far in this Fed cycle. Further, ebbing inflation will only serve to reinforce the attractiveness of bonds as time passes.

For investors who are looking for better yields, higher coupons, and portfolio stability, now is the time to review opportunities in fixed income investments.

We are committed to our long-term strategy of purchasing liquid, high-quality bonds for our client's portfolios. Our portfolio construction and deliberate security selection process are the main tenants of our strategy. We seek to build portfolios with safety, liquidity, and quality as their primary characteristics.

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