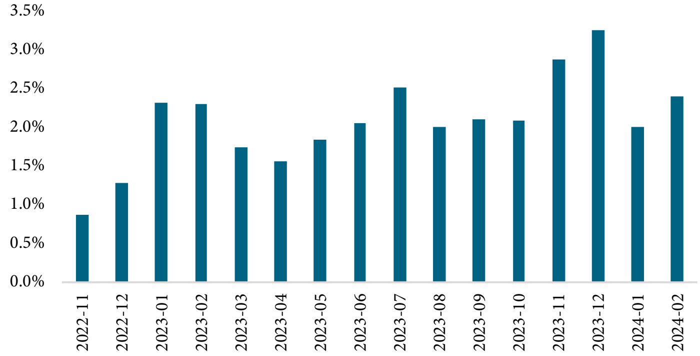
KEY TAKEAWAYS:

1. **The recent string of hotter than expected inflation readings led yields higher, cast doubt on the hoped for soft landing, and may mean that higher rates persist this year.**
2. **Credit spreads fell during the quarter back near historic lows as investors continue to seek out higher yielding securities. We believe markets are underappreciating risks and spreads should be higher.**
3. **Overall, investment grade bonds remain an excellent opportunity for investors given higher yields and the potential for future interest rate cuts.**
4. **We remain committed to our long-term strategy of purchasing investment grade, liquid bonds.**

The first quarter began with high expectations for the Federal Reserve Board (the Fed) to cut interest rates six to seven times over the following 12 months. Since then, U.S. economic activity has remained resilient and the steady march towards lower inflation has become uneven. By the end of the quarter, the number of forecasted cuts fell to three and have been pushed to the second half of the calendar year. In response, the U.S. Treasury yield curve shifted upwards as inflation may be more stubborn than the Fed initially forecast.

Several macroeconomic data series underscore the sturdiness of the economy. Employment has been very strong as we have seen 39 consecutive months of job gains. Housing, which should be sensitive to higher interest rates, has only dimmed slightly, suffering more from low inventory than a lack of buyers. Inflation-adjusted consumer behavior, measured by year-over-year changes to the Real Personal Consumption Expenditures index, has been steadily positive in the post-pandemic period.

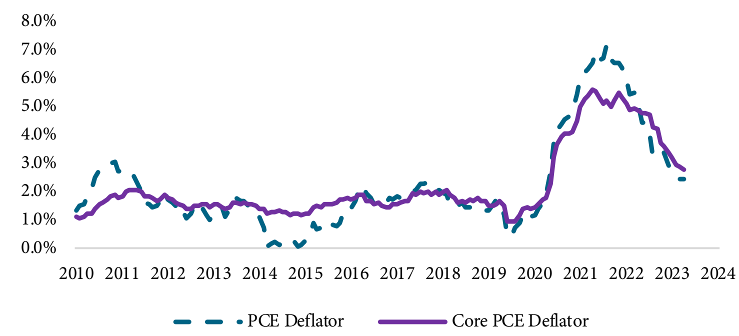
Figure 1 Real Personal Consumption Expenditures (% Change from a Year Ago) 2022 - 2024



Source: US Bureau of Economic Analysis

Recent changes in inflation measures are also notable. What used to be a rhythmic tempo of downward steps now resembles a staggering path. The previously discernable trend has become less consistent. Market makers who had extrapolated the formerly broad trend now find their confidence waning that inflation will hit the Fed's 2% target rate. This has cast doubt on the hoped-for "soft landing" and may mean higher rates persist throughout the year.

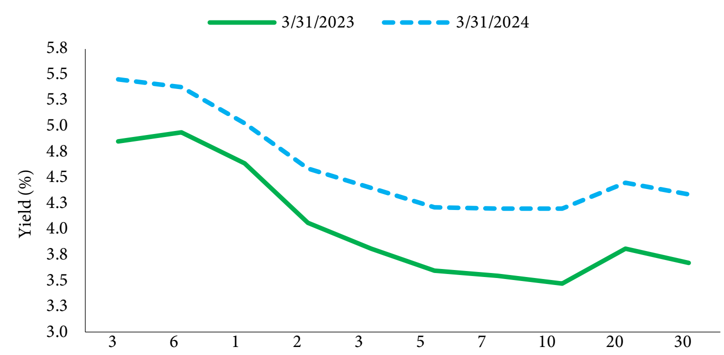
Figure 2 Personal Consumption Expenditures Price Indices (YoY)



Source: FactSet

U.S. Treasury yields pushed higher in quarter as a reaction to the changing inflation outlook. The threat of higher inflation pushed up longer-dated bond yields as investors shifted their thinking. Elevated inflation eats into future returns, compelling buyers to demand higher yields to stem the erosion of those returns. Shorter-dated issues, which are less sensitive due to their near maturity, saw less pronounced moves upwards.

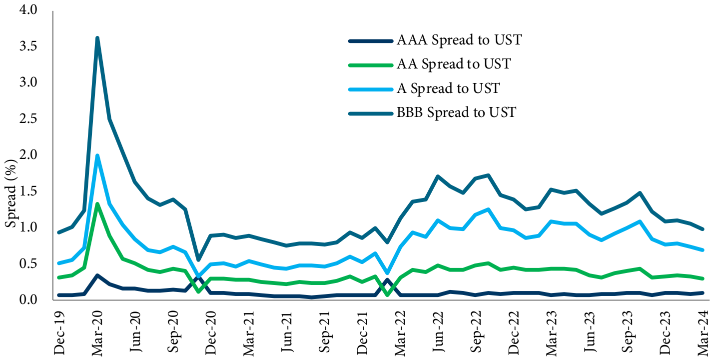
Figure 3 U.S. Treasury Yield Curve on March 31, 2023 and March 31, 2024



Source: FactSet

Credit spreads, or the additional yield required by investors to compensate for default risk, fell during the first quarter. Lower quality once again led the charge as investors continue to seek out higher yielding securities. Given the already sparse credit spreads, this appetite for yield is as aggressive as it is voracious. Issuance of new corporate bond deals has already topped the $500 billion mark for the year-to-date timeframe and the market has had no problems digesting this record dollar amount of new deals. We reiterate our concerns that, generally, risks are probably being underappreciated and that spreads should be higher.

Figure 4 Intermediate Investment Grade Credit Spreads (OAS) by Rating Cohort December 2019 to March 2024



Source: Bloomberg, FactSet

Performance for the quarter once again saw corporate bonds outshine U.S. Government guaranteed debt. Rising yields pushed U.S. Government guaranteed issues into slightly negative territory. Corporate bond returns stayed positive with their higher yield providing a cushion, with higher-rated issues underperforming lower rated issues. Digging deeper, higher quality issues posted negative returns while lower quality issues sported positive returns. This high versus low quality dichotomy is a trend that has carried over from the previous calendar year into the current year.

As we look forward, our expectations for continued volatility in longer term rates are still firmly in place. The short end of the curve should see more stability as those rates will be closely aligned with any policy moves made by the Fed. With the onset of inconsistent inflation measures, any easing of monetary policy by the Fed will likely play out over a longer timetable than markets have been expecting. Recent data points have not been sufficient to initiate any changes, suggesting that a return to more concrete and directional changes to pricing data will be required for the Fed to act.

Investment grade bonds are an excellent opportunity with today's higher yields for investors. After a long period of near zero interest rates, high-quality bonds now sport an appeal that had been missing for some time. The interest rate cycle of hikes by the Fed appears to be finished with a possible set of cuts in the future, further bolstering their appeal.

We remain committed to our long-term strategy of purchasing investment grade, liquid bonds for our client's portfolios. Our portfolio construction process is thoughtful and employs the knowledge and experience of our Fixed Income team. Now is a great time to review possible opportunities in fixed income as either a stand-alone investment or as part of a larger investment strategy.

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