Quarterly portfolio manager commentary

Cash Management Portfolios

What market conditions had a direct impact on the bond market this quarter?

Yield curve levels soared on higher inflation data, a 25 basis point (bps) Federal Reserve (Fed) rate hike and an increase in market expectations for more aggressive Fed tightening. The war in Ukraine and general market volatility pushed credit spreads wider in the quarter. The combination of higher yields and wider spreads resulted in deeply negative performance for most fixed income indices.

Economic Activity – U.S. economic conditions weakened throughout the quarter, highlighted by slowing global growth and surging inflation pressures owing to rising commodity prices. U.S. Gross Domestic Product (GDP) slowed in the first quarter (Q1), with growth estimates in the 1.5% range following the fourth quarter's strong 6.9% pace which benefited from a large inventory build-up. The headline Consumer Price Index (CPI) rose to 7.9% in February, with CPI ex. food and energy rising 6.4% year-over-year (YoY). The Fed's preferred inflation index – the PCE Core Deflator Index – increased 5.4% YoY for February, the highest reading since 1983. Inflation levels are projected to peak over the next couple of months, but given persistent supply chain issues and wage and price pressures, we expect them to remain elevated into next year. Consumer spending continues to outstrip supply and production capacity, further aggravating inflation pressures. U.S. consumers remained resilient throughout the quarter despite higher inflation and reduced purchasing power. Employment conditions remain tight, with February U.S. Job Openings standing at 11.266 million open positions vs. March's Total Unemployed Workers in the Labor Force of 5.952 million. Further emphasizing strong labor demand, the U3 Unemployment rate fell to 3.6% in March and Average Hourly Earnings rose a healthy 5.6% YoY. Non-farm Payrolls (NFP) readings continued the strong pace of 2021, averaging 560,000 jobs per month during Q1. Despite broad-based labor market strength throughout the quarter, historically tight conditions are constraining economic growth and driving prices higher.

Monetary Policy – The Fed lifted rates 25 bps at the March 16th meeting and indicated through their Dot Plot expectations for an additional 150 bps of tightening in 2022. Surging inflation numbers have increased both market expectations and Fed rhetoric for a more aggressive pace to rate hikes, with 50 bps increases at the May 3rd and June 15th meetings becoming the market's base case. Further, the March 16th meeting minutes revealed plans to begin balance sheet reduction at a $95 billion ($60 billion in U.S. Treasuries and $35 billion in agency mortgage-backed securities) monthly pace, likely starting in May.

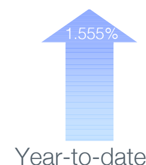
Jim Palmer, CFA
Chief Investment Officer

Fed funds target rate:
25-50 basis points
Last Change: March 16, 2022

1-year Treasury Yield
March 31, 2022: 1.595%

Year-to-date

3-year Treasury Yield
March 31, 2022: 2.512%



Year-to-date

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March 31, 2022

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Fiscal Policy – After two years of unprecedented fiscal stimulus to counter the negative economic impact of COVID-19, government spending will likely be a drag on U.S. GDP in 2022. State and local governments are, for the most part, in excellent shape, flush with surging tax collections and still unspent federal pandemic relief funding. Given current inflation pressures and the difficulty in passing legislation during the 2022 election cycle, the probability of further fiscal stimulus measures is low.

Credit Markets – Spiraling inflation numbers, lift-off to Fed rate hikes with expectations for an accelerated pace going forward sent U.S. Treasury yields soaring in the quarter. As a result, fixed income performance was deeply negative in the quarter. Demand for new-issue debt remained strong, although market volatility has begun to expose some cracks in overall market liquidity, reflected mainly in wider bid-ask spreads. Money market fund, T-Bill and agency discount note yields have lifted off the zero barrier post-March 16th rate hike.

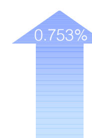
Yield Curve Shift

U.S. Treasury Curve	Yield Curve 12/31/2021	Yield Curve 3/31/2022	Change (bps)
3 Month	0.030%	0.482%	45.2
1 Year	0.376%	1.595%	121.9
2 Year	0.732%	2.335%	160.3
3 Year	0.957%	2.512%	155.5
5 Year	1.263%	2.460%	119.7
10 Year	1.510%	2.338%	82.8

Treasury yield curve levels surged as markets accelerated the pace and magnitude of Fed rate hikes with two- and three-year yields most impacted. The rise in 10-year yields was significant but less so than for shorter maturities, suggesting markets expect inflation levels to ease over the longer run.

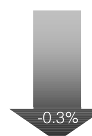
The three-month to 10-year portion of the yield curve steepened a healthy 37.6 bps to 185.6 bps. At the same time, the two-year to 10-year portion of the yield curve flattened 77.4 bps, creating an essentially flat, to sometimes inverted, yield curve. The diversion between the two portions of the curve implies 1) significant Fed rate hikes are priced into two-year yields, and 2) recession risks, as reflected in the shape of the yield curve, are rising.

3-Month LIBOR
March 31, 2022: 0.962%



Year-to-date

Unemployment Rate
March 31, 2022: 3.6%



Year-to-date

Source: Bloomberg U.S. Treasury Actives Curve, US0003M and USURTOT Indices

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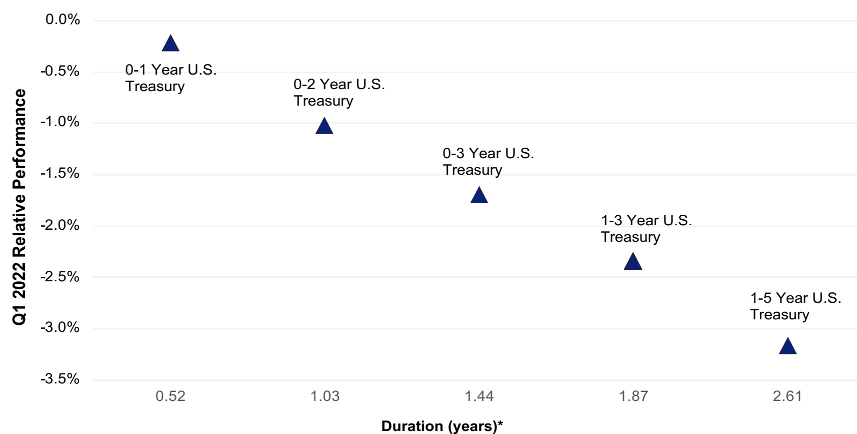
Duration Relative Performance



**Duration estimate is as of 3/31/2022*

Q1 2022 U.S. Treasury performance played out as expected, with longer duration strategies more adversely impacted by rising rates. The ICE BofA 1-5 Year U.S. Treasury Index's -3.162% Q1 return was the index's worst quarterly performance in more than 40 years.

Credit Spread Changes

ICE BofA Index	OAS* (bps) 12/31/2021	OAS* (bps) 3/31/2022	Change (bps)
1-3 Year U.S. Agency Index	-3	2	5
1-3 Year AAA U.S. Corporate and Yankees	6	12	6
1-3 Year AA U.S. Corporate and Yankees	19	28	9
1-3 Year A U.S. Corporate and Yankees	37	56	19
1-3 Year BBB U.S. Corporate and Yankees	70	93	23
0-3 Year AAA U.S. Fixed-Rate ABS	36	71	35

Corporate and ABS credit spreads widened in the quarter, with most of the damage done in the first two months of the year. AAA-A spreads stabilized in the second half of March. The steep decline in BBB corporate spreads in March was primarily related to removing Russian-related bonds from the index at quarter-end.

*Option-Adjusted Spread (OAS) measures the spread of a fixed-income instrument against the risk-free rate of return. U.S. Treasury securities generally represent the risk-free rate.

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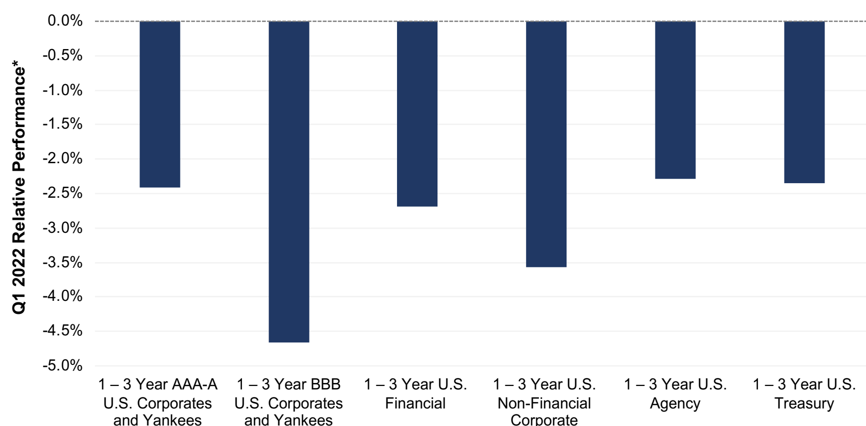
Credit Sector Relative Performance of ICE BofA Indexes



**AAA-A Corporate index underperformed the Treasury index by 6.3 bps in the quarter*

AAA-A Corporate index outperformed the BBB Corporate index by 224.8 bps in the quarter

U.S. Financials outperformed U.S. Non-Financials by 87.8 bps in the quarter.

Not surprisingly, Q1 investment performance was abysmal across all asset classes, given the jump in yields and wider credit spreads. Credit sectors underperformed comparable duration Treasuries, although the differential vs. AAA-A rated credits was relatively minor. BBB credit significantly underperformed their higher-rated counterparts, partially due to the presence of several Russian-related issuers in the BBB benchmarks. These issuers tend to be industrials rather than banks, which account for the majority of the performance dispersion between the non-financial and financial indexes.

What strategic moves were made and why?

Taxable Portfolios – U.S. Treasury yield curve levels spiked due to higher inflation data and the growing probability of more aggressive rate hikes from the Fed. As a result, quarterly fixed income returns were meaningfully negative in historic fashion, illustrated by the ICE BofA U.S. Treasury Index's -3.162% Q1 return, the lowest quarterly return in more than 40 years. Credit spreads widened in the quarter as well, which resulted in underperformance for credit vs. comparable duration Treasuries. BBB credit underperformed A-rated counterparts, but a significant portion of the noise within BBB indexes was related to Russian-linked industrials which saw their spreads blow out before being removed from the indexes. The cheapening of credit was widespread and more related to global-macro events and imminent Fed tightening than any meaningful deterioration in the fundamental credit quality of our investment grade universe.

Tax Exempt and Tax-Efficient Portfolios – We added to traditional municipal allocations significantly for the first time in years. This activity was spurred by a dramatic increase in absolute and relative yields. Short municipal rates (1-3 year) soared by approximately 150 bps and municipal ratios relative to comparable Treasuries improved from around 35% to a much more reasonable range of 75-90%. Often times these sort of moves occur as a

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result of an elevated level of municipal supply. However, in this case, it was a massive reversal in municipal bond fund flows (more than $28 billion in outflows YTD) which proved to be the main catalyst. As investment opportunities priced in significant Fed tightening, we welcomed the higher levels as a way to add income to portfolios in a more immediate way. Given the high level of uncertainty around the Fed path, we were motivated to "average-in" these fixed-rate positions throughout the quarter. We also sought to purchase a range of maturities in a laddered structure from as short as a few months out to three years.

How are you planning on positioning portfolios going forward?

Taxable Portfolios – Higher Q2 yields continued the trend of creating or deepening portfolio unrealized gain positions. We encourage investors to focus on re-investment opportunities to increase book yield and portfolio income rather than unrealized losses, particularly if there is no need to sell these positions. With portfolios now marked to current higher yields, monthly and quarterly performance numbers will benefit from a larger cushion against further price deterioration should yields move higher. Going forward, we expect very short yields (less than six months) to rise dramatically as the Fed embarks on a more aggressive rate hike tempo. We expect two- to five-year yields will be biased higher in Q2, although the market has already priced in significant Fed tightening and further increases in the quarter will likely be more limited than seen in Q4/21 and Q1/22. As a result, we are positioning portfolios short of benchmark duration and focusing allocations to the front-end of the curve to reinvest as quickly as possible. Given our outlook for continued GDP growth, the resiliency of the U.S. consumer and solid company fundamentals, we remain constructive on corporate, bank and ABS sectors and view the cheapening of credit as an opportunity to add portfolio income. Financials remain an overweight vs. industrials given their higher yields, strong balance sheets and limited exposure to vexing supply chain issues. Yield curve volatility has provided more opportunities in the agency callable space as a high-quality investment alternative to Treasuries or bullet agencies.

Tax Exempt and Tax-Efficient Portfolios – We believe a mix of fixed-rate and variable-rate securities is a prudent approach to investing in this market environment. The ultimate path of Fed tightening remains highly uncertain in terms of both the pace and the terminal rate. Current allocations for municipal-only mandates are approximately 65/35, tilted towards variable-rate. There is plenty of room for fixed-rate exposure to continue to grow in the coming quarter and that is our plan and expectation. Tax-exempts have become a much more viable alternative to corporates in some maturities. Most notably, we like maturities inside of one year for tax-efficient accounts. Municipals are trading in this area at levels approaching, and in some cases, exceeding treasuries on a pre-tax basis. After-tax yields are competitive vs. corporates. We may look to avail ourselves of some of these opportunities in the coming months as a diversifier to increase credit quality and potentially add incremental yield.

Sources

Bloomberg C1A0, CY11, CY21, CY31, G1P0, ICE Bond, JOLTTOTL, NFP TCH, PCE CYOY, US0003M, USUETOT and USURTOT Indices

Bloomberg, U.S. December Employment Situation: Statistical Summary, Bloomberg, U.S. Economic Forecast

Bloomberg, U.S. Treasury Actives Curve

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