

AUGUST 2023

## Risk Management Update

The risk management model (chart right) seeks to reduce exposure to fixed-income sectors most sensitive to equity drawdowns. The risk management model was unchanged from last month and entered August recommending full model exposure to areas most sensitive to equity markets: U.S. High Yield, Emerging Markets, U.S. Investment Grade, and Floating Rate Notes.

Figure 1: Smart Sector® Fixed Income Risk Management Model

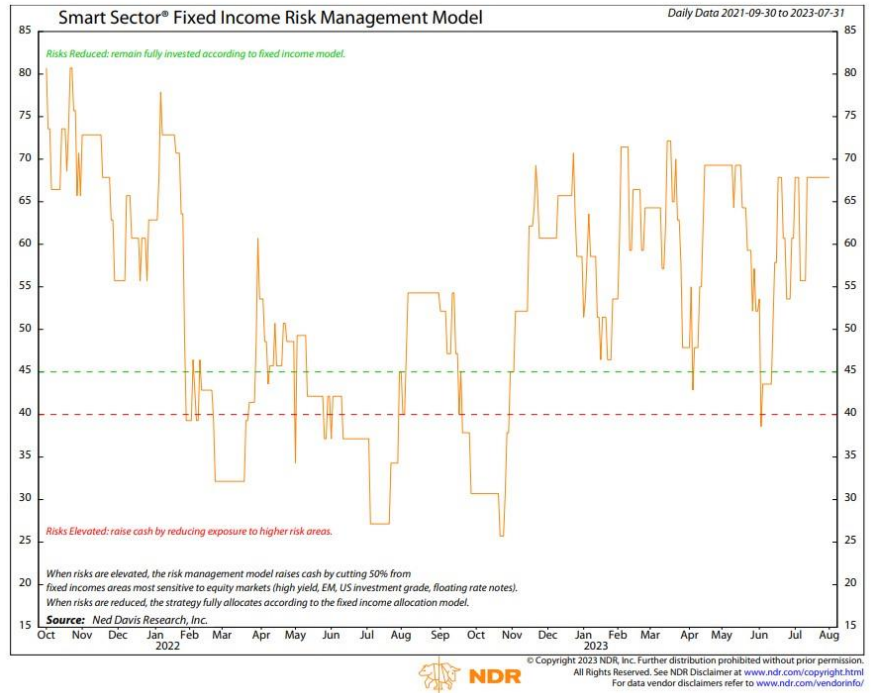
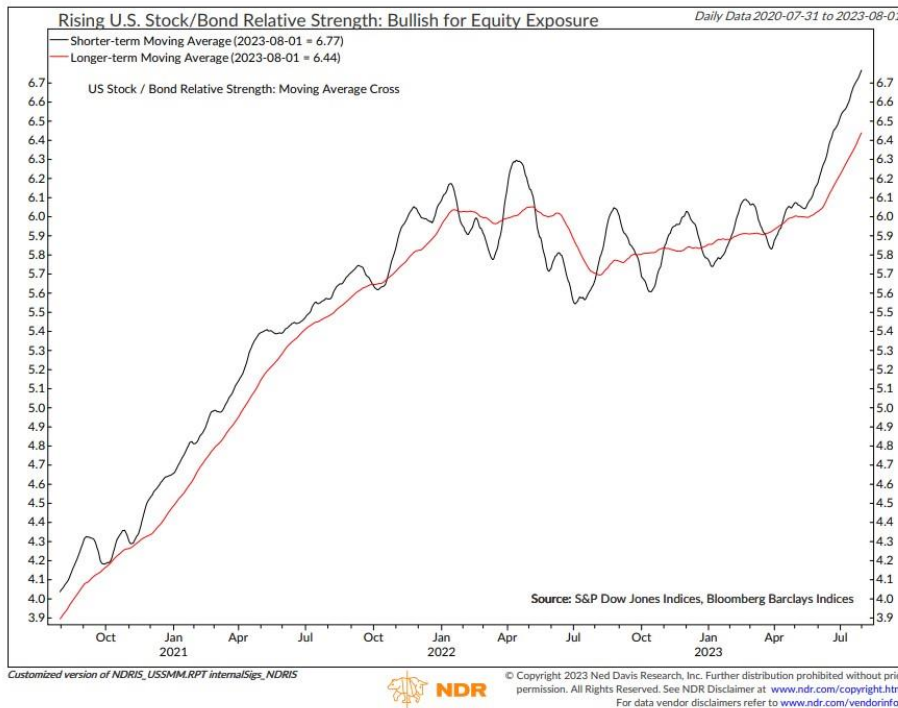


Figure 2: Rising U.S. Stock/Bond Relative Strength: Bullish for Equity Exposure



The model's steadiness is driven by five (of seven) internal (price-based) measures that remain bullish, including rising stock/bond relative strength (chart left). While external influences such as trade and market sentiment remained bearish, they're offset by bullish readings from high-yield and emerging market bond breadth, as well as high-yield option-adjusted spreads. For now, the weight of the evidence recommends a fully invested allocation to fixed-income sectors according to the model.

## Fixed Income Market Update

The Bloomberg Barclays U.S. Aggregate Bond Total Return Index was flat in July. Returns have been flat or negative for eight of the past 12 months. Breadth remained strong—seven of the nine fixed-income sectors we track had positive returns in July—but weakness in U.S. Treasuries dragged down the Aggregate.

As widely expected, the Fed raised the target for the Fed Funds rate by 25 basis points in July to a range of 5.25% to 5.50%, the highest since March 2001. The Fed has raised rates 525 basis points since March 2022, making it the fastest hiking cycle ever. The Fed also maintained its tightening bias and is keeping its options open with respect to another rate hike to

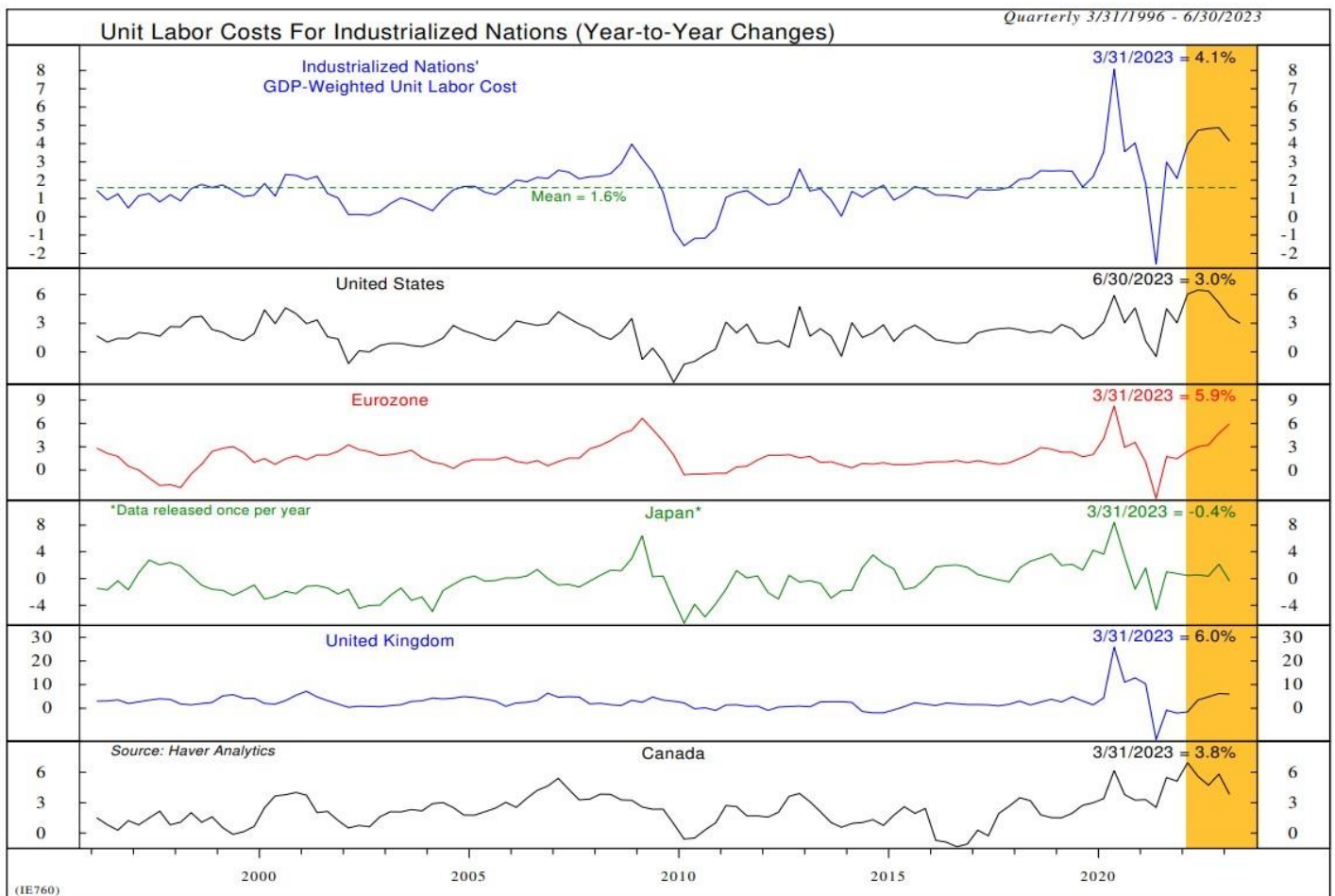
underscore its commitment to fighting inflation.

Although central banks have different mandates and face different economies, they share a common inflation objective of 2%. While all policymakers look at a wide array of data in making decisions, none is more central than labor compensation. Wages are highly correlated with core inflation and are a good proxy for measuring inflationary pressures in the non-shelter services sector. The U.S. is making progress. Unit labor costs slid to 3.0% in Q2 from a peak of 6.5% in Q2 2022 (chart below), but it still has a way to get down to target.

If the data evolves as we expect, the Fed will likely skip raising rates in September. But the upside risks to inflation could lead to another rate hike in Q4. However, the markets, once again, appear to be underpricing the risk of additional hikes.

Entering August, the fixed income allocation strategy has a moderate risk-on message. The model is overweight U.S. High-Yield Bonds, U.S. Long-Term Treasuries, Emerging Market Bonds, and International Investment Grade Corporates. We are underweight U.S. Treasury Inflation-Protected Securities, Floating Rate Notes, and U.S. Mortgage-Backed Securities.

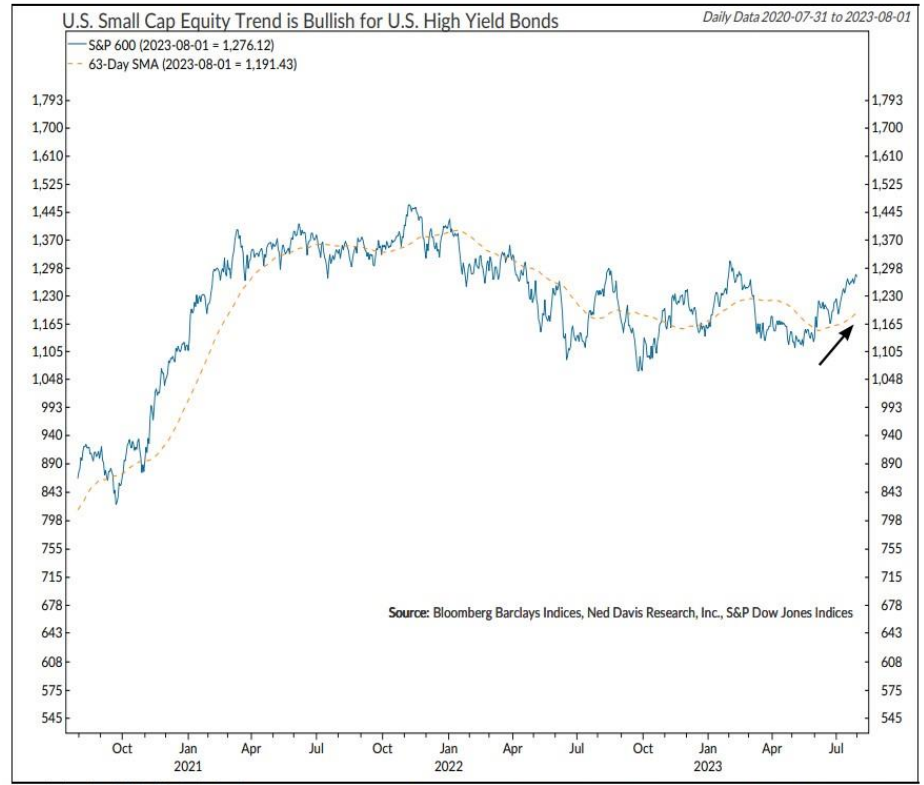
Figure 3: Unit Labor Costs For Industrialized Nations (Year-to-Year Changes)



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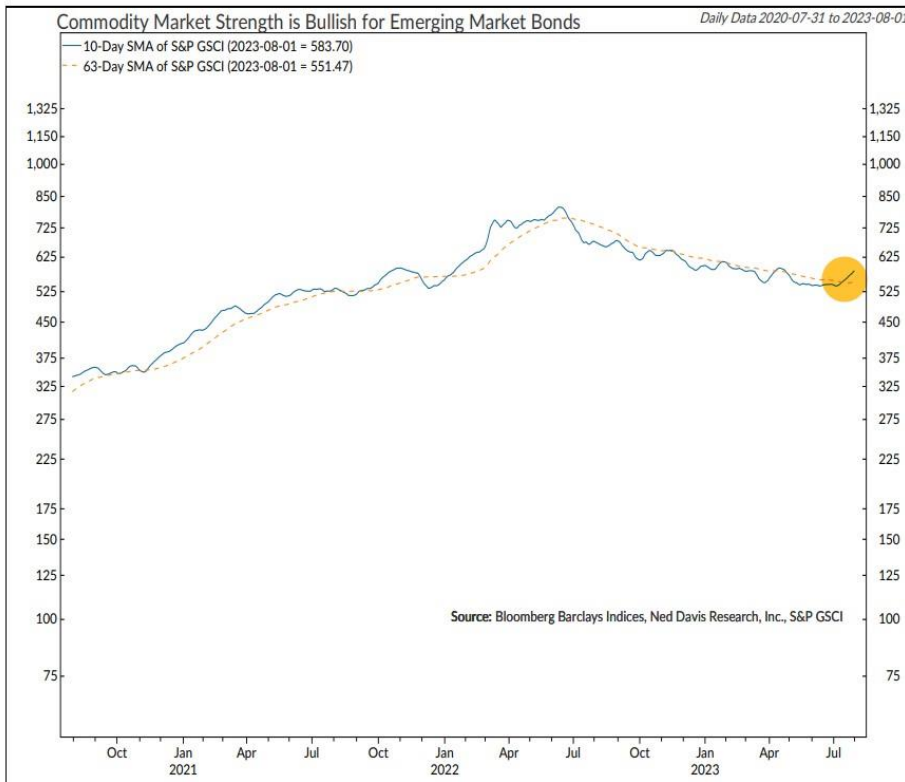
**Figure 4: U.S. Small Cap Equity Trend is Bullish for U.S. High Yield Bonds**

U.S. High Yield bonds' allocation rose over 500 basis points in July and is an overweight position. All six indicators remained bullish. External influences such as the small-cap equity trend (chart right), the VIX, and option-adjusted spreads continue to provide tailwinds for the sector. The three internal (price-based) measures of trend and breadth confirm the model's positive message.



Source: Bloomberg Barclays Indices, Ned Davis Research, Inc., S&P Dow Jones Indices  
 Customized version of US Small Cap Equity Trend  
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**Figure 5: Commodity Market Strength is Bullish for Emerging Market Bonds**

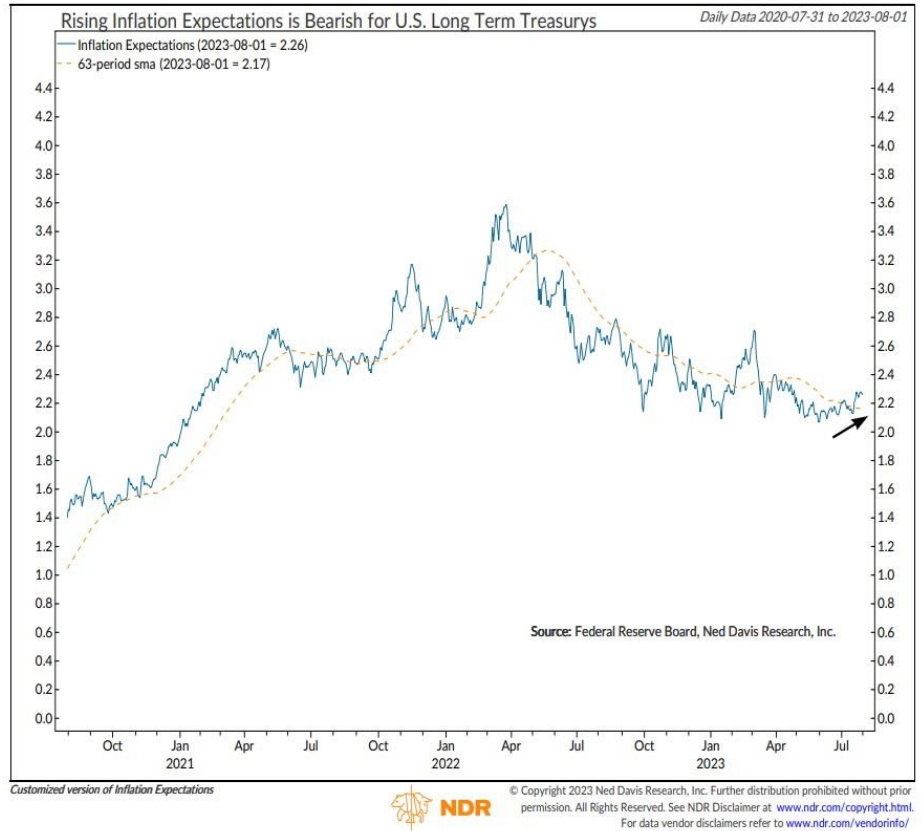


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 Customized version of Commodity Market Strength  
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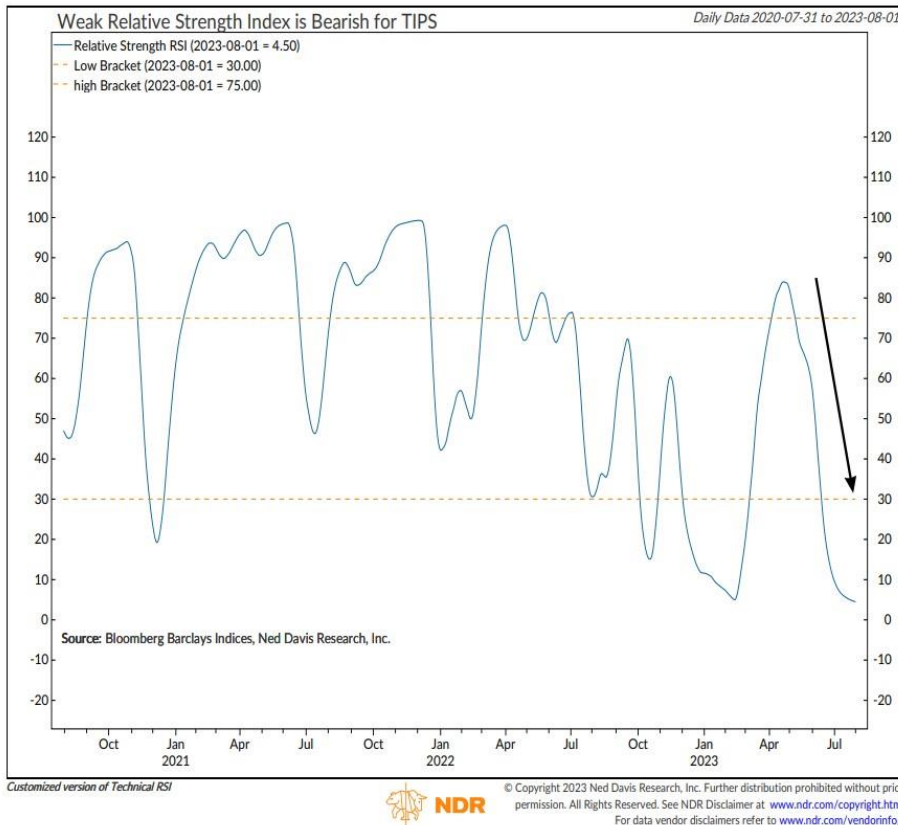
The Emerging Market (EM) bonds' allocation is also an overweight position. Four of the five indicators remained steady. Emerging Markets have a positive relationship with rising commodity prices. During July, commodity strength improved to a bullish level for the sector (chart left).

**Figure 6: Rising Inflation Expectations is Bearish for U.S. Long Term Treasuries**

The U.S. Long-Term Treasuries' allocation is overweight relative to the other credit sector positions but underweight the benchmark. While the sector's trend and the U.S. equity market trend remained bearish for the sector, a few indicators changed during the month. Momentum moved neutral, and U.S. swaps became bearish. Rising inflation expectations, a sign that investors believe the Fed tightening cycle may not be over just yet, also flashed a bearish signal for the sector (chart right).



**Figure 7: Weak Relative Strength Index is Bearish for TIPS**



U.S. Treasury Inflation-Protected Securities (TIPS) allocation was steady in July and remains a significant underweight position. TIPS typically outperform when inflation is high. Since we have passed the peak in inflation, the sector has been under pressure. All six indicators remain bearish for the sector. The sector's relative strength index (RSI) has been weak since early May (chart left).

## Summary

Entering August, the fixed income allocation strategy has a moderate risk-on message. The model is overweight U.S. High-Yield Bonds, U.S. Long-Term Treasuries, Emerging Market Bonds, and International Investment Grade Corporates. We are underweight U.S. Treasury Inflation-Protected Securities, Floating Rate Notes, and U.S. Mortgage-Backed Securities.

This strategy utilizes measures of price, valuation, economic trends, monetary liquidity, and market sentiment to make **objective, unemotional, rational decisions about how much capital to place at risk, as well as where to place that capital.**

NDR Strategists contributing to this publication: Brian Sanborn, CFA, Ed Clissold, CFA, Rob Anderson, CFA, Thanh Nguyen, CFA, Tim Hayes, CMT, Joe Kalish



## Strategy Description

- The Smart Sector® Fixed Income strategy combines two Ned Davis Research quantitative investment strategies: The NDR Fixed Income Allocation and the NDR Catastrophic Stop.

## The process is based on the weight of the evidence

- The fund begins by overweighting and underweighting fixed income sectors based on Ned Davis Research's proprietary fixed income models.
- Each of the models utilize sector-specific, weight-of-the-evidence composites of fundamental, economic, technical, and behavioral indicators to determine each area's probability of outperforming the other categories.
- Sectors are weighted accordingly relative to an equal-weighted benchmark.

## When market risks become extraordinarily high — reduce your portfolio risk

- The model remains fully invested unless the Ned Davis Research Catastrophic Sell Stop (CSS) model is triggered, whereupon the areas which underperform during periods of market stress (high yield, Emerging Markets, U.S. Investment Grade, and Floating Rate Notes) are trimmed by 50%.
- The NDR Catastrophic Sell Stop model combines time-tested, objective indicators designed to identify periods of high risk for the broad financial markets. The model uses price-based, breadth, deviation from trend, fundamental, economic, interest rate, behavioral and volatility-based indicator composites.

## When market risks return to normal — put your money back to work

- When the NDR CSS model moves back to bullish levels, indicating lower risk, the strategy immediately moves back to fully invested.

For more information, please contact us at:

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