Smart Sector® Fixed Income Strategy

JULY 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 improved from last month and entered July, 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

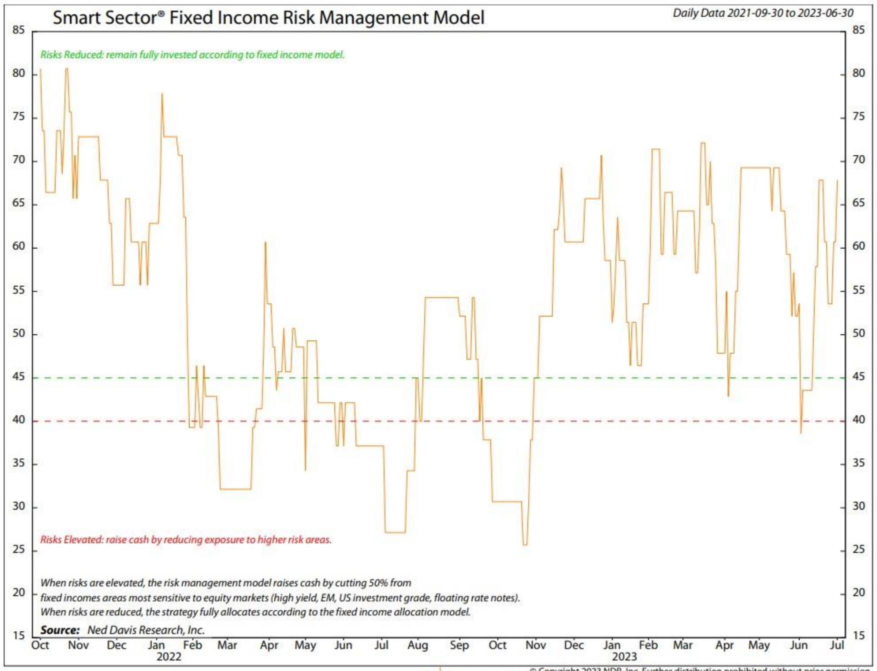


Figure 2: NDR Volume Demand Outpacing NDR Volume Supply: Bullish for Equity Exposure

Customized version of NDRIS_USSMM.RPT internalSigs_NDRIS

The model improvement was driven by two internal (price-based) measures that moved bullish during the month—stronger global stock market breadth and stock volume demand outpacing supply (chart left). While external influences such as trade and market sentiment moved bearish during the month, it was partly offset by a bullish reading from high-yield and emerging market bond breadth. For now, the weight of the evidence recommends a fully invested allocation to fixed-income sectors according to the model.

Fixed Income Market Update

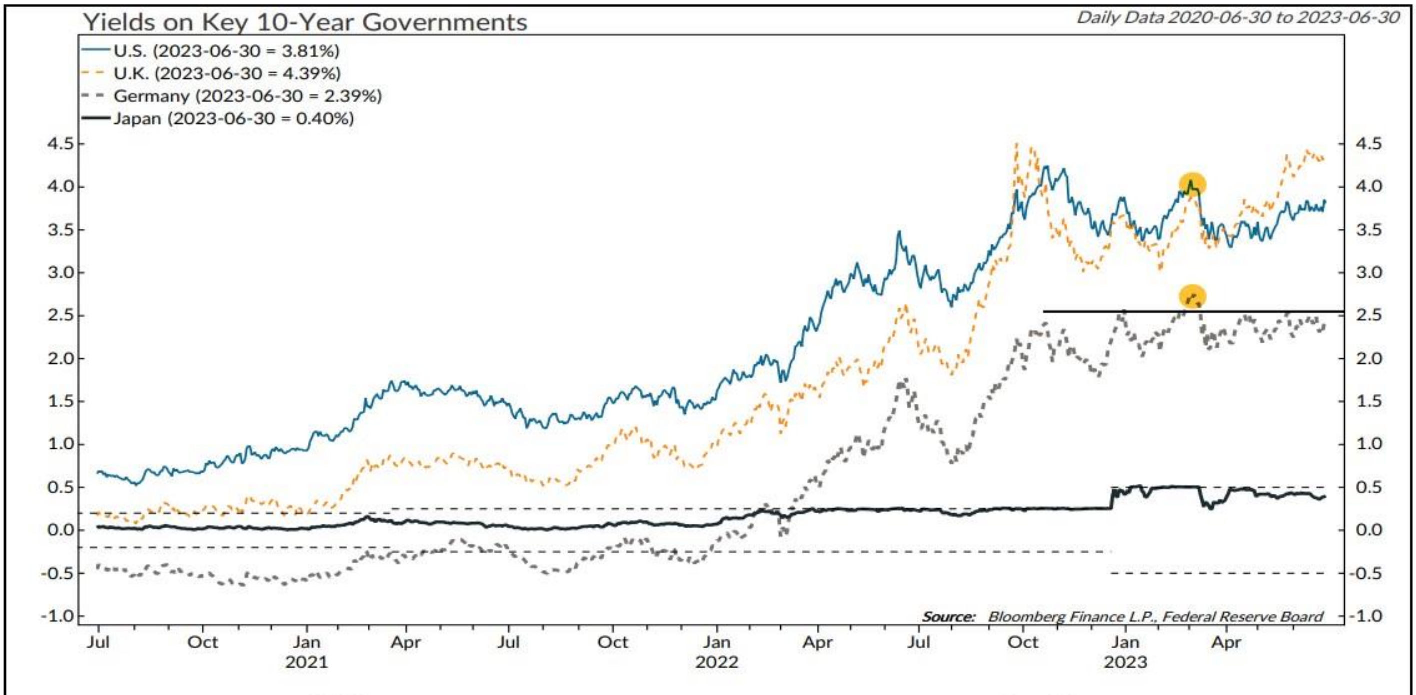
The Bloomberg Barclays U.S. Aggregate Bond Total Return Index declined less than 0.5% in June. Returns have been negative for seven of the past 12 months. Breadth improved—seven of the nine fixed-income sectors we track had positive returns in June—but the weak performance by mortgage-backed securities (MBS) dragged down the Aggregate.

Fixed-income markets are likely to chop around in the second half of 2023. Short-term yields are being pushed up by continued tightening by central banks in the developed markets. Longer-term yields are being pulled down by slower growth and cooling inflation expected later this year. After pausing their tightening cycles earlier this year, the Reserve Bank of Australia and the Bank of Canada resumed their rate hikes, as inflation remained sticky. The Fed paused in June but indicated two more hikes are coming later this year. The European Central Bank and the Bank of England never stopped hiking.

Technically, the March peaks are significant in this battle (chart below). We would be surprised to see 10-year Treasurys hold above 4.00% for very long, confirmed by German 10-year yields above 2.75%. These levels should provide an upward cap to global yields. The lower end of the range will be defined as 3.25% and 2.00%, respectively.

Entering July, the fixed income allocation strategy had very small changes in sector allocations. The model is overweight U.S. Short-Term bonds, U.S. Mortgage Backed, U.S. Long-Term Treasury, and Emerging Market Bonds. We have moved to underweight Floating Rate Note, U.S. Corporate, TIPS, and U.S. High Yield. (Note: We were underweight High Yield and TIPS last month.) International Investment Grade Corporate Bonds are neutral.

Figure 3: Yields on Key 10-Year Governments



Full History
Correlation Matrix
1992-01-02 to 2023-06-30

Assets	U.S.	U.K.	Germany	Japan
U.S.	1.00			
U.K.	0.96	1.00		
Germany	0.95	0.98	1.00	
Japan	0.86	0.92	0.90	1.00

Chart History
Correlation Matrix
2020-06-30 to 2023-06-30

Assets	U.S.	U.K.	Germany	Japan
U.S.	1.00			
U.K.	0.97	1.00		
Germany	0.97	0.98	1.00	
Japan	0.90	0.91	0.93	1.00

Customized version of B190

NDR

Floating rate notes typically outperform during a rising rate environment—yields have recently been in a trading range. Four of five indicators remained steady in June. The only measure to change was the short-term price momentum indicator, which moved bearish this past month (chart right). With U.S. 10-year note yields approaching 4% and potential resistance levels, we have reduced exposure.

Figure 4: Short-Term Momentum: Bearish for U.S. Floating Rate Notes

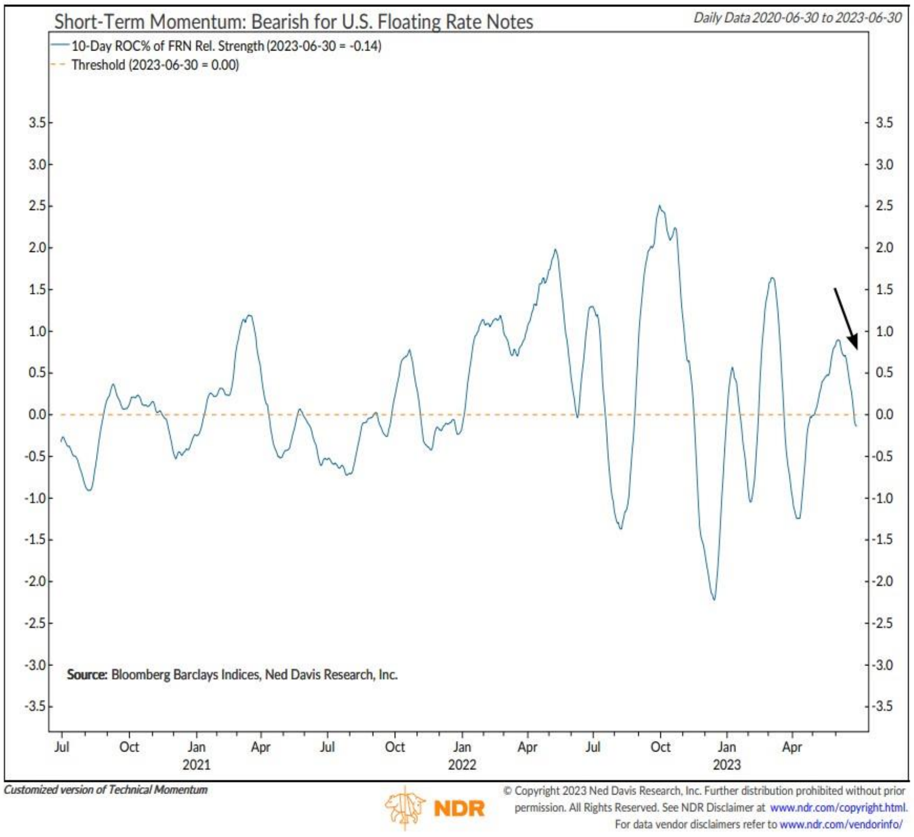


Figure 5: Short-Term Relative Strength Trend: Bullish for International Investment Grade Bonds.

International Investment Grade bonds' allocation was also steady and remained neutral. No indicators changed this month. External influences such as high-yield returns vs. inflation and U.S. swaps remained neutral for the sector. The three internal (price-based) measures stayed the same, including the bullish readings from relative strength trends (chart left) and the bearish reading from the equity risk VIX.

Emerging Market (EM) bonds' allocation was steady in June and remains at a slightly overweight position. Three of the five indicators remained steady. Two price-based signals moved bullish during the month of June—EM equity momentum and EM bond trends (chart right).

Figure 6: Short-Term Trend: Bullish for Emerging Market Bonds

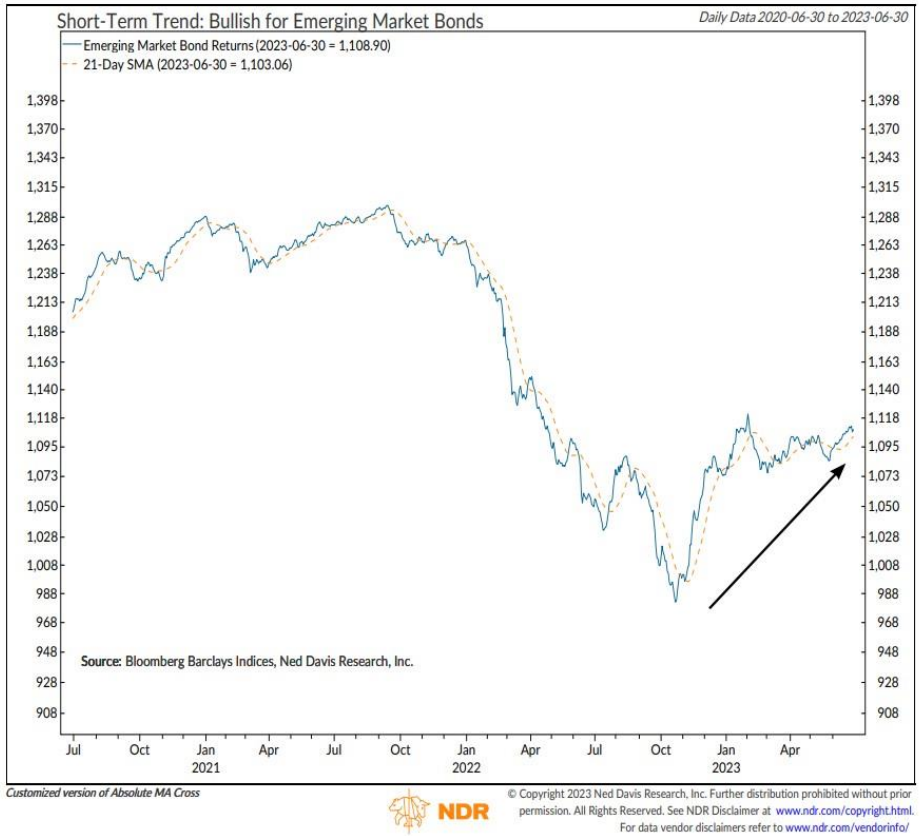
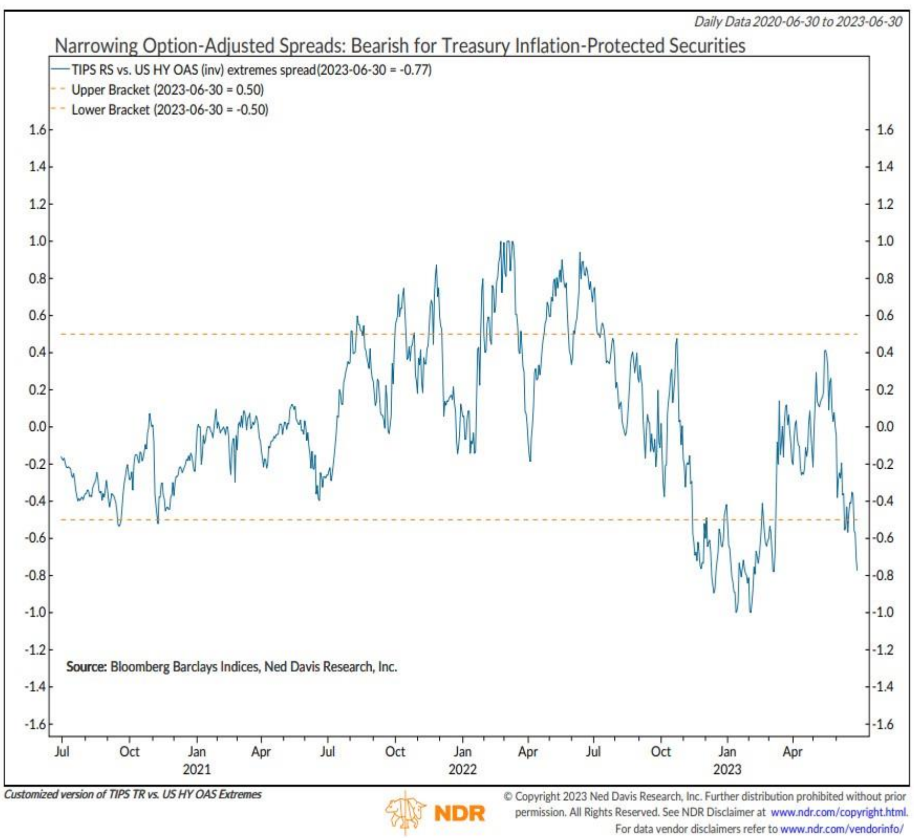


Figure 7: Narrowing Option-Adjusted Spreads: Bearish for Treasury Inflation-Protected Securities



U.S. Treasury Inflation-Protected Securities (TIPS) allocation was steady in June and remains the largest 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 are now bearish for the sector, including narrowing high-yield option-adjusted spreads, which moved to an unfavorable level for TIPs (chart left).

Summary

Entering July, the fixed income allocation strategy had very small changes in sector allocations. The model is overweight U.S. Short-Term bonds, U.S. Mortgage Backed, U.S. Long-Term Treasury, and Emerging Market Bonds. We have moved to underweight Floating Rate Note, U.S. Corporate, TIPS, and U.S. High Yield. (Note: We were underweight High Yield and TIPS last month.) International Investment Grade Corporate Bonds are neutral.

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.

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Smart Sector® Fixed Income Strategy

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.

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