# Smart Sector®
# Fixed Income Strategy

MAY 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 May recommending full model exposure to U.S. Treasury, U.S. Mortgage-Backed Securities, U.S. Corporates, International Investment Grade Bonds, and U.S. Short-Term Bonds.

**Figure 1:** Smart Sector® Fixed Income Risk Management Model

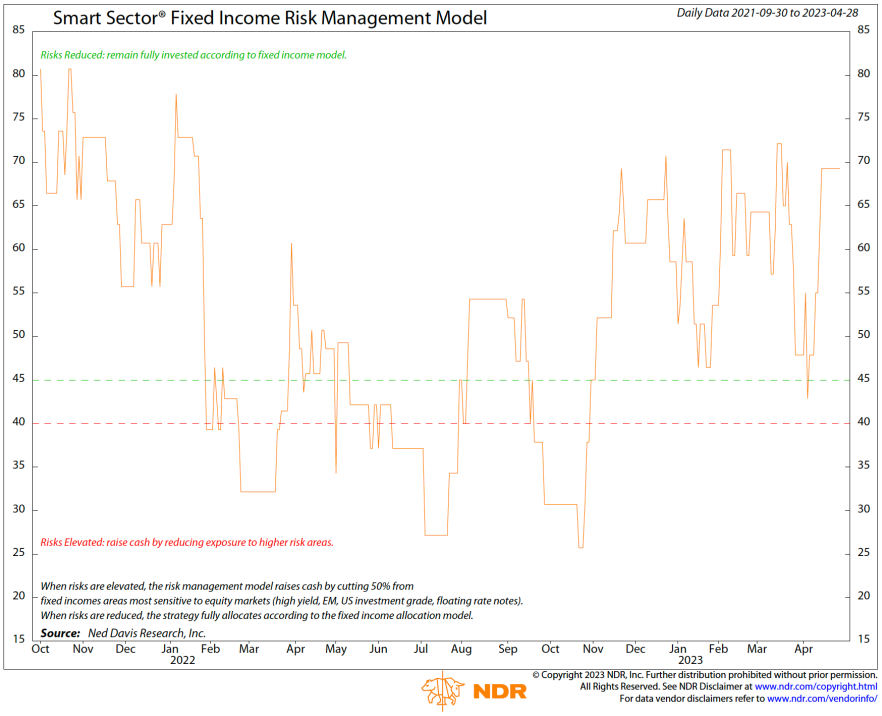
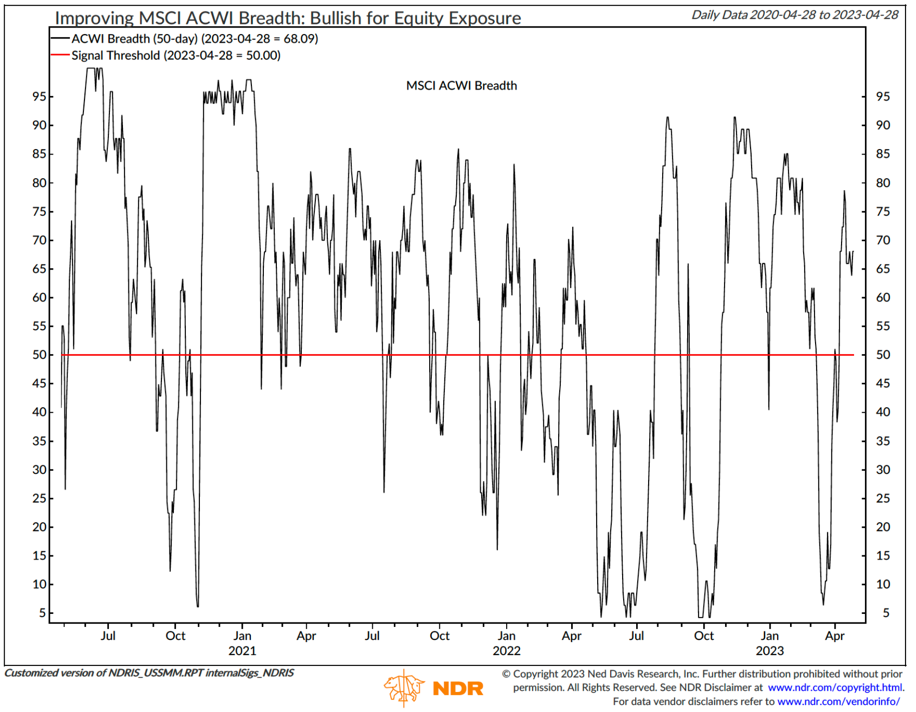



**Figure 2:** Improving MSCI ACWI Breadth: Bullish for Equity Exposure




The model improvement was mostly driven by stronger technicals—stock/bond relative strength, global stock market breadth (chart left), and stock market short-term trend all improved to bullish levels during the month. In terms of external influences, the breadth for High Yield and Emerging Market bonds and global trade (as measured by the Baltic Dry Index) remains bullish, while high-yield option-adjusted spreads remain bearish.

For now, the weight of the evidence recommends a fully invested allocation to fixed-income sectors according to the model.

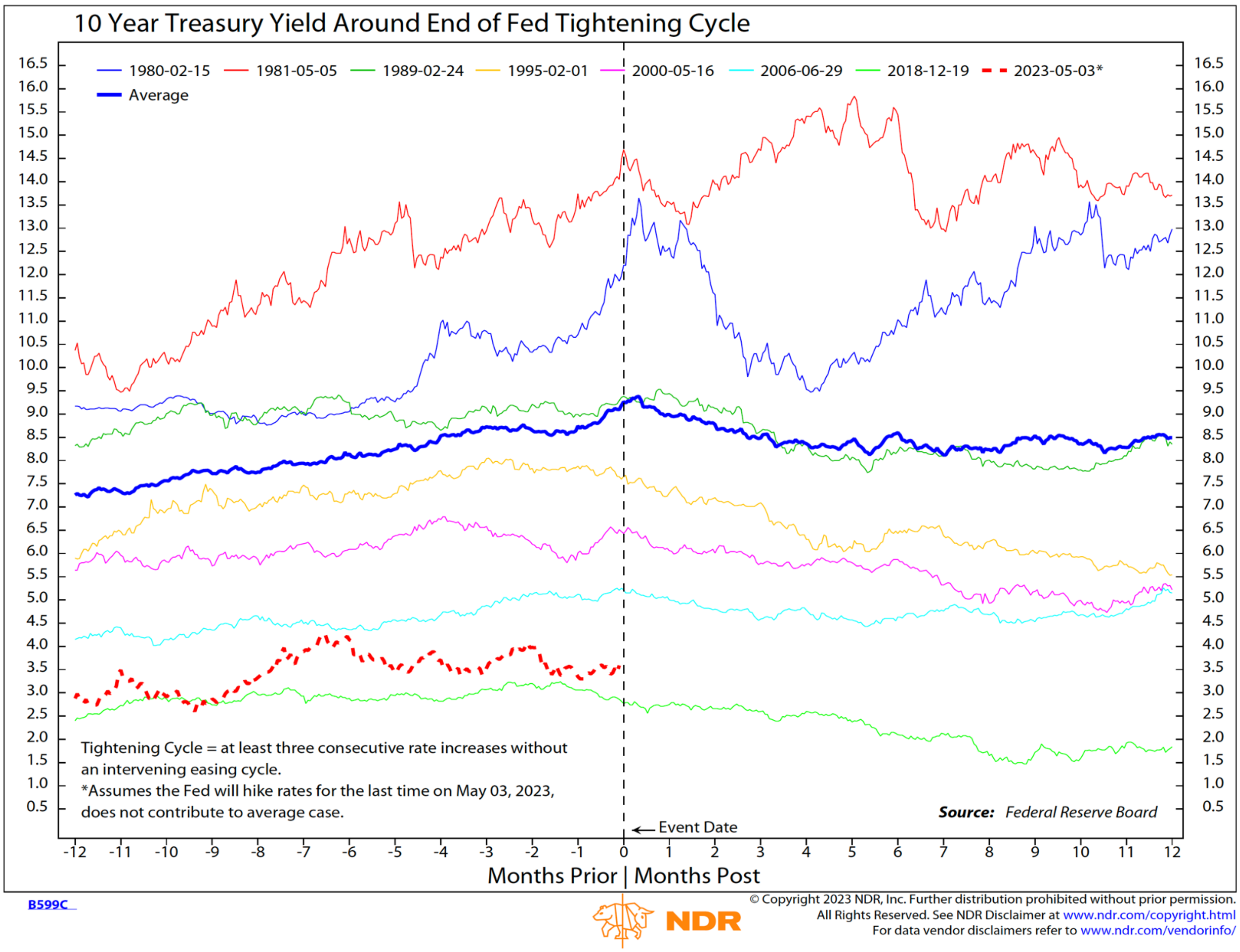
## Fixed Income Market Update

After a 3% gain in March, the performance of the Bloomberg Barclays U.S. Aggregate Bond Total Return Index moderated—the index gained less than 1% in April. Returns have been positive for six of the past 12 months. Breadth has been strong—all nine fixed-income sectors we track had positive returns in April.

We expect the Fed to raise the Fed funds target range another 25 basis points on Wednesday to 5.00% to 5.25%. We think it will be the last rate hike of this tightening cycle. The Fed, however, will want to preserve its optionality—just in case the economic data doesn't come in as expected before the next meeting in mid-June. Quantitative tightening will continue to roll on.

Although this has been the most aggressive Fed tightening cycle in history, we never started out in such a deep hole in terms of the real Fed funds rate. The Fed hopes inflation comes down to allow the real Fed funds rate to rise above 1.5% and prays that nothing else breaks. Looking at history, typically, yields fall, and the yield curve steepens after the end of the tightening cycle (chart below). This will have implications for fixed-income sector leadership.

**Figure 3:** 10 Year Treasury Yield Around End of Fed Tightening Cycle



U.S. Investment Grade Corporate bond allocation remained at neutral levels. Implied volatility and credit default swaps both moved bullish during the month. This was confirmed by technicals, as the short-term moving average crossed above the long-term moving average, a bullish signal for the sector (chart right).

**Figure 4:** U.S. Investment Grade Corporate Technical Cross: Bullish for the Sector

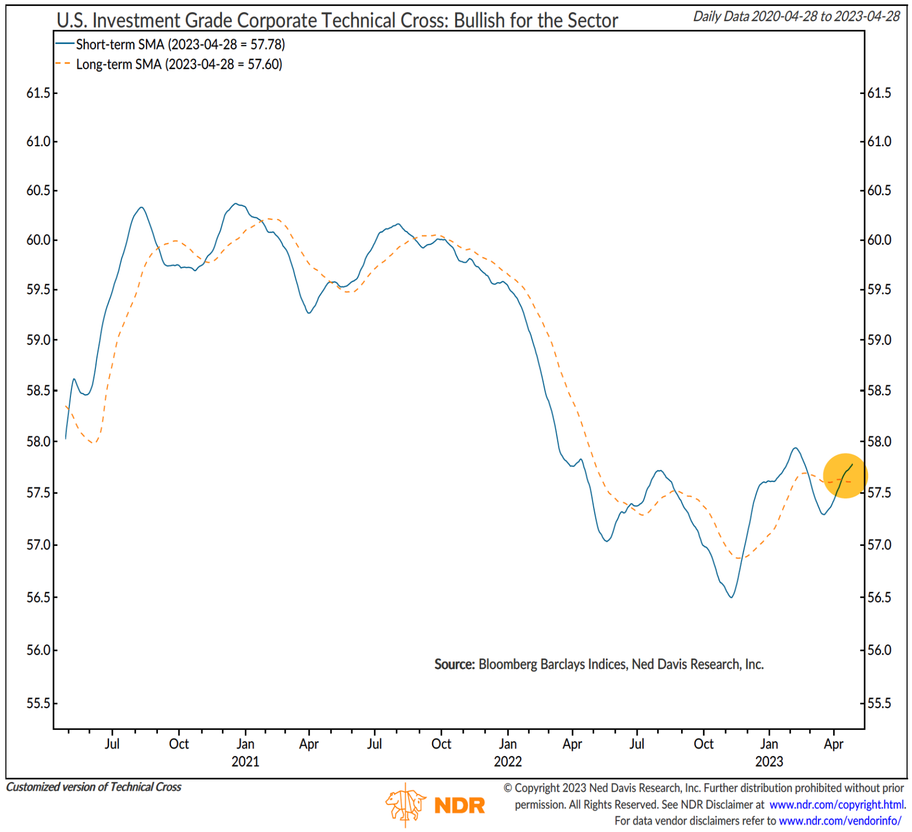
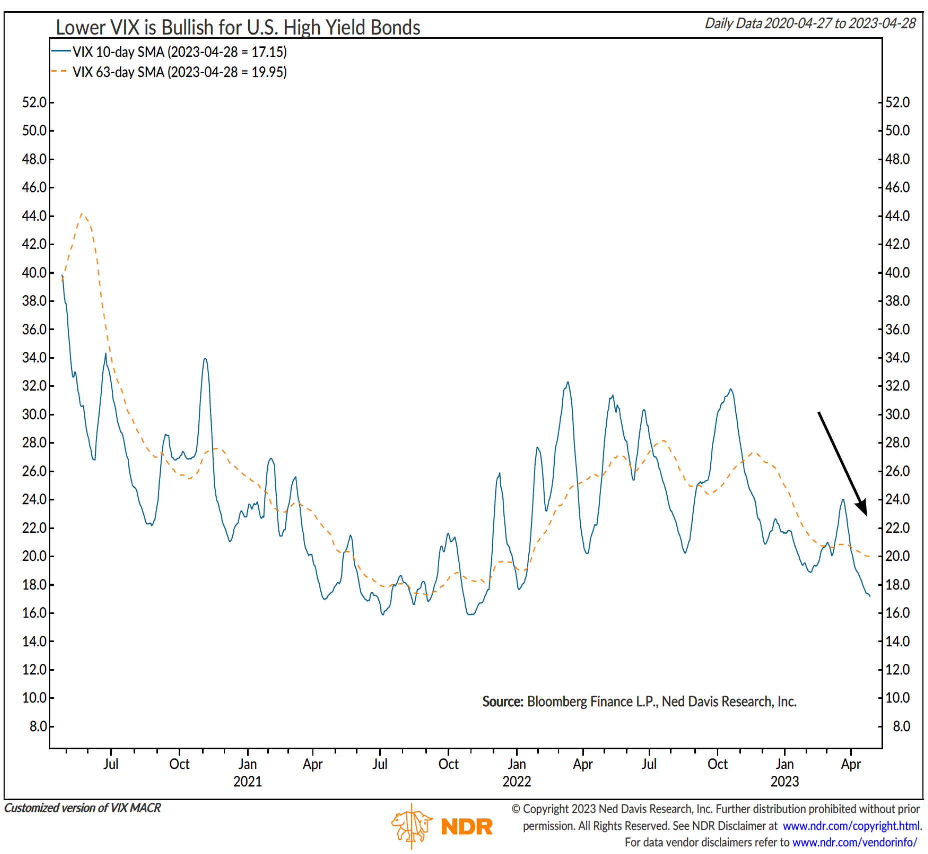



**Figure 5:** Lower VIX is Bullish for U.S. High Yield Bonds




High Yield bonds' allocation was reduced in April, moving it to underweight. Indicators are mixed. The bullish breadth and absolute trend are offset by a weaker small-cap equity trend and moving average crossover measures. One indicator improved to bullish last month—lower short-term market volatility, which indicates investors' appetite for riskier assets (chart left).

Floating Rate Notes' remains the largest underweight position. Floating rate notes typically outperform during a rising rate environment—yields have recently been in a trading range. Eighty percent of the model's indicators remain bearish. The only improvement this past month was from the relative strength slope indicator, which moved bullish for the sector (chart right).

**Figure 6:** Rising U.S. Floating Rate Notes' Relative Strength is Bullish for the Sector

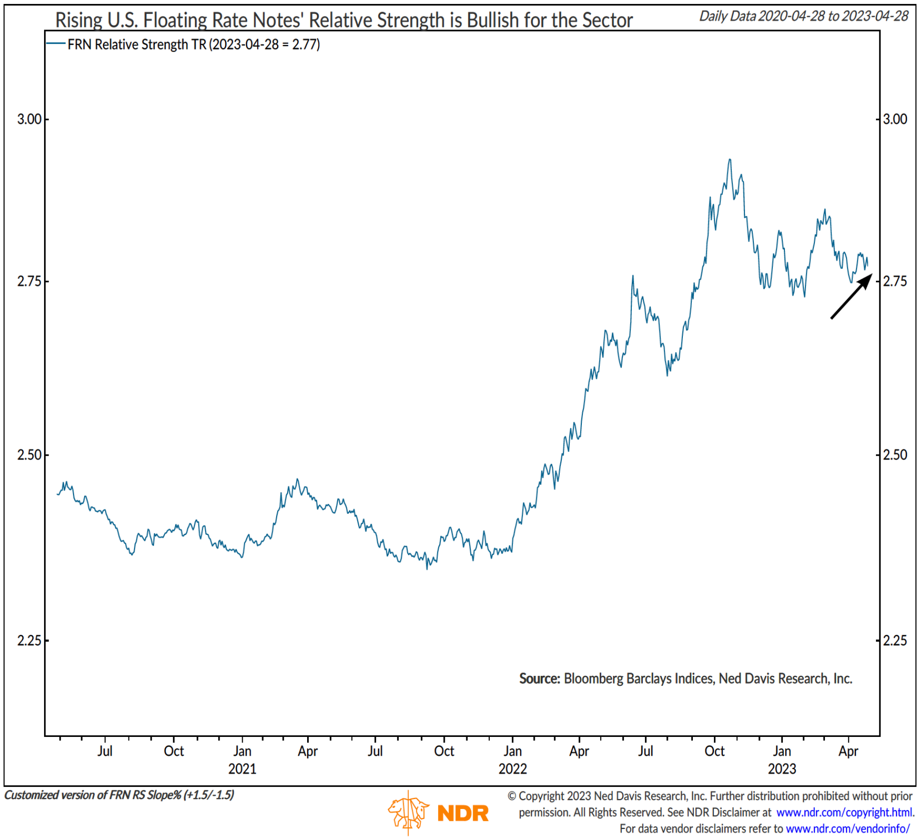
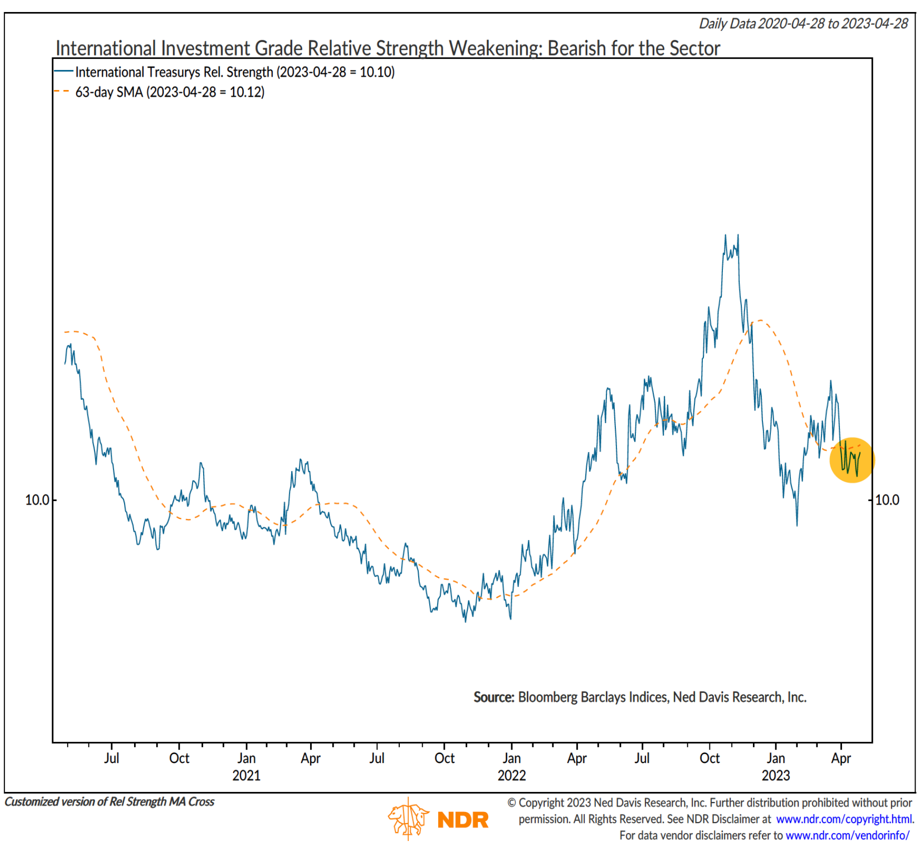



**Figure 7:** International Investment Grade Relative Strength Weakening: Bearish for the Sector




International Investment Grade bond's allocation dropped from an overweight position to a slightly underweight position. While external indicators such as high-yield returns vs. inflation and U.S. swaps remained neutral for the sector, all three technical measures flipped from bullish to bearish for the sector, including international investment grade bond relative strength trends (chart left).

## Summary

Unlike the stock market, investors shifted allocations to riskier fixed-income sectors during April. Entering May, we have full exposure to U.S. Treasury, U.S. Mortgage-Backed Securities, U.S. Corporates, International Investment Grade Bonds, and U.S. Short-Term Bonds.

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

# 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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