Smart Sector® Fixed Income Strategy

OCTOBER 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 deteriorated from last month but entered October 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

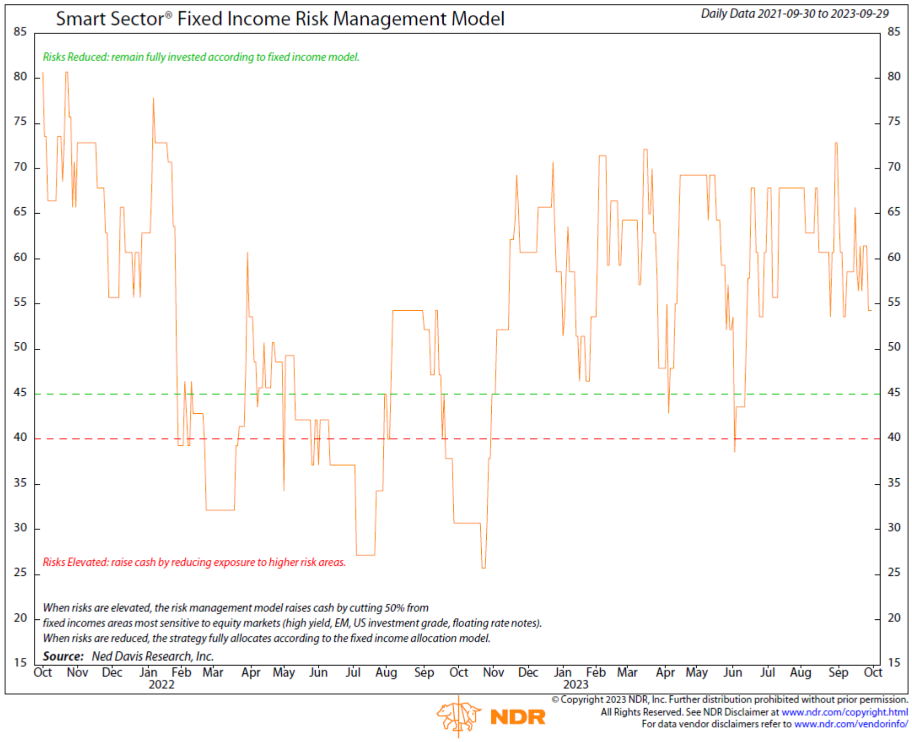


Figure 2: Volume Supply Exceeding Demand: Bearish for Equity Exposure

The model's overall reading is driven primarily by bullish external influences such as trade, market sentiment, and high-yield spreads. However, price-based measures have weakened during the month—three additional indicators flashed a sell signal including supply vs. demand (chart left). 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 down for the fifth month in a row, dropping 2.5% in September. Breadth remained weak—seven of the nine fixed income sectors we track had negative returns in September—significant weakness in U.S. Treasurys again dragged down the Aggregate.

Sticky inflation, rising oil prices, and tight labor markets have been pushing yields higher all summer. Economic growth is likely to slow in Q4 and in 2024 (due to student loan repayments, strikes, etc.), labor markets should cool and get back into balance, and impacts from credit tightening should be increasingly felt.

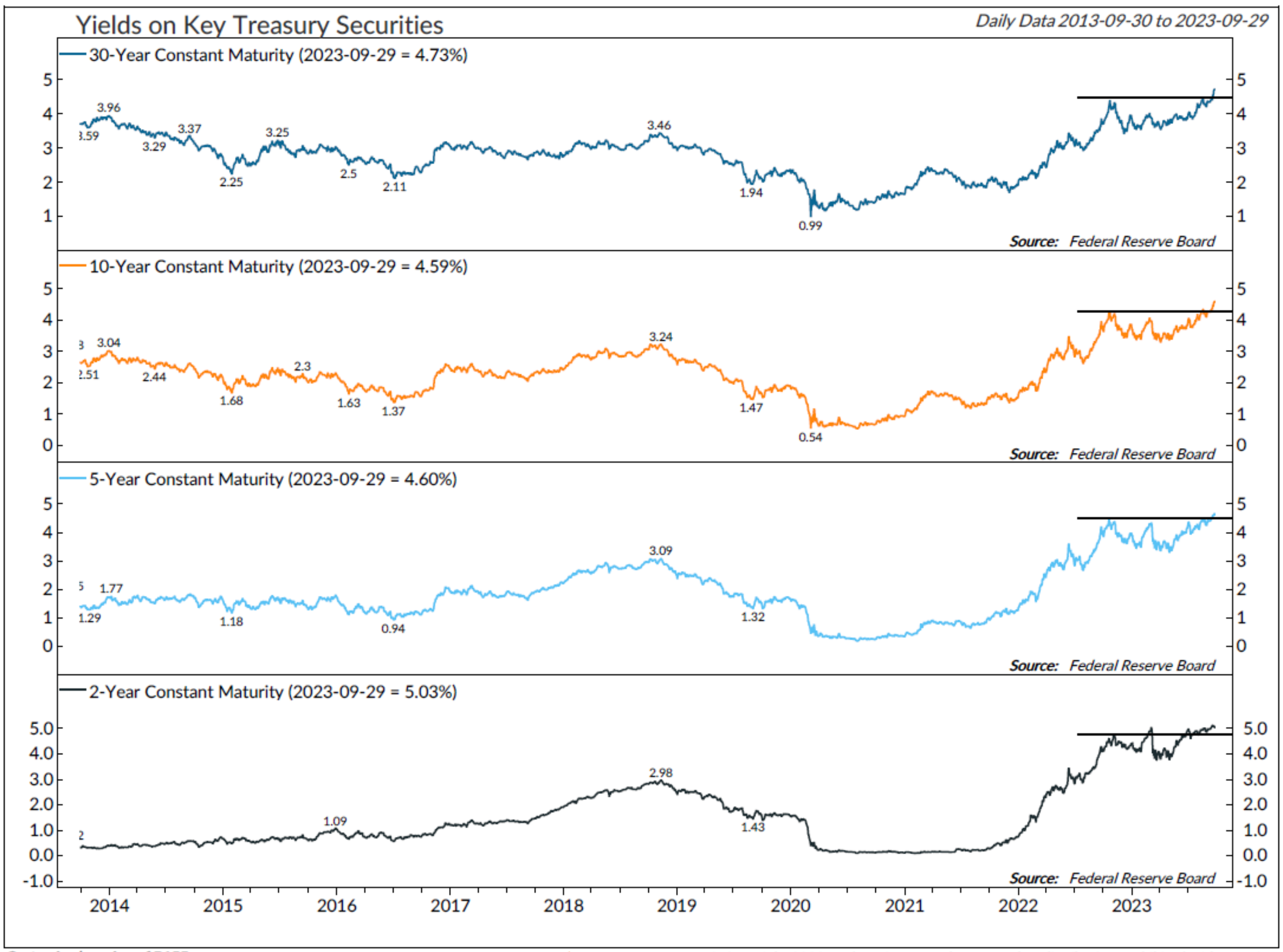
In September, the Fed surprised the markets by reaffirming its projection for another rate hike this year and indicating two fewer rate cuts next year, even though inflation was revised lower for 2023. The Fed successfully communicated a "restrictive for longer" policy stance.

The Fed's policy projections had two important implications. One is the pricing in of higher rates at the front end of the curve due to a higher terminal rate than the market had been expecting.

Two is a steeper yield curve since yields will be higher next year than previously thought. As a result, yields broke out across the curve and around the world (chart below) while yield curves steepened.

As a result, entering October, the fixed income allocation strategy rebalanced and favored mixed leadership. The model is overweight U.S. Treasury (10-20 years), International Investment Grade, and U.S. High Yield. Emerging Market bonds were downgraded to marketweight, joining U.S. Corporates and U.S. Mortgage-Backed Securities. The model is underweight U.S. Floating Rate Notes and U.S. Treasury Inflation-Protected Securities.

Figure 3: Yields on Key Treasury Securities



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U.S. Treasury Inflation-Protected Securities' (TIPS) allocation rose over 300 basis points in September, though is still underweight. Similar to U.S. Floating Rate Notes, TIPS typically outperform when inflation is high (which then leads to higher interest rates). While inflation is down from its peak, there are still areas that are sticky. Commodity prices—led by energy—are rising and has provided a tailwind for the sector (chart right). This positive development was confirmed by two relative strength measures flashing bullish signals during the month.

Figure 4: Rising Commodity Price Trends are Bullish for U.S. TIPS

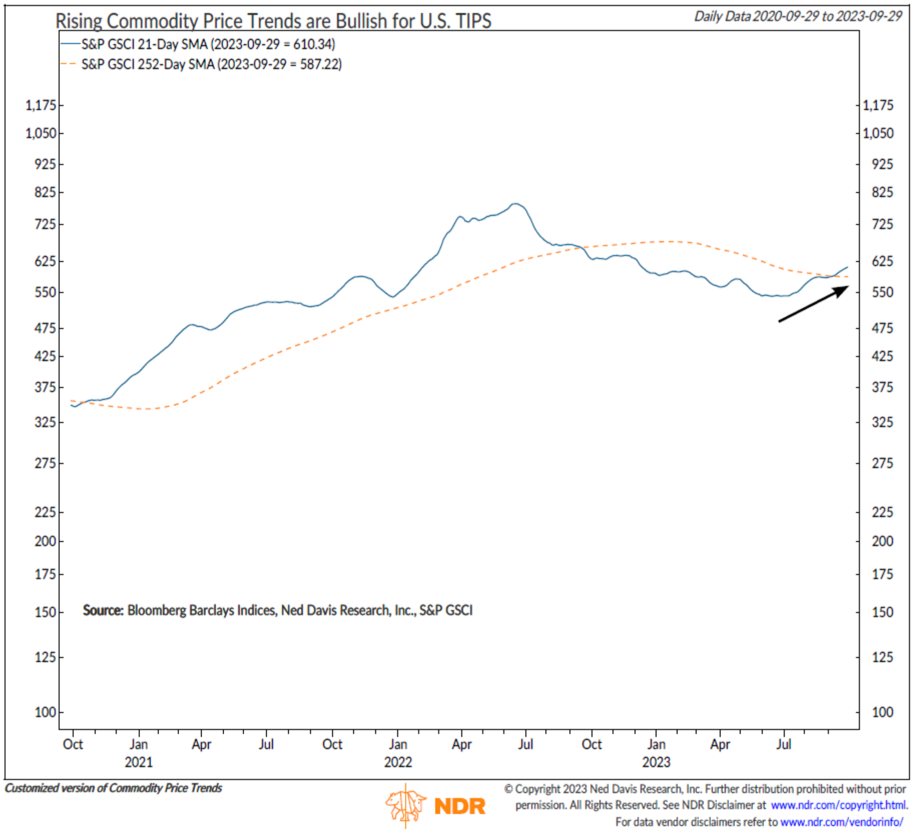
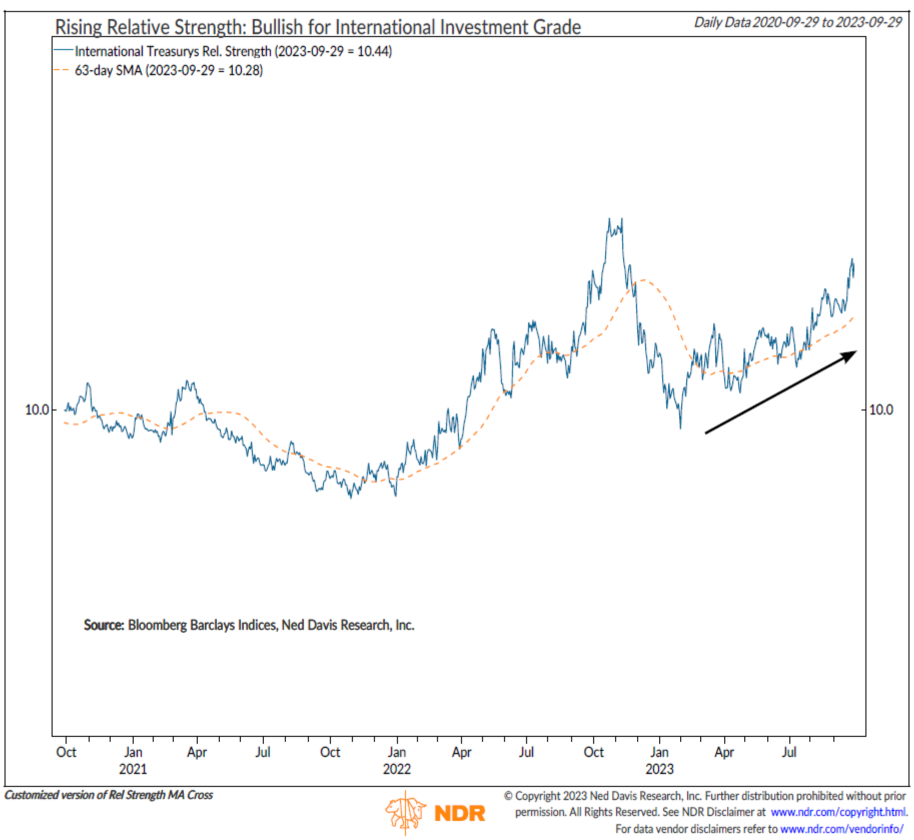


Figure 5: Rising Relative Strength: Bullish for International Investment Grade



International Investment Grade bonds' allocation remains overweight. While global option-adjusted spreads and U.S. swaps remain neutral, equity volatility is bullish. This was confirmed by two bullish price-based measures including rising relative strength trends (chart left).

U.S. High Yield bonds' allocation remained steady September, at an overweight position. Four of six indicators are now bearish, with two flipping negative during the month—absolute trend and breadth (chart right).

Figure 6: Weak Sector Breadth is Bearish for U.S. High Yield Bonds

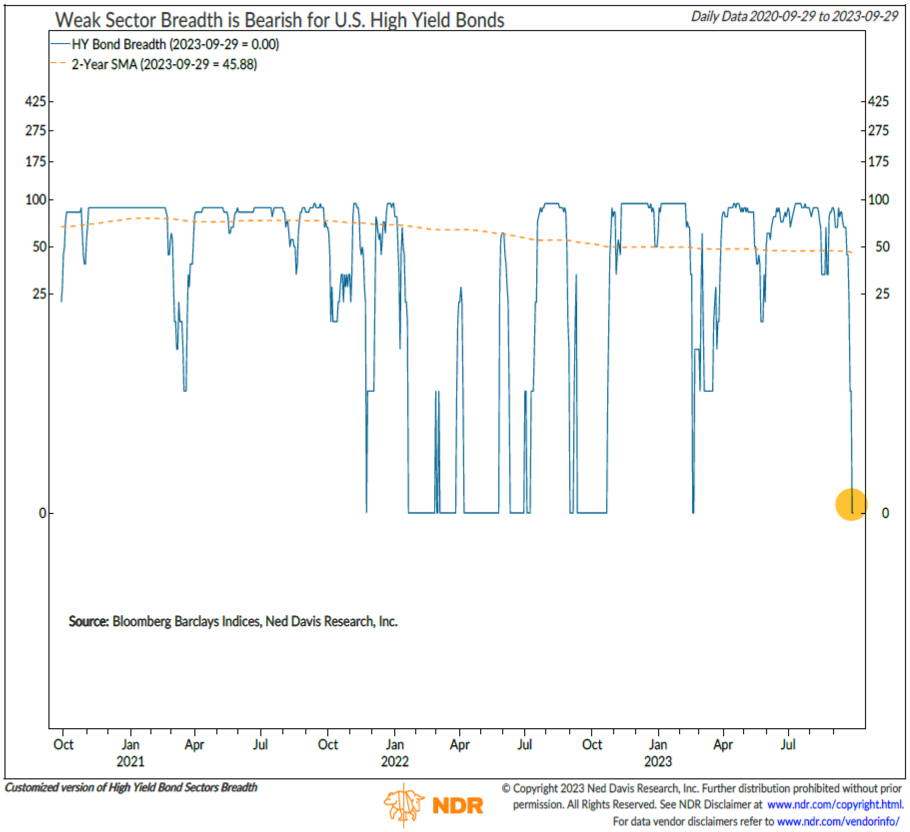
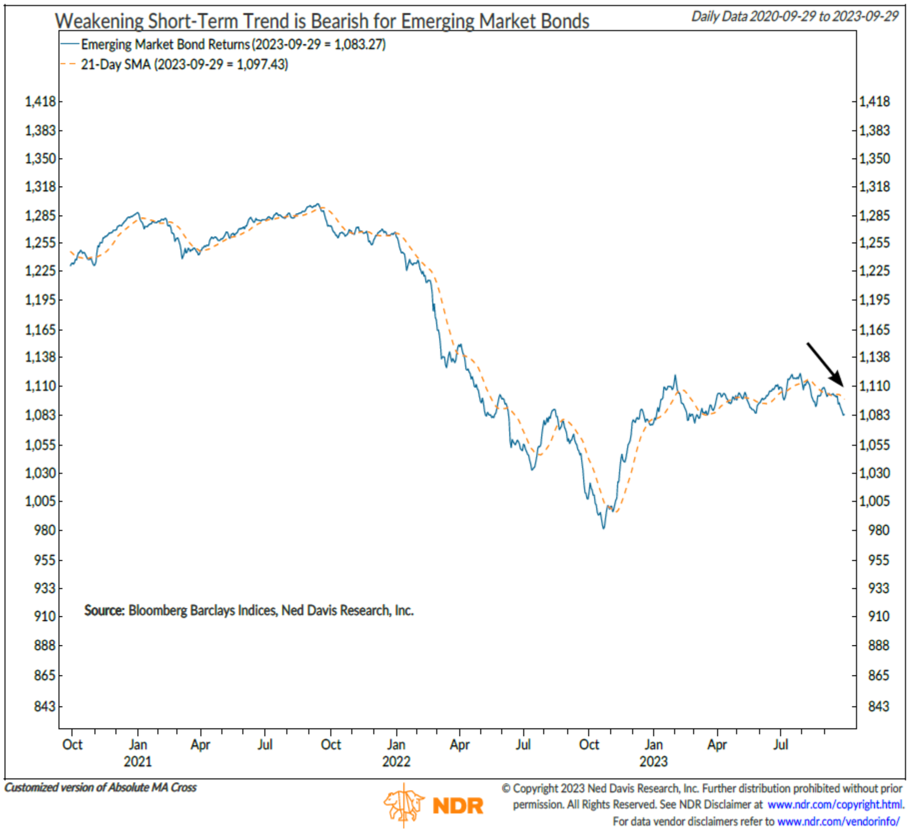


Figure 7: Weakening Short-Term Trend is Bearish for Emerging Market Bonds



Emerging Market (EM) bonds' allocation remains marketweight. On a fundamental basis, while rising commodity prices is bullish for Emerging Market bonds, weakness in emerging market equity momentum and currencies have been an offset. Technicals are mixed—relative strength remains bullish, but absolute trend moved to a bearish level for the sector during the month (chart left).

U.S. Investment Grade Corporate bonds' allocation dropped over 200 basis points in September, downgrading the sector from overweight to an underweight position. Four of the six indicators are now bearish. While the U.S. dollar index and a mean reversion measure remained bullish for the sector, spreads, credit default swaps, and a trend indicator are bearish offsets. Additionally, implied bond volatility rose to a bearish level for the sector during the month (chart right).

Figure 8: Rising Bond Volatility is Bearish for U.S. Investment Grade Corporate

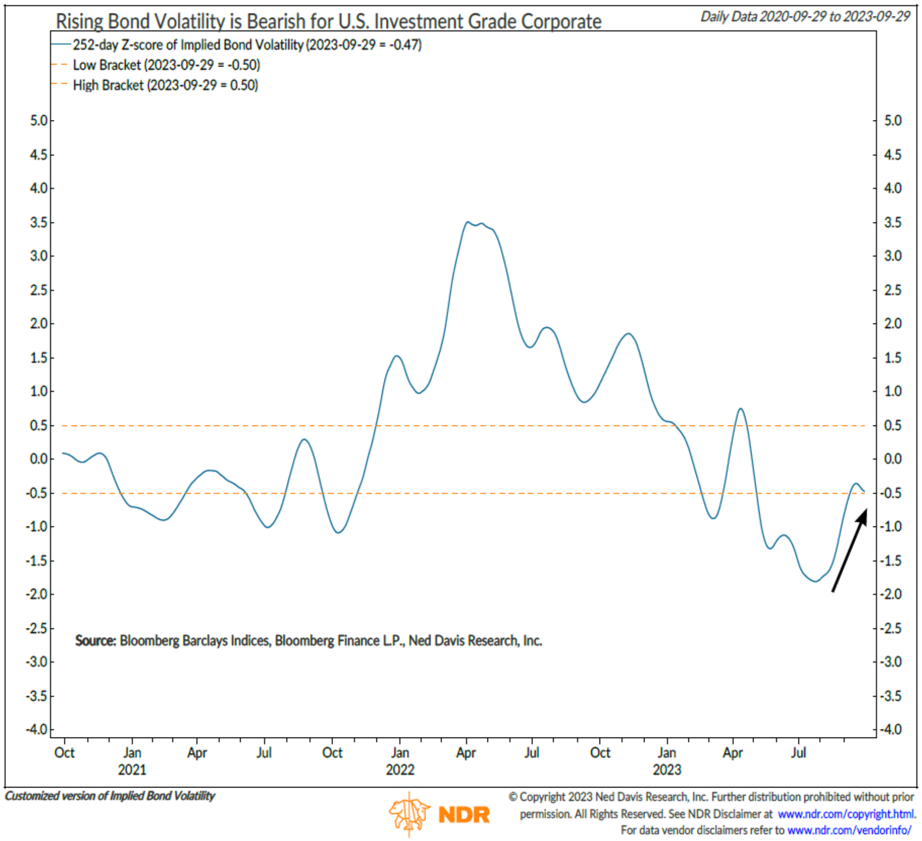
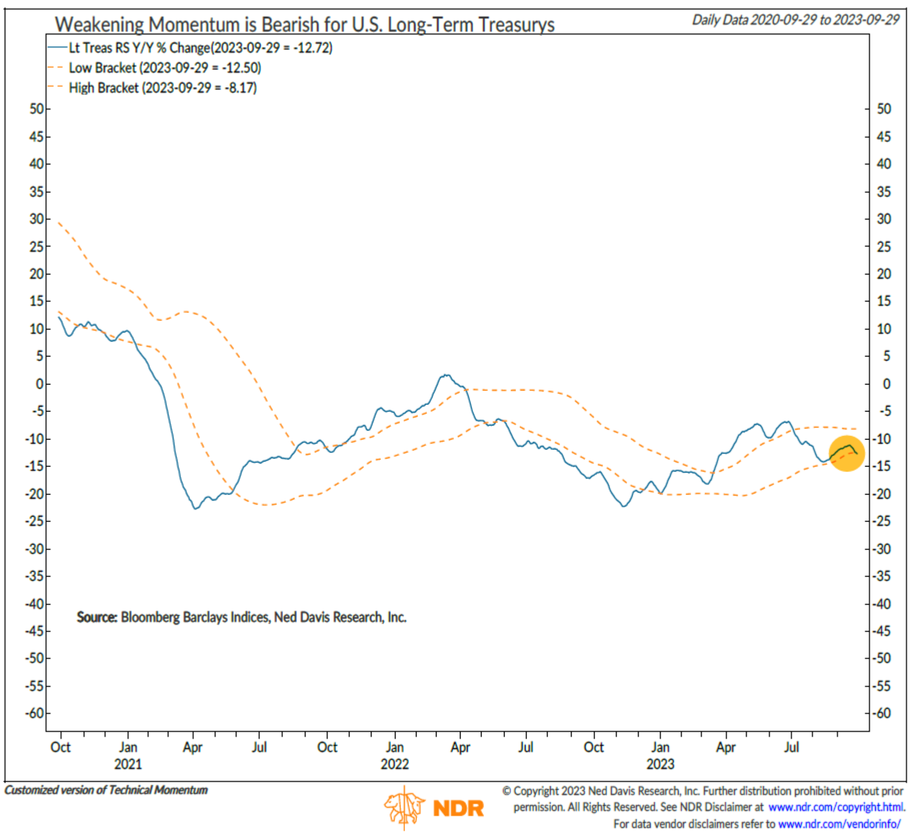


Figure 9: Weakening Momentum is Bearish for U.S. Long-Term Treasurys



U.S. Long-Term Treasurys' allocation increased in September. While inflation expectations appear contained and have remained bullish for the sector since the Jackson Hole meeting, a few indicators changed during the month. The U.S. equity market trend, U.S. swaps, and sector momentum all flashed bearish signals during the month (chart left).

Summary

Entering October, the fixed income allocation strategy favors mixed leadership. The model is overweight U.S. Treasury (10-20 years), International Investment Grade, and U.S. High Yield. Emerging Market bonds were downgraded to marketweight, joining U.S. Corporates and U.S. Mortgage-Backed Securities. The model is underweight U.S. Floating Rate Notes and U.S. Treasury Inflation-Protected 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 and 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 utilizes 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 that 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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