DAY HAGAN
ASSET MANAGEMENT

NDR
NED DAVIS RESEARCH

Smart Sector® Fixed Income Strategy

JANUARY 2024

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 remained steady during the month and entered January 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

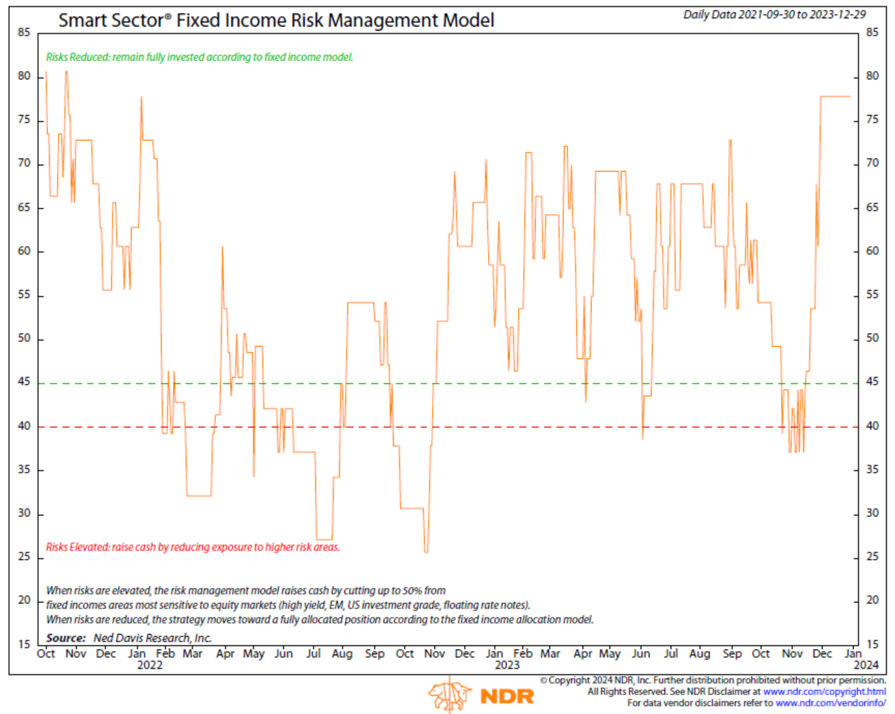
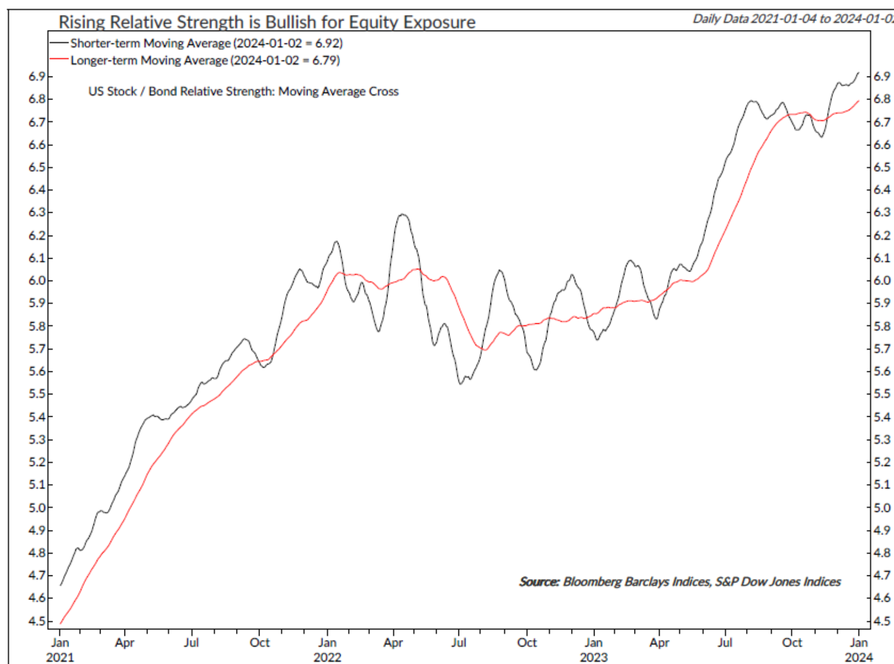


Figure 2: Rising Relative Strength is Bullish for Equity Exposure



The improvement in the model was purely driven by better technicals—five of the seven price-based measures are now bullish, including breadth rising to its highest level since July (chart left). Investor sentiment is now excessively optimistic, so we will keep an eye on these measures. 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 the strong performance by the Bloomberg Barclays U.S. Aggregate Bond Total Return Index in November, the index rebounded further and gained 3.8% in December. Breadth was strong—all nine fixed-income sectors we track had positive returns in December.

Ten-year Treasury yields have always fallen in the 2-3 months before the first rate cut going back to 1970 (chart below). The market is tracking and is currently expecting a rate cut in March. After the cut, yields tend to stabilize. Over the easing cycle, 10-year Treasury yields generally declined, with a median drop of 67 basis points.

Spreads between Baa and Aaa tend to widen modestly heading into the first rate cut. Similarly, excess returns declined heading into a rate cut. Higher-quality sectors generally performed well during an easing cycle. Credit spreads between Baa and Aaa changed little in past easing cycles.

Although the TIPS market has a shorter history, it shows a clear pattern of falling going into the first rate cut. And except for the Long-Term Capital Management incident, real yields kept falling in the months after the first cut.

Real yields have fallen significantly over the entire easing cycle (around 100 basis points or more) except for 1998 when they rose modestly after liquidity concerns dissipated.

Entering January, the fixed income allocation strategy shifted to risk-on leadership. The model is relatively overweight: U.S. High-Yield, Long-Term Treasurys, Short-Term TIPS, U.S. Investment Grade Corporates, International Investment Grade, and Emerging Market Bonds. The model is relatively underweight in U.S. Mortgage-Backed Securities and U.S. Investment-Grade Corporations.

Figure 3: Treasury Yields Fall Into The First Rate Cut

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Figure 4: Lower Bond Volatility is Bullish for U.S. Investment Grade Corporate

U.S. Investment Grade Corporate bonds' allocation remained steady at an overweight position. Four of the six indicators are bullish. Two indicators changed during the month—widening option-adjusted spreads was offset by lower bond volatility (chart right).

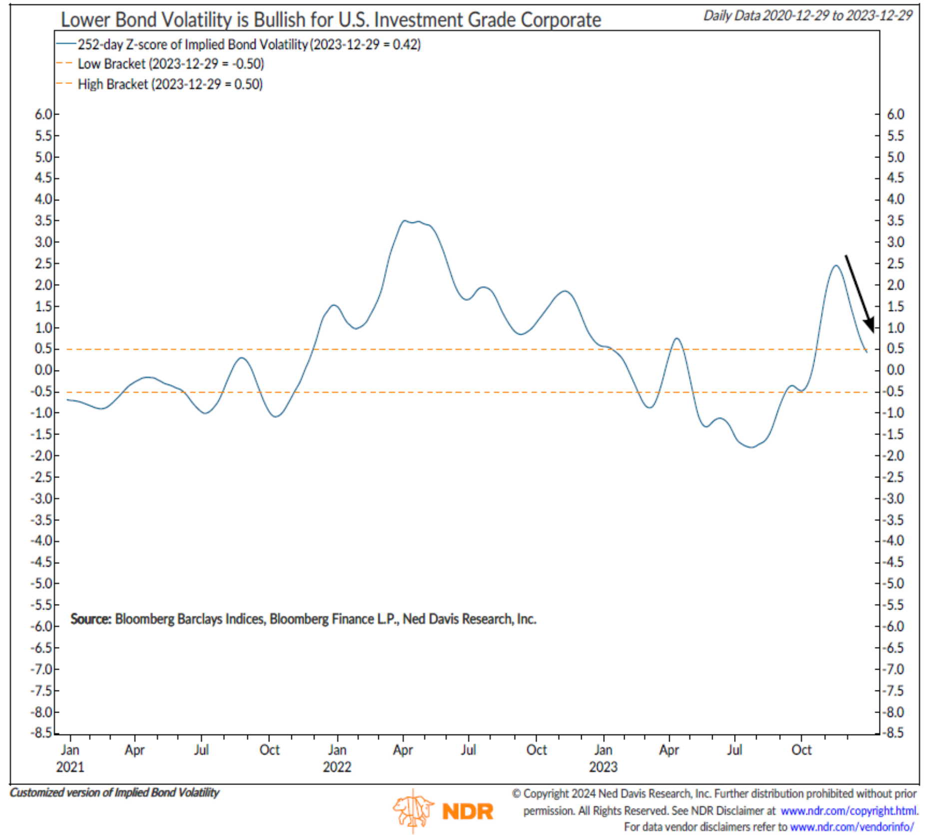


Figure 5: Relative Strength is Bullish for Emerging Market Bonds

Emerging Market bonds rallied by over 4% in December. The model's allocation to the sector was steady, and it remains a significant overweight. Four of five indicators remain bullish for the sector including Emerging Market relative strength (chart left).

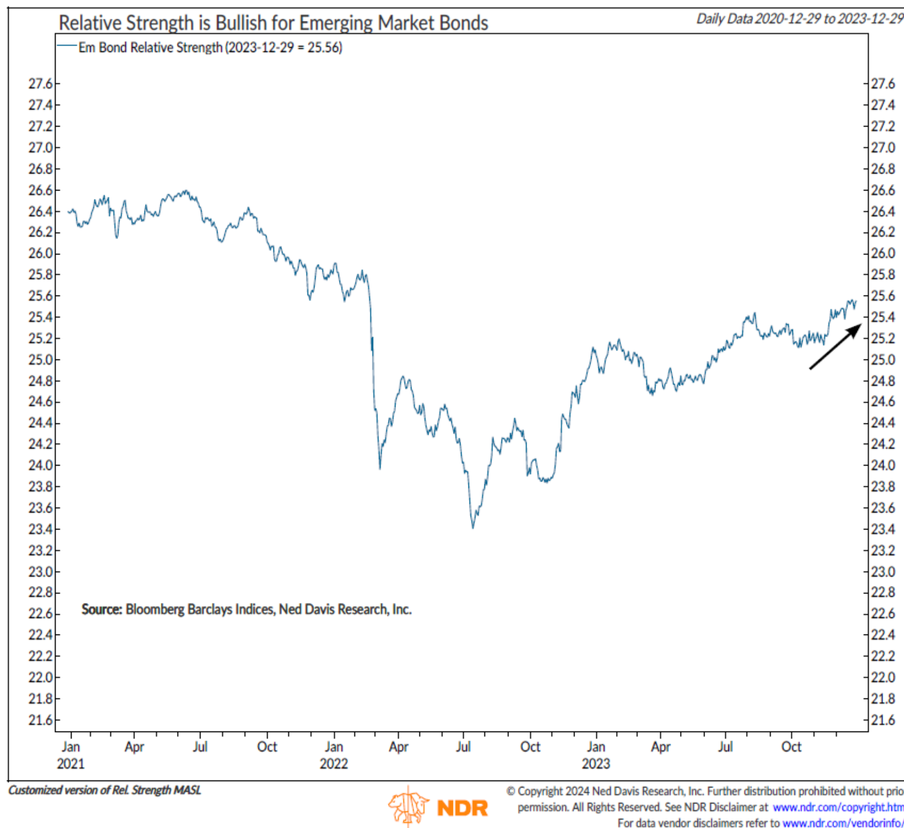


Figure 6: Short-Term Trend is Bearish for U.S. Floating Rate Notes

U.S. Floating Rate Notes' allocation remained steady as the largest underweight position. Floating rate notes typically outperform when rates are rising. With the further drop in rates in December, the sector continued to underperform. All five indicators remain bearish for the sector including short-term trend (chart right).

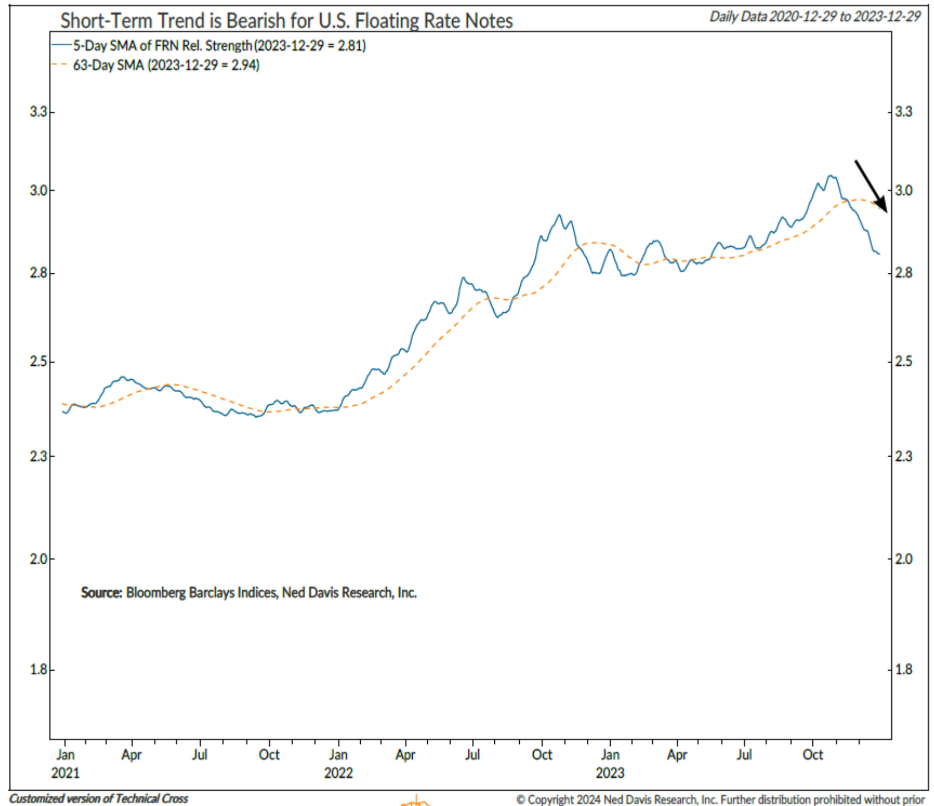
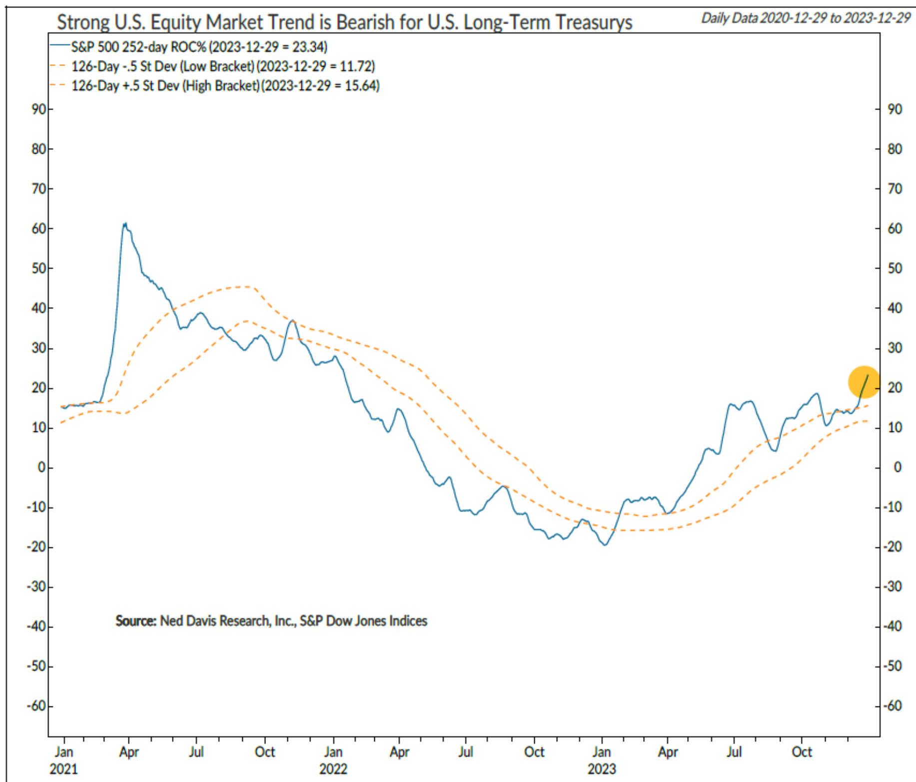


Figure 7: Strong U.S. Equity Market Trend is Bearish for U.S. Long-Term Treasurys



U.S. Long-Term Treasurys' allocation remained steady at slightly overweight. The sector's performance rebounded for the second month in a row in December, which was picked up by the two price-based measures—trend and momentum. However, the stronger trend in U.S. equities became a headwind for the sector during the month (chart left).

Summary

Entering January, the fixed income allocation strategy shifted to risk-on leadership. The model is relatively overweight: U.S. High-Yield, Long-Term Treasurys, Short-Term TIPS, U.S. Investment Grade Corporates, International Investment Grade, and Emerging Market Bonds. The model is relatively underweight in U.S. Mortgage-Backed Securities and U.S. Investment-Grade Corporations.

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 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) may be trimmed by up to 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 will reverse toward being fully invested.

For more information, please contact us at:

Day Hagan Asset Management

1000 S. Tamiami Trl

Sarasota, FL 34236

Toll Free: (800) 594-7930

Office Phone: (941) 330-1702

Website: https://dayhagan.com/ or https://dhfunds.com/

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