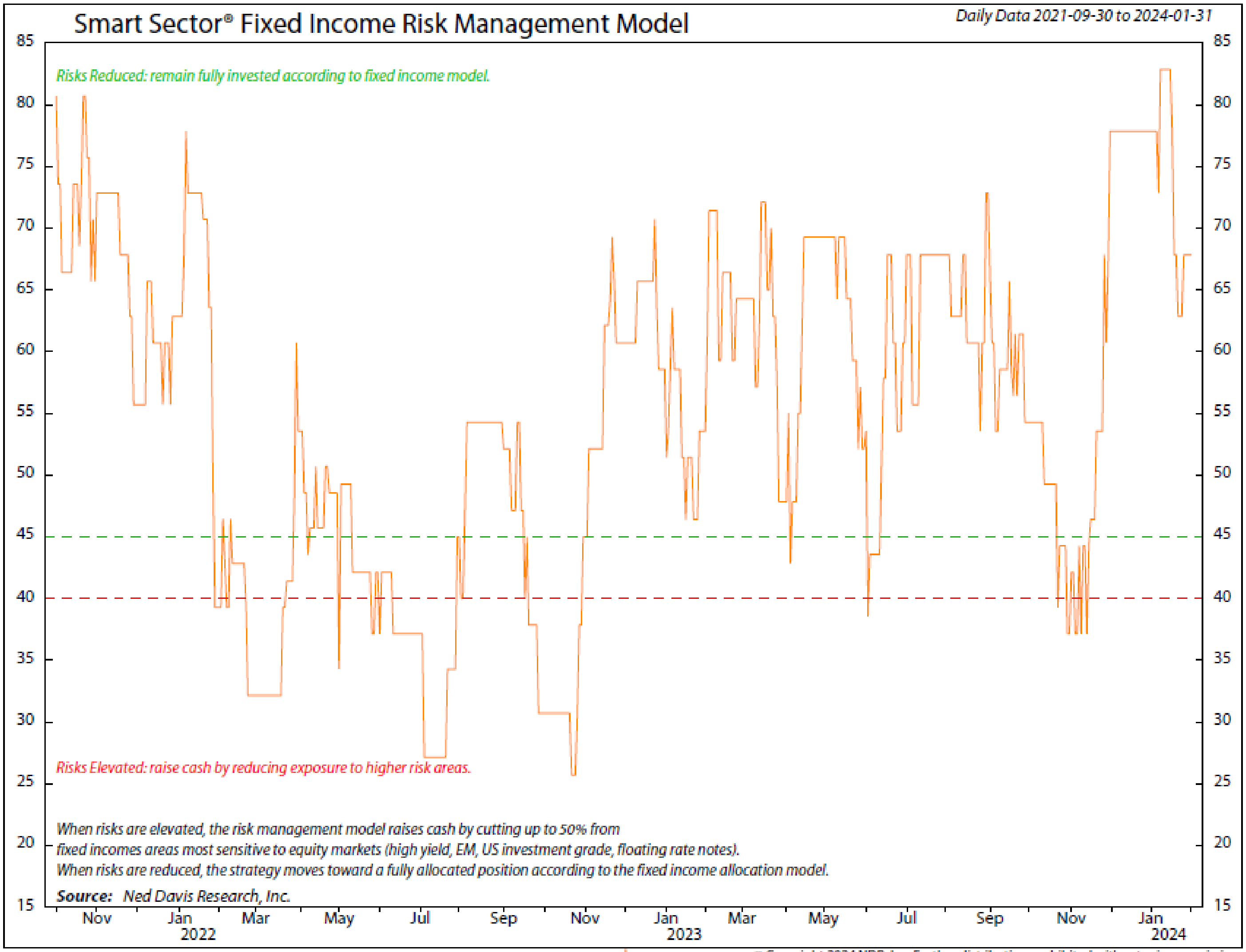
Smart Sector®
Fixed Income Strategy

FEBRUARY 2024

Risk Management Update

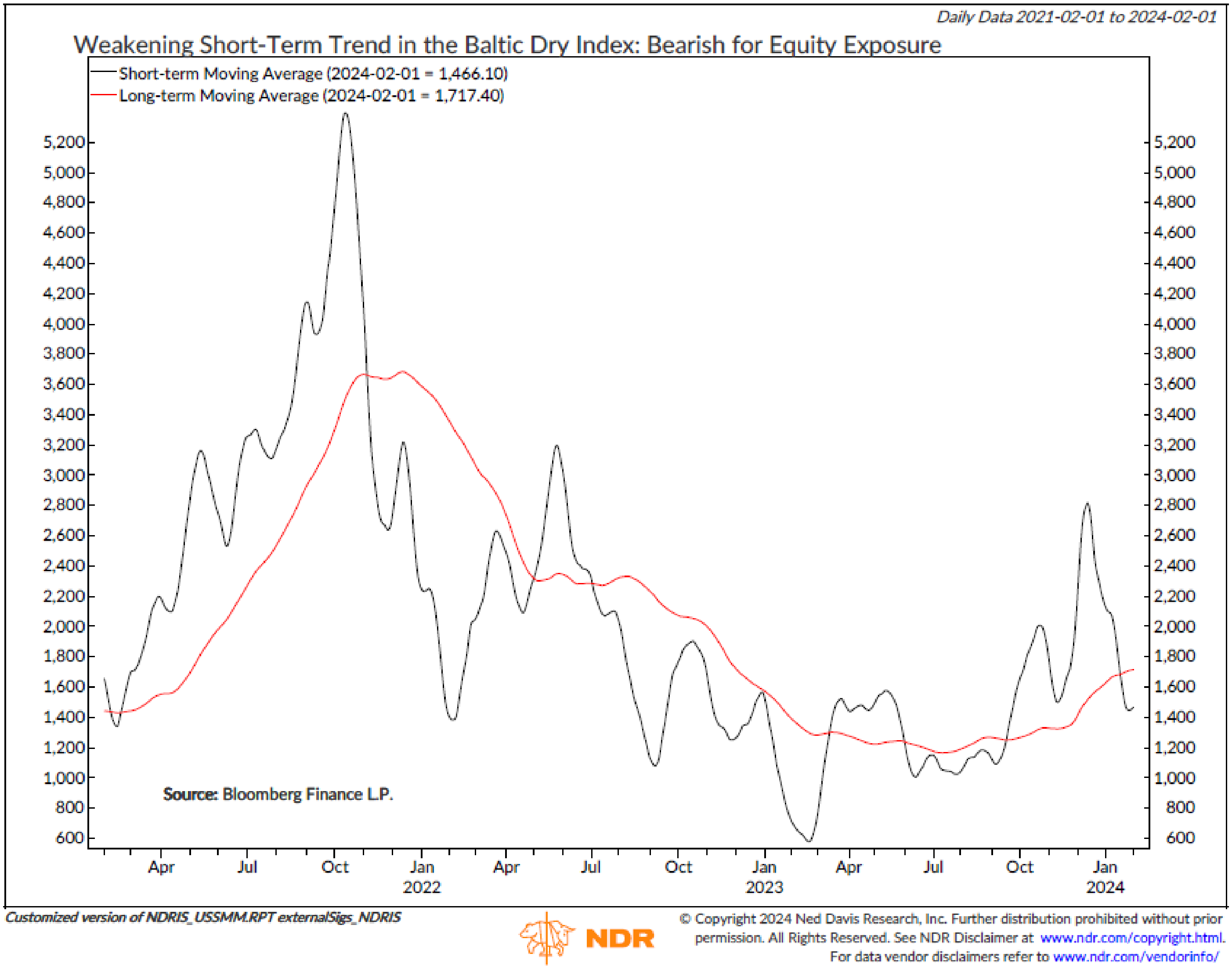
The risk management model (Figure 1) seeks to reduce exposure to fixed-income sectors most sensitive to equity drawdowns. The risk management model weakened during the month but entered February recommending full model exposure to areas most sensitive to equity markets: U.S. High Yield, Emerging Markets, U.S. Investment Grade, and Floating Rate Notes.

Figure 1: Smart Sector® Fixed Income Risk Management Model



The bullish reading from the model is driven by strong internals. Five of the seven price-based measures—including relative strength, trend, and breadth—remain bullish. However, external measures are more mixed. While option-adjusted spreads and high-yield and emerging market breadth are bullish, the short-term trend in global trade—as measured by the Baltic Dry Index—became bearish during the month (Figure 2). Furthermore, investor sentiment remains excessively optimistic, which is bearish for stocks. For now, the weight of the evidence recommends a fully invested allocation to fixed-income sectors according to the model.

Figure 2: Weakening Short-Term Trend in the Baltic Dry Index: Bearish for Equity Exposure



Fixed Income Market Update

After the strong performance by the Bloomberg Barclays U.S. Aggregate Bond Total Return Index in November and December, the index dropped modestly in January (-0.275%). Breadth weakened—five of the nine fixed-income sectors we track had negative returns in January, with long-term Treasurys' performance the weakest.

In January, central bankers and economic data pushed back on market expectations of early rate cuts. In the U.S., better-than-expected data on retail sales, consumer sentiment, and unemployment claims, and comments from several Fed officials ran counter to a March rate cut that was nearly fully priced in before the Martin Luther King, Jr. holiday. As a result, markets unwound their Powell pivot rally.

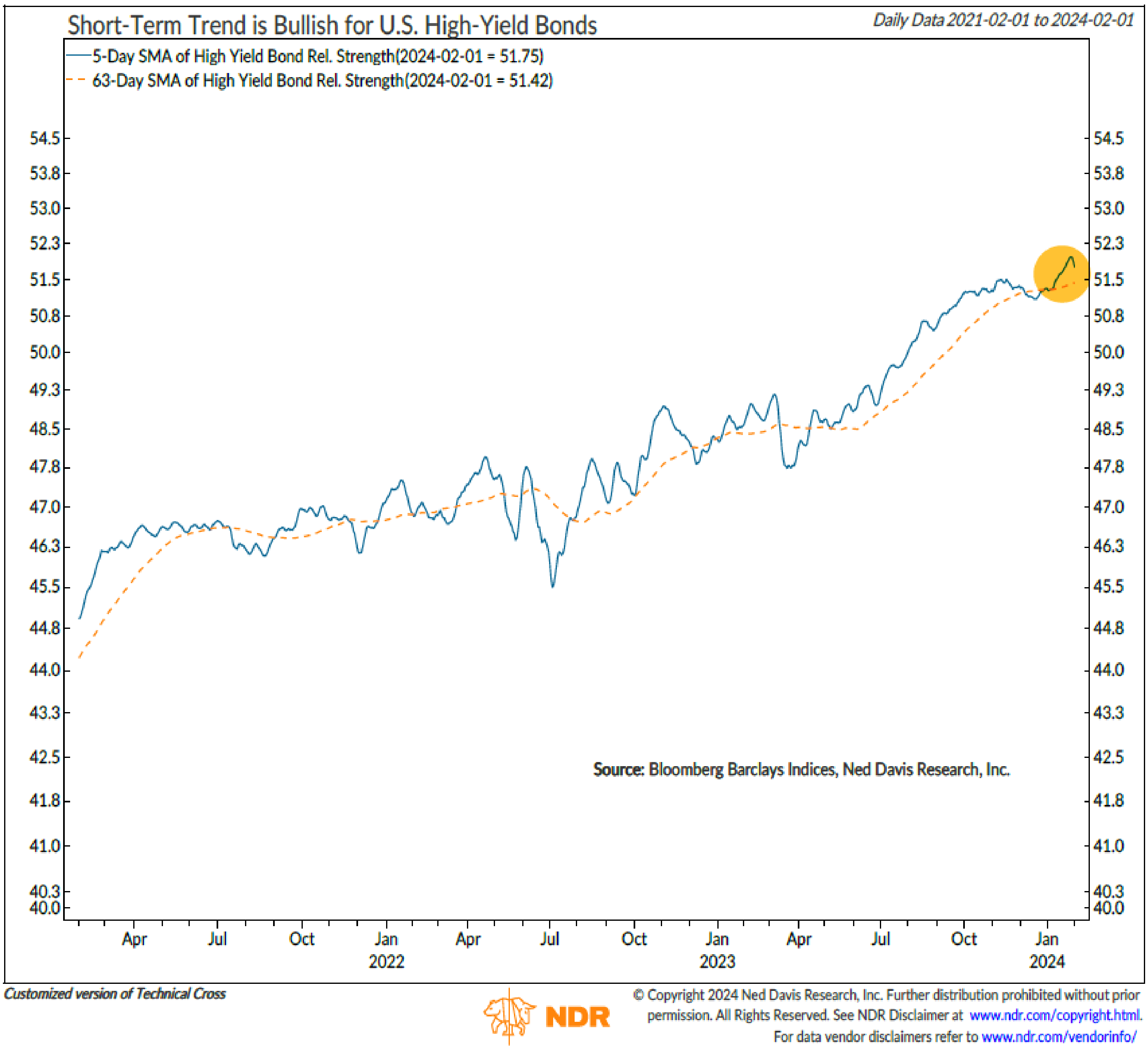
As expected, at the late January meeting, the FOMC left the fed funds target range at 5.25% to 5.50%. Fed Chair Powell said March was not their base case for a rate cut. We affirmed our Q2 call, most likely in May, for the first cut. Ten-year Treasury yields have always fallen during the three months before the first rate cut going back to 1970. With the 10-year yield near 4.00%, yields may test their December lows, at a minimum, and our message has been to buy backups in yield (Figure 3).

Entering February, the fixed income allocation strategy continued to favor risk-on leadership but did rebalance. The model remained overweight (versus the AGG benchmark), U.S. Treasuries (allocated across short-, intermediate-, and long-duration), High Yield, and Emerging Market Bonds. The portfolio is market weight TIPS and Mortgage-Backed Securities and underweight U.S. Floating Rate Notes, U.S. Investment Grade, International Investment Grade, and International Bonds.

Figure 3: 10-Year Treasury Yield

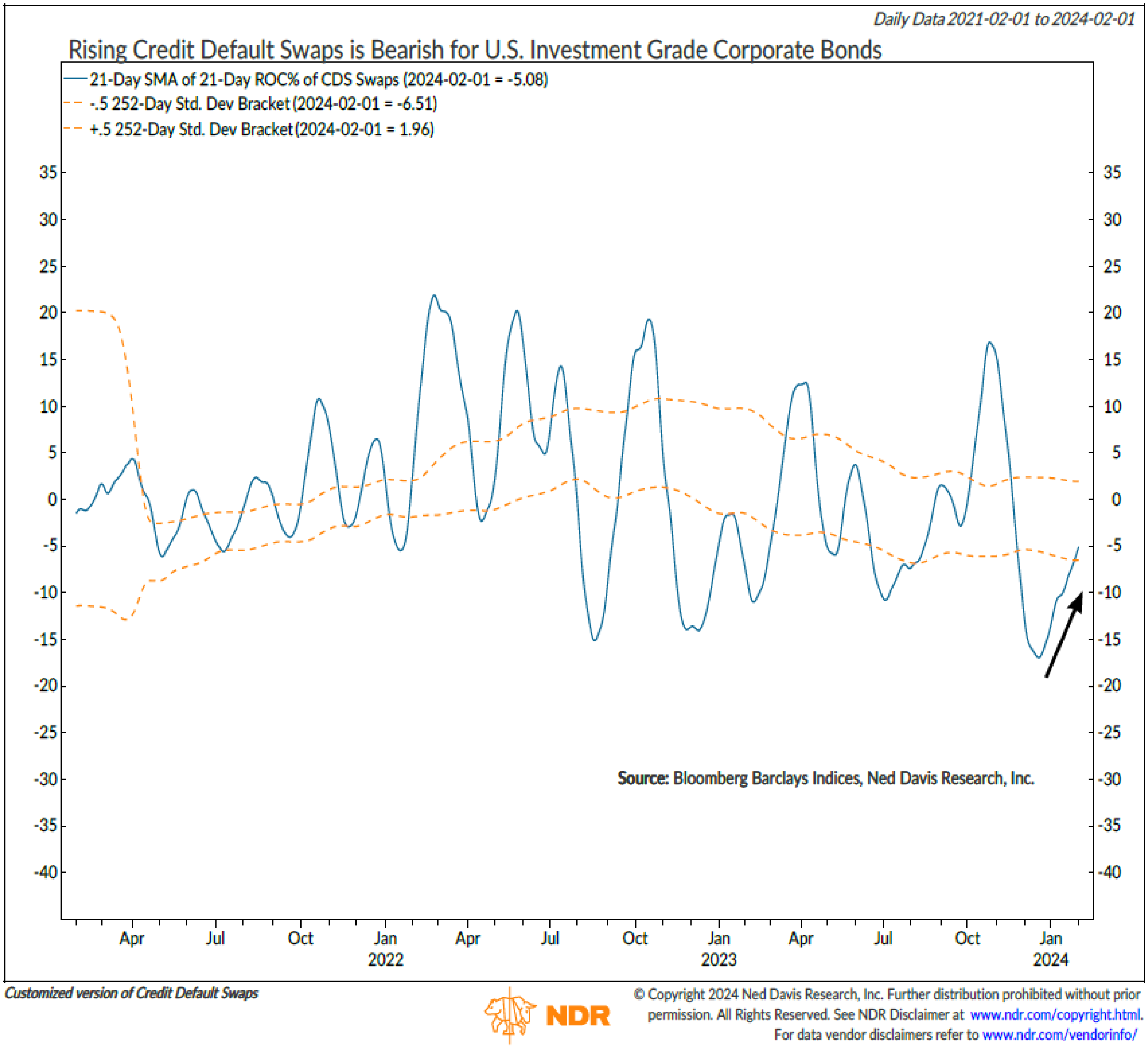
U.S. High-Yield bonds' allocation rose sharply and is now the largest overweight. All six indicators remain bullish for the sector. On a fundamental basis, the trend in small-cap equities and investor sentiment, as measured by both the VIX and option-adjusted spreads, is bullish. This is confirmed by bullish technicals, including breadth and trend (Figure 4).

Figure 4: Short-Term Trend is Bullish for U.S. High Yield Bonds



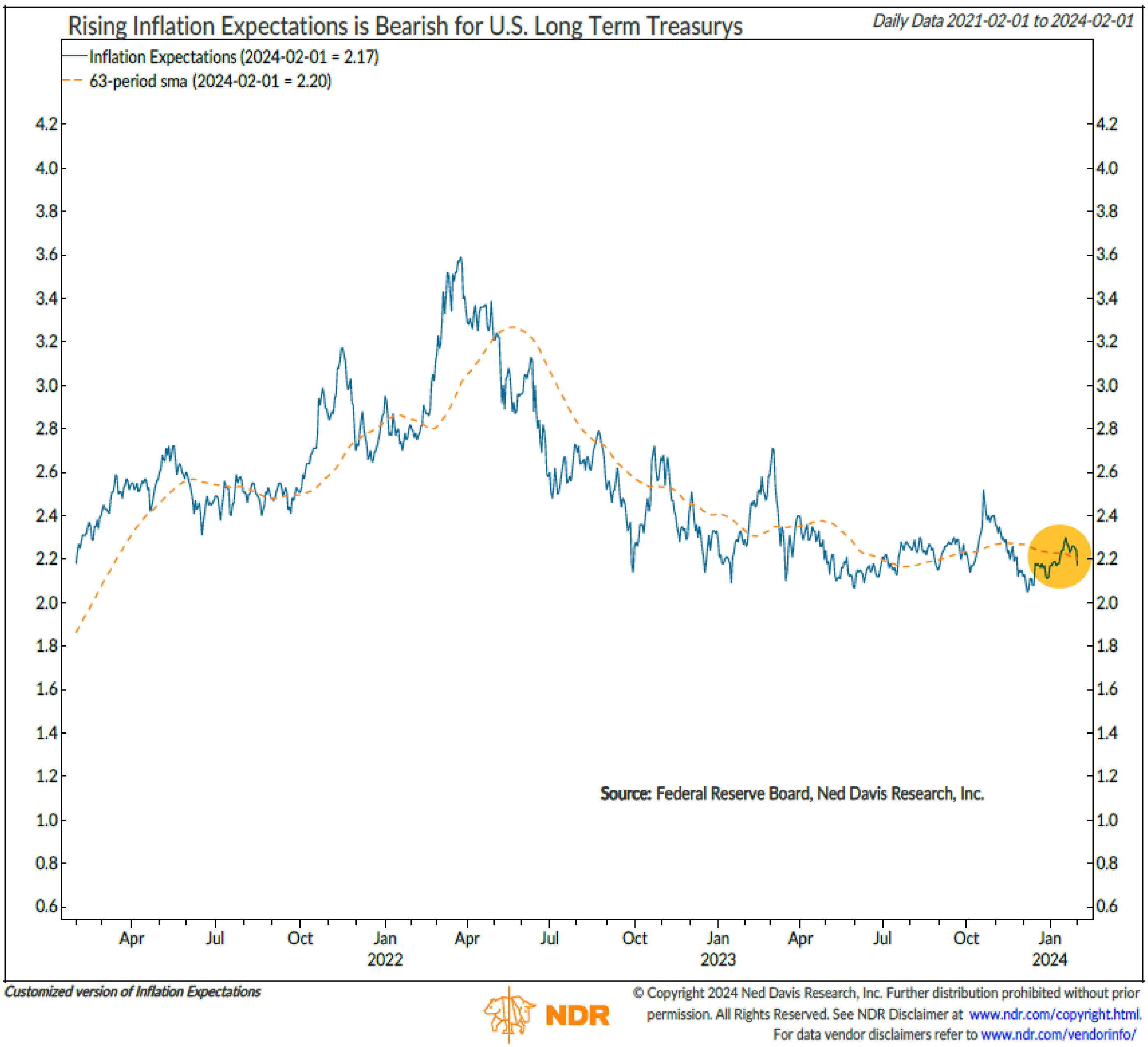
The U.S. investment-grade corporate bond allocation dropped and is slightly underweight. Four of six indicators remain bullish, but two indicators changed during the month—the bullish trend in the U.S. dollar was offset by rising credit default swaps (Figure 5).

Figure 5: Rising Credit Default Swaps is Bearish for U.S. Investment Grade Corporate Bonds



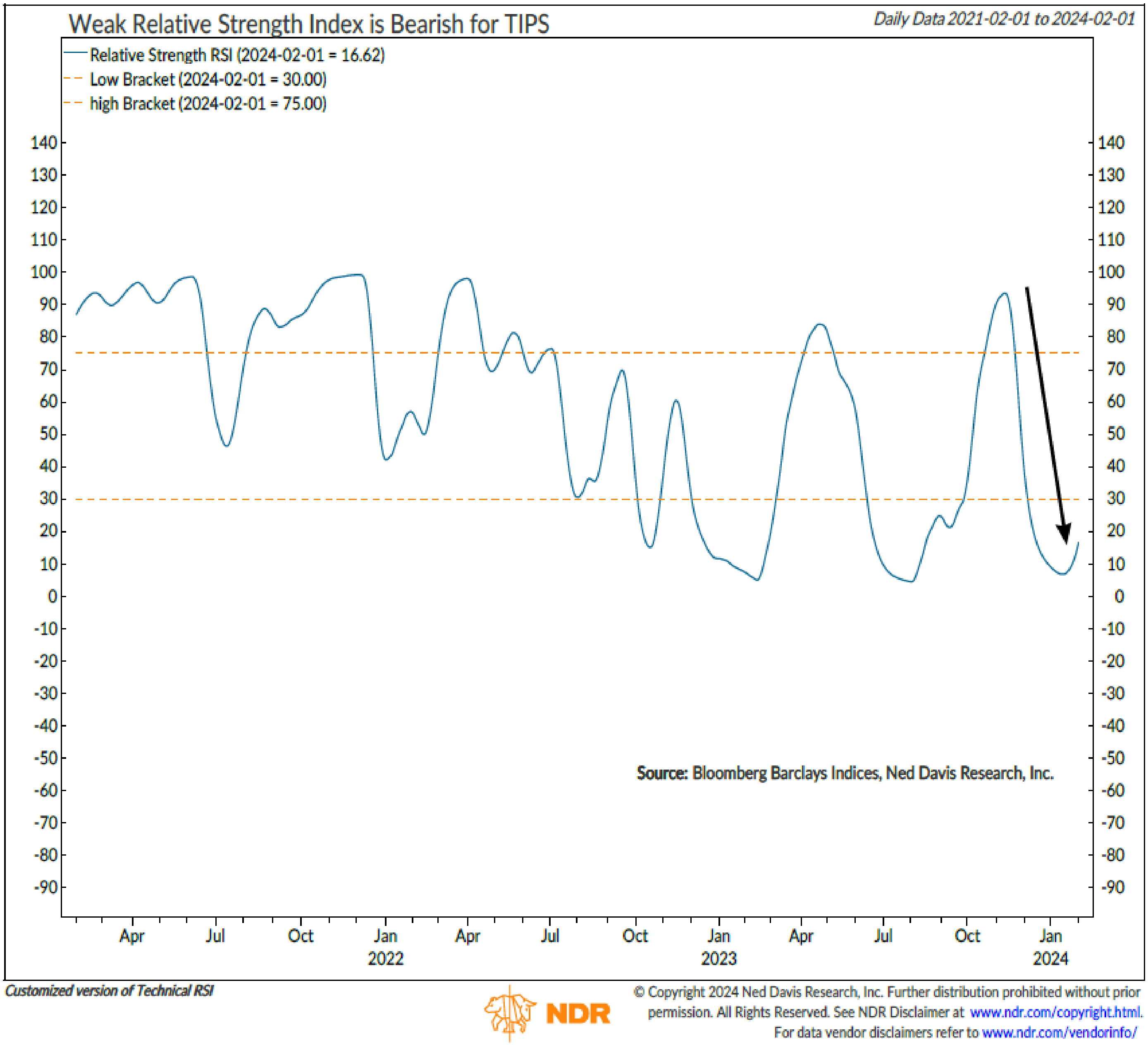
U.S. Long-Term Treasurys' allocation improved and is overweight. The portfolio holdings in Treasurys are allocated among short-, intermediate-, and long-duration holdings. Price-based measures are now mixed. The trend remains bullish, while momentum moved neutral during the month. Rising inflation expectations triggered a negative signal for the sector during the month, but it has since reversed back to a bullish reading (Figure 6).

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



While U.S. Floating Rate Notes' allocation increased, U.S. Treasury Inflation-Protected Securities (TIPS) allocation dropped sharply—both remain underweight. Commodity price trends and high-yield option-adjusted spreads remain headwinds for TIPS. These bearish measures are being confirmed by TIPS' weak technicals, including the relative strength index (Figure 7).

Figure 7: Weak Relative Strength Index is Bearish for TIPS



Summary

Entering February, the fixed income allocation strategy continued to favor risk-on leadership but did rebalance. The model remained overweight (versus the AGG benchmark), U.S. Treasuries (allocated across short-, intermediate-, and long-duration), High Yield, and Emerging Market Bonds. The portfolio is market weight TIPS and Mortgage-Backed Securities and underweight U.S. Floating Rate Notes, U.S. Investment Grade, International Investment Grade, and International 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.**

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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.

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