Smart Sector®
Fixed Income Strategy

NOVEMBER 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 and entered November recommending reduced 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

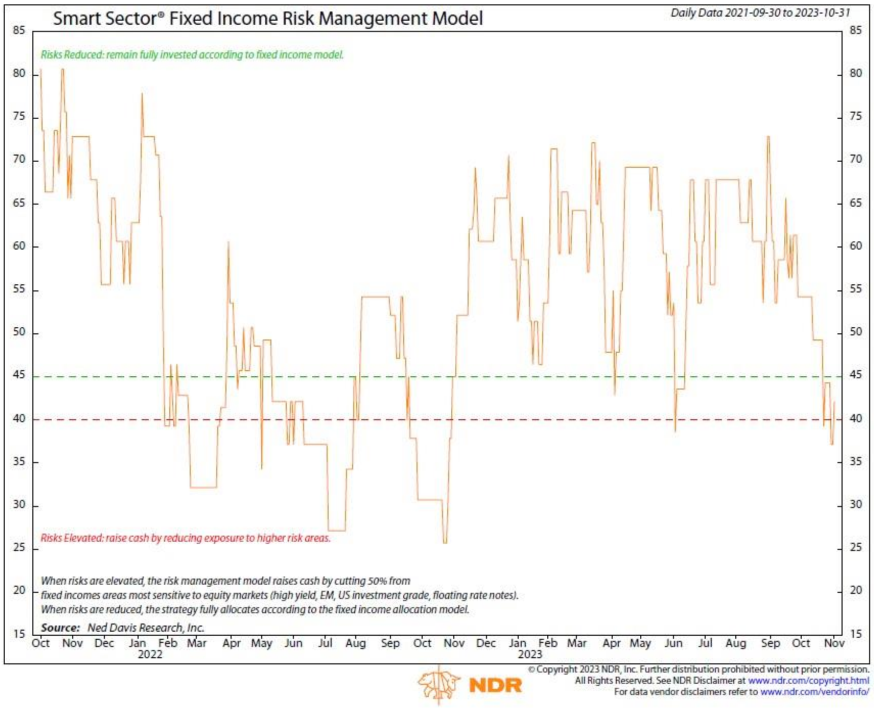
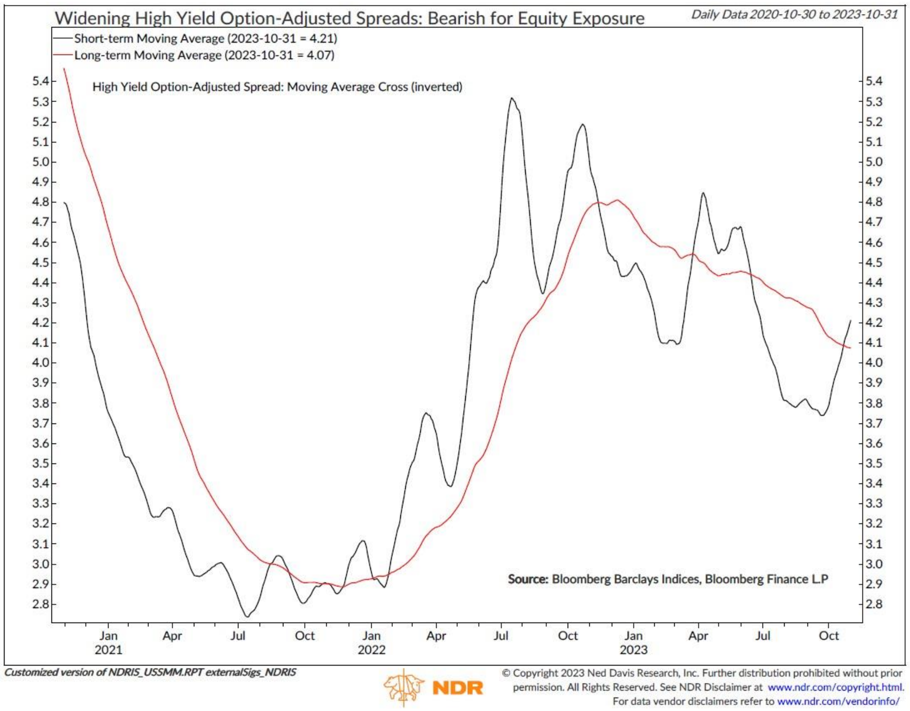


Figure 2: Widening High Yield Option-Adjusted Spreads: Bearish for Equity Exposure



The deterioration in the model was driven by widening high-yield option-adjusted spreads, which moved bearish for equity exposure (chart left). This was confirmed by technicals—five of seven price-based measures are now bearish. For now, the weight-of-the-evidence recommends a reduced 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 sixth month in a row, dropping about 1.6% in October. Breadth remained weak—seven of the nine fixed income sectors we track had negative returns in October—and significant weakness in U.S. Treasurys again dragged down the Aggregate.

Fair value on Treasurys moved up to 5.26% with the October update (chart below), but it's likely a bit overstated due to the transient nature of the pandemic and the supply shocks from the Russia/Ukraine war. The 5.25% yield level was an important double-top in 2006-07 and represented the peak 10-year yield and fed funds rate of that tightening cycle. A sustained break of this level would not only indicate major technical damage but may imply a higher level for fair value. Where do rates go from here?

A move to 3.00% or less can't be ruled out and would be supported in a recession or disinflationary scenario, where nominal growth would sink significantly below the rate of interest. The greater long-term risk, however, is if yields went the other way–toward 7.00%. Prior to the pandemic, the term premium averaged 1.65% since 1961. PCE inflation has averaged 3.3% since 1960. Add all that up and you get 7.20%. So, getting comfortable with a 5.00% 10-year Treasury is actually quite conservative!

Entering November, the fixed income allocation strategy continued to favor mixed leadership. The model is overweight U.S. Long-Term Treasurys, International Investment Grade, and U.S. Treasury Inflation-Protected Securities. The model is underweight U.S. Floating Rate Notes, U.S. Investment Grade Corporate, and U.S. Mortgage-Backed Securities. Note that the positions in U.S. High Yield, Emerging Markets, U.S. Investment Grade, and Floating Rate Notes were reduced due to the risk management model sell signal. The proceeds were placed into the SPDR Bloomberg 1-3 Month T-Bill ETF (which currently has a 30-day SEC yield of 5.25%).

Figure 3: U.S. 10-Year Treasury Fair Value Model

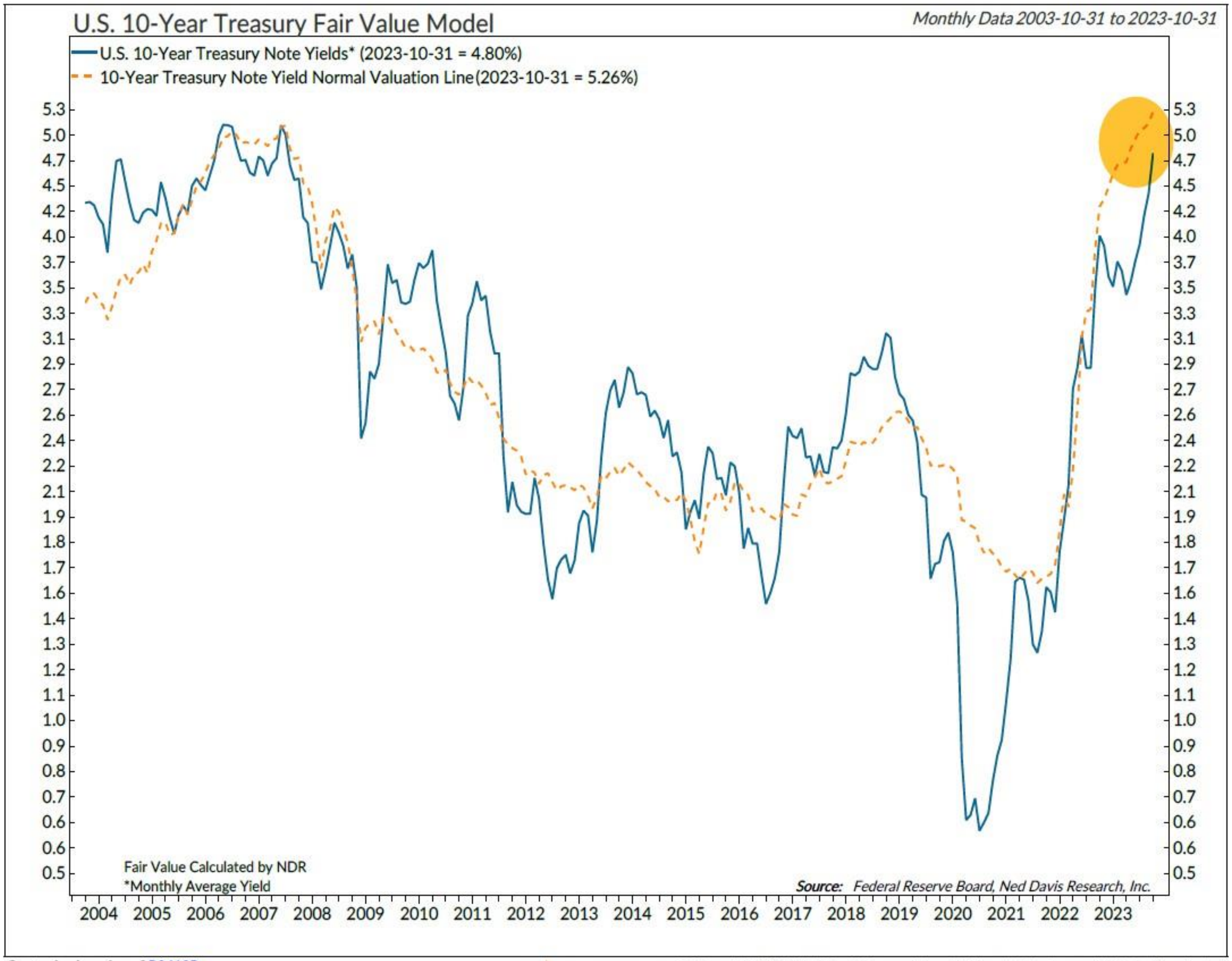


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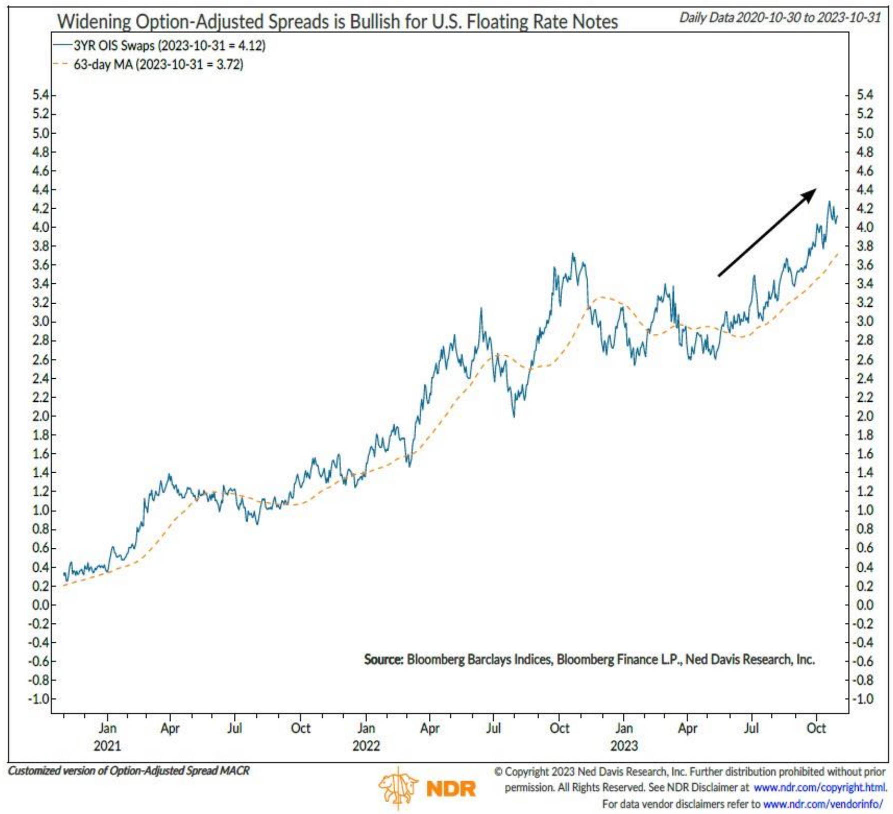
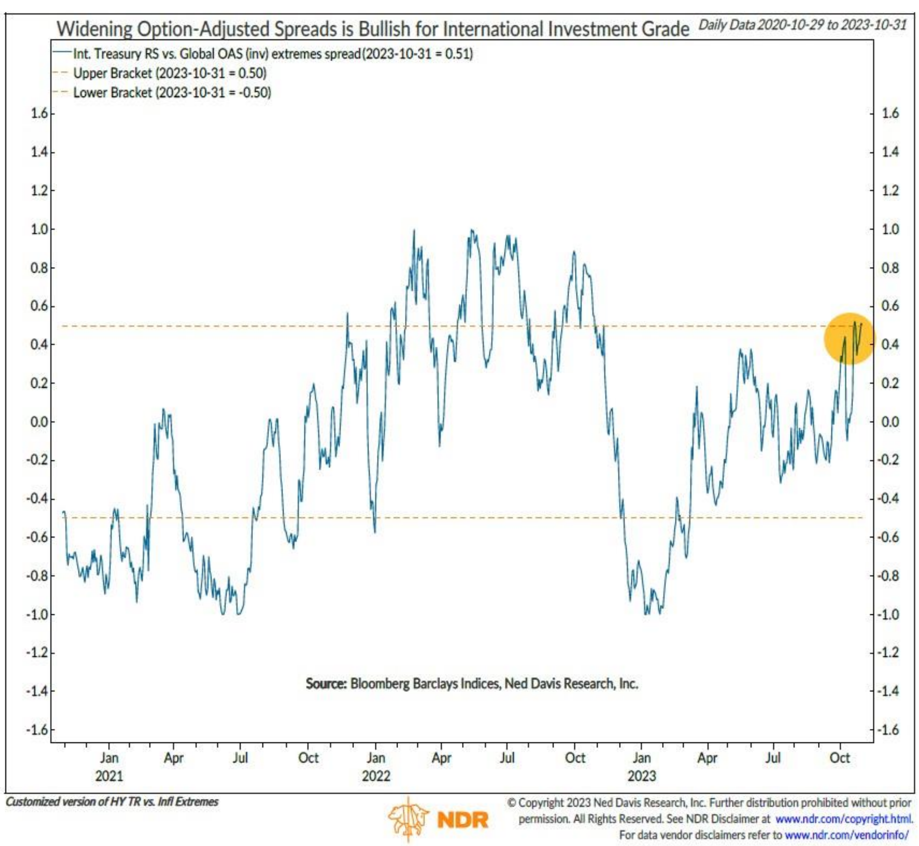
Figure 4: Widening Option-Adjusted Spreads is Bullish for U.S. Floating Rate Notes



U.S. Floating Rate Notes' allocation was steady in October and remains underweight, with longer-term interest rates nearing calculated fair value. Floating rate notes typically outperform when rates are rising, and with rates approaching resistance, we are cautious. Widening option-adjusted spreads is a tailwind for the sector (chart right). We are watching this credit sector closely as we near important levels.

Figure 5: Widening Option-Adjusted Spreads is Bullish for International Investment Grade



International Investment Grade bonds' allocation was steady in October and remained at overweight. While U.S. swaps remained neutral, widening global option-adjusted spreads flashed bullish (chart left) joining the equity volatility indicator. This is confirmed by two bullish price-based measures including rising relative strength trends.

Figure 6: Widening Option-Adjusted Spreads is Bullish for U.S. Investment Grade Corporate

U.S. Investment Grade Corporate bonds' allocation was steady and remains underweight. While bond volatility, credit default swaps, and short-term trend are bearish for the sector, the U.S. dollar and mean reversion are positive offsets. Only one indicator changed during the month—option-adjusted spreads moved bullish for the sector (chart right).

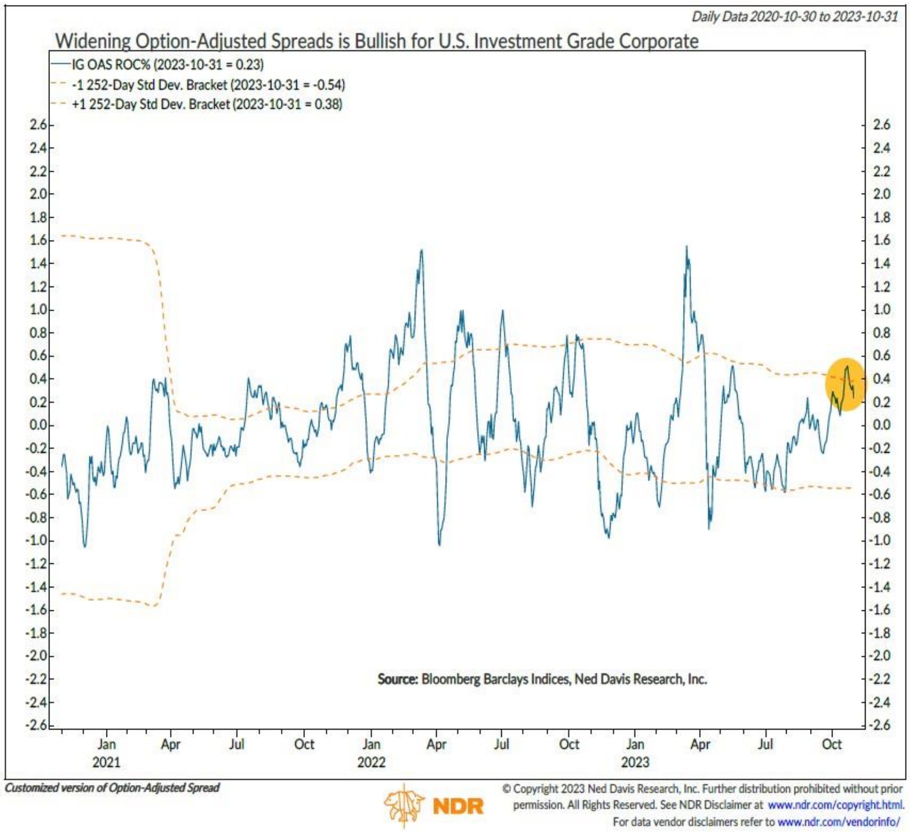
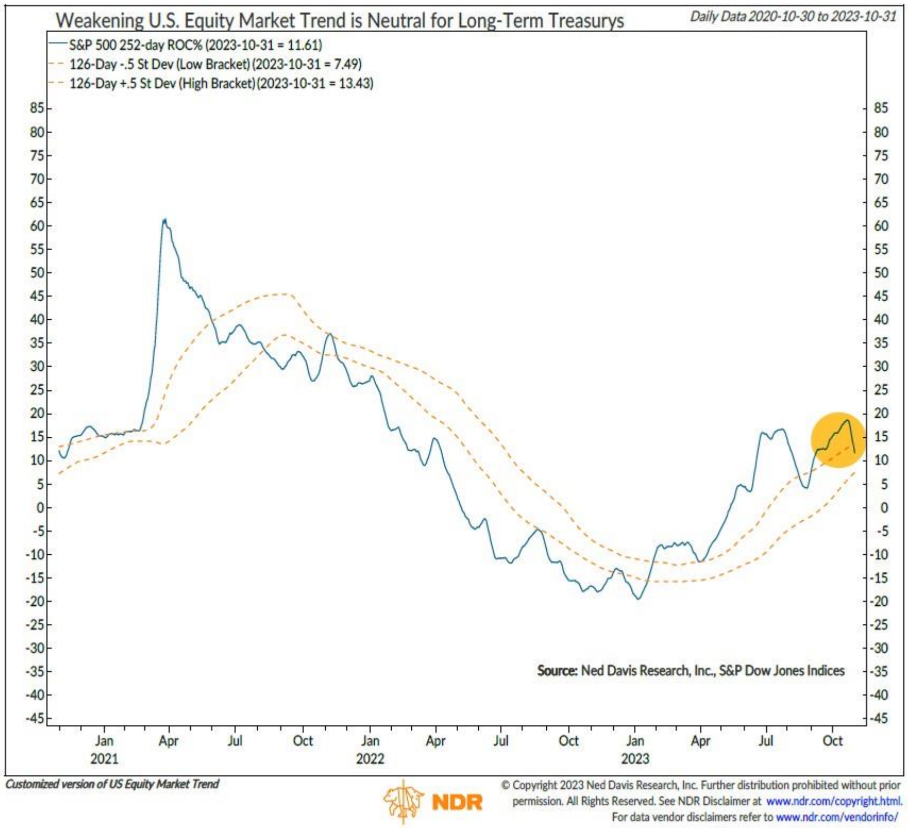


Figure 7: Weakening U.S. Equity Market Trend is Neutral for Long-Term Treasurys



U.S. Long-Term Treasurys' allocation dropped modestly in October but remains overweight. Inflation expectations, U.S. swaps, and sector trend remain on bearish signals. However, both sector momentum and the U.S. equity market trend moved to neutral during the month (chart left). If investors see recession risks rising and/or the stock market's earnings yield deteriorates, Treasurys may have an opportunity to rally off their lows.

Summary

Entering November, the fixed income allocation strategy continued to favor mixed leadership. The model is overweight U.S. Long-Term Treasurys, International Investment Grade, and U.S. Treasury Inflation-Protected Securities. The model is underweight U.S. Floating Rate Notes, U.S. Investment Grade Corporate, and U.S. Mortgage-Backed Securities. Note that the positions in U.S. High Yield, Emerging Markets, U.S. Investment Grade, and Floating Rate Notes were reduced due to the risk management model sell signal. The proceeds were placed into the SPDR Bloomberg 1-3 Month T-Bill ETF (which currently has a 30-day SEC yield of 5.25%).

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DAY HAGAN ASSET MANAGEMENT

NDR NED DAVIS RESEARCH

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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