Smart Sector® Fixed Income Strategy

SEPTEMBER 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 slightly from last month but entered September, recommending full model exposure to several areas sensitive to equity markets: U.S. High Yield, Emerging Markets, and U.S. Investment Grade.

Figure 1: Smart Sector® Fixed Income Risk Management Model

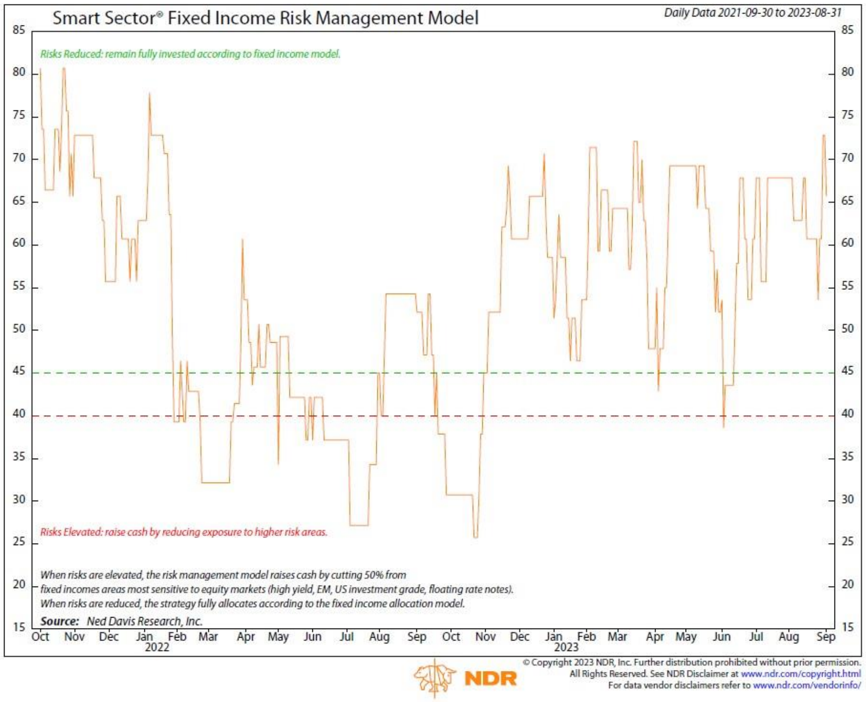
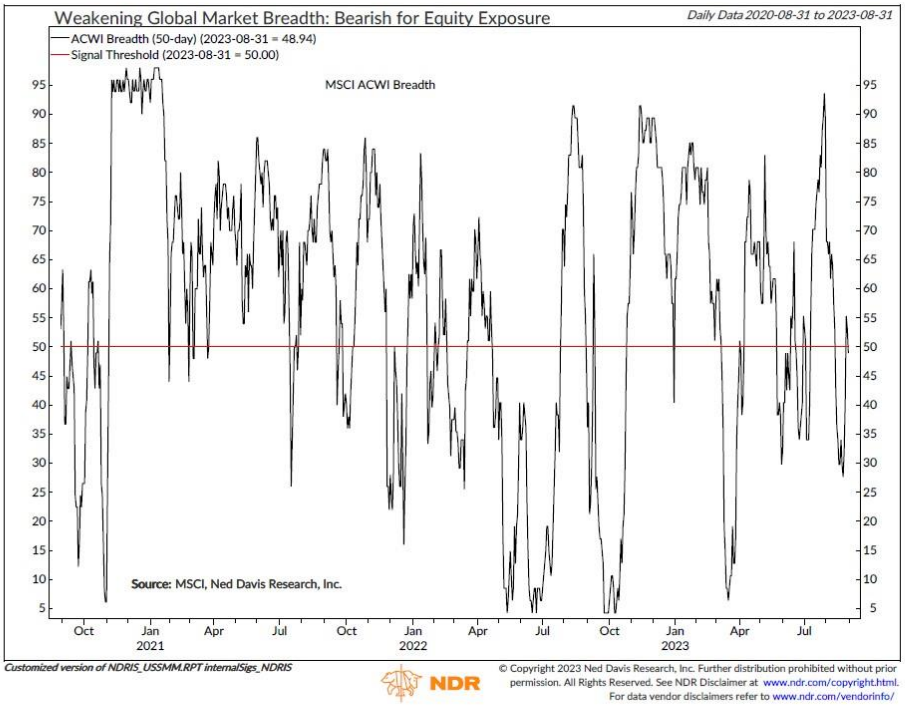


Figure 2: Weakening Global Market Breadth: Bearish for Equity Exposure



The model's overall bullish position is driven by four of the seven (price-based) measures that remain positive for stocks. However, global market breadth weakened during the month and flashed a sell signal (chart left). While external influences such as trade and market sentiment remained bearish and neutral, respectively, they're offset by bullish readings from high-yield and emerging market bond breadth, as well as high-yield option-adjusted spreads. 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 less than 1% in August. Returns have been flat or negative for eight of the past 12 months. Breadth weakened—five of the nine fixed income sectors we track had negative returns in August—weakness in U.S. Treasurys again dragged down the Aggregate.

Bond yields have come a long way in a short period of time. Ten-year Treasury yields have backed up 100 basis points (bp) from their April lows. Nearly all of the rise has been due to higher real yields.

Over that span, the 10-year Treasury Inflation-Protected Securities (TIPS) yield has climbed 91 bp (chart below). Changes in growth expectations are the primary driver of real yields.

As the "soft landing" narrative has gained traction, real yields have risen. An increase in the supply of Treasurys also likely contributed to higher real yields. The market seemed surprised by the amount of issuance announced earlier in August. However, there was more planned issuance than had been anticipated for the current quarter, which was mostly due to timing, as less debt was issued in the prior quarter. Back in May, the Treasury had warned us that an increased coupon supply was coming.

At the Jackson Hole address, Fed Chairman Powell noted that the outlook for economic growth and inflation remains shrouded in uncertainty, mainly stemming from the unknown duration of policy lags and changing labor market dynamics. While a soft landing is more likely, Fed policy will remain restrictive, which will slow down economic growth in the coming year.

Entering September, the fixed income allocation strategy remains with a risk-on message and suggests no rebalancing from the month prior. The model remains overweight U.S. Treasurys, U.S. High-Yield Bonds, U.S. Investment Grade Corporate, U.S. Mortgage-Backed Securities, Emerging Market Bonds, and underweight U.S. Treasury Inflation-Protected Securities, and Floating Rate Notes.

Figure 3: TIPS vs Nominal Treasury Yields By Maturity

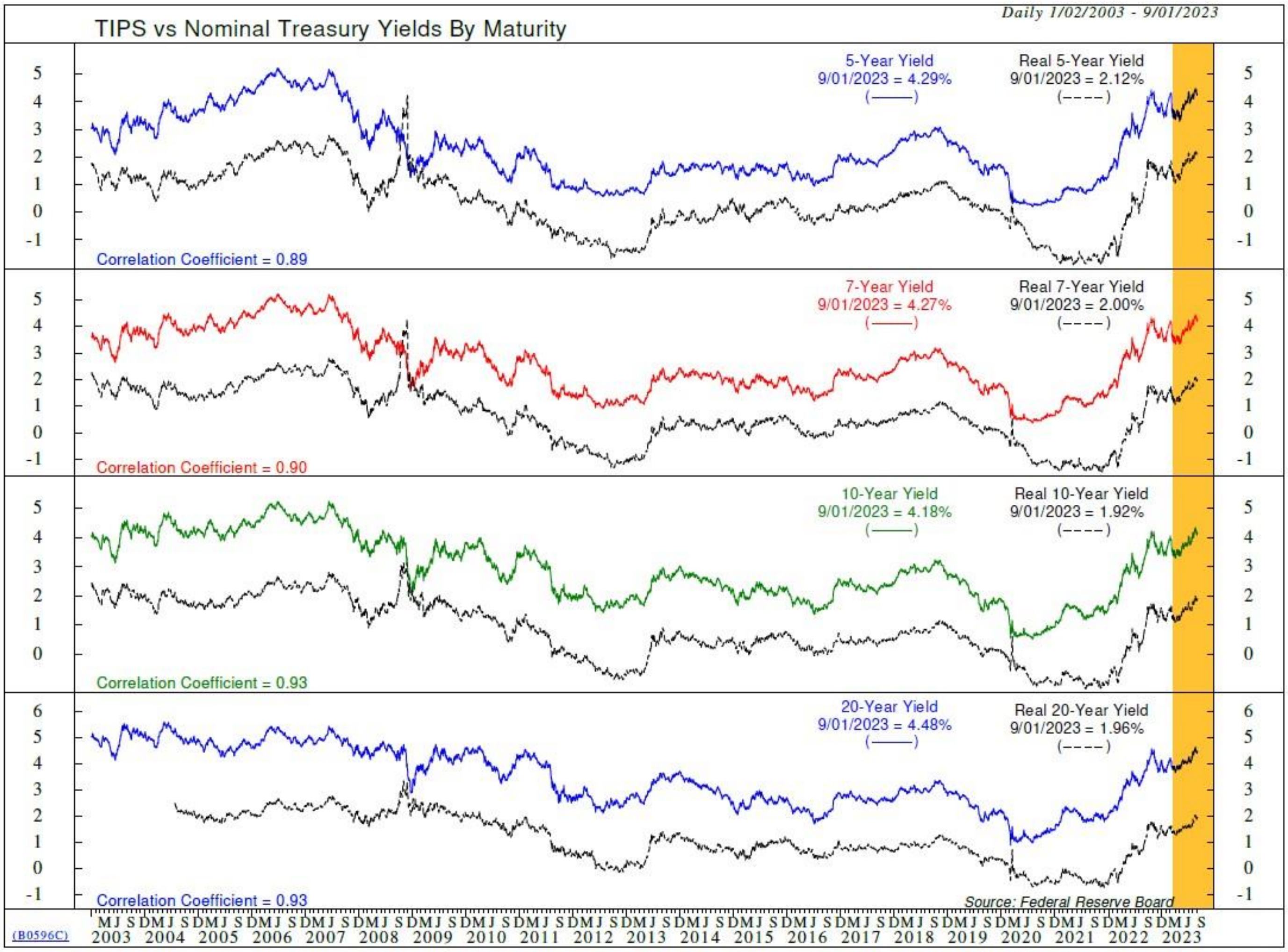
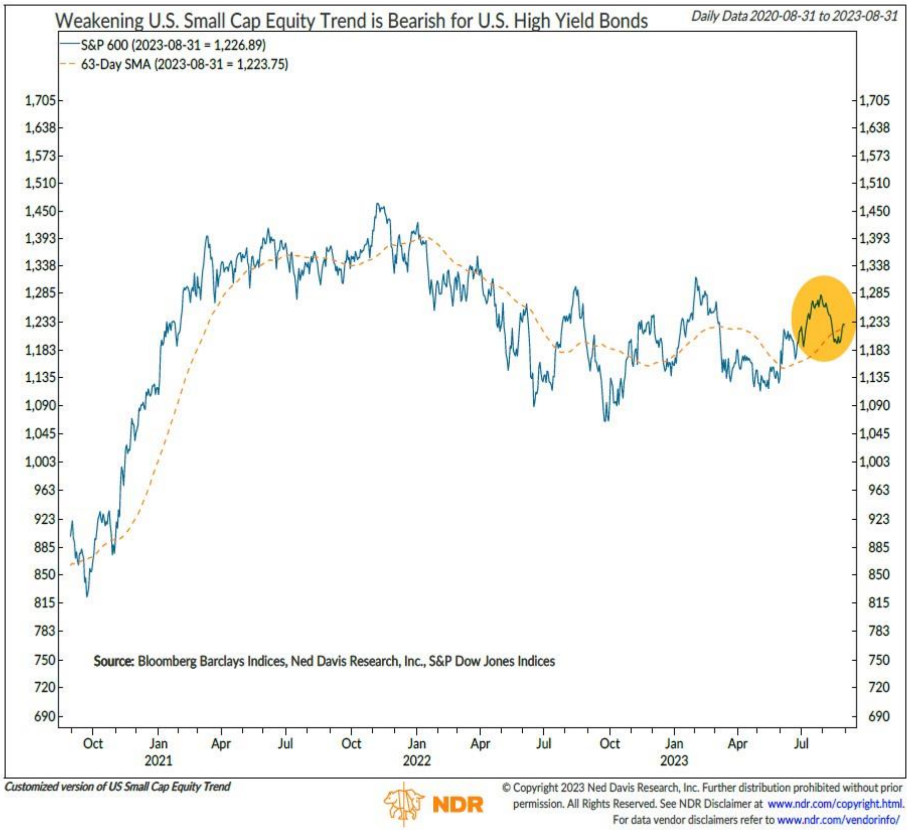
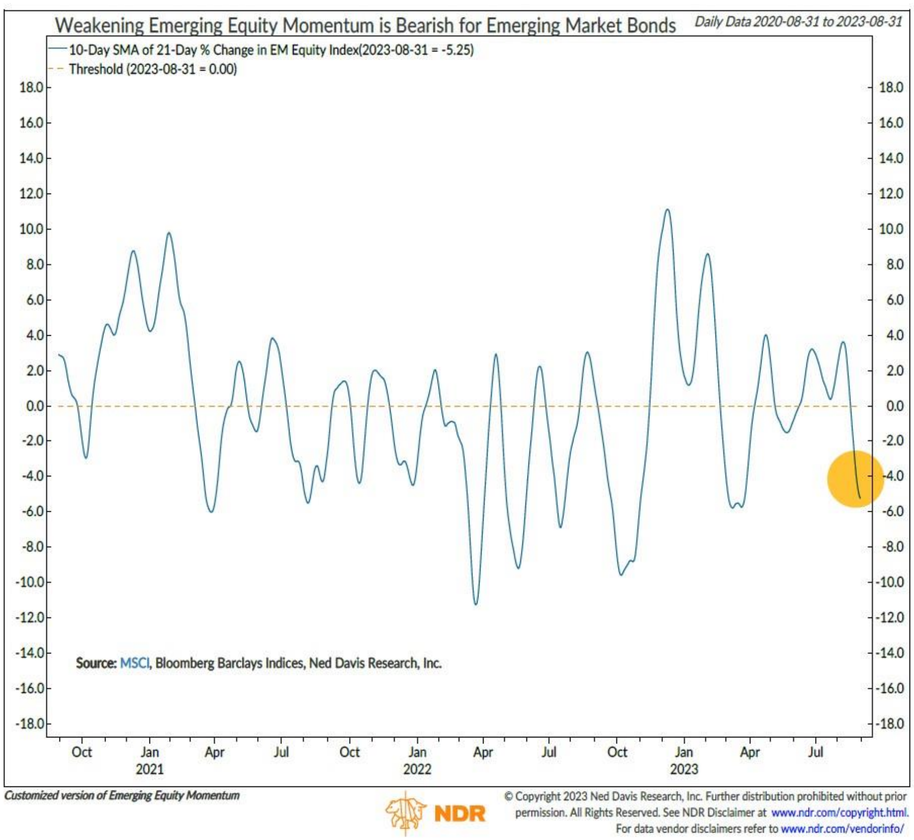


Figure 4: Weakening U.S. Small Cap Equity Trend is Bearish for U.S. High Yield Bonds



U.S. High Yield bonds' allocation was steady in August and remains in an overweight position. While four of six indicators remained bullish, two flipped negative during the month—the VIX and the small-cap equity trend (chart right). However, the small-cap equity trend is hovering near its 3-month moving average, so this indicator might get whipsawed.

Figure 5: Weakening Emerging Equity Momentum is Bearish for Emerging Market Bonds



Emerging Market (EM) bonds' allocation declined slightly in August. Four of the five indicators remained steady. Emerging Markets have a positive relationship with rising commodity prices. However, during the month of August, the short-term momentum of Emerging Market equities moved to a bearish level for the sector (chart left).

U.S. Long-Term Treasurys' allocation was steady in August and remains the largest overweight position. While the sector's trend and momentum remained steady for the sector, a few indicators changed during the month. The U.S. equity market trend and U.S. swaps moved neutral. Inflation expectations, which have been quite volatile this past year, flashed a bullish signal for the sector right before Powell's Jackson Hole speech (chart right).

Figure 6: Lower Inflation Expectations is Bullish for U.S. Long-Term Treasurys

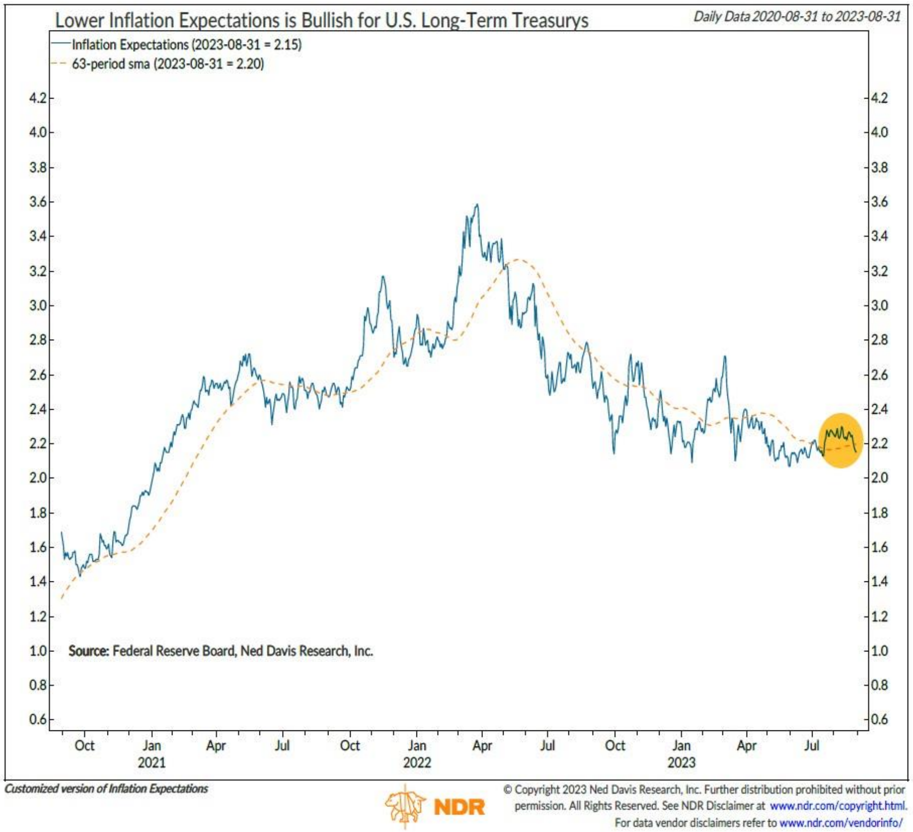
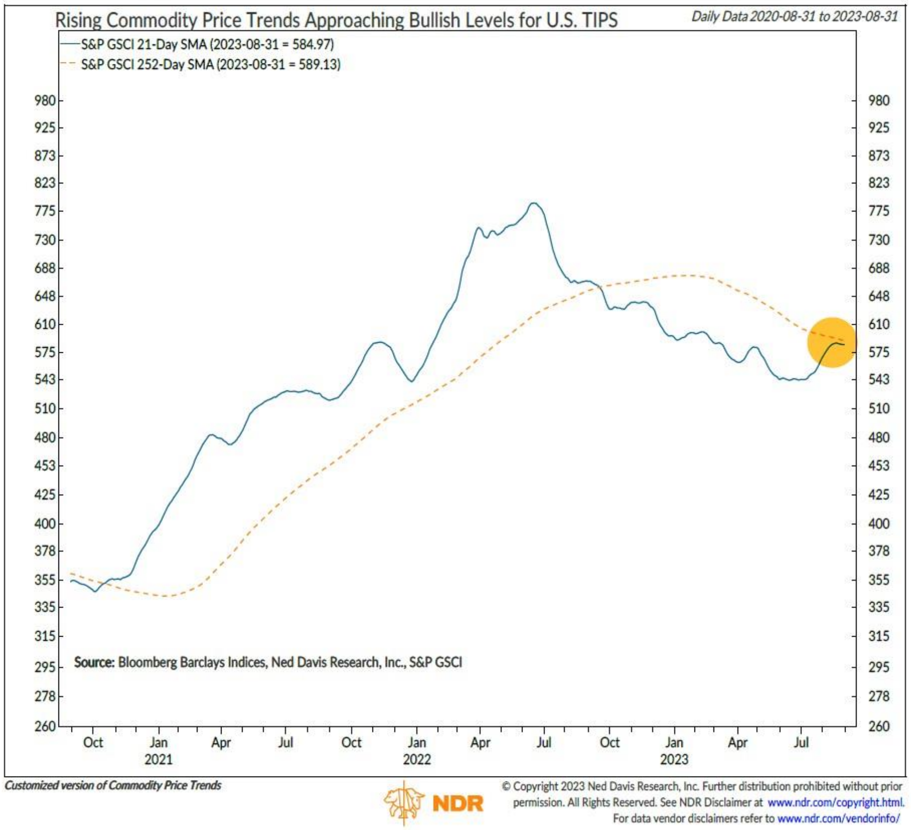


Figure 7: Rising Commodity Price Trends Approaching Bullish Levels for U.S. TIPS



U.S. Treasury Inflation-Protected Securities (TIPS) allocation was steady in August and remains a significant underweight position. TIPS typically outperform when inflation is high. All six indicators remain bearish for the sector. We expected inflation to fall pretty hard into the spring and summer months, which it has. However, commodity prices—led by energy—have bounced, which could soon provide a tailwind for the sector (chart left).

Summary

Entering September, the fixed income allocation strategy remains with a risk-on message and suggests no rebalancing from the month prior. The model remains overweight U.S. Treasurys, U.S. High-Yield Bonds, U.S. Investment Grade Corporate, U.S. Mortgage-Backed Securities, Emerging Market Bonds, and underweight U.S. Treasury Inflation-Protected Securities, and Floating Rate Notes.

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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) 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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