Smart Sector® Fixed Income Strategy

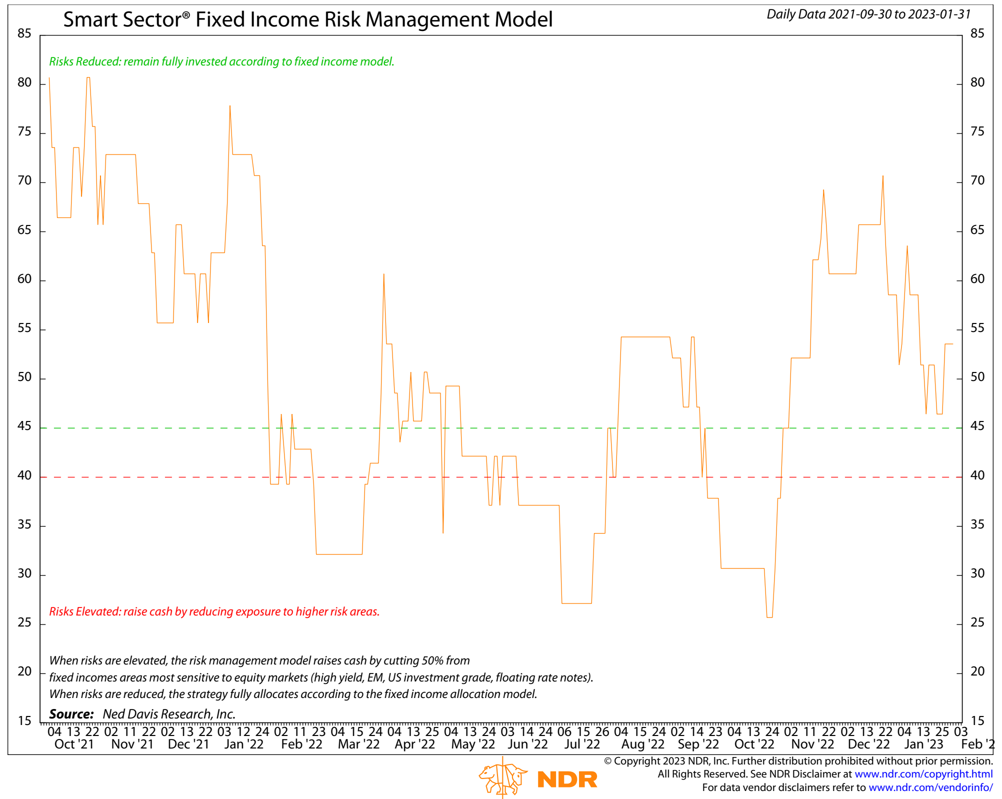
DAY HAGAN ASSET MANAGEMENT

NDR NED DAVIS RESEARCH

FEBRUARY 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 improved from last month and 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.



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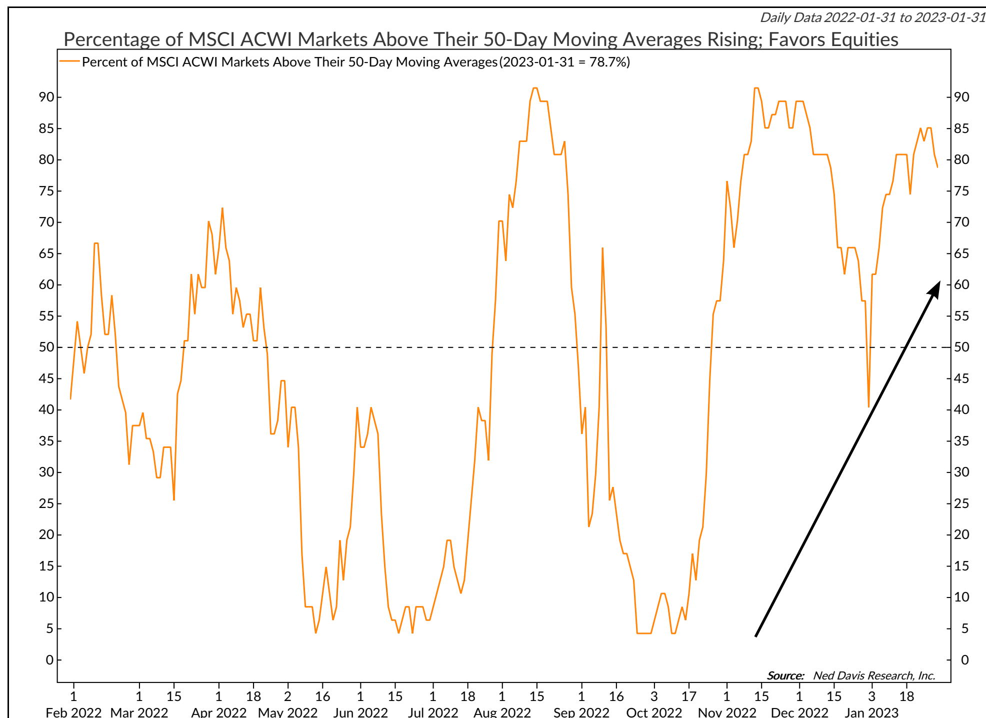

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Stronger breadth measures drove the model improvement. The percentage of global markets above their 50-day moving average rose to 85%, well above the 50% positive threshold for the model (chart left). In terms of external influences, high yield and Emerging Market bond breadth improved, which was offset by extremely optimistic, short-term stock market sentiment.

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 a challenging 2022, the Bloomberg Barclays U.S. Aggregate Bond Total Return Index gained about 3% in January. The index has been positive for only four of the past 12 months. Of the nine fixed income sectors we track (including cash), all of them had positive returns in January.

As widely expected, the Fed, once again, downshifted its pace of rate hikes to 25 basis points (bp) in February, following a slowdown in December to 50 bp. As a result, the fed funds target range is now 4.50% to 4.75%, the highest since October 30, 2007. The Fed has raised rates a total of 450 bp since March 2022, making it the fastest hiking cycle ever with data going back to 1963.

While the Fed acknowledged improvement in inflation at the February meeting, Chairman Powell continued to characterize inflation as "elevated," and repeated that "ongoing increases...will be appropriate." But he also reiterated that they will be data dependent and operate meeting by meeting.

Softer labor markets are the key for giving the Fed confidence that inflation is heading back to its 2% target. Powell, however, described the labor market as "out of balance." Job openings are incredibly robust (chart below), and unemployment claims remain near their lowest level since 1969. If the Fed is going to pause and eventually reverse the course of monetary policy later this year, we better start seeing some more softness in the labor market data real soon. Investors "fighting the Fed" may be premature to do so.

Entering February, the fixed income allocation strategy is overweight U.S. Investment Grade Corporate, Emerging Market Bonds, U.S. High Yield, and Mortgage-Backed Securities while being underweight Floating Rate Notes, International Investment Grade bonds, Treasury Inflation-Protected Securities, and U.S. Long-Term Treasurys.

Measures of Labor Market Tightness

Monthly Data 2000-12-31 to 2022-12-31

- Unemployed/Job Openings (2022-12-31 = 0.520)
- Labor Pool/Job Openings (2022-12-31 = 0.990)

Source: Bureau of Labor Statistics

Shading indicates NBER-defined recessions

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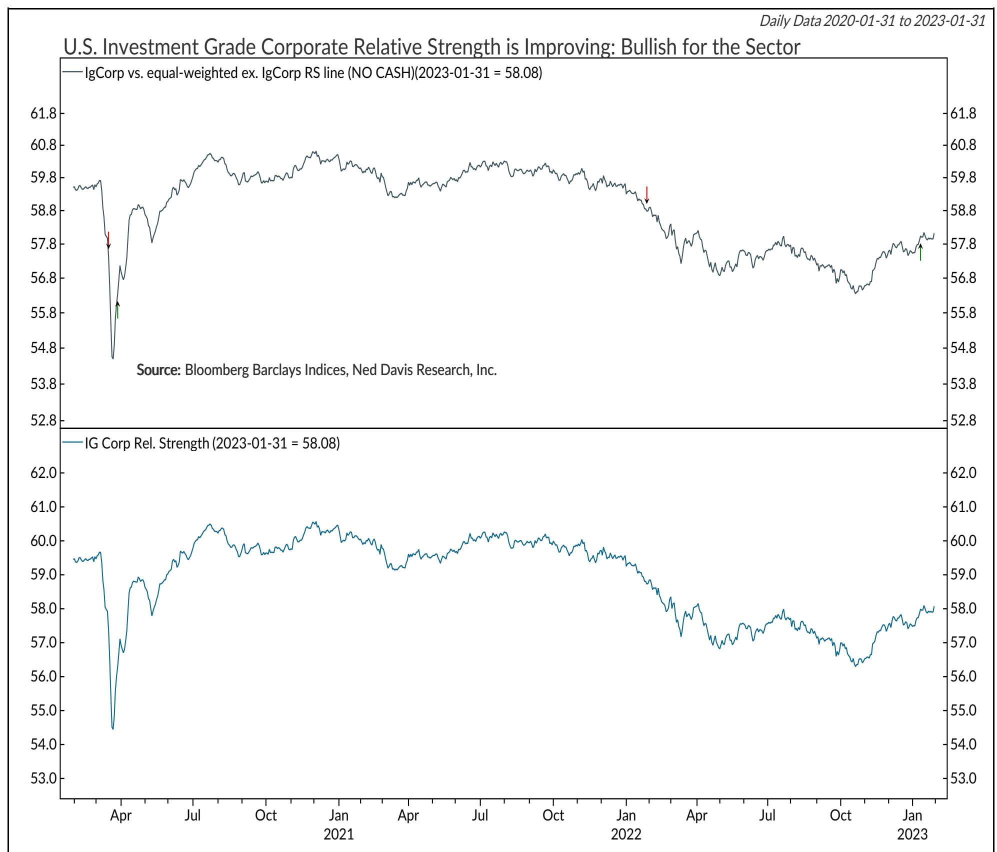
The model's allocation to U.S. Investment Grade Corporate saw a sharp rise in February, which pushed it from a slight underweight to the largest overweight position. Four of the six indicators are now bullish. In February, option-adjusted spreads—a measurement of default risk—narrowed and is now neutral for the sector. Two other indicators moved bullish last month—bond volatility and mean reversion. With investors moving back into risk assets in January, relative strength has improved for the sector (chart right). Only the U.S. dollar remained bearish for the sector.



Customized version of Price Mean Reversion

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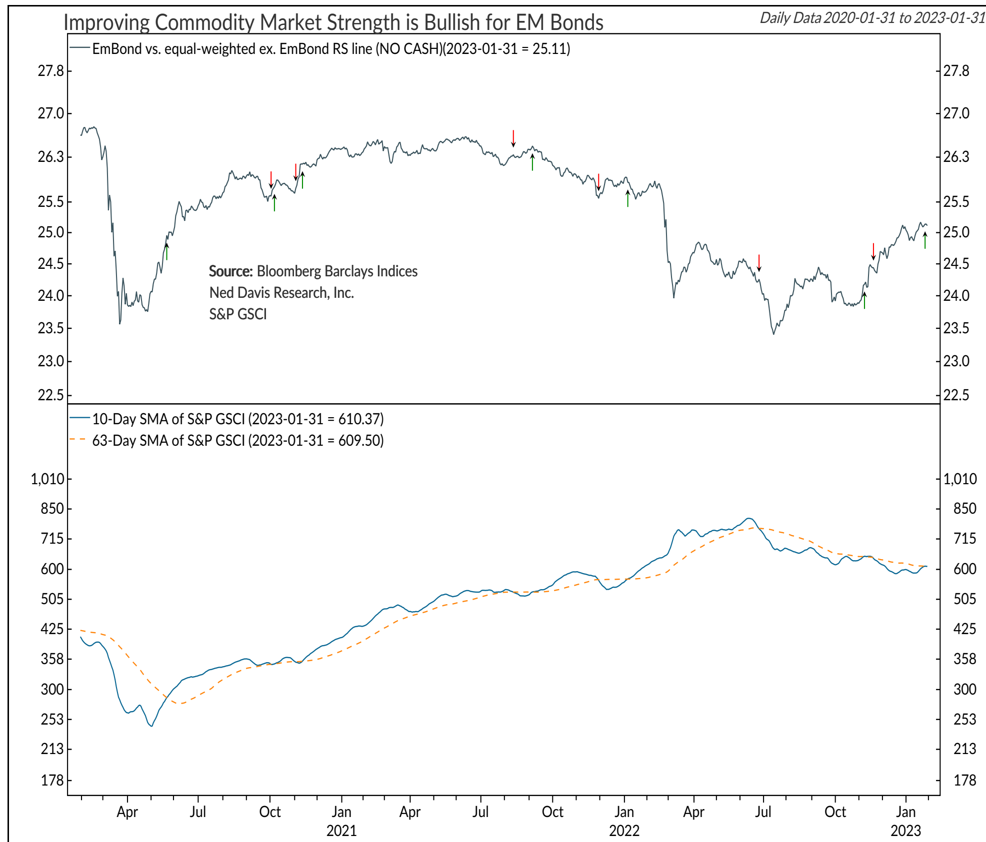

Customized version of Commodity Market Strength

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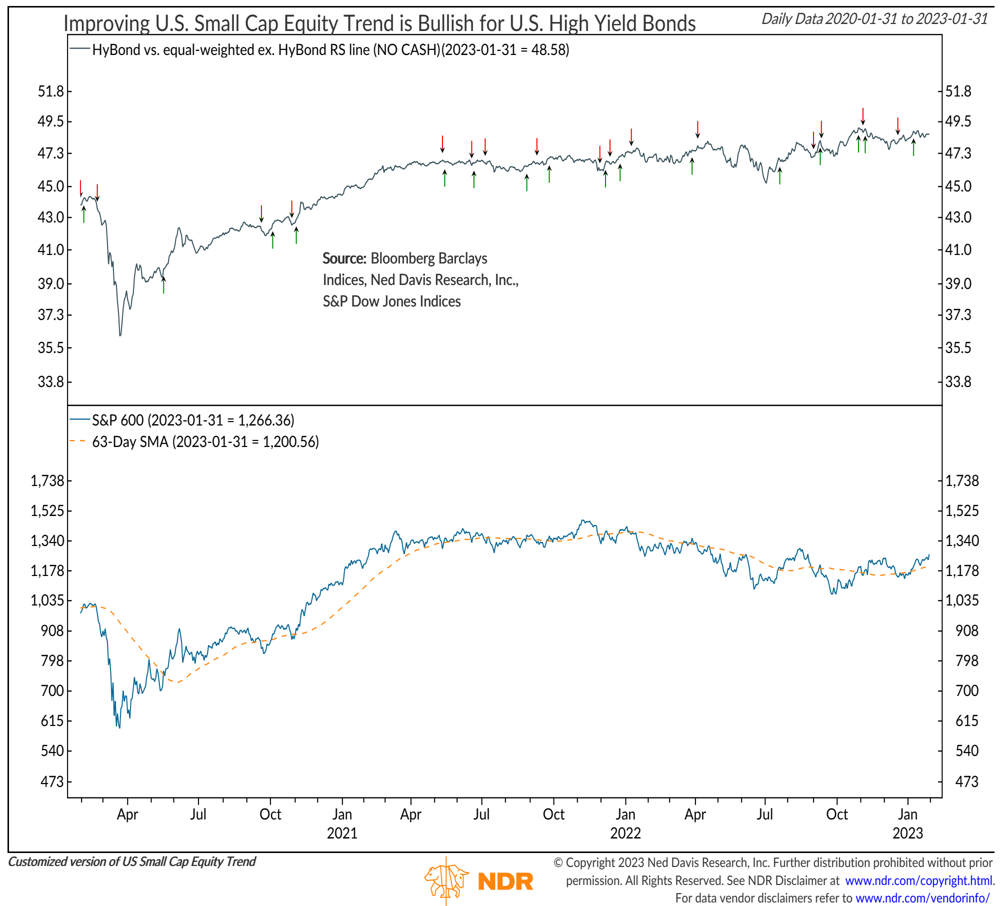
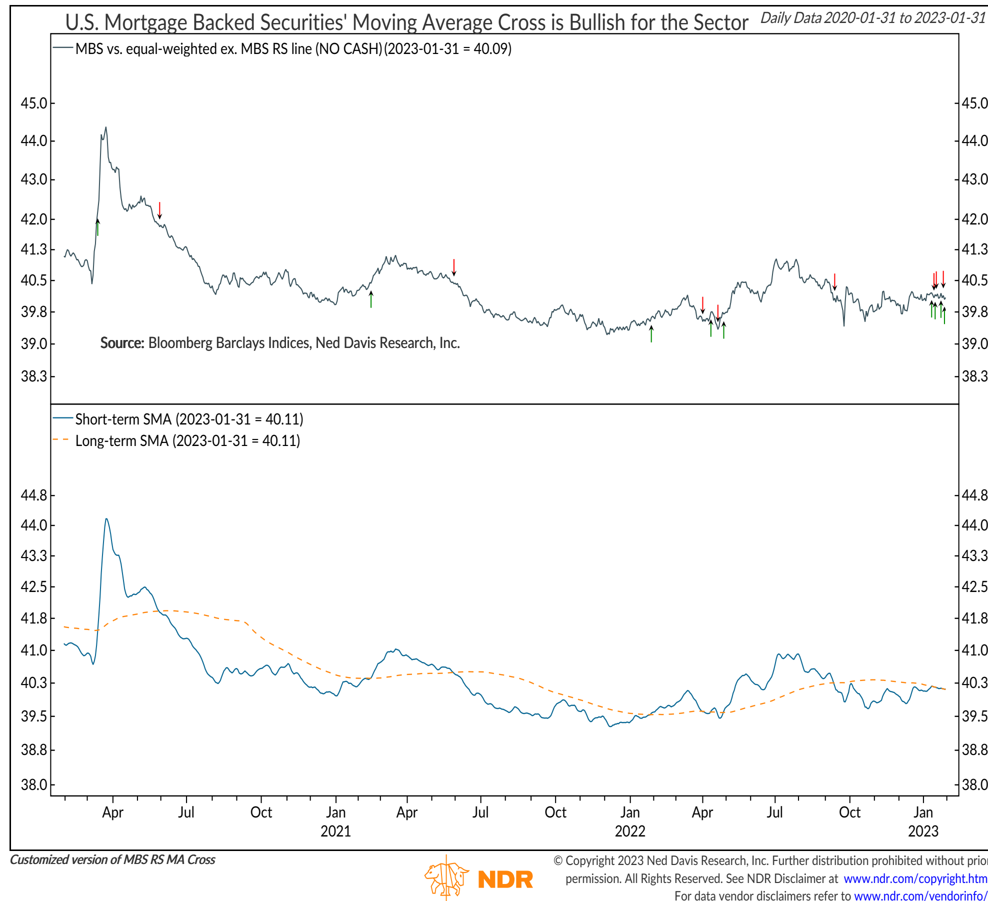
Emerging Market (EM) bonds overweight allocation rose in February. Technicals and fundamentals are bullish for the sector. The U.S. dollar continued to roll over from its peak levels. Due to the inverse relationship with Emerging Markets, a weaker dollar is a bullish condition for both emerging market equities and bonds. With the reopening of China, commodity market strength improved to a bullish level for EM bonds (chart left).

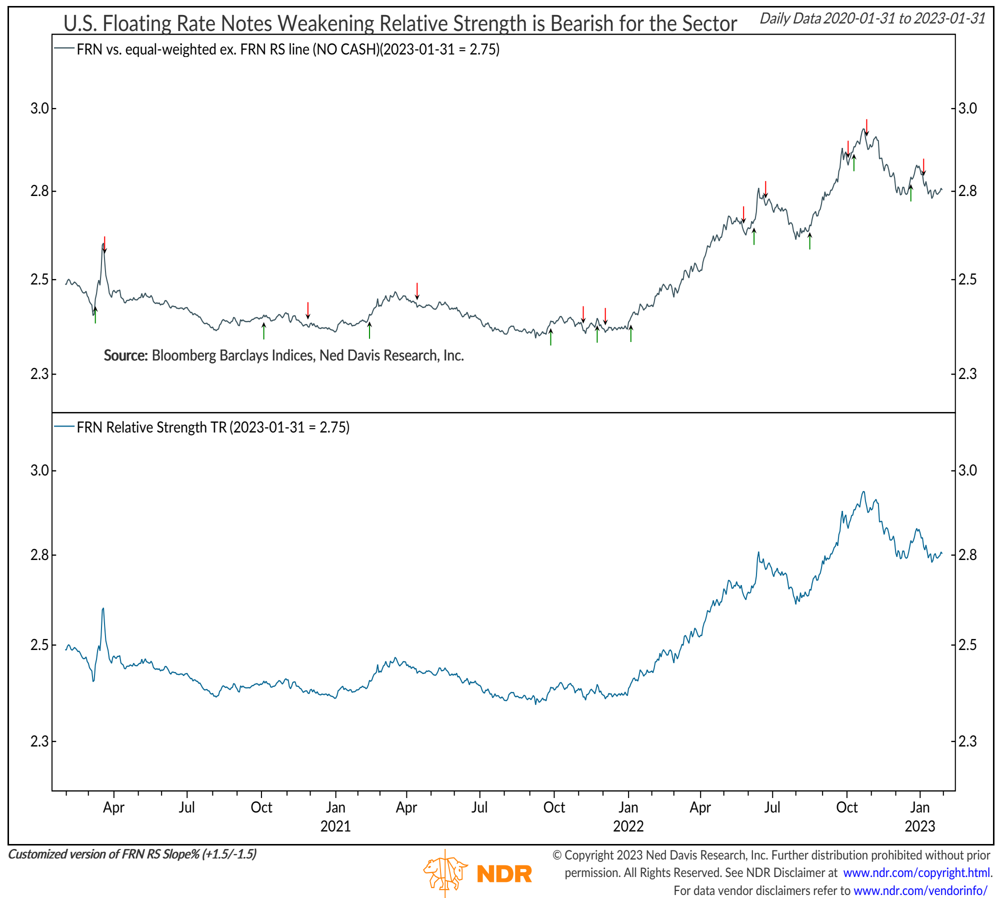
U.S. High Yield also increased in allocation this month and remains overweight. As investors moved back into riskier assets, high-yield bonds gained more than 3% in January. Fundamentals are bullish, including an improving small-cap equity trend (chart right). All technical indicators are bullish, with absolute trend joining the others this past month.

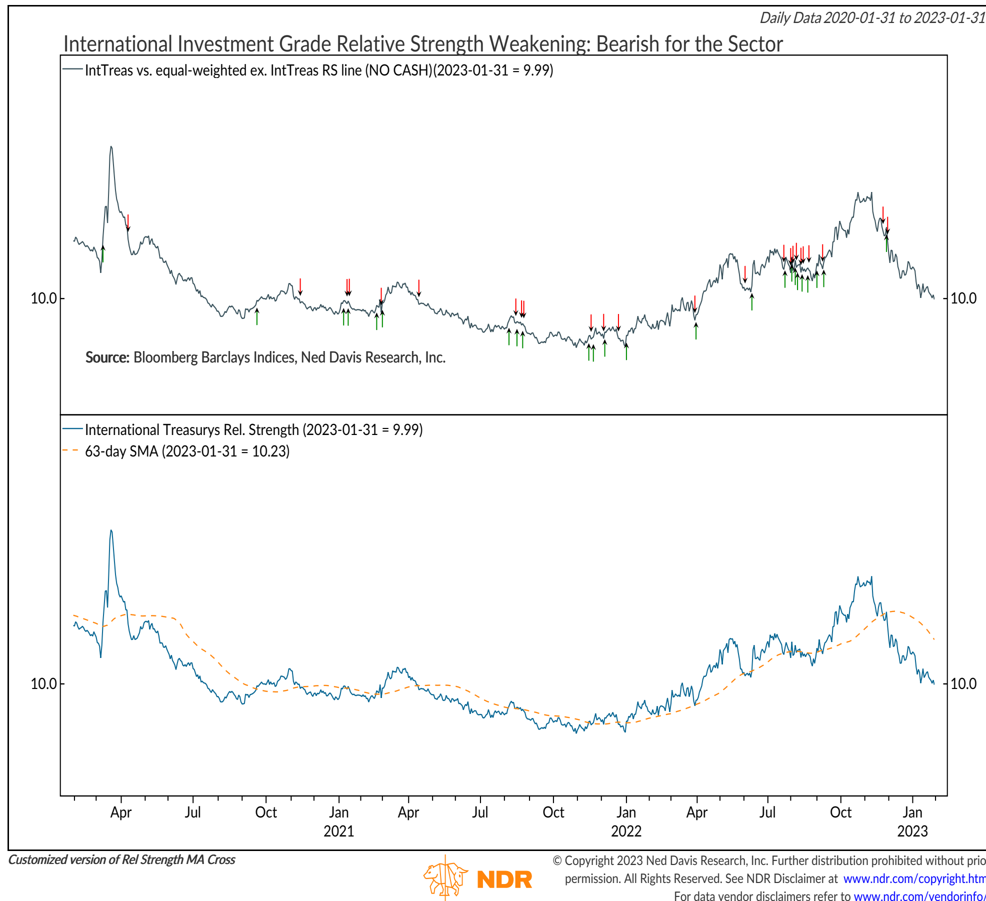




Mortgage-Backed Securities' allocation increased slightly and remained a modest overweight in February. While technical indicators aren't fully confirming yet, the sector's moving average cross flashed a bullish signal (chart left). This was partly offset by high-yield spreads which became bearish for the sector.

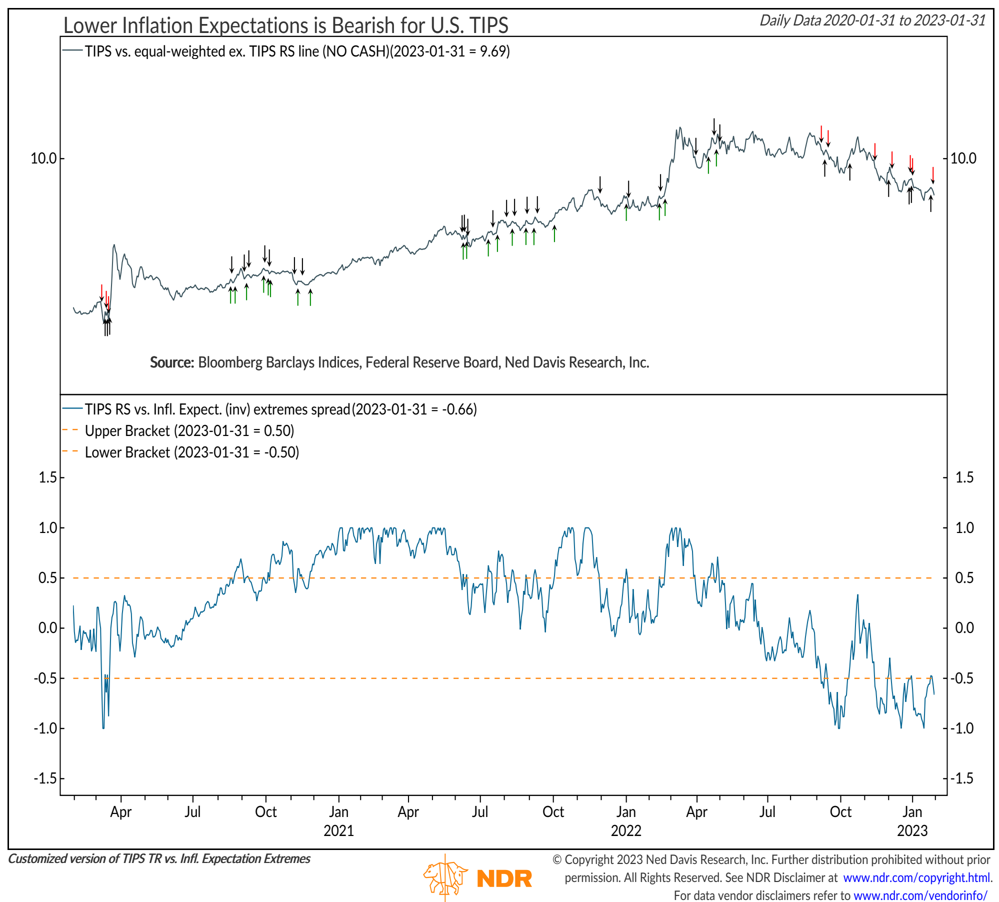
Floating Rate Notes' allocation dropped sharply in February and is now the largest underweight allocation. Floating rate notes typically outperform during a rising rate environment, but yields declined in January. Trend, price momentum, and spreads remain bearish for the sector. Relative strength versus other fixed income sectors deteriorated in January and is now bearish (chart right).

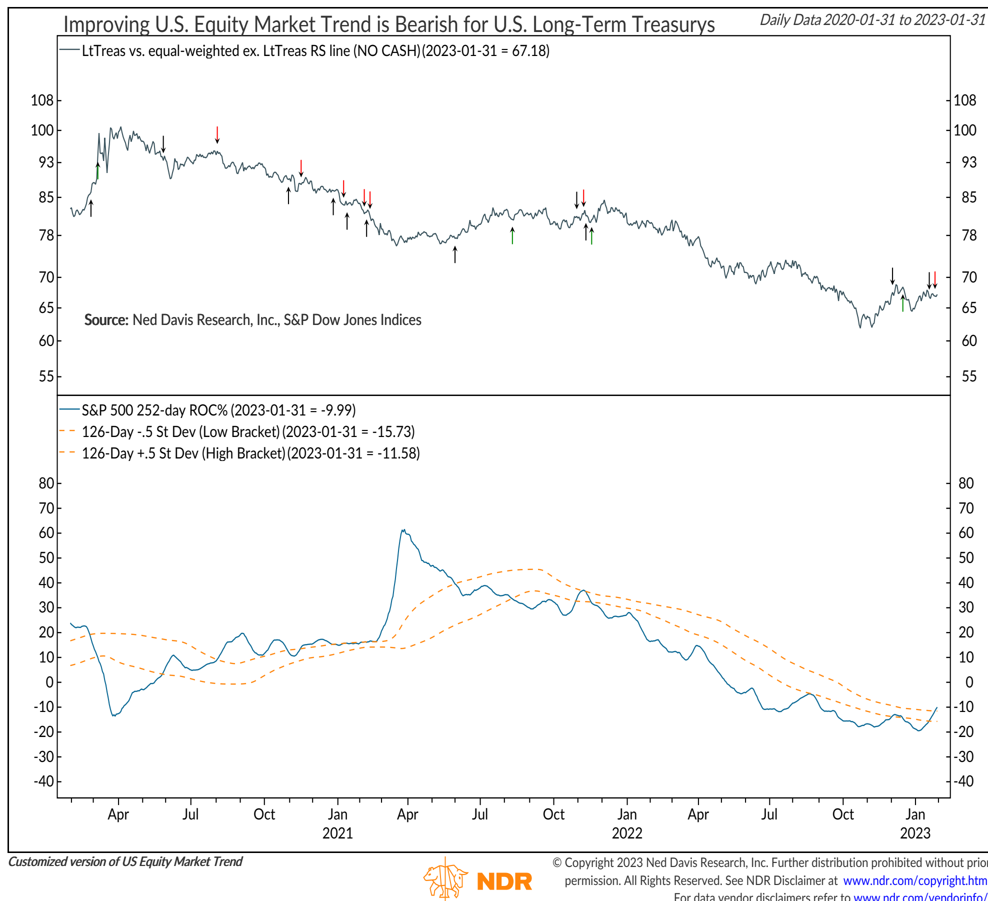




International Investment Grade bonds' allocation decreased and remains at underweight. Most of the fundamental and technical indicators, such as weakening relative strength (chart left), remain bearish for the sector. Only the extreme in 10-year swap spreads is neutral for this defensive fixed income sector.

U.S. Treasury Inflation-Protected Securities' (TIPS) allocation decreased further and remains underweight. Most fundamental and technical indicators are bearish for the sector. TIPS typically outperform during periods of rising inflation. With inflation measures moderating from last year's peak, inflation expectations have also declined, which is bearish for the sector (chart right).





The model's allocation to U.S. Long-Term Treasurys saw a sharp decline in February, moving it from an overweight to a slight underweight. Investors move back into riskier assets in January. As a result, the stronger equity market trend became bearish for this defensive sector (chart left).

Summary

While recessionary evidence was building in January, investors continue to "fight the Fed." As a result, riskier assets—such as investment grade and high yield—saw much stronger performance. A declining U.S. dollar and reopening of China has led to emerging market bond outperformance. Lower inflation expectations have made U.S. TIPS less attractive. Defensive sectors such as U.S. Long-Term Treasurys and International Investment Grade have moved to underweight allocations.

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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) 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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