Market Overview

The US high yield bond market, as represented by the Bloomberg US Corporate High Yield 2% Issuer Capped Index, returned -9.8% in the second quarter.

Taken as a whole, second quarter data began to indicate a material slowdown from the post pandemic growth environment we’ve experienced over these last two years. From a nominal perspective, some areas like retail sales and personal spending indicated that consumer activity continued to grow even as inflation related to food and energy drove the cost of essentials to uncomfortably high levels. Meanwhile, purchasing manager indices, which are calibrated to indicate growth when above 50, have not fallen below that critical level. On the other hand, consumer confidence levels sank to all-time lows, primarily driven by gloomy expectations for the future. Simultaneously, data across a range of measures missed economist expectations by wider margins based on economic surprise indices. All of this points to a serious deceleration. While time will tell if it equates to a domestic or global recession, the risk of one is clearly increasing.

Inflation measures continued to show price increases across a wide range of goods and services. The Producer Price Index (PPI), a measure of the price change in goods as they leave their place of production, grew by more than 10% annualized in May. PPI sometimes serves as a leading indicator for consumer prices as producers pass along higher raw material costs to consumers in future months, which is a cause for concern as consumer prices for May registered a multi-decade high. With several food and energy commodities surging higher into the later part of the quarter, it is possible that headline PPI could increase further.

The Fed has turned its focus entirely to fighting persistent inflation and maintaining an anchor around long-term inflation expectations. A severe decoupling of inflation expectations from the Fed’s stated target of 2% over time could lead to changes in consumer behavior and a greater likelihood of a price-wage spiral. Having already hiked its overnight interest rate from the zero lower bound to a range of 1.50%–1.75%, markets are anticipating seven more 25 basis points Fed hikes to take effect before year end. The actual amount of policy tightening from here will be driven in large part by how the inflation environment unfolds in the coming months. Quantitative tightening has officially begun as well, with the Fed allowing balance sheet holdings of Treasury and mortgage-backed securities to roll off as opposed to reinvesting the proceeds.

Covid is far from gone, but its level of influence on markets has waned as governments attempt to hit the appropriate balance between public health and economic normalcy. A lack of fiscal stimulus will also translate to a deceleration in spending as Covid-era transfer payments are unlikely to reemerge.

Domestic equity markets delivered deeply negative returns across market capitalizations and styles. Historically, defensive sectors such as consumer non-discretionary, utilities and healthcare outperformed, while consumer discretionary and technology sectors fared worse. The strongest performing sector across asset classes has been energy, which is unusual given the growth outlook but reflects the strength of both the commodity complex and operating margins of the sector.
High yield credit spreads were substantially wider. Having drifted from post-Covid averages at the close of the previous quarter, credit sold off aggressively into quarter end as the market repriced higher recession risk. The move wider in investment grade spreads was more moderate and orderly. Performance by rating category within the high yield market was directional, with the move to wider spreads driving negative returns across the credit spectrum. BB rated bonds returned -8.4%, whereas B rated issuers delivered a loss of -10.8%, and CCC rated paper returned -13.0%. Defaults had begun trending higher in the first quarter and continued to do so following several, anticipated defaults. The trailing 12-month default rate doubled to 1.1%, still well below the long-term average of 3.6%. After closing the first quarter with option-adjusted spreads on high yield bonds at 328 basis points, the market waned this past quarter, closing at 570 basis points. For investment grade spreads, the market closed at 155 basis points, wider than the 116 basis points in the prior quarter. The best performing sectors in the Bloomberg US Corporate High Yield 2% Issuer Capped Index were electric utilities (-7.0%), energy (-8.0%) and transportation (-8.2%) while brokers/asset managers/exchanges (-12.6%), finance companies (-11.4%) and consumer non-cycicals (-11.4%) represented the largest laggards.

Performance Review

The portfolio’s return of -8.80% (gross of fees) outperformed the Bloomberg US High Yield 2% Issuer Capped Index return of -9.84% for the quarter.

» Security selection within the consumer cyclical sector boosted results, specifically in the pharmaceuticals industry.

» Security selection within the transportation sector also contributed positively, notably in the airlines industry.

» The portfolio’s underweight to electric utilities, the market’s best performing sector of the quarter, detracted from performance.

» The overweight to consumer non-cycicals, a poorly performing sector, also weighed on performance.

Positioning and Portfolio Changes

Our base case expects further spread volatility and a move to moderately higher interest rates across the Treasury curve for the balance of 2022. We have been looking for low-cost opportunities to migrate portfolio quality higher through senior and secured structures. Additionally, our appetite for credit risk and duration risk have moved closer to parity, given the growing likelihood

<table>
<thead>
<tr>
<th>REPRESENTATIVE PORTFOLIO LARGEST 10 HOLDINGS</th>
<th>COMPANY</th>
<th>COUPON %</th>
<th>MATURITY</th>
<th>PORTFOLIO %</th>
</tr>
</thead>
<tbody>
<tr>
<td>HUB International, Ltd.</td>
<td>7.00</td>
<td>5/1/2026</td>
<td>0.8</td>
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<tr>
<td>Team Health Holdings, Inc.</td>
<td>6.76</td>
<td>2/17/2027</td>
<td>0.6</td>
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<tr>
<td>Sprint Corp.</td>
<td>7.13</td>
<td>6/15/2024</td>
<td>0.6</td>
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<td>Bausch Health Americas, Inc.</td>
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<tr>
<td>CSC Holdings, LLC</td>
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<td>1/15/2030</td>
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<tr>
<td>MALLINCKRODT INTERNATIONAL</td>
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<td>CSC Holdings, LLC</td>
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<td>Jefferies Finance, LLC / JFIN Co-Issuer Corp.</td>
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<td>Petsmart, Inc. / PetSmart Finance Corp.</td>
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<td>2/15/2028</td>
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<tr>
<td>Iron Mountain, Inc.</td>
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<td>3/15/2028</td>
<td>0.5</td>
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<td><strong>TOTAL</strong></td>
<td><strong>6.1</strong></td>
<td></td>
<td></td>
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The information provided should not be considered a recommendation to purchase or sell any security. There is no assurance that any securities presented herein will remain in the portfolio at the time you receive information or that securities sold have not been repurchased. The securities discussed do not represent an account’s entire portfolio and in the aggregate may represent only a small percentage of an account’s portfolio holdings. It should not be assumed that any securities transactions or holdings presented were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities presented herein. Largest 10 Holdings exclude any government/sovereign bonds or broad-based index hedging securities the portfolio may hold. Data as of 6/30/22.

All portfolio positioning and sector information is for a representative portfolio. Please see last page for additional information.
of recession. We extended duration during the quarter, and while we continue to doubt that the above-trend inflation environment will lead to drastically higher interest rates in long-dated maturities, we are maintaining slightly cautious duration implementation.

From an economic sector perspective, the portfolio holds overweight positions in the insurance and consumer non-cyclical sectors. Underweights include communications and consumer cyclicals. Over the course of the quarter, notable sector changes to the portfolio included:

**Transportation.** The team increased the energy sector allocation primarily within airlines.

**Communications.** The allocation to the communications sector was decreased, in both the cable satellite and media entertainment industries.

From a credit quality perspective, we are positioned with an underweight to BB rated issuers. We continue to find out-of-benchmark positions in both leveraged loans and investment grade credit that we believe benefit the portfolio’s construction.

**Outlook**

Risk premia are back. Investors are demanding a higher level of compensation for any level of assumed risk across asset classes and securities, including higher requirements for equity investments in the form of lower multiples, higher spread compensation for credit risk, and higher term premia for duration risks. Some of these shifts were bound to happen as the Fed unwinds years of extraordinarily easy monetary policy as we emerge from the Covid pandemic. And some of these shifts are related to outlooks that expect weaker growth and employment data to start showing up alongside of persistent, generationally high inflation. We expect the uncertainty and associated higher levels of compensation to endure.

The probability of left-tail risk (e.g., a recession, supply chain issues, a return to Covid lockdowns) is increasing along with the median expectation for growth moving materially lower. This calls for a risk-off environment with lower asset prices.
So far, we believe little of the Fed’s activity has transmitted to the real economy. Even if we apply the shortest of historical lags, we are barely three months removed from the first step higher in overnight rates, and even less so from the moves of greater magnitude. However, the market has done a lot of tightening of financial conditions on its own.

Inflation is rotating away from goods and toward services as more consumer dollars are spent on experiences outside the home post pandemic, including travel. This is a negative development from our perspective because goods are largely produced outside the US while services are almost entirely produced and consumed domestically, leading to a greater likelihood of a price-wage spiral.

Additionally, the massive moves higher in shelter components of the Consumer Price Index will continue to play out over the next year as those measurements are gradually included in the calculation. The Fed’s inflation fight is likely to be more difficult and longer than most market participants are acknowledging.

The associated elevated volatility being applied to account for a wide range of potential outcomes is unfortunately here to stay for a while.

Given that economic growth at the aggregate level is all about marginal activity, we also expect real economic growth to roll over much more quickly and prominently than broad market expectations. People in the bottom income quartile have exhausted their pandemic savings and are faced with costs of essentials that are hundreds of dollars a month higher than they were a year ago. Although a technical recession may be avoided, this level of deterioration in economic activity will feel like a recession to many Americans.

We may be near the peak differential between economic data and market outlook. Something will have to give. Our bias is toward economic activity deterioration as opposed to risk assets moving meaningfully higher. Even so, yields have increased significantly, and fixed income securities now offer investors a return for taking these risks. In addition, quality assets should provide more of their traditional risk-mitigated status if a bear case were to occur.