Eagle Quarterly Commentary

EAGLE | Asset Management

Fixed Income

Fourth Quarter | 2022

James Camp, CFA
Managing Director and Portfolio Manager

Joseph Jackson, CFA
Portfolio Co-Manager

Burton Mulford, CFA
Portfolio Co-Manager

Sheila King, CFA
Portfolio Co-Manager

Market Overview[1,2]

The bond market, as measured by the Bloomberg U.S. Aggregate Bond Index, gained 1.87% in the fourth quarter and finished the year down -13.01%. The positive return for the quarter can be largely attributed to November's strong performance as the index gained 3.86% due to a combination of a sharp pullback in interest rates and a tightening of corporate credit spreads. November's exceptional return was marginally offset by negative returns in October and December.

The yield on the benchmark 10-year U.S. Treasury note rose from 3.83% on Sept. 30 to 3.87%, but this quarter-over-quarter comparison does not capture the whipsaw dynamic felt along the U.S. Treasury curve throughout the fourth quarter. The 10-year yield initially spiked in October to an intra-day high of 4.33% before falling to 3.40% in early December and then rapidly rising to 3.87% to close out the quarter. The volatility within the yield curve was a direct result of investors digesting economic data and front-running how the U.S. Federal Reserve (Fed) may alter its monetary policy schedule.

Fed Update and Outlook[1]

Our near-term macroeconomic outlook remains cautious as the setup heading into 2023 has plenty of challenges still in place – mainly the Fed tightening into an economic slowdown with past-peak inflation and the impact that will have on corporate earnings.

Core economic activity has slowed for five consecutive quarters and the simple math of base effects (or "comps") suggests this trend will continue until the third quarter of 2023. Consumers remain stressed, with a lot of the damage from persistent, decades-high inflation having already been done, evidenced by the falling savings rate and record increases in credit card balances. The strain on consumers also is evident across multiple consumer sentiment surveys.

It's also true that the economy has been resilient, mainly because of healthy employment. However, it's a tough proposition to hold out hope for a "soft landing" based on such a historic lagging indicator when several other economic and market gauges are flashing yellow and red. It would essentially require a case to be made that "this time is different." But if ever such a case could be made, now seems somewhat plausible with the labor market having undergone seismic swings as a result of the pandemic and the federal response (i.e., fiscal stimulus). Some evidence suggests that companies are willing to hoard employees due to the difficulty of acquiring and keeping workers over the past two years while some industries remain in a tight labor regime.

For the purposes of our outlook, however, we'll stick with the highest-probability outcome that eventually the labor market will succumb to the economic reality of corporations facing a higher cost of capital and the double whammy of slowing, but still elevated inflation. We believe that means decelerating inflation will crimp revenue and earnings growth since much of that growth has recently been driven by pricing. That said, inflation is not likely to slow fast enough to provide relief for consumers and the Fed, putting further pressure on economic activity.

Adding to the complexity are markets caught up in a game of bad news is good news, hoping for more economic data to confirm the U.S. economy is losing steam faster to give leeway for the Fed to ease back on its rate-hike campaign. However, this sort of game carries significant risks for investors willing to engage because at some point the consensus will realize that recession risk outweighs yesteryear's focus on peak inflation, and bad news will simply be that: bad news.

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For fixed income investors, this macroeconomic setup likely means the worst is over. Historic mark-to-market losses on individual bonds should slowly recover as upward pressure on long-term rates slows and reinvestment begins to capture higher yield levels. More importantly, with yields on bonds at decade highs, and dividend style factors outperforming, the "income" component of the income-investing landscape is markedly improved. Our positioning remains defensive and is ready to take advantage of opportunities as they arise.

As a side note, this time of year typically brings forecasts for the upcoming year. We generally refrain from such endeavors as making 12-month best-guess estimates for year-end "levels" is a dicey proposition in the best of times, and yet speaks nothing to the path that respective markets and securities may take to get to those levels. We would, however, like to highlight some general points about the year we just wrapped up and about what may lay ahead. Pandemics, like famine and war, drive structural aftereffects that flow through society, the economy, and markets long after their immediate impacts abate. Inflation, a byproduct of turbo-charged fiscal and monetary policy responses and public health initiatives aimed at slowing the spread of the virus, is the market death knell of post-financial crisis boundless liquidity. The economic and market transition underway is difficult as all transitions tend to be. However, the reset of the bond and equity markets sets the stage for capital allocations based on fundamentals, not speculation. The destruction of trillions in capital in things like crypto exchanges and non-fungible tokens (NFTs) marks an important inflection point in a capital allocation process based on easy money. We are moving from a liquidity-driven stock and bond market to a fundamentally driven market of stocks and bonds. The economy and capital markets may recede for a period, but the resiliency and "reordering" of the economy sets the foundation for a more productive economy and balanced capital markets.

Corporate Market Review[1,2]

Investment-grade corporate bonds, as measured by the Bloomberg U.S. Corporate Bond Index, gained 3.63% during the quarter, which was the best quarterly return since June 2020, and ended the year down -15.76%. Again, the positive quarterly performance was primarily driven by a stellar November that captured the fall in interest rates and the tightening of corporate credit spreads. The average credit spread for the index tightened 29 basis points during the quarter from 1.59% on Sept. 30 to 1.30%, with a majority of the move happening during November. It then traded within a range in December.

Corporate bonds outperformed all other major fixed-income sectors on a total return basis and outperformed relative to U.S. Treasuries on a duration-adjusted basis. Both government-related securities and securitized products (asset-backed securities and mortgage-backed securities) posted a positive total return during the quarter and outperformed relative to Treasuries.

Municipal Market Review[1,2]

It was a challenging year for all investment markets, including the municipal bond market. A recap of 2022's challenges includes an economic recovery from the COVID-19 pandemic, the breakdown of traditional supply chains, war in Europe, inflation at 40-year highs, and significant fiscal restriction from the U.S. Federal Reserve (Fed). As a result, the Bloomberg Municipal Bond Index was down 8.53% at year end, with the fourth quarter up 4.1%, offsetting some of the negative performance. Despite the heightened volatility last year and the expectation of a recession in 2023, our municipal team is constructive on the municipal bond market in 2023. Internal forecasts anticipate municipal bonds will outperform other fixed income asset classes due to favorable supply and demand technicals, credit strength, and a lack of significant changes in tax policies.

Municipals outperformed the Bloomberg U.S. Treasury Index by 3.93 percentage points, with Treasuries down 12.46% at year-end. Inflation concerns, heightened interest rate volatility, and the Fed raising interest rates resulted in longer-duration municipal bonds experiencing the most pain as investors found safety in short-duration securities. The Bloomberg Long (22+ year) Municipal Bond Index was down 15.58% for the year, with the selloff sending 30-year AAA yields from a 1.54% at the beginning of the year to 3.63% at the end of the year. Municipals down the curve fared better with the 5-year and 10-year indices down only 5.26% and 6.57%, respectively.

Over the quarter, AAA municipal general obligation to Treasury yield ratios were lower across the curve with the 5-year, 10-year, and 30-year ratios 13 percentage points (pp), 18 pp, and 13 pp richer, ending the year at 63%, 68%, and 91%, respectively. Municipal ratios are currently expensive relative to their 5-year averages. They are expected to stay at these tight levels and even continue to rally into 2023 given the seasonal strength of January with elevated redemptions and constrained new issue supply. Total new issuance in 2022 was down 21% from the prior year, totaling $384 billion at year-end, well below the $400 billion to $500 billion forecast by most firms. December issuance was no exception, totaling a minuscule $17.2 billion, down 58% year over year.

The Fed hiked rates seven times last year by a total of 375 basis points, making bond refundings out of the money for most issuers. Due to these higher rates, refunding deals declined by 58% year over year, from $111.7 billion in 2021 to $46.5 billion in 2022. In addition, tax revenues have been strong over the last several years, boosting reserves. That, coupled with leftover federal COVID stimulus aid, has reduced municipalities' need to issue debt. Our municipal team anticipates lighter to flat new issuance in the first quarter of 2023 as the Fed continues to raise rates and as issuers keep fixed costs manageable due to the heightened risks of a recession. Consensus projects higher issuance in 2023 than 2022, but the forecasts are mixed across the municipal market, ranging from $350 billion to $500 billion. Record high municipal issuance was $484 billion in 2020.

Given the volatility in the market last year, investors continued to withdraw money from municipal mutual funds. In the fourth quarter, net outflows totaled $29.2 billion, bringing total net outflows to $120.4 billion in 2022. Market outflows have been partially offset by inflows into exchange-traded funds (ETFs), as mutual fund investors have harvested tax losses by selling out of their funds at a loss and reinvesting the proceeds into ETFs to maintain their municipal exposure while taking advantage of the tax opportunities. Net inflows into municipal ETFs totaled approximately $29 billion last year. With high-grade municipal yields now 200 to 300 basis points higher compared to a year ago, we expect that retail investor demand will accelerate and put upward pressure on municipal bond prices.

Municipal default rates have historically been low, currently at 0.41% (excluding Puerto Rico) in 2022. Credit quality remained healthy in 2022, and we expect this to persist into 2023. We have a positive bias on the state and local government sectors given their healthy level of reserves, as well as strong financial governance. As noted earlier, most state and local governments went into the pandemic with strong reserves and, combined with the additional federal pandemic aid, now have significant cushions. We remain overweight both the water and sewer sector as well as electric, given the essentiality of both sectors. Sectors we are closely monitoring include healthcare and higher education. U.S. not-for-profit hospitals and healthcare systems have experienced significant margin compressions due to higher labor and supply costs that have been a drag on earnings. The one-time federal stimulus funding during COVID-19 has tapered off. While these funds provided short-term relief, they likely will not be enough to offset the broader structural mismatch of revenues and expenses. Like the hospital sector, higher education also is experiencing an increase in expenses as schools return to normal operations, leading to operating deficits for a growing number of institutions. To the extent a recession could materialize in the latter half of 2023, this could further pressure financial performance. Monitoring of municipal credit quality is a top priority of our credit team, and we will monitor these sectors and others, making adjustments in our holdings as necessary. At this time we are underweight in both the hospital and higher education sectors, with an emphasis on high credit quality in the bonds we own in those sectors. While last year brought its challenges, we believe big things are possible in 2023.

1. References to specific securities are intended to illustrate the types of securities Eagle may hold in this portfolio. They are not intended as representations of specific investment recommendations that would have been profitable to an investor. Past performance is not a guarantee of future results. Opinions and estimates offered constitute Eagle's judgment and are subject to change without notice as are statements of financial-market trends, which are based on current market conditions. Investing involves risk, including the possible loss of principal.

2. Sources: Investor Tools Perform and Yield Book

Investing in bonds involves risks that may adversely affect the value of your investment such as inflation risk, credit risk, call risk, interest rate risk, and liquidity risk, among others. The two most prominent factors are interest rate movements and the credit worthiness of the bond issuer. Investors should pay careful attention to the types of fixed income securities that comprise their portfolios and remember that, as with all investments, there is the risk of loss of capital. A Real Estate Mortgage Investment Conduit (REMIC) is a type of multiclass mortgage-related security in which interest and principal payments from mortgages are structured into separately traded securities. These classes are distinguished by their sensitivity to the prepayment risk of the underlying mortgage-related collateral. Therefore, they may be more or less sensitive to prepayment risk, bear different interest rates, and have various average lives and final maturities.

Investment grade refers to fixed-income securities rated BBB or better by Standard & Poor's or Baa or better by Moody's. Convertible securities and preferred stock combine the fixed income characteristics of bonds with some of the potential for capital appreciation of equities and, thus, may be subject to greater risk than pure fixed-income instruments. Unlike bonds, preferred stock and some convertible securities do not have a fixed par value at maturity, and in this respect may be considered riskier than bonds. Convertible securities may include convertible bonds, convertible preferred stocks and other fixed-income instruments that have conversion features.

Investments in high-yield bonds and convertible securities are subject to the client's authorization, as set forth in the Investment Management Agreement. Such investments may be subject to greater risks than other fixed-income investments. The lower rating of high-yield bonds (less than investment grade) reflects a greater possibility that the financial condition of the issuer or adverse changes in general economic conditions may impair the ability of the issuer to pay income and principal. Periods of rising interest rates or economic downturns may cause highly leveraged issuers to experience financial stress, and thus markets for their securities may become more volatile. Moreover, to the extent that no established secondary market exists, there may be thin trading of high-yield bonds, which increases the potential for volatility.

A credit spread is the difference in yield between a U.S. Treasury bond and another debt security with the same maturity but different credit quality. Also referred to as "bond spreads" or "default spreads," credit spreads are measured in basis points, with a 1% difference in yield equaling a spread of 100 basis points. Credit spreads reflect the risk of the debt security being compared with the Treasury bond, which is considered to be risk-free. Higher quality securities have a lower chance of the issuer defaulting. Lower quality securities have a higher chance of the issuer defaulting.

A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity.

Front-running is trading any financial asset based on knowledge of a future transaction or development that will substantially affect the price of the asset.

Basis points (bps) are measurements used in discussions of interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

Securitized products, such as asset-backed securities (ABS) and mortgage-backed securities (MBS), are created by pooling loans from a variety of sources and issuing bonds that are backed by these loans. Creditworthiness stems from the credit quality of the underlying loans, as opposed to corporate bonds in which creditworthiness is derived from the earning power of the issuing company. The primary risk of these securities is interest-rate risk. Rising interest rates might cause loan principal prepayments to slow, resulting in less available principal to invest at prevailing higher rates. Conversely, rate decreases might accelerate prepayments, leaving more dollars to invest at lower rates.

Total return, when measuring performance, is the actual rate of return of an investment or a pool of investments over a given period of time. Total return includes interest, capital gains, dividends, and distributions realized over the specified period. Total return accounts for two categories of return: income including interest paid by fixed-income investments, distributions, or dividends and capital appreciation, representing the change in the market price of an asset.

Duration incorporates a bond's yield, coupon, final maturity and call features into one number, expressed in years, that indicates how price-sensitive a bond or portfolio is to changes in interest rates. Bonds with higher durations carry more risk and have higher price volatility than bonds with lower durations.

A consensus estimate is a forecast of a public company's projected earnings, the expected findings of a macroeconomic report, or an expected economic trend over time based on the combined estimates of analysts and other market observers who track the stock or data in question.

Mark to market is a method of measuring the fair value of assets, liabilities, or other accounts that can fluctuate over time. Mark to market strives to provide a realistic appraisal of a company or institution's current financial circumstances based on current market conditions. During volatile markets, however, mark-to-market measurements may not accurately represent an asset's true value in an otherwise orderly market.

Defensive securities provide consistent, stable returns regardless whether an overall capital market is rising or falling. Companies with securities considered to be defensive tend to have a constant demand for their products or services and thus their operations are more stable during different phases of the business cycle.

An NFT, which is short for non-fungible token, is a unique cryptographic asset, including images, other works of art, or property rights, on a blockchain with unique identification codes and metadata that distinguishes it from any other asset and ensures that it cannot be replicated.

Technicals refers to technical indicators of historic market data, including price and volume statistics, to which analysts apply a wide variety of mathematical formulas in their study of larger market patterns.

A municipal to Treasury ratio is a comparison of the current yield of municipal bonds, such as AAA municipal general obligation bonds, to U.S. Treasuries. The ratio is used to assess whether the municipal bonds in question are an attractive buy in comparison to Treasury bonds.

Out of the money describes an investment transaction with no intrinsic value, resulting in an investor either overpaying for the investment or being underpaid for what they put into the instrument.

Fund flow is the net of all cash inflows and outflows into and out of a particular financial asset. It typically is measured on a quarterly or monthly basis. Investors and others look at the direction of fund flows for indications about the health of specific securities and sectors or the overall market.

An exchange traded fund (ETF) is a type of security that tracks a market index, sector, commodity, or other assets, but which can be bought or sold on a stock exchange the same way a regular stock or other security can. An ETF can be structured to track a wide variety of securities, including stocks, bonds, individual commodities, diverse aggregations of securities, and specific investment strategies.

Margin compression is what happens when input costs rise faster than the sale price of a product. As a result, the producer's profit margins decline over time.

The Bloomberg U.S. Aggregate Bond Index is composed of the total U.S. investment-grade bond market. The market-weighted index includes Treasuries, agencies, commercial mortgage-backed securities (CMBS), asset-backed securities (ABS) and investment-grade corporates. The inception date of the index is Jan. 1, 1976.

The Bloomberg U.S. Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market.

The Bloomberg Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market.

The Bloomberg U.S. Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

The Bloomberg Municipal 5-Year Bond Index is an unmanaged index comprised of investment-grade municipal bonds with maturities of four to six years.

The Bloomberg 10-Year Municipal Bond Index is an unmanaged index comprised of investment-grade municipal bonds with maturities of eight to 12 years.

The Bloomberg Long (22+ Year) Municipal Bond Index is a rules-based, market-value-weighted index comprised of investment-grade municipal bonds with maturities of more than 22 years.