# Eagle Quarterly Commentary

EAGLE Asset Management

## Vertical Income Portfolio

Fourth Quarter | 2022


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### Market Overview[1]

Investment-grade corporate bonds, as measured by the Bloomberg U.S. Corporate Bond Index, gained 3.63% during the quarter – the best quarterly return since June 2020 – and ended the year down -15.76%, the worst annual return since the index's inception in 1973. 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 from 1.59% on Sept. 30 to 1.30% at the end of the quarter. Investment-grade credit spreads peaked at 1.65% on Oct. 12 before rapidly tightening into the end of the year with a majority of the tightening – a change of -16 basis points – taking place in November.

The yield on the benchmark 10-year U.S. Treasury note rose from 3.83% on Sept. 30 to 3.88%, 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%, fell to 3.40% in early December, and then rose rapidly to 3.88% to close 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.

### Portfolio Allocation Review[1,2]

We believe the allocation changes made within the Vertical Income Portfolio over the course of the year have provided us with appropriate positioning heading into 2023. Throughout the year, we took a relatively defensive approach compared to the benchmark and ended with an underweight to corporate bonds, equities, and preferred securities. On a year-over-year comparison, we've reduced our combined weight to common stocks and preferred securities by 16.1 percentage points. With those proceeds, we allocated 14.1 percentage points to corporate bonds to benefit from the enhanced yield landscape and added 1.9 percentage points to our cash and cash equivalents position.

We increased cash and cash equivalents by nearly 100 basis points in the fourth quarter and continue to hold short-term U.S. Treasury bills to benefit from an incremental yield pick-up over cash. The U.S. Treasury bill provides us with a reasonable income stream relative to other fixed-income securities and is highly liquid, so we can use it as dry powder when opportunities present themselves. We expect to draw down our cash and cash equivalents position nimbly in the new year.

### Outlook

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 resulting 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 in the form of 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 so as 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 just that: bad news.

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 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 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 turbocharged fiscal and monetary policy responses and public health initiatives aimed at slowing the spread of the virus, is the market death knell of the post-financial crisis era of 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.

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.

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The product described is a separately managed account with fixed-income components and is subject to interest-rate risk, inflation-rate risk and may experience a loss of principal. Other products may be more appropriate, depending on your investment needs. As with all investing, there is the risk that an unexpected change in the market or within the company itself may have an adverse effect. As with all investments, there is the risk of the loss of capital. High-yield securities may be subject to greater risk than pure fixed-income instruments.

Equity Income investing is based upon the identification of companies that possess both moderate growth rates as well as higher-than-average and consistent dividend distributions. There are risks associated with dividend investing, including that dividend-issuing companies may choose not to pay a dividend, may not have the ability to pay, or the dividend may be less than what is anticipated. Dividend-issuing companies are subject to interest rate risk and high dividends can sometimes signal that a company is in distress. Historically, dividend yields have been relatively constant and therefore have created a cushion for investors when stock prices have declined. However, there is the risk that a company will not achieve its expected earnings results, or that an unexpected change in the market or within the company will occur, both of which may adversely affect investment results. The biggest risk of equity investing is that returns can fluctuate and investors can lose money. Investment-grade refers to fixed-income securities rated BBB or better by Standard & Poor's or Baa or better by Moody's.

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.

Definitions

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. 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.

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%.

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.

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.

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.

Dividend factor investing is a strategy that seeks to invest in companies that pay out dividends and considers a company's dividend yield, ability to grow and pay dividends over time, and dividend payout ratio, or the amount being paid out to shareholders in the form of dividends versus how much income the company retains.

A non-fungible token, or NFT, 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.

Indices

The Bloomberg U.S. Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. The inception date of the index is Jan. 1, 1973.

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