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Webcast Summary

2Q22 Market & Strategy Update

The unexpected invasion of Ukraine by Russia changed the investment landscape significantly, introducing new geopolitical uncertainty and elevated volatility that continue to dominate markets. At the same time, risks to global growth and inflation that were in place before the invasion were exacerbated further. Central banks overall have turned more hawkish in an effort to tame rising global inflation, though we expect inflation to moderate later this year. We believe global growth will downshift yet remain resilient. Given this view, we will continue to overweight certain high-quality spread products.

Market Review

- The Russia/Ukraine conflict poses massive geopolitical uncertainty, elevating both inflation and downside growth risks.
- Covid continues to bedevil global populations, but is transitioning from pandemic to endemic. Given the decline in global cases, it appears this incredible medical challenge is receding.
- Elevated inflation, spiking commodity prices and stagnant wage growth (personal income is actually lower now than in 2020) is putting a lot of pressure on real disposable income and consumption rates.
- Consumer sentiment is at its lowest level since the global financial crisis in 2008 or the recession in 1981.
- Goods prices have been very elevated (boosted by demand during Covid-induced shut-ins), but is already starting to moderate.
- Although Federal Reserve (Fed) Chair Jerome Powell revised down the estimate for 2022 US growth from 4.0% to 2.8%, the strong labor market should be able to handle the withdrawal of Fed accommodation.
- Given the elevated inflation levels and Powell's acknowledgement that his forecast increased by a couple of tenths of a percent in January, the Fed has turned decidedly hawkish, raising rates in March.

Inflation

- Elevated global inflation was exacerbated, perhaps somewhat artificially by the pandemic, and further by the Russian invasion of Ukraine.
- Central banks, which were unable to achieve their inflation targets for many years (Japan for 30 years, Europe for 20 years, the US for 10 years) continue to face the same persistent headwinds of debt, aging demographics and technological displacement.
- Over time, central banks' tightening to combat inflation will also serve as an impediment to global growth.
- Higher inflation around the world is putting significant pressure on wages and consumers, not the least of which is energy inflation that has been intensified by the Russia/Ukraine conflict.

US Economic Outlook

- We expect to see a moderation in both growth and inflation in the second half of 2022.
- With the Fed's more hawkish rhetoric this year, and its 25-basis point (bp) hike in March, we now expect a 50-bp hike at the Fed's next meeting in May, but realize this is not a sure thing given the geopolitical uncertainty.
- The flattening of the yield curve is a warning signal, and should inflation begin to slow, we might expect the Fed to take caution before hiking aggressively.
- Housing prices are way up, due partly to tremendous demand during the pandemic as people left cities for suburbs. The pent-up demand is being addressed by increasing supply, and should help attenuate the price pressures.
- There is tremendous upward pressure on wages as people (perhaps up to a million individuals) returned to work after the height of the pandemic. Moving forward, this should be a powerful force to help keep wage inflation in check.

Global Economic Outlook

- The global economy could see slower growth as many growth forecasts have come down while inflation forecasts have gone up.
- After a rapid bounce, global growth is slowing due to lower real disposable income; downside risks are higher in Europe given the Russian invasion of Ukraine.
- Japan remains firmly entrenched in the accommodative camp despite the global hawkish shift. Inflation rates in Japan are likely to remain subdued.
- China is trying to remain supportive of Russia without violating the West's sanctions. Its 5% growth target at the beginning of the year now looks ambitious. Lower inflation gives China the ability to ease policy and we believe it has the tools to get growth back on track but that will likely take time and effort.

Investment Themes

- **Spread sectors:** All sectors have seen negative excess returns YTD with the exception of non-agency residential mortgage-backed securities (NARMBS). Higher rates and wider credit spreads have significantly improved valuations.
- **Investment-grade:** Valuations are sharply higher and high-quality short- to intermediate-term debt looks attractive. The US remains the largest credit market with the most yield (vs. Japan, the EU, the UK and Asia). Hedging costs also remain low for international investors.
- **High-yield:** The quality of the high-yield market has improved significantly, but risks of a policy mistake from the Fed threaten the progress made. Many names downgraded from investment-grade during Covid are finally on the verge of being upgraded.
- **Bank loans:** We are seeing strong demand with rates rising given the floating-rate structure. Collateralized loan obligation (CLO) managers are also keeping demand strong. We continue to be constructive on bank loans.
- **Structured product:** We have been underweight agency mortgages and will continue to remain underweight. Agencies are under pressure from the Fed given the end of QE and dawn of QT. If we enter a lower-volatility environment we would likely reduce our underweight.
- **Emerging market (EM) debt:** The landscape has changed in a spectacular way. The backdrop of a broadening global recovery and dissipating Covid bode well for EM. The Russian invasion of Ukraine and higher commodity prices are forcing countries with limited means and lower disposable incomes to

lower their growth expectations. Commodity exporters benefit from higher prices while importers face acute challenges.

Q&A Highlights

- Inflation has clearly been more persistent than we or the Fed expected. We acknowledge the outlook has deteriorated, and the market has repriced to a bearish inflation outlook. This is not demand-driven inflation, but rather driven by supply shocks.

- The level of global debt is a headwind for growth; however, the Fed is unlikely to feel constrained in raising rates even given the high US debt service costs.

- The yield curve continues to be a useful predictor, even considering how much debt is on the Fed's balance sheet. Multiple past examples of reasons to ignore the curve's behavior have proved incorrect. The reality is that the curve has a stronger record as a predictor than does the Fed.

- It will take time for long-term inflation rates to return to their pre-Covid levels, but the backdrop for fixed-income is attractive. We have been in a declining-rate environment for decades but there is always demand globally to generate income in a safe and risk-efficient manner.

- We expect to see a substantial number of fallen angels upgraded before the end of the year. Our credit team has a timeline for each and every credit. Rating agencies are notoriously slow in making changes, but we don't wait for the agencies, rather we try to forecast changes before they happen.