



2023 Outlook

HAPPY NEW YEAR.

I could not be happier to wave goodbye to 2022, and I am very excited about 2023.

As in the past, I have asked my investment partners to commit time to thinking about key themes as well as underlying opportunities and risks in their respective focus areas for the year ahead. I am pleased to share the views of the Smith Capital Investors team and encourage your ongoing engagement with our entire team in the coming year. 2023 promises to be another exciting year for investors, one that will again require great discipline with a keen focus on active management.

From my end, I wish I could share that we are going to enter an easier market than what we experienced in 2022, but I don't believe that to be the case. Fortunately, the return profiles for fixed income are dramatically better than where we started last year. The proverbial math behind the market leads me to believe that this is going to be a much better year in fixed income than the horrendous 2022, but there are many risks on the horizon.

I still anticipate high levels of volatility and significant uncertainty. At the core of our outlook is a view that the economy is going to slow but not fall off a cliff. Lindsay covers this well in her "Macros, Rates, and Curves Outlook" piece. I think the risk of the growth outlook worsening as the year progresses is high and anticipate periods where the market defaults to a view that the Fed has once again blown it. I am reminded that predicting recessions is not an easy business, however paying close attention to the direction of the economy always yields better decisions. If the growth trajectory changes significantly from the consensus, the bond market may prove to be a safe haven for investors.

I believe that rate volatility could subside in 2023 but will be met with higher levels of volatility in credit and securitized markets. Valuations have adjusted but still have risks to the downside. Eric, Jonathan, and Garrett all highlight this in their writings. As we move into a new stage of the cycle, possibly away from the Fed-centric market of 2022, I believe we will turn from high levels of focus on inflation to more focus on growth. The emphasis will be more about a slower growth trajectory and outlook and less about inflation as the year progresses. If I am wrong, I will likely be wrong in my views on interest rate volatility declining.

One of my biggest concerns for fixed income investors in 2022 is still alive in 2023. Many asset allocators are still underweight and/or short duration. While this was absolutely the right positioning in 2022, the underlying hatred of the bond market needs to be reconsidered post the significant backup in yields and spreads. Yield has returned to the market and durations have come down reflecting basic bond math. We see many examples of positive real rates across the

yield curve making the market much more interesting. The new spread environment has absolute yields looking attractive on a historical basis as is discussed by both Jonathan and Garrett. These new yields could be the source of money finding its way back to fixed income as investors embrace the new return profiles and seek shelter from the volatility of other markets. The world still needs yield.

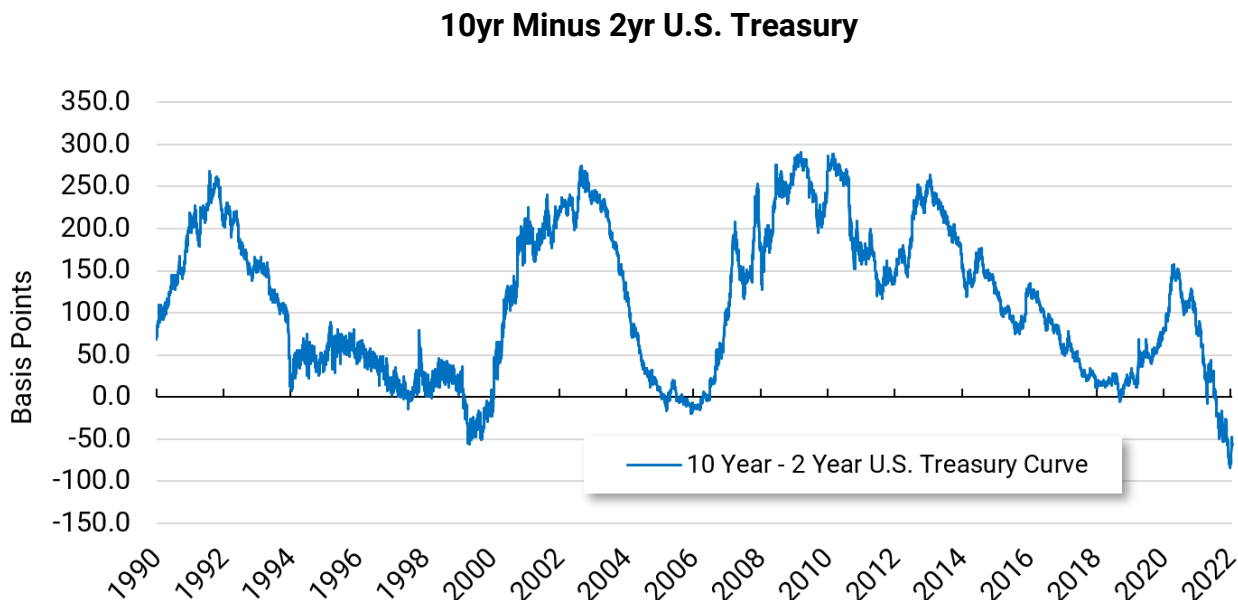
Something we don't cover in detail is the correlation between bonds and stocks, which should be on every asset allocator's mind. The strong positive correlation in a Quantitative Easing world makes a lot of sense to us. As we transition to a new environment of Quantitative Tightening, one should anticipate that relationships and correlations could change and change significantly. While hard to predict, this is worth some serious consideration. Flashbacks to 2019 sit firmly in our minds.

I close with the things I think we must get right in 2023. As part of our process, we commit a lot of time to discussing and diagnosing where we should be committing our focus and energy, and five key areas stand out to me. I am confident these areas of focus will change as the year progresses, but I think that getting these right will be a source of alpha and can provide a smoother ride in what promises to be another volatile and highly uncertain year in fixed income.

Five key areas I think we must get right in 2023

1. Yield Curve Management

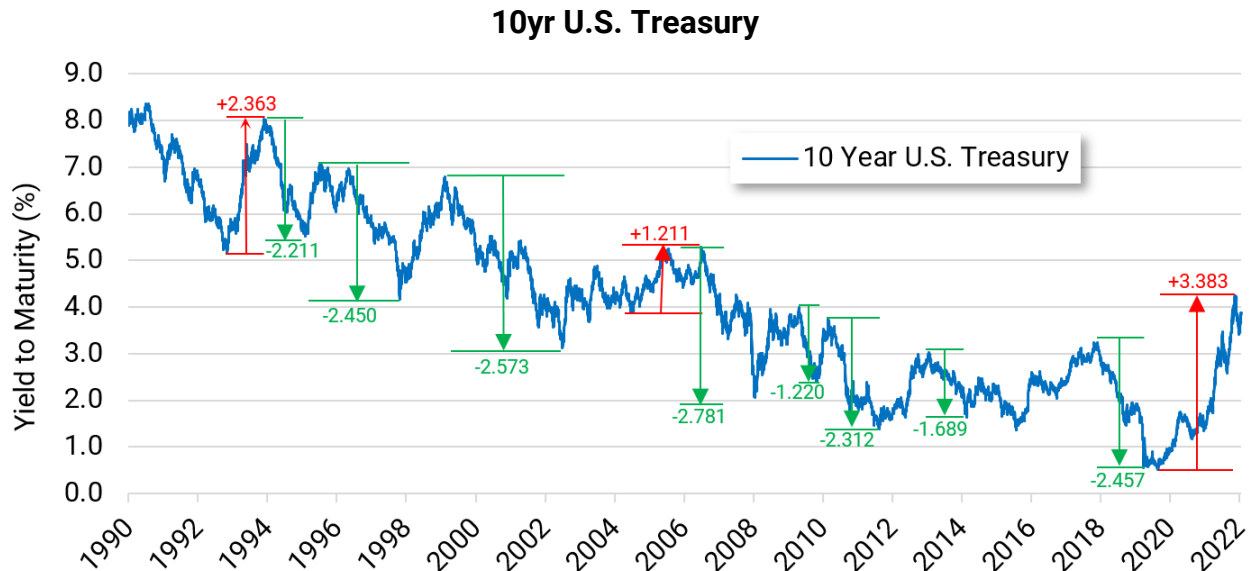
The significant yield curve inversions of 2022 should start to normalize as the Fed pauses in further raising front end rates. We will also have to contend with the next stage of tightening—the reduction of the balance sheet. Getting the yield curves right is an important focus in 2023. The historical reminder is that yield curve normalization can be quick and violent as the graph below shows us.



Source: Smith Capital Investors, Bloomberg, 1/9/2023

2. Duration Management

Over the 35 plus year bull market in bonds, I remind investors that it was not an easy bull market. There were multiple 150–250 basis point changes both up and down. The recent correction in yields has proven to be one of the more significant ones as investors wrangled with policy tightening and a significant change in inflation and inflation expectations. Understanding these cycles and getting the duration positioning right will prove to be extremely important in 2023. There will be times to be long duration in portfolios and other periods to be short. The free ride for long duration passive investing is over and presents a new risk to fixed income investors. (Me checking my bias at the door.)



Source: Smith Capital Investors, Bloomberg, 1/9/2023

3. Sector/segment management/rotation

Eric, Jonathan, and Garrett all touch on this. The repricing of fixed income in 2022 has wiped out much of the significant differentiation across segments of the fixed income markets. The most glaring example is the duration adjustment in mortgages moving from 1.5 years of duration to over 6.0 years in 2022. The yield and duration differentials between credit and mortgages have largely normalized, making allocations to these markets a critical component of generating returns in 2023. Our bearish positioning in mortgages for most of 2022 is being reconsidered. While getting allocations to both MBS and Credit right in 2023 is important, security selection in these markets will be critical too. Lastly, our use of out of index positioning effectively could prove to be the special sauce in 2023.

4. Correlation

A new awakening is happening on the correlation front. I mentioned this earlier but understanding the relationship between stocks and bonds could prove to be one of the most important active decisions for asset allocators in 2023. This has significant implications for fixed income investors. A break or reduction in the positive correlation between stocks and bonds in 2023 will have broader implications around flows for fixed

income than I believe many understand. Stay tuned for more thoughts on this in the near future.

5. **Interaction of global monetary and fiscal policy and geopolitics**

Keeping this short, we believe that understanding the damaged US/China relationship is critical in 2023. I have frequently referred to this as the healthy dysfunctional relationship that keeps the global economy rolling, but new tensions and the wake-up call that the covid period provided the United States will have significant implications around this relationship. This may be a focus for the next decade, but I believe that having a deeper understanding and attention around how this is evolving is critical to managing fixed income money. Grasping this and positioning around the changes will be important in 2023 and beyond.

I close with a consideration that we have been discussing as a team. We call it the “Front-End Yield Trap”. In an environment where yield curves are significantly inverted, investors are given the opportunity to take advantage of higher yields on shorter duration/maturity assets. We think it makes a ton of sense to find the highest yield and lowest risk opportunities in the front end of the market. However, we see a growing group of investors with a solid appetite for yield wanting to take advantage of this opportunity and putting all their eggs in one basket. We don’t want to lose sight of the reasoning behind this outcome—markets believe that there is a weaker economic outlook and a lower inflation environment on the horizon. Significantly inverted yield curves tell the story clearly. In a world that still needs yield, the draw to the front end is logical, but let’s not lose sight that duration is a recession’s best friend and yield is just one element of total return. I am not suggesting that a long duration positioning is the right approach right here and right now, but I urge you to not fall victim to the “Front-End Yield Trap” and to reconsider the math behind the market when thinking about your fixed income allocations. More on this as the year progresses.

I am always appreciative of your time and entrusting your assets to our firm. We take the responsibility and accountability behind our relationship very seriously and aspire to be a great partner to you and your teams. As a young firm with a lot of experience behind it, we are constantly looking for ways to improve. Without a question, we will be focused on performance in 2023, but we ask, in the vein of wanting to be a great partner, that you please guide us on how we can best serve you in 2023.

Thank you and let’s make 2023 the best year of our lives!

Now onto the really smart folks—my teammates.

A handwritten signature in cursive script, appearing to read "Lillem".

Key Themes for 2023

Macro, Rates, and Curve Outlook: Lindsay Bernum, Head of Macro and Rates

Lindsay covers a number of related themes including growth and the potential of avoiding a recession, the uneven economy, a Fed hold frustrating the market, slowing of inflation, the belly sympathetic with a long end that reflects recession fears, and an expected curve steepening as the front end starts pricing in a recession. [READ THIS](#)

Mortgage-Backed Securities and Preferred Outlook: Eric Bernum, Portfolio Manager

Eric looks at the MBS outlook through the lens of ongoing QT headwinds, housing fundamentals, valuation moves, and the importance of security selection. His Preferred outlook focuses on relative value vs. other yield products, headwinds to corporate fundamentals, and thesis-based investing. [READ THIS](#)

Investment Grade Credit: Jonathan Aal, Portfolio Manager, IG Credit

Jonathan explores possibilities around sector dispersion, slower growth, earnings vulnerability, and spreads versus yields. [READ THIS](#)

High Yield and Leveraged Loans: Garrett Olson, Portfolio Manager, HY Credit

Garret explores opportunities to generate strong risk-adjusted returns, the potential for default rates to remain low, attractive valuations in high yield with vulnerability in leveraged loan markets, and the need to consider both yield and spread valuations. [READ THIS](#)

Trading: Zach Tucker, Head of Trading

Zach focuses on the continuation of an ongoing theme over the last couple years, that of traders seeking liquidity. [READ THIS](#)

Macro, Rates, and Curve Outlook

Lindsay Bernum, Head of Macro and Rates

Macro

After the Fed raised rates over 400bps in 2022 and will likely take the Fed Funds Rate to a terminal level above 5% in 2023, we expect the Fed to pause and allow monetary policy to work its way through the real economy. Much to the surprise of the market, the economy absorbed the rapid pace of hikes shockingly well, and we believe the economy is actually in a position to walk a thin but strong line avoiding recession. This is not to say that we won't see sector specific softening/recession tendencies, but overall, we expect the consumer to remain in a position of strength and growth to mark modestly positive.

Housing and manufacturing, both beneficiaries of the pandemic, will remain depressed in 2023 due to the impact of higher rates slowing demand. We expect housing to start to normalize with a modest amount of relief from mortgage rates and continuing tight supply. Manufacturing spent much of 2022 working through supply chain-related disruptions, and we now expect normalization and a slowdown at this point due to demand softening. When we look back on the square root impact of the pandemic, after a dramatic decline and quick recovery, we expect to

return to the pre-pandemic trend.

We expect the consumer to be fragile but overall resilient in 2023. Though we acknowledge that employment is a lagging indicator, the consumer continues to have opportunities for employment as well as strength from wages, savings, and credit to utilize. The consumer showed us that they have options, shifting from goods in the pandemic to services in the recovery, and 2023 will see inflationary pressures starting to ease with the consumer being the beneficiary.

Speaking of inflation, the unwind is beginning. Inflation rose quickly and seemed sticky, but it is now expected to rise at a slower pace. The combination of normalization and the rebasing effect is expected to bring Core CPI down to the high 3% YoY level and Core PCE into the mid 3% range in 2023. While not technically achieving the Fed's 2% target, at a minimum, we will be moving in the right direction.

We expect the market to continue to push on the Fed, and therefore volatility will remain. Avoiding a recession will give the Fed the upper hand, however, the market wants to see a dovish Fed emerge and will push for the "pause and pivot" view that plagued most of 2022.

If the pandemic has taught us anything, it is to expect the unexpected. There will be winners and losers as we near the end of this cycle.

Rates and Curve

The move from Treasuries in 2022 was reminiscent of the 1994 correction. While painful to live through, the economy accepted the tightening of financial conditions relatively well all things considered. Our mantra was "Don't Fight the Fed" as volatility was ever present. To add insult to injury, the market fought the Fed every step of the way. 2023 may prove more rational as the Fed is nearing the terminal level and is expected to pause as the economy, more specifically inflation, is expected to normalize. While the market will desire a pivot, it will likely accept the pause, because a pause will remove a degree of uncertainty from the equation.

Over the last 20 years, the market has been conditioned with low rates and ample liquidity. We expect the market to push this agenda again in the background, which will first reprice the 10-year and 30-year U.S. Treasury (similar to recent price action) on recession fears and then cause a repricing of the front end in the hope of a pivot. This would take us from the 2022 curve inversion to a flat curve then onto the curve steepener—similar to previous periods.

As we experienced during the pandemic and recovery, market cycles are much faster, and the market tends to, or at least attempt to, front-run the Fed. We expect a similar sentiment in 2023 as the market pushes on the Fed and the Fed pushes back causing quick repricing within Treasuries. Volatility will initially remain high until we settle into an acknowledgment that growth is limping along, that the Fed is holding at the terminal level, and that inflation is subsiding. At that point, we will move between the market pricing in recession fears and the market accepting low growth. We believe we marked the high yields on Treasuries in 2022, and 2023 will provide ample opportunities in the fixed income space across the curve.

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Mortgage-Backed Securities and Preferred Outlook

Eric Bernum, Portfolio Manager

Mortgage-Backed Securities

2022 will go down in the history books as one of the toughest years on record for Agency MBS. Valuations coming into the year were on the tighter end of long-term ranges and were skewed by the effect of the massive Fed QE intervention in the market. Interest rate volatility spiked to decade highs and stayed elevated. The Fed flipped directions and began its QT run off for MBS holdings. Home price appreciation (HPA) began to roll over. And as icing on the cake, primary mortgages rates moved from the low 3% range to the mid 6%—a move of such magnitude not seen since the early 1980s. These combined factors led to extremely poor excess returns for MBS in 2022.

Looking forward to 2023, the headwinds appear to remain daunting, though there are some green shoots of optimism. However, given the wide range of mortgage securities following the 2022 valuation and yield moves, MBS has clearly become a much more diversified asset class as certain outcomes will impact different mortgages in almost completely diametric ways. This amplifies the importance of individual security selection in driving returns.

The MBS market will continue to face headwinds into 2023 caused by stickier than expected interest rate vol, technical headwinds from the Fed QT program, and further pressure on home prices, affordability, and refinanceability. All of this is exaggerated by the year-end rally in MBS valuations, which left the asset class looking far more average from a valuation perspective compared to even four weeks prior.

On the positive side, the biggest factor in favor of MBS is that interest rate volatility remains above long-term averages, so a mean reversion in this would be a significant tailwind. Refinancing activity will be essentially non-existent if mortgage rates stay near current levels, which will reduce the shorter-term impact of negative convexity on return outcomes. Additionally, using historic measures that admittedly come from very different market environments, MBS now looks fair to marginally attractive versus Investment Grade Corporates—especially as market concerns around credit risk and the potential for a recession look to be a major focus in 2023.

After acknowledging the factors both for and against MBS, we are left biased to the negative. Starting with a foundation of “Don’t fight the Fed”, we think that any sustainable decline in interest rate volatility and a more positive technical backdrop for MBS is contingent on deceleration in the Fed’s QT efforts. With valuations not being attractive enough to entice large scale buyers to offset the Fed’s runoff, we think that technicals will remain a large headwind for the asset class.

We are cognizant that the speed and magnitude of 2022 MBS valuation changes were far beyond normal. We would expect this to continue into 2023. Similar to 2022 when we purchased substantial amounts of MBS exposure as valuations moved to more attractive risk-adjusted levels in late Q3/early Q4, we expect our view may change rapidly if valuations move to levels reflecting more of the headwinds we foresee. Additionally, the vast divergence of underlying MBS characteristics in this new environment and the disparate outcomes make security selection and avoidance of vital importance moving into 2023.

Preferreds:

Over the course of 2022, we saw preferred security valuations move substantially higher. To begin the year, generic preferreds were yielding in the mid to low 4% range. Exiting 2022, the generic yield on preferreds had reset to the mid to low 6% range. More so than any other Fixed Income asset class, investment outcomes for preferreds are driven by unique security specific

characteristics. So, while it is much harder to speak to index yields given the number of assumptions required, it's clear there is significantly more yield available in the preferred market compared to one year ago. To illustrate this, on October 19, 2021, Bank of America issued a fixed for life preferred at 4.25% that is not callable until 2026. As of early December 2022, this bond was trading at approximately 70 cents on the dollar and yielding in the low 6% area.

Many pundits have pointed to this dramatic increase in preferred yields as an attractive area for investors. However, take a step back from headline yields, and we find the conclusion is more complicated than it seems. Similar to the debate in the Investment Grade (IG) and High Yield (HY) markets, the attractiveness of preferreds is skewed depending on whether one views valuations on a yield or spread basis. Using the Bank of America example above, the yield on the security is just under 200 bps higher since issuance. However, during the same time period, the yield on long duration U.S. Treasuries (UST) are roughly 160 bps higher. This means the implicit spread of the preferred vs long-duration USTs is approximately 30 bps wider on the year. Viewed through that lens, it can be argued that generic preferreds have outperformed IG credit, which is counterintuitive given the far higher sensitivity of preferreds to changes in economic and corporate fundamental outlooks.

Additionally, when the current yields of preferreds are compared to the Bloomberg U.S. Corporate Bond Index (IG Index) and the Bloomberg U.S. Corporate High Yield Index (HY index) yields, the attractiveness of the asset class doesn't seem attractive. The IG index currently yields in the low 5% area, while the HY index is in the mid to high 8% range. With corporate fundamentals set to face headwinds into 2023, an approximate 100 bps pick up to buy preferreds compared to IG or an approximate 250 bps give in yield compared to HY doesn't appear overly interesting from a high level.

Despite macro valuations on preferreds that may not seem that appealing, as was mentioned initially, the preferred asset class is one where individual security characteristics drive an outsized proportion of returns compared to other fixed income asset classes. With this backdrop, we believe there will be continued attractive investment opportunities in the preferred universe if one is willing to do the requisite extensive research to help identify these unique securities. As we have seen repeatedly in 2022, large divergences in individual performance have been driven by an individual preferred's callability, potential coupon resets, floating or fixed rate nature, convexity profile, loss of capital treatment, and attractive repurchase opportunities for the issuer. We believe our deep fundamental-focused credit research process aligns with the ability for security selection to be an outsized driver of returns within the preferred universe.

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Investment Grade Credit

Jonathan Aal, Portfolio Manager, IG Credit

We have gone through one of the largest and quickest repricing of capital in the history of U.S. financial markets. As of December 13, 2022, investment grade corporate credit spreads are only 36bps wider YTD. A year ago, most of us would likely have said those two sentences should not come in sequence with the insinuation being greater spread widening would have been expected. This is not an unreasonable thought.

Despite the widespread repricing of money making its way into every nook and cranny of markets, broad based corporate fundamentals, balance sheets, credit quality, liquidity profiles,

and maturity ladders have handled things well so far. This lends credence to why excess returns in credit did relatively well this past year reporting at -1.08% as of December 13, 2022.

As we peer into 2023, one thing we know for certain is the path forward will not chart a straight line. We need to consider the lagged effect of the 2022 monetary policy working its way through the 2023 economy and therefore the fundamental inputs to corporate and consumer credit profiles. Paired with current spread valuations, we should remain vigilant around the potential vulnerability of earnings and therefore spreads.

Since 2020, we have noted more sector dispersion when it comes to the position of varying businesses in the business cycle. This shouldn't come as a big surprise as through the pandemic some companies thrived while others paused for varying periods of time. We bring this up as we look to 2023, because we would not be surprised to see business cycle dispersion become more evident in sector spread valuations. Having the credit expertise to correctly identify where a particular issuer is in its business cycle will be imperative to enhancing both security selection and avoidance.

We foresee the conversation around spreads versus yields, as it pertains to valuations, continuing to be meaningful; particularly in an environment where despite the increase of yields, durations remain elevated, specifically within investment grade. This leaves investors more exposed to changes in both credit and interest rate risk in both directions. While no prior period is a perfect analog for the future currently staring us in the face, we do believe all-in yields matter for credit investors. When yields are higher, this income has the potential to cushion against volatility and therefore increases the probability of realizing positive risk-adjusted returns. Ultimately, we believe both yields and spreads will be important.

Regardless of what future conditions materialize, we are confident that the path will not be straight, and the impact on individual company growth, earnings, and cash flows will be differentiated. As such, we will continue to fully exercise our active management nimbleness when it comes to portfolio construction and hunt for securities that may possess more attractive risk/reward profiles than the broader market.

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High Yield and Leveraged Loans

Garrett Olson, Portfolio Manager, HY Credit

Fundamentals

Leveraged finance fundamentals look relatively resilient as we enter 2023. Per J.P. Morgan 3Q High-Yield Credit Fundamentals, the leverage of U.S. high yield issuers decreased in 3Q to 3.98x—its lowest level since 4Q of 2012. Excluding pandemic recovery sectors such as Gaming/Leisure and Transportation, leverage is at a post-GFC low. This strength also shows through in interest coverage ratios reporting at an all-time high of 5.85x and in still healthy revenue and EBITDA margin trends. While our expectation is for a deterioration in fundamentals due to a slowdown in economic activity, we see ample opportunity to generate strong risk-adjusted returns by investing in resilient businesses and management teams that prioritize optionality. Similarly, we expect default rates to remain low by historical standards at around 3% on average but to tick up from an LTM rate of 1.61% for high yield and 1.59% for leveraged loans. Tight primary market conditions are likely to impact the ability of some issuers to refinance upcoming maturities, but

we do not expect the impact to be widespread as market maturity walls look relatively benign following heavy refinancing activity in 2020 and 2021.

Technicals

In 2022, high yield funds have seen the second largest outflow on record, while loan funds have seen modest outflows following extremely strong inflows in 2021. Our confidence around predicting flows is low, but we expect valuations in high yield on both an absolute and relative basis to be seen as more attractive than in recent years. However, concerns around economic sensitivity may dampen enthusiasm around potential allocations. Ratings trends will likely have a big impact on leveraged finance markets in 2023. While the LTM upgrade/downgrade ratio in high yield is still above 1.0 at 1.52 as of writing, November saw just 0.4 upgrades per downgrade. This is a trend we expect to continue in 2023 with weakening economic activity due to restrictive monetary policy. A ratings downgrade cycle will impact both high yield and leveraged loan markets, but we see the leveraged loan markets as particularly vulnerable. Fundamental metrics in the loan market enter 2023 in a weaker position than high yield peers, and the average rating on the loan index is lower than that of the high yield bond index. Furthermore, CLOs, which are the primary source of demand for leveraged loans, are particularly sensitive to ratings actions and could be forced sellers of downgraded loans. That said, we are also mindful of the impact fallen angel supply may have on the high yield market in 2023.

Valuations

After a strong rebound in October and November, valuations on the Bloomberg U.S. Corporate High Yield Bond Index (HY Index) may be less attractive than at various points in 2022. That said, we continue to note the dispersion in yield-to-worst (YTW) versus option-adjusted spread (OAS) metrics in a historical context. On an OAS basis, the HY Index stands in the 64th percentile for the trailing one-year period and in the 68th percentile compared to the past 10 years. YTW metrics look more favorable in the 71st percentile on a one-year basis and the 94th percentile on a 10-year basis. While we believe that investors should consider both yield and spread valuations, we would note that elevated coupon income provides a tailwind that can offset the impact of dollar price declines on realized return. Combined with a historically low entry point in terms of dollar price, we believe the math behind the market may provide a favorable setup for fixed income investors in 2023.

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Trading

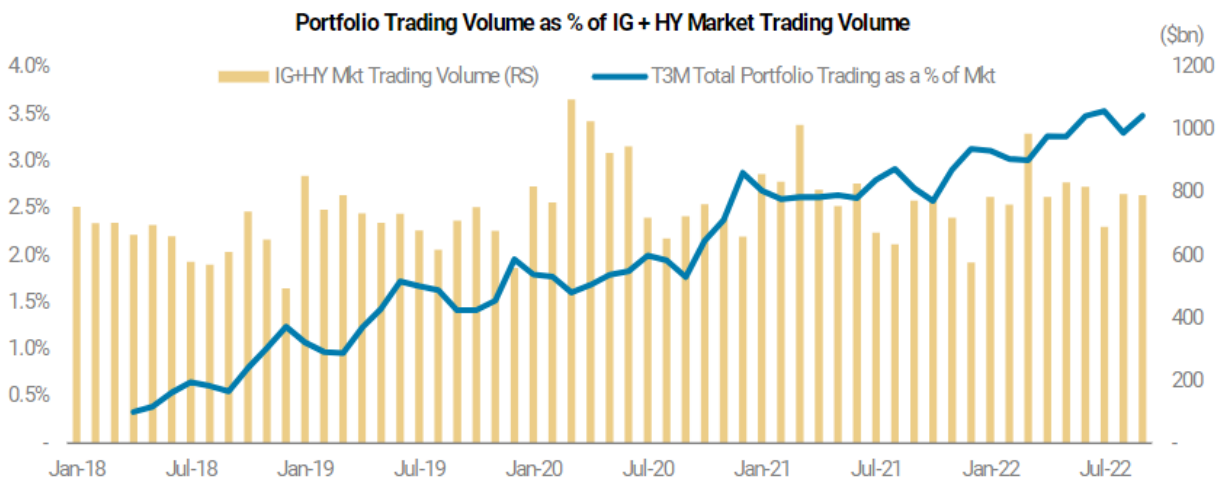
Zach Tucker, Head of Trading

If 2021 was the celebration party for portfolio trading (PT), then 2022 was the year of the exchange-traded fund (ETF). We closed 2021 engaged with numerous counterparties regarding PT capabilities listening to accomplishments and platitudes around the latest financial product touted to be profitable for both parties. Realistically, PT was created to address the issue of liquidity for custom baskets of securities. A nuance we must acknowledge is that these portfolios may be a combination of buys and sells. A fund experiencing large inflows/outflows or desiring a quick change in strategy could more efficiently price a large number of bonds for a swift transaction with a single counterparty. In short, the PT service made things more efficient from a time, pricing, and resources standpoint. No matter the iterations or details, let us be clear that this was a tool for liquidity.

In 2022, there were numerous periods where liquidity in credit markets was sub-optimal. During those periods, brokers remarked consistently that ETF funds were skewing their markets by blindly hitting bids or lifting offers to fit within their basket of bond parameters. In a market of bespoke securities such as fixed income, the ETF investor looks for broader exposure rather than single-bond risk. Many fixed income managers bemoaned a wide bid-ask spread and the ‘stupid’ levels where bonds were executed with many of these trades attributable to ETF funds, while some managers instead saw an opportunity. One thing that became clear was that ETFs had become the new tool solving for the same issue as PTs—the need for liquidity.

While we reflect on the past year and consider themes for the next, how the liquidity picture will look and develop should be top of mind. Financial engineering is always progressing in the background, and there are certain to be more products, tools, and outlets as fluid market dynamics demand. Much ink was spilled on the PT (r)evolution despite garnering just ~3.5% of credit trading volumes. It was a product used predominantly by active fixed income managers. As we can see from ETF fund flows in 2022, investors sought the “buy or sell at any level” liquidity it provided, perhaps with less of an eye for returns and more for the ability to express a macro view. To throw another product into the liquidity mix, we should give a nod to the U.S. government soliciting solutions to improve Treasury liquidity as the Fed removes itself from being an active buyer.

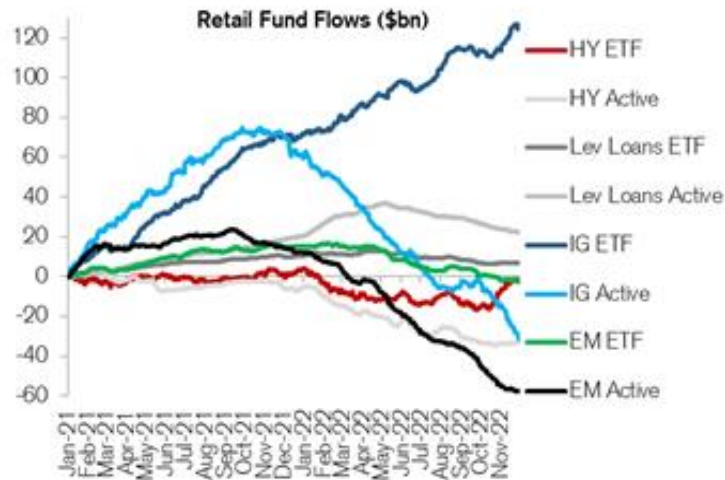
We see this trend of seeking liquidity continuing in 2023, and one that will hold the attention of Wall Street quants and stodgy investors alike.



Source: Morgan Stanley Research, FINRA TRACE; Note: Data now includes both public + 144a trades

Morgan Stanley Corporate Credit Strategy October 14, 2022

YTD Retail Fund Flows



Source: Credit Suisse, EPFR

CS Credit Strategy Daily, December 7, 2022

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