



Short Government Only Managed Account

Quarterly Review

- Investment-grade bonds finished the first quarter with a narrow loss, as the benefit of narrowing spreads was outmatched by rising US rates. Bonds rallied significantly in the final two months of 2023 on expectations that falling inflation would allow the US Federal Reserve (Fed) to begin reducing interest rates. Coming into the year, the futures markets were indicating that the Fed would enact as many as six to seven rate cuts in 2024, with the first potentially occurring in March. This positive outlook ultimately proved to be premature, as rising oil prices and robust economic data began to fuel concerns that inflation may be set to reaccelerate. The consensus number of rate cuts fell to three by quarter-end as a result, with the likely timing of the first cut pushed back to June. While Fed Chairman Jerome Powell reiterated his December statement that the Fed indeed is on track to begin cutting rates this year, market participants appeared to display a lower degree of confidence. In combination, these factors led to uninspiring returns for most segments of the bond market.
- The less favorable interest rate outlook led to a slightly negative total return for US Treasuries. Although bonds with maturities of two years and below finished with small gains, the benefit was outweighed by weakness in longer-term issues. The yield on the two-year note rose from 4.23% to 4.59% (as its price fell) over the course of the quarter, while the 10-year climbed from 3.88% to 4.22%. The yield curve remained inverted—meaning that short-term yields were above those on longer-term debt—extending the duration of the inversion to the longest in history and exceeding the previous high set in 1978.
- Security selection within Treasuries contributed to excess return. Overall, sector allocation detracted marginally from excess returns.
- Duration and yield curve effects positively impacted excess return over the quarter. The strategy is focused on US Treasury securities and does not hold benchmark eligible US Agency securities which may contribute to additional return. Sector allocation detracted slightly from excess returns.

Outlook

- The Federal Reserve held the Fed Funds rate steady at 5.25% throughout the first quarter. Markets reacted to inflation prints that came in hotter than expected, partly due to residual seasonality, but ended the quarter with expectations for 75 bps of cuts between now and year-end. This market expectation is consistent with the Fed's Summary of Economic Projections and a "soft landing" narrative. Meanwhile, risk appetites remained robust and spreads continued to tighten during the quarter. The yield curve remained inverted, with higher yields on shorter maturity Treasuries relative to longer-dated notes and bonds. We believe that growth and inflation are likely to be slightly lower throughout the remainder of this year, with potential for the unemployment rate to edge up slightly. We think this implies some chance the Fed may be more accommodative than the market currently anticipates. Yields on 10-year Treasuries returned to the 2023 year-end level 3.88% in early February before pushing higher, ending the quarter at 4.20%.
- We continue to hold the view that we are in the late phase of the credit cycle. Corporate balance sheets have deteriorated, but from a very strong starting point; profit margins could continue to be pressured amid higher input costs, tighter credit conditions, and a slowdown in de-leveraging trends. We believe a relatively healthy middle class consumer and resilient labor market should prevent the economy from entering into a severe recession in this cycle.
- We anticipate continued volatility in interest rate markets should inflation data come in much higher or lower than expectations, even as the broad disinflation trend remains intact. We remain concerned about the lagged



effects of significant monetary tightening and potential exogenous shocks to growth, possibly emanating from the ongoing conflict in the Middle East. We do not believe that current spreads provide adequate compensation for the risks facing the economy and markets.

- Our government-only strategies primarily focus on US Treasury securities and seek to maintain a duration equivalent to the benchmark.

Important Disclosure

Key Risks: Credit Risk, Issuer Risk, Interest Rate Risk, Liquidity Risk, Prepayment Risk and Extension Risk.

Past performance is no guarantee of future results.

There is no guarantee that the investment objective will be realized or that the strategy will generate positive or excess return.

Commodity interest and derivative trading involves substantial risk of loss.

Diversification does not ensure a profit or guarantee against a loss.

Any investment that has the possibility for profits also has the possibility of losses, including the loss of principal.

Market conditions are extremely fluid and change frequently.

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