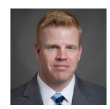
Asset Allocation in an Uncertain Environment

June 2023

Asset Allocation Insights

KEY INSIGHTS

- Despite lingering economic headwinds, "the most anticipated recession ever" has, so far, failed to materialize.
- In an environment of economic resilience amid an uncertain outlook, we believe high yield bonds offer an attractive risk/reward trade-off.



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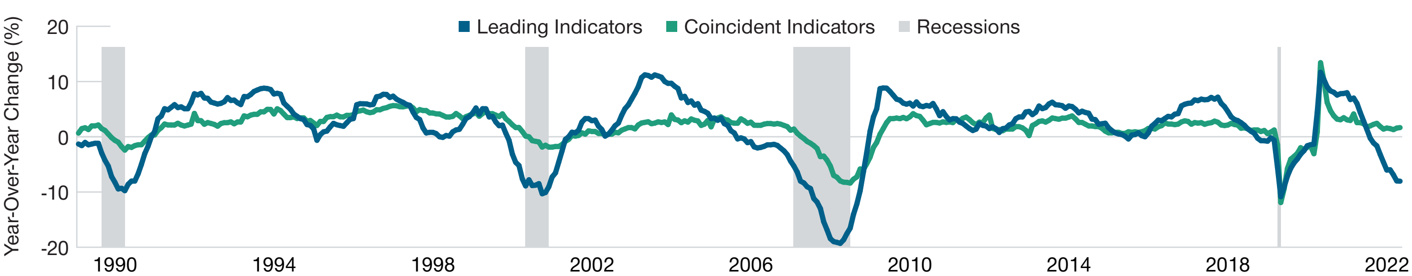
Many investors were bracing for a recession in 2022 as they muddled through an array of challenges, including runaway inflation, an extremely hawkish Federal Reserve, geopolitical turmoil, and rapidly deteriorating economic data.

Despite these headwinds, the U.S. economy has remained surprisingly resilient, and the widely anticipated recession has not yet come to pass. The breakdown in the normal relationship between the year-over-year changes in the Conference Board's Leading Economic Index and its Coincident Economic Index captures this unusual dynamic (Figure 1).

The leading index is designed to gauge how the economy might behave in the next three to four months. Typically, when this forward-looking indicator deteriorates, the coincident index, which reflects current economic conditions, follows the same trajectory within a few

The U.S. Economy Has Been Resilient

(Fig. 1) Leading indicators vs. coincident indicators



January 31, 1990, through April 30, 2023.
Past performance is not a reliable indicator of future performance.
Sources: The Conference Board, U.S. Bureau of Economic Analysis/Haver Analytics.

months. This time has been different. While the leading index has been falling sharply since July 2022, the coincident index has remained stubbornly positive.

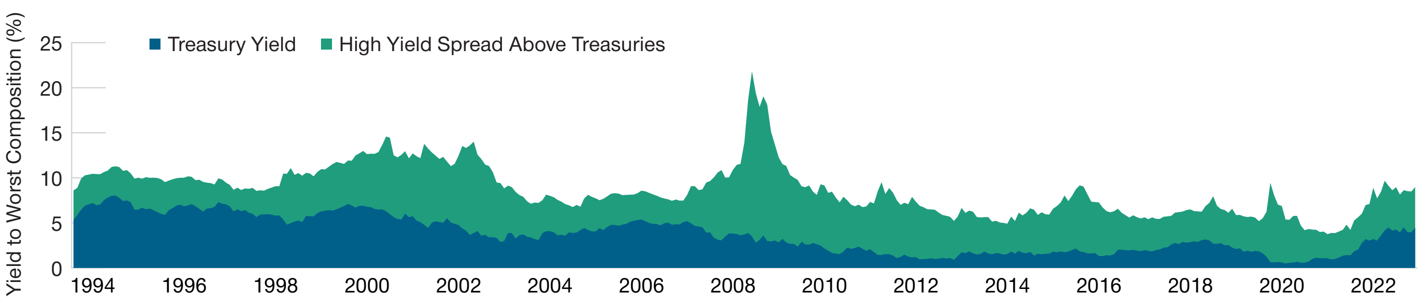
Key factors that have supported the economy remain in play. U.S. consumers still have excess savings to spend. They have also benefited from falling inflation—especially in energy costs—and low unemployment. Manufacturing activity also appears to be stabilizing, as bloated inventories have declined to normal levels. Further, despite elevated mortgage rates, housing construction is picking up in response to low supply.

Still, caution is warranted. The lagged effects of higher interest rates and tighter bank credit conditions could weigh meaningfully on economic activity. In this uncertain environment, the healthy yield offered by high yield bonds could provide a buffer for investors (Figure 2).

High yield bonds tend to be sensitive to economic events. However, they currently offer attractive yields, and active security selection could help to identify issuers with elevated interest coverage ratios and low leverage ratios that might suffer less in a recessionary scenario. As a result, our Asset Allocation Committee is overweight to high yield bonds. We believe the asset class offers an attractive risk/reward trade-off in the current environment.

High Yield Bonds Currently Offer Attractive Yields

(Fig. 2) Yield composition of Bloomberg U.S. Corporate High Yield Index



January 31, 1994, through May 23, 2023.

Past performance is not a reliable indicator of future performance.

Index performance is for illustrative purposes only and is not indicative of any specific investment. Investors cannot invest directly in an index.

Credit Spread—Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar maturity, high-quality government security.

Source: Bloomberg Index Services Limited. Please see Additional Disclosures.

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