February Highlights:

- 10-year Treasury yield up 0.60% during the month, from 3.4% back to the 4% range.
- Core personal consumption expenditures (PCE) inflation posted a surprise *increase* month-over-month from 4.6% to 4.7%, causing bond markets to re-price interest rates "higher for longer."
- S&P 500 Index declined 2.4%.

Evidence accumulated in February that inflation is going to be sticky, despite the Fed's unprecedented pace of interest rate hikes. The tight labor supply appears to be a primary culprit for the Fed's difficulties. Unemployment fell to 3.4%, the lowest rate in 53 years, while the reports for monthly core PCE inflation over the previous year edged up from 4.6% in December to 4.7% in January.

The market's recognition of these inflation and labor challenges took the wind out of the optimism that had produced strong stock returns in the last quarter of 2022 and into January. The S&P 500® Index dipped -2.4% for the month, putting the year-to-date return at +3.7%. The same pressures caused bond yields to rebound during the month as the 10-year Treasury yield appreciated from 3.4% to end the month in the 4% range. The continued strength of consumer spending in January was another worry for those looking for interest rate relief from the Federal Reserve.

Federal Reserve Chairman Powell and his governors have been broadcasting their intent to continue raising rates and to maintain them for "some time." These statements have been seen as positioning needed to keep expectations and financial markets dampened. However, the recognition that underlying inflation may be showing stubborn persistence has convinced more investors to take the Fed at its word. One result over the past month has been a reckoning that upcoming raises in the Fed Funds Rate may be more aggressive than previously anticipated. Fed futures trading reflects an increased possibility of a 0.50% increase coming at the March meeting rather than just another 0.25% increase. At the same time, economic trends revealed this past month have diminished hope that the Fed may pivot before the end of 2023.

Another interesting development in February was the release of December's M2 money supply data that showed the first year-over-year contraction of the money supply since 1981, indicating that the Fed's tightening policies are finally showing signs of implementation. However, even with December's contraction, the total M2 money supply is still up 39% compared to pre-pandemic levels.

It seems that, at least for the moment, the consensus has concluded that we can anticipate higher rates for longer. This shift will likely demand continued patience from investors as the lagging effects of rate increases slowly reverberate through the economy. Corporate earnings predictions for the remainder of the calendar year are declining, while investment grade bond yields have increased to the 5% range, marking the first time since 2008 that the yield on bonds is competing with the earnings yield on stocks.

With bond yields at their most attractive levels since pre-2008, we feature Mike Wachter, Head of the Reinhart Fixed Income Team at Madison Investments, in this month's Q&A.

PORTFOLIO MANAGER Q&A - MIKE WACHTER

Given the big move in rates last year, the inverted yield curve, and the volatility in the markets, where do you see opportunities in this environment?


Mike Wachter, CFA is Head of Reinhart Fixed Income

For the last decade and a half, fixed income has been an incredibly challenged asset class. Rates had been kept low coming out of the Great Recession. There were points where the Fed started to raise interest rates, only to be forced to lower them quickly again – for example, during the pandemic. In general, without any yield in a portfolio, it is difficult to expect great returns from fixed income. That ended last year. We're now sitting with yields in the 4.5% to 5% range in our portfolios. That yield that had previously been missing now provides investors with a base for solid returns. If interest rates do not change from here on out, you can expect a 4.5% to 5% return. That's a great starting level. Then consider the inverse relation between a bond's price and rates. If interest rates were to move up from 4.5%, that yield would serve as a buffer against the negative price performance. If rates were to go down, you would get the 4.5% yield plus the additional price performance. All this considered, we think fixed income, as an entire asset class, is attractive right now.

When we started the year, there seemed to be a disconnect between what the Fed was planning and what the market was actually pricing in. Where do we stand today? And what are your expectations for rates moving forward?

At the end of 2022 and into 2023, we started to see inflation moderating and signs of a slowdown in the economy. The market interpreted this as an indication that we may get rate cuts by the end of 2023, despite what the Fed has been saying about keeping rates higher for longer. Fast forward a month, we get a great nonfarm payroll unemployment report, retail sales are up 3%, and inflation data is stronger than expected. That flipped the market's narrative on its head.

One thing I've learned in my 30-plus years as a fixed income investor is don't fight the Fed. That being said, I think that the Fed will do exactly what they are telling us they will do by continuing to raise rates. I don't expect them to stop until we get a fed funds rate north of 5%.

The big question is, will it have the effect that the Fed is looking for? Will it slow employment? Does it create more slack in the economy such that inflation will continue to come down? That's what we'll be watching for.

Let's get into the mechanics of bonds for a minute. Although yields in corporates and Treasuries are 4% to 5%, average coupons remain low in the 2% to 3% range. Can you comment on how investors will see their 4% to 5% return on these bonds?

With market yields in the 4.5% to 5% range, no one would buy a bond with a 2% or 3% coupon unless you sell it to them at a discount. So, you ultimately achieve the higher market yield with the lower coupon level by accounting for the accretion of that discount towards maturity. For example, if I were to buy a five-year bond with a 3.5% coupon at a price of 95 cents on the dollar, over the course of that five years, I would add another 1% of yield on top of the coupon rate. It doesn't work exactly like that, but conceptually, you buy a bond at a discount (95 cents) and are paid back at the full par value (1 dollar). The back-of-the-envelope math for this basic example would be: 3.5% coupon + 1% from the price going up each year = 4.5% yield.

U.S. EQUITIES (%)

	Feb.	YTD	1 Year	3 Year	5 Year	10 Year
DJ Industrial Average	-3.9	-1.1	-1.6	11.0	7.8	11.3
S&P 500	-2.4	3.7	-7.7	12.1	9.8	12.3
Russell 1000	-2.4	4.2	-8.2	11.9	9.7	12.1
Russell 1000 Value	-3.5	1.5	-2.8	11.0	7.2	9.6
Russell 1000 Growth	-1.2	7.0	-13.3	12.1	11.5	14.3
Russell Midcap	-2.4	5.7	-5.0	11.5	8.4	10.7
Russell 2000	-1.7	7.9	-6.0	10.1	6.0	9.1

U.S. EQUITY SECTORS - S&P 500 (%)

	Feb.	YTD	Weight
Communication Services	-4.7	9.2	7.7
Consumer Discretionary	-2.1	12.6	10.6
Consumer Staples	-2.4	-3.3	6.7
Energy	-7.1	-4.5	4.8
Financials	-2.3	4.4	11.7
Health Care	-4.6	-6.4	14.3
Industrials	-0.9	2.8	8.5
Information Technology	0.5	9.8	27.3
Materials	-3.3	5.4	2.8
Real Estate	-5.9	3.4	2.7
Utilities	-5.9	-7.8	2.8

U.S. EQUITY CHARACTERISTICS - S&P 500

	February	2022
Price/Earnings Ratio	20.1	19.1
Weighted Avg. Market Cap ($B)	462.1	417.5
Dividend Yield (%)	1.7	1.7

INTERNATIONAL EQUITIES (%)

	Feb.	YTD	1 Year	3 Year	5 Year	10 Year
ACWI	-2.9	4.1	-8.3	8.8	5.8	7.9
ACWI ex USA	-3.5	4.3	-7.2	5.3	1.6	3.9
MSCI EAFE	-2.1	5.8	-3.1	6.8	2.6	4.8
Emerging Markets	-6.5	0.9	-15.3	1.0	-1.9	1.5
China	-10.4	0.2	-16.1	-6.2	-5.5	2.4
Japan	-3.8	2.1	-9.3	3.4	0.1	5.1
Germany	-1.9	10.3	-4.5	4.6	-0.8	3.5
United Kingdom	0.2	6.8	-0.1	8.4	3.0	3.6
India	-4.6	-7.4	-10.0	10.6	5.1	6.9

KEY ASSET PRICES

	February	2022
EUR/USD	1.05	1.06
USD/CAD	1.36	1.36
USD/JPY	136.36	132.78
GBP/USD	1.19	1.21
Bitcoin ($)	23,147.4	16,514.0
Gold ($/oz)	1,830.0	1,827.0
Crude Oil (WTI) ($/bbl)	75.6	80.4

FIXED INCOME (%)

	Feb.	YTD	1 Year	3 Year	5 Year	10 Year
Government Bond	-2.3	0.1	-10.0	-4.1	0.4	0.6
Municipal	-2.3	0.5	-5.1	-1.6	1.7	2.1
U.S. Aggregate Bond	-2.6	0.4	-9.7	-3.8	0.5	1.1
Investment Grade Corporate	-3.0	0.7	-10.1	-3.8	1.1	1.9
High Yield	-1.3	2.5	-5.5	1.3	2.9	4.1

U.S. TREASURY YIELDS (%)

	February	2022
3-Month	4.9	4.4
6-Month	5.2	4.8
2-Year	4.8	4.4
5-Year	4.2	4.0
10-Year	3.9	3.9
30-Year	3.9	4.0

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The MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets countries (excluding the US) and 23 Emerging Markets countries. With 1,843 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

The MSCI EAFE (Europe, Australasia & Far East) Index is a free-float adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. and Canada.

Emerging Markets - MSCI Emerging Market Index – captures large and mid cap representation across 24 Emerging Markets (EM) countries. With 1,138 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

China - MSCI China Index - captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs).

Japan - MSCI Japan Index - is designed to measure the performance of the large and mid cap segments of the Japanese market.

Germany - MSCI Germany Index - is designed to measure the performance of the large and mid cap segments of the German market.

United Kingdom - MSCI United Kingdom Index - is designed to measure the performance of the large and mid cap segments of the UK market.

India - MSCI India Index - is designed to measure the performance of the large and mid cap segments of the Indian market.

Fixed Income Definitions
Government Bond - Bloomberg US Government Index - measures the performance of the U.S. Treasury and U.S. Agency Indices, including Treasuries and U.S. agency debentures. It is a component of the U.S. Government/Credit Index and the U.S. Aggregate Index.

Municipal - Bloomberg U.S. Municipal Index - covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.

U.S. Aggregate Bond - Bloomberg U.S. Aggregate Bond Index - is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage backed securities, asset-backed securities and corporate securities, with maturities greater than one year.

Investment Grade Corporate - Bloomberg U.S. Credit Index - measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

High Yield - Bloomberg U.S. Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Bloomberg EM country definition, are excluded.

Definitions
Weighted Avg. Market Cap: measures the size of the companies in which the portfolio invests. Market capitalization is calculated by multiplying the number of a company's shares outstanding by its price per share.

Price-to-Earnings (P/E) Ratio: measures how expensive a stock is. It is calculated by the weighted average of a stock's current price divided by the company's earnings per share of stock in a portfolio.

Dividend Yield: the portfolio's weighted average of the underlying portfolio holdings and not the yield of the portfolio.

A basis point is one hundredth of a percent.

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