Catalyst Funds

The Outlook for Bonds in a Bear Market:

Guidance for Uncertain Times

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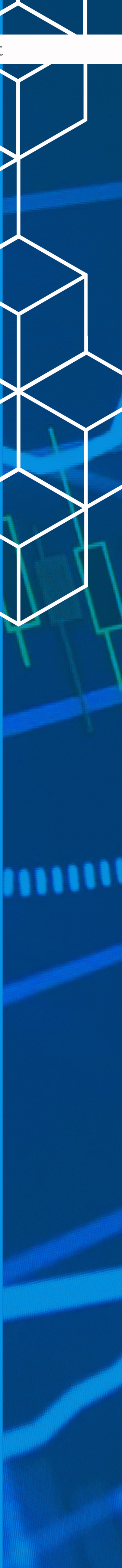
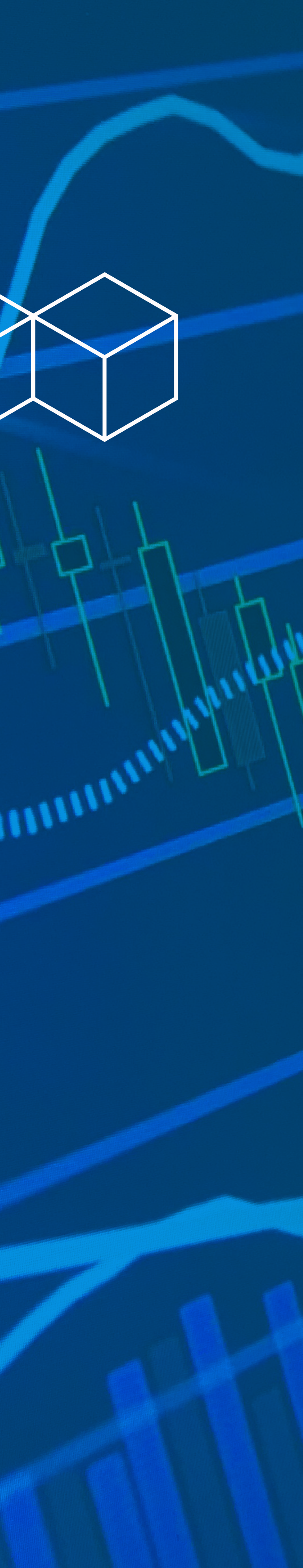
The Outlook for Bonds in a Bear Market





2022 Year-End Estimates

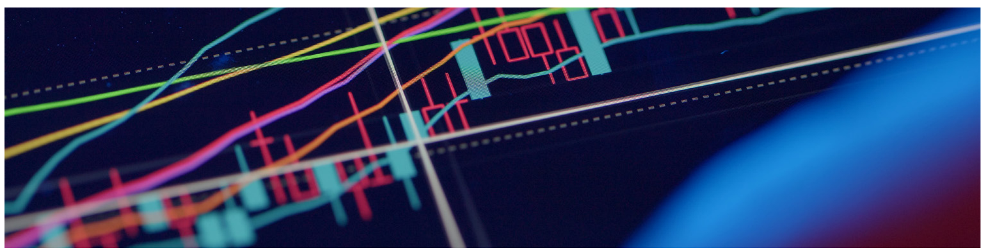
10-Year Treasury Yield	3% - 3.5%
Federal Funds Rate	2.25% - 2.75%
Soft Landing?	No
Growth Recession?	Yes
Stagflation Environment?	Yes (If Inflation persists)

Key Takeaways

- Seek credit investments with uncorrelated returns
- Duration management (ideally shorter duration is essential)
- Opportunistic corporate/convertible bonds with undervalued relative pricing.
- Floating Rate (Bank Loans) hedge portfolios from interest rate risk without being a tactical shift
- Legacy NARMBS are high principal investments with a strong structural support to weather market uncertainty.
- Special Situation credit investment opportunities can deliver strongly uncorrelated returns through unique positionings.

01.

Economic Backdrop



As summer draws to a close and we enter the last few months of a tumultuous 2022, many questions remain regarding the trajectory of financial markets and the economy. Our stance on stagflation (or "recession-inflation") remains steadfast. Drawing parallels to the mid-1970s, structurally, we are in, or at least moving toward, a stagflation environment amid the 41-year high supply-side inflation driven by soaring oil prices and food prices, slowing GDP growth (now in a technical recession), and the necessary unravelment of the tight labor market.

Amid stagflation, the economic situation remains murky, though we see a clear path for monetary policy: raising rates. However, questions remain on the velocity of the Federal Reserve's (Fed) quantitative tightening and the length needed for hawkish policy to tame inflation.

Though inflation recently contracted slightly from 9.1% to 8.3%, it is important to note that this was largely a result of dropping energy prices as domestic recession fears and China's economic slowdown questioned sustained demand.

Thus, the market rally in June and July overestimated a dovish pivot from the Fed amid some optimistic economic data and peaking inflation. The recent rally is likely a bear market rally with valuations and heightened credit risk set to weigh on risker asset classes.

Therefore, the recession fears and related price movement may not be as bad as the market has priced in during the first half of the year, but monetary policy risks and tighter economic financing may anchor riskier asset's performances for the remainder of the year. We believe that the consumer remains strong, as proven by consumer sentiment improving to its highest level since May, suggesting Americans are growing more optimistic about the economy amid falling gas prices – a temporary support. This is enough to either support a soft landing (our view is that's unlikely) or minimize the downward pressure of a structural recession.

However, as consumer demand normalizes and cyclically slows, the growth trajectory of equity and retail-focused markets may be lackluster. Thus, our belief is that investors should not be concerned with this recession, but rather the economic aftershocks of taming inflation. For a soft landing to occur, the Fed hopes to see those that quit their jobs during the pandemic return to the workforce faster than currently employed workers losing their job. Thus, the Labor Force Participation Rate (LFPR) must rise as people who quit their job during the pandemic return to work as employers slow hiring amid higher interest rates (usually unemployment rate goes up during an economic slowdown as layoffs increase).

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Though a possibility (with likelihood of higher rates for longer), investors should be prepared if a soft landing (dependent on abnormal labor market patterns) is not accomplished, and a stagflation environment and recessionary pains persists. What remains more likely and potentially more painful is a growth recession (coined by NYU economist Solomon Fabricant) which is a period of protracted meager growth and rising unemployment, which leaves the door wide open for another 75-basis point hike. With that said, we estimate that the unemployment rate would have to reach approximately 5.5% for CPI to reach a strategically adjusted 3% inflation target, or the unemployment rate would have to reach approximately 6% to be in line with the TIPS 10-year breakeven rate of 2.55%. For PCE to reach the Fed's adjusted 3% target, the unemployment rate would have to reach approximately 4.5% since CPI inflation is usually higher than PCE inflation.

We continue to believe that a technical recession's impact on financial markets may be minimal, mainly due to markets already heavily pricing in the possibility coupled with a Midterm election year and market seasonality (September historically the worst performing month). Additionally, a successful soft landing remains a monetary goal but is not statistically likely based on historical data when comparing periods of high inflation and tight labor market patterns. Any prior soft landings' economic backdrop does not resemble the current economic environment. For instance, in 1984 and 1994, unemployment was higher, inflation was lower, and wage growth was lower. The Fed also raised interest rates above the inflation rate, though that seems impossible today with inflation at 8.3%.

High job openings and employee quit rates have driven up wages and core inflation. As we described in *Capitalizing on Stagflation: A Deep Dive into Stagflation and What it Means for Financial Markets*, "Amid supply side inflation, if the Fed raises rates to tame inflation, the economic equilibrium could only be obtained with an increase in unemployment (despite labor markets tightening to 3.6%) as the ability to pay employees becomes more expensive for employers, resulting in layoffs."

In short, our base case holds—a priced-in recession with weaker employment numbers and hawkish monetary policy weighing on riskier assets will likely continue. Amid a technical recession, hawkish monetary policy, 41-year high inflation, and persistent macroeconomic uncertainties, market volatility will persist even if we are through most of the aggregated cross-asset underperformance.

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02.

Credit Capital Markets

Fixed income markets have struggled thus far this year, with the Bloomberg US Aggregate Bond Index returning -10.75% YTD as of 8/31/2022. Additionally, the yield curve steepened and structurally shifted upward; however, we expect the yield curve to start to flatten as hawkish monetary policy continues throughout the year as seen by the hawkish comments out of Jackson Hole. It is important to note that global bonds, represented by the Bloomberg Global Aggregate Index, ihave entered into a bear market for the first time in a generation, illustrating the structural credit weakness abroad and the complex uncertainty domestically.

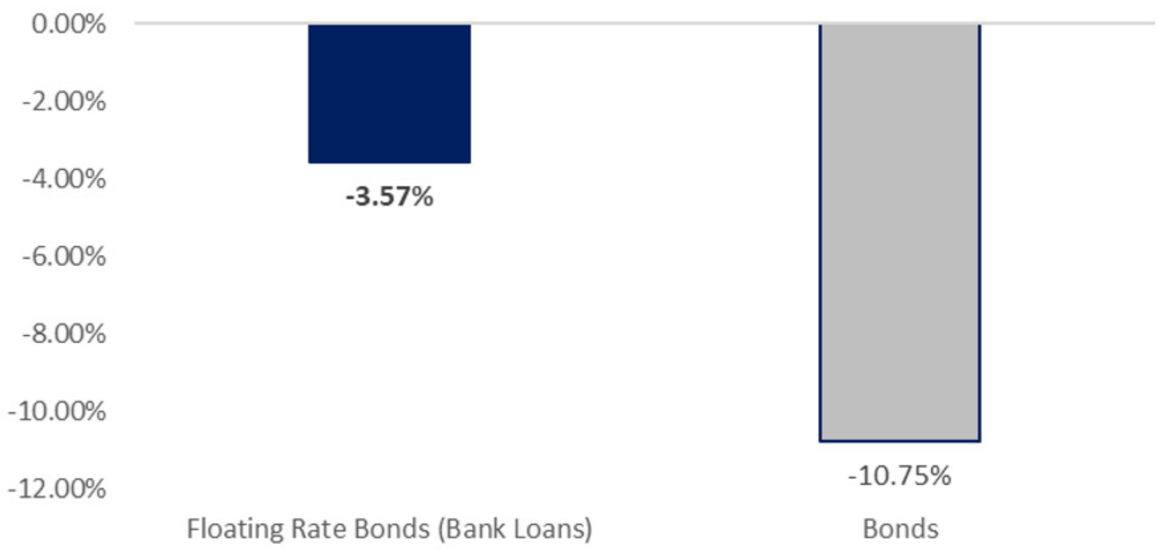
The brief bond and broader market rallies in June, July, and early September were driven by bets on a dovish Fed pivot where debased and borderline irrational as inflation remains above 8%, economic data remained mixed and the Fed not yet shrinking their approximately $9 trillion balance sheet. Thus, risk on assets without structurally sound credit fundamentals remain in open waters.

Though we believe inflation will remain elevated, the TIPS 10-year breakeven rate of 2.42% (as of 9/13/2022), which has been significantly decreasing since April, suggests inflation expectations over the next ten years will remain rangebound below 3% - though still higher than the Fed's 2% inflation target. With that said, the 2-year yields domestically and internationally continue to rise, with the 2/10-year yield curve inversion at the widest spread since 2007 and reaching dot-com level spreads through the end of August at 35 bps. Yield curve inversions historically foreshadow a recession (which it did yet again), but inverted yield spreads that are increasing the risk of a sustained downturn remain top of mind for investors, with correlated riskier assets at the inflection of uncertainty.

Before the June and July rebound, the huge jump in yields has made selective credit securities look attractive from a pricing perspective as recession fears and inflation appear largely priced into credit markets. Currently, the same credit opportunities may have some room to come back into a price range adjusted for sustained hawkish monetary policy and higher interest rates to tame persistent inflation.

Though they bring the potential of more credit risk, we see relatively attractive opportunities in higher-yielding corporates as the yield and price reaction compensate for macro-level credit risk -though idiosyncratic credit risk parity to yields remains a case-by-case basis. Amid equity volatility, investors should remain cautious about excessive credit risk or higher equity delta bonds, with Investment Grade (IG) corporates and municipals delivering higher quality credit fundamentals and higher relative yields compared to a few years ago. Duration management should be credit investors top priority to mitigate asset return attrition and leakage during a rising rate environment. It is important for investors to understand that income is available without taking on too much credit risk. For instance, structured credit investments such as floating rate bonds or bank loans may strategically and tactically position portfolios to weather interest rate hikes while minimizing the return downside of fixed rate bonds (as yields increase bond prices fall as the demand for those bonds yielding less are not as attractive). Therefore, structured credit remains a bright spot within credit assets supported by the S&P/LSTA U.S. Leveraged Loan 100 Price Index down -3.57% YTD (as of August 31, 2022) as seen below:

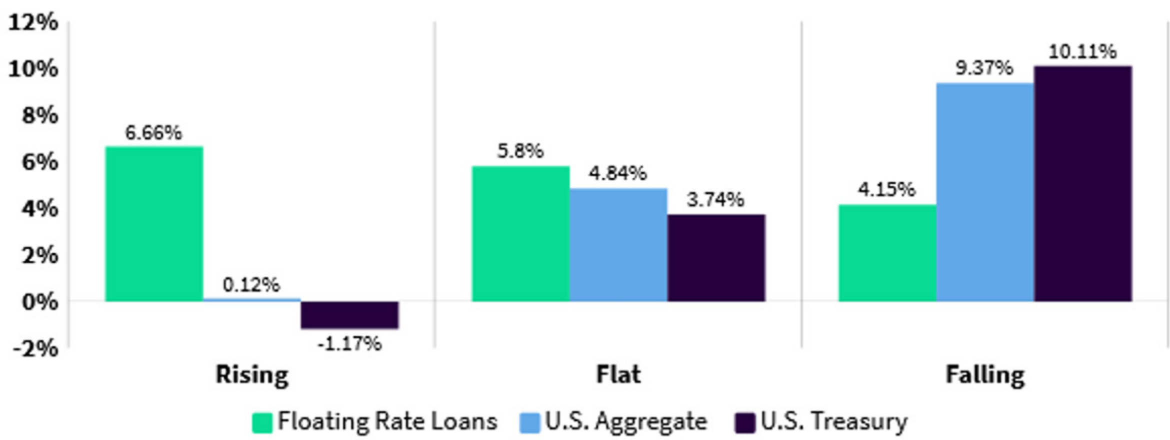
Floating Rate Bonds Perform Can Hedge the Risks of a Rising Rate Environment



*Source: Bloomberg | *Floating Rate Bonds (Bank Loans) represented by the S&P/LSTA U.S. Leveraged Loan 100 Price Index | *Bonds represented by the Bloomberg US Aggregate TR (Bond) Index | *Returns through 08/31/2022

Floating rate bonds perform best relative to other fixed income securities during a rising rate environment (as illustrated below). However, that does not mean they are a tactical shift. Rather, floating rate bonds perform during a rising, flat, and falling rate environment, potentially delivering a strategic solution to a tactical economic dilemma.

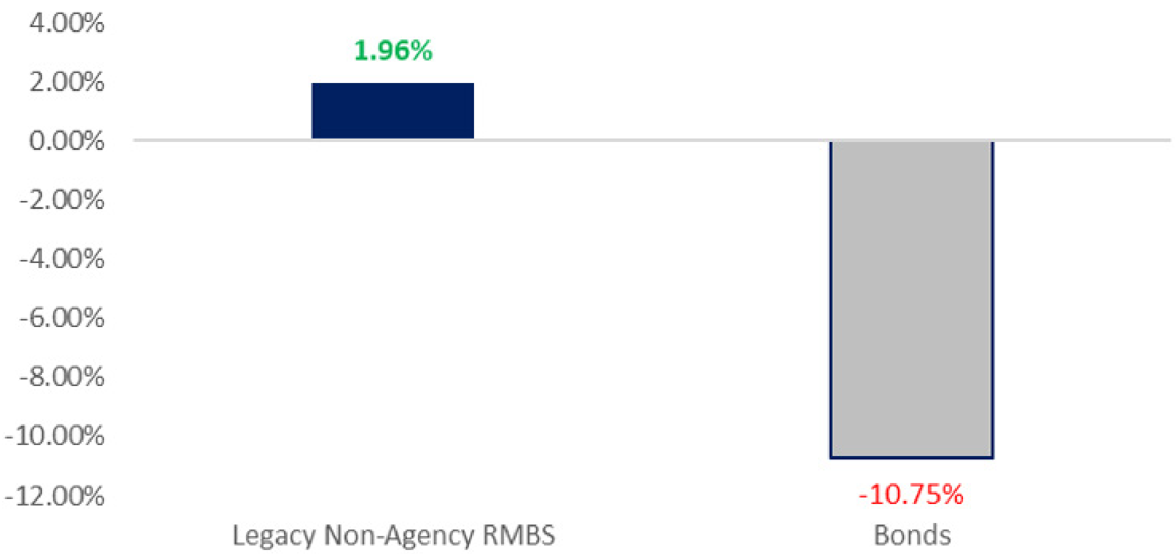
Senior Secured Notes Perfom in Rising, Flat and Falliing Rate Environments



*Source: Credit Suisse and Bloomberg Indices. "Rising" indicated by an increase of more than 50 bps. "Falling" indicated by a decrease of more than 50 bps. Data reflects rolling 12-month periods from 01/31/93 through 06/30/2022.

Furthermore, one notably optimistic investment story within fixed income has been the resiliency of the legacy Non-Agency Residential Mortgage Backed Securities (NARMBS) space, proving that the opportunity bias of the "the survivor" bonds' argument of uncorrelated returns holds. Survivor bonds have weathered worse credit environments than we are currently experiencing -- i.e., Great Financial Crisis [GFC]. For context, these borrowers have a proven track record through the worst housing crisis in history. They have approximately 40%-60% equity in their homes, over 200 months of payment history with current payments largely principal, and the potential pricing arbitrage (trading at discounts) of the bonds from the perspective that the quality of the borrowers may enable these bonds to mature at par. The amortization of legacy NARMBS fundamentally results in the bonds systematically becoming safer as the underlying loans and the mortgage itself de-lever. Thus NARMBS, which is up +1.96% through 08/31/2022 (as seen below), will likely remain a relative bright spot within a dismal year for fixed income. As stated above, income opportunities are available without taking on too much credit risk -especially if you fundamentally understand the credit structure of specific securities.

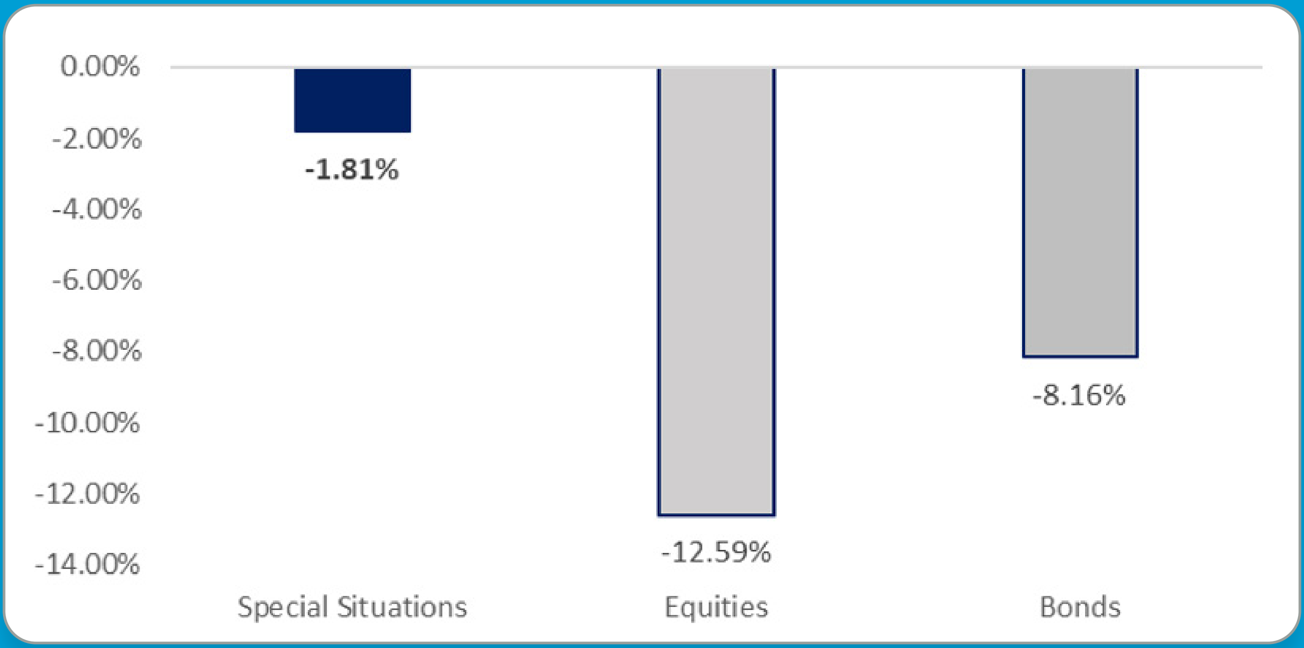
Legacy NARMBS' Uncorrelated Returns Outpace Overall Bond Market



*Source: Bloomberg | *Legacy Non-Agency RMBS represented by the Markit iBoxx US Non-Agency RMBS USD Index
*Bonds represented by the Bloomberg US Aggregate TR (Bond) Index | *Returns through 08/31/2022

Additionally, special situation investments (specifically, fixed income) may provide investment outperformance uncorrelated to overall market volatility. For instance, litigation, mergers, acquisitions, bankruptcy, spinoffs, tender offers, capital structure dislocations, activism, stock buybacks, or any other atypical event which has the high potential to alter the future course of business, materially impacting returns. During times of high volatility from economic uncertainty, investment opportunities that deliver uncorrelated returns should be top of mind. Thus, this can be viewed as an alternative approach to maximize risk premia. As seen below, represented by the Bloomberg Special Situations Hedge Fund Index (which includes more than fixed income), special situation investments have outperformed the overall market with a return of -1.81% YTD (through 7/31/2022).

Special Situations Have Outperformed Traditional Asset Classes YTD (through 7/31/2022)



Source: Bloomberg

03.

Conclusion

- Looking forward, we see the 10-yr Treasury finishing the year between 3%-3.5%, with the Fed Funds Rate finishing the year between 2.25%-2.75%.
- Additionally, we still see some room for fixed income spreads to widen until the Fed shows tangible control on inflation. Though we also believe that the downside is limited due to front-loaded market anticipation of a recession driven by inflation.
- As it appears we are entering into a new more inflationary economic era (driven by de-globalization); thus stickier hawkish policy response likely enables us to continue to favor shorter duration corporates (with intermediate duration providing some relative opportunities), high yield corporates (though income can be achieved without extensive credit risk), uncorrelated asset classes such as legacy NARMBS and special situations, and floating rate (bank loans) bonds.

The Outlook for Bonds in a Bear Market

Hunter Frey is an Analyst at Catalyst Capital Advisors, LLC and Rational Advisors Inc. covering all in-house equity strategies and an insider buying income-oriented strategy at Catalyst Funds. Mr. Frey received a Bachelor of Science degree in International Business with a focus in Spanish from Gardner-Webb University, Godbold School of Business, and is in pursuit of a Master of Business Administration in Economics and Finance from New York University, Stern School of Business.

Definitions

CPI - The Consumer Price Index measures the overall change in consumer prices based on a representative basket of goods and services over time.
TIPS - Treasury Inflation-Protected Securities, or TIPS, provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index.
PCE - Personal consumption expenditures (PCEs) are imputed household expenditures for a defined period used as the basis for the PCE Price Index.

Important Risk Considerations