January 4, 2024

Dear Clients and Friends:

As 2023 draws to a close, we find ourselves reflecting on a year that vividly embodied the German phrase "Sturm und Drang," which translates to "Storm and Stress." Although the term is now used to describe turmoil generically, it originally identified a late 18th-century movement in German literature and music that emphasized intense emotion and individual subjectivity, providing a counterpoint to the rationalism, empiricism, and universalism that defined the Age of Enlightenment.

The most prominent author associated with the Sturm und Drang movement, Johann Wolfgang von Goethe, wrote a dialectical dyad, "Prometheus" and "Ganymed," that offers relevant allegories. These two poems, drawing from Greek mythology, follow a rich tradition of exploring the interplay of opposing concepts and present an important parallel to how we navigated 2023, or any other year for that matter. (Goethe is most famous for his two-part tragic play "Faust" – the origin of the term "Faustian bargain" – which will perhaps provide the subject of a future letter more directly involving the Federal Reserve.)

In "Prometheus," Goethe presents the titular Titan as the embodiment of defiance and resilience. He is the archetypal rebel, challenging the divine order (aka Zeus) to bestow upon humanity the gift of fire – a symbol of creativity, ingenuity, and the relentless human spirit. Conversely, "Ganymed" portrays a harmonious and rewarding union with the divine, reflecting an acceptance of fate and alignment with greater forces. At the risk of waxing too poetic, these contrasting themes from Goethe's works illustrate the dual nature of our investment approach, a dual mandate if you will. On the one hand, we channel the spirit of Prometheus, challenging consensus views and taking contrarian positions when appropriate. On the other hand, we embrace the wisdom of Ganymede through the strategic alignment of portfolios with broader economic trends and long-term market dynamics.

Amid the sturm and a whole lot of drang over Federal Reserve policy and rising interest rates in 2023, some may find it surprising that U.S. Treasury rates barely changed when the dust finally settled. The 2-year Treasury yield *declined* by 18 basis points year-over-year, the 10-year was unchanged, and the 30-year rate rose by a mere 6 basis points. These rather modest annual movements stand in stark contrast with the Treasury market's extreme volatility throughout the year. This is not to say that nothing happened in 2023 – plenty of things happened in terms of geopolitics, macroeconomics, Fed policy shifts, etc. – but the past year was undoubtedly shaped by vacillating extremes in market sentiment and underlying narratives that defied linear and purely logical paths. Navigating this rapidly shifting landscape required us to balance Prometheus' defiance with Ganymede's harmony, ensuring that our portfolios were able to take non-consensus tactical stances while also operating within a consistent strategic framework.

For the majority of 2023, our portfolios maintained an above-neutral duration stance, reflecting attractive real yields that reached levels last seen, on a sustained basis, in 2006/07. While real yields are still reasonably attractive on a long-term basis, they are certainly less so now than they were in October. Respecting the sharp Treasury rally in Q4 2023 and the somewhat aggressive Fed pivot that is currently priced into the forward curve, we have reduced duration and adopted a much more neutral stance heading into 2024. This shift gains further merit when connected to current risk asset valuations, which imply a scenario of declining

interest rates without an accompanying deterioration of economic conditions. While this outcome is possible, it is not highly probable in our view.

Accordingly, we have also reduced our exposure to corporate credit. Corporate spreads, though not wholly unattractive, now present less compelling relative value, particularly against the backdrop of a slowing economy and the potential for a recession in 2024. Additionally, we have reduced exposure to non-U.S. dollar assets following two months of USD weakness that coincided with the decline in U.S. Treasury yields. A meaningful overweight to the mortgage sector, which was built during 2023, remains as a high-conviction position. Although the mortgage sector outperformed over the final two months of the year, spreads are still wide and attractive. Notwithstanding this mortgage overweight, we have transitioned our portfolios to a more balanced posture that will allow us to react more nimbly to near-term volatility.

Widening the aperture, it's crucial to recognize that the risk landscape for bond investors has shifted significantly. The focus for the past two years has been on inflation, rising rates, and heightened volatility. As we look towards the future, however, the real risk is not a continuation of these trends but rather their reversal. In other words, a return to artificially low interest rates and suppressed volatility. This is not a Q1 2024 problem – unless something truly drastic unfolds – and the shift would be beneficial in the short term, but a return to the dark days of the post-GFC period represents a significant long-term risk that bond investors should begin to confront.

As we forge ahead, our unwavering goal is to identify and prepare for an evolving set of risks and opportunities. In a dynamic macroeconomic and market environment, our commitment is to balance being flexible and disciplined, proactive and prudent. This approach, drawing inspiration from both Prometheus and Ganymede, should allow us to continue to produce superior results for our clients, with more storm and stress surely to come in 2024.

Sincerely,

Mark M. Egan, CFA
Managing Director

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