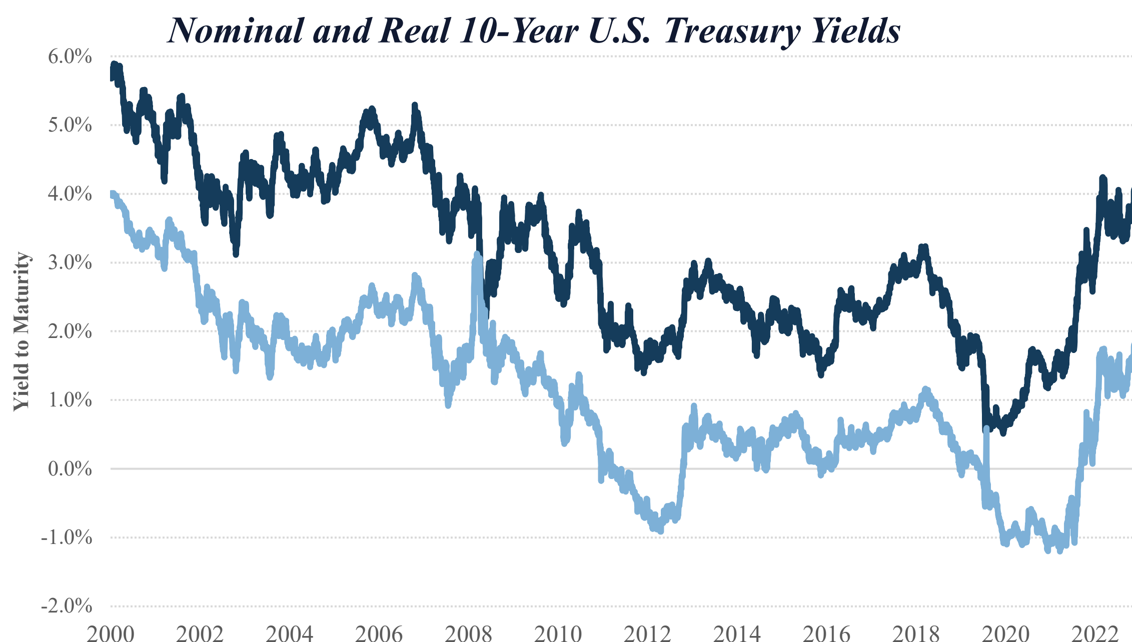
FIDELIS CAPITAL

FIXED INCOME TODAY

The 10-year U.S. Treasury yield moved above 4.5% for the first time since 2007. Time for investors to re-examine their fixed income allocation. The yield to maturity on the U.S. 10-year Treasury has recently moved above 4.5%. It is the highest yield for this benchmark security since the financial crisis of 2007-2008. In addition to this increase in the nominal 10-year interest rate, the 10-year Treasury real rate (the interest rate adjusted for expected inflation) has moved above 2%, a level not recently observed (see chart below). This current historically high level of interest rates should not be ignored – these rates are attractive given the decades-low financial repression engineered by global central banks. To be clear, we are not forecasting the peak in longer term interest rates, but we do believe the Federal Reserve and other central banks are nearing the end of their rate-hiking cycle and markets are starting to price in future policy rate declines.



Source: Bloomberg (9/27/23)

- Given these current high market yields, we believe that fixed income allocations should be moving towards a minimum neutral to a slight overweight positioning, depending on the client's objectives and risk tolerance. This would include short-term, highly liquid securities as well as longer term bonds.

- While we have highlighted Treasury yields above, however, we see a better opportunity in the highest quality investment-grade corporate bonds, mortgage-backed securities (MBS) and, for those investors in a high marginal tax rate, municipal bonds, but not exclusively. In particular, the MBS sector is offering relative value not seen in many years. All these sectors offer more yield than comparable Treasuries. We would **not** recommend investing in lower-in-credit bonds as we feel these securities have not appropriately priced in the risk of a potential recession.

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- Additionally, a barbell approach to marginally extending duration is warranted. A barbell structure is one where investors own short maturity bonds and longer maturity bonds while avoiding the intermediate-term maturities. For the longer bonds end of the barbell, now would be a good time to lock in these higher rates for a portion of the portfolio. This will help in providing protection against reinvestment risk due to future lower rates and serve as a hedge against a potential recession. For the shorter bonds end of the barbell, exposure to the higher yields in short-term bills, bonds and money-market funds would be appropriate. We are not suggesting a large move in the overall portfolio's duration or maturity, but rather a measured move longer.

- The risk to this strategy adjustment would be a continued increase in interest rates. However, given the current higher-yield environment, fixed-income securities now offer a much larger yield cushion, which can absorb future negative price movements better than in the recent past.

As mentioned in previous commentary, we think fixed income is an attractive asset class, which now offers competitive relative returns and portfolio diversification opportunities that we have not seen in many years. If you are interested in discussing further, please reach out to any member of your relationship team.

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FIDELIS CAPITAL PARTNERS, LLC

Contact us at info@fideliscapital.com to learn more about Fidelis Capital Partners, LLC or visit our website at www.fideliscapital.com.

Contact Us

Tampa Office:

4221 W Boy Scout Blvd, Suite 730, Tampa, FL 33607

Main: (813) 934-6246

Dallas Office:

910 S Pearl Expy, Dallas, TX 75201

Main: (469) 708-0225

Washington, D.C. Office:

7200 Wisconsin Ave, Suite 500, Bethesda, MD 20814

Main: (202) 571-5807

Greenwich Office:

500 W Putnam Ave, Suite 400, Greenwich, CT 06830

Main: (203) 293-2719

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