The **PACER PERSPECTIVE**
July 2022

Trend following in Fixed Income Markets in 2022

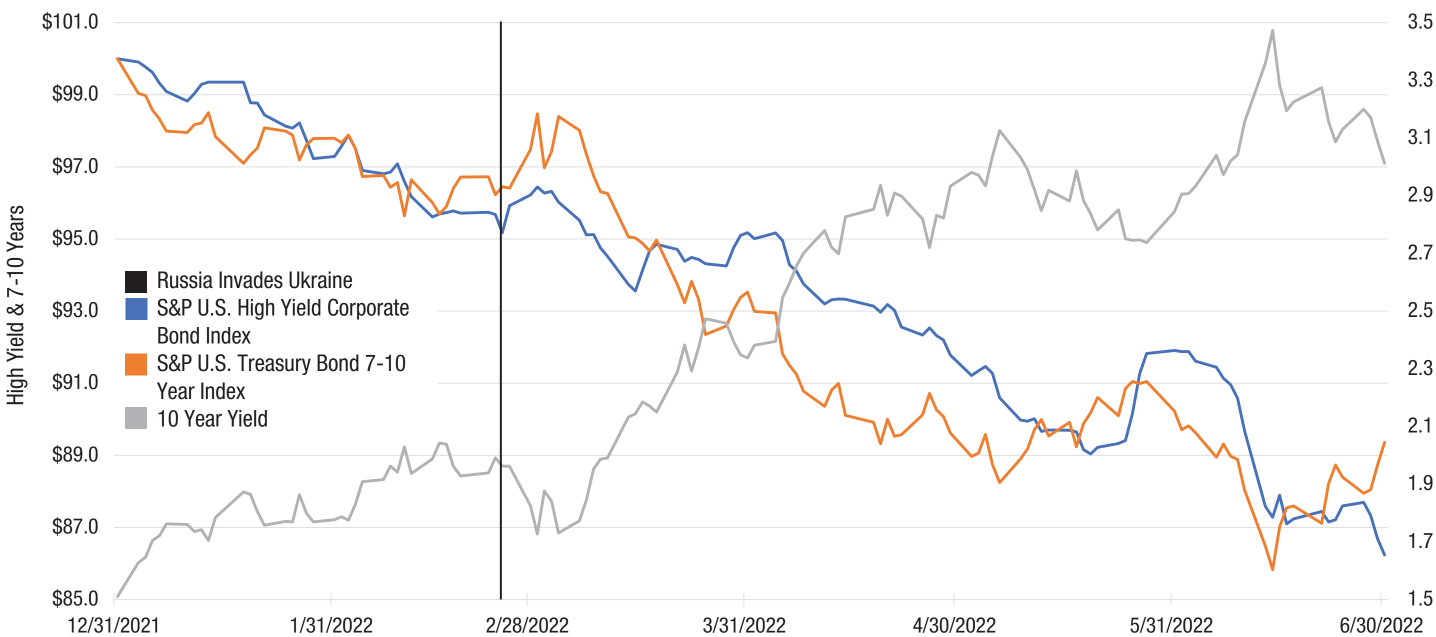
– Dylan Snyder, Portfolio Manager

2022 has been a unique year for fixed income trend following strategies in that credit spreads and interest rates have increased at the same time. During the first half of the year, it seemed like the Federal Reserve would focus on inflation. And subsequently, high yield outperformed.

Then Russia invaded Ukraine, and investors sought safety through U.S. Treasuries. However, markets eventually realized Russian sanctions would not cause many corporate defaults in the U.S. As a result, the focus switched back to inflation, rates increased, and high yield once again outperformed. Throughout June, the focus shifted back to poor economic data and the chance of a recession. This means Treasuries rallied, and high yield underperformed.

Ultimately the market has struggled to determine if the Federal Reserve will focus on inflation or fighting a recession. So, it's been hard to follow a trend if a trend has yet to be established.

Relationship Between Returns of S&P U.S. High Yield Corporate Bond Index, Treasuries & S&P U.S. Treasury Bond 7-10 Year Index
12/31/2021 – 6/30/2022



Source: Bloomberg

Thanks to rising interest rates, fixed income markets have been a sore spot for investors in 2022. When rates go higher, prices go lower. This is a relatively new phenomenon for most investors since the last time we had a sustained period of rising interest rates was during the stagflation period of the 1970s and 1980s.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. YOU CANNOT INVEST IN AN INDEX.

In such a scenario, we would expect high yield corporate bonds to outperform U.S. 7-10 Year Treasuries. This is for two primary reasons, first is the lower duration of high yield corporate bonds compared to 7-10 years.* The lower duration is attributable to the higher coupons that corporate bonds offer, as coupons cushion the blow to principal values. Second, when the Fed has to raise rates, it is a sign that the economy is strong. As a result, default rates should decline, and the spread between corporate bonds and Treasuries should tighten.

*Duration - the measure of how long it takes, in years, for an investor to be repaid the bond's price by the bond's total cash flows. It is most often used as a measure of the sensitivity of the price of a bond to a change in interest rates.

Annualized Monthly Return When 10 Year Yield Increases (12/31/1996 – 6/30/2022)

S&P U.S. High Yield Corporate Bond Index	S&P U.S. 7-10 Year Treasury Bond Index
7.10%	-10.04%

Annualized Monthly Return When High Yield Corporate Bond Spread Decreases (12/31/1996 – 6/30/2022)

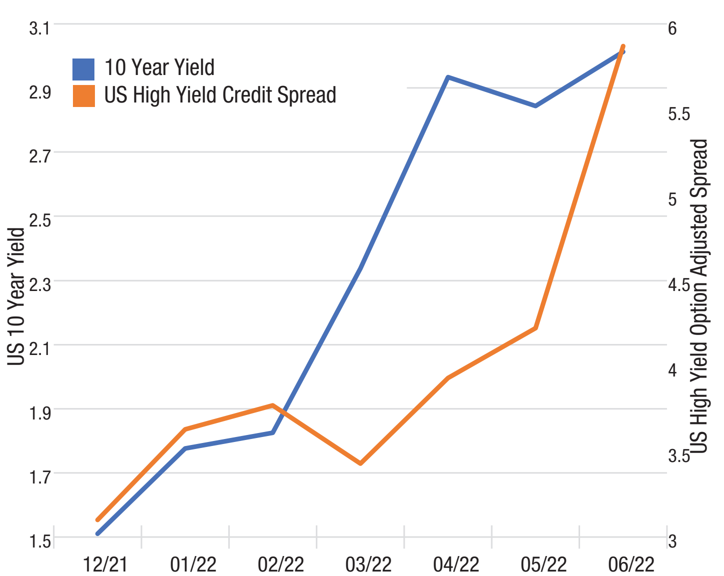
S&P U.S High Yield Corporate Bond Index	S&P U.S 7-10 Year Treasury Bond Index
21.53%	-2.98%

Source: Bloomberg & Federal Reserve Bank of St. Louis

Unfortunately, we find ourselves in an environment where both rates and spreads are increasing at the same time. This has occurred in less than 15% of months since 1996. This begs the question, what is the catalyst to have caused such a unique circumstance?

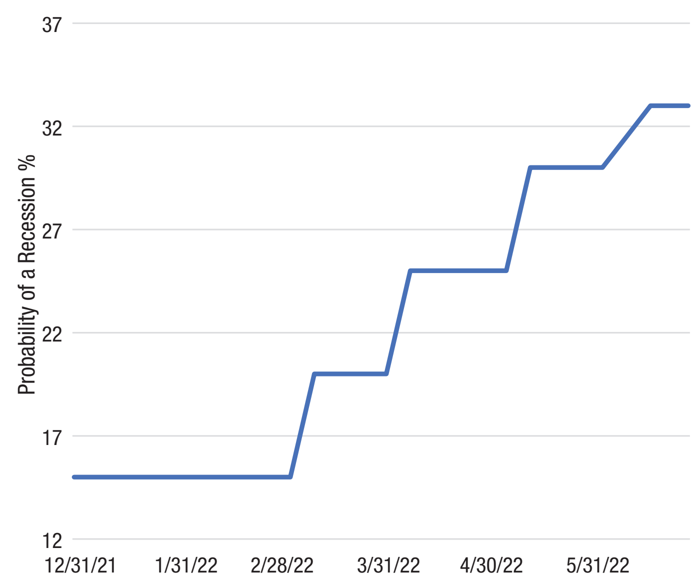
Spreads increase when credit markets begin to price in a greater chance of a recession. This would typically cause a flight to safety in longer-dated Treasuries like 7 – 10 years, subsequently pushing yields lower and prices higher. This year, major banks have steadily increased their probability of a recession occurring over the next 12-18 months. However, credit markets know the Fed must push interest rates higher to fight inflation. This has caused many to ask, will the Fed prioritize inflation over fighting a recession?

Rates and Spreads Have Both Increased YTD
12/31/2021 – 6/30/2022



Source: Bloomberg

Average Probability of a Recession From Major Banks
12/31/2021 – 6/30/2022



Source: Bloomberg

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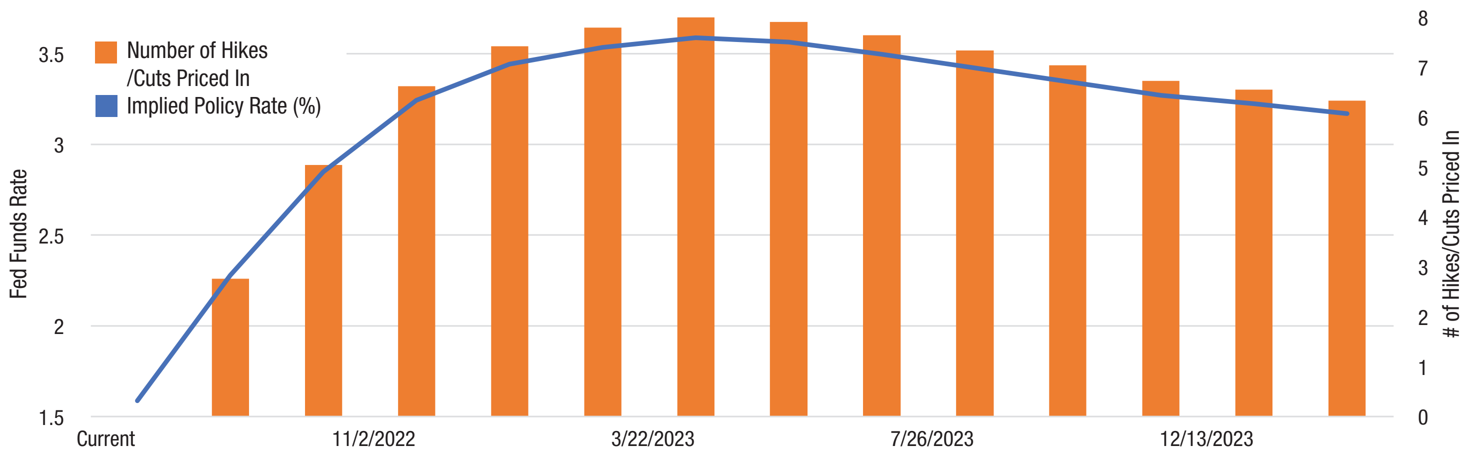
At this time, it seems like there is a fair chance the Fed will reverse course by lowering rates if a recession occurs, despite high inflation. The evidence can be found in the futures market for the Fed Funds rate. As of June 28th, the market is pricing in the Fed Funds rate beginning to drop starting in March of 2023. Additional evidence can be found in our most recent move into Treasuries. Since the Fed meeting on June 15th, a rally in Treasuries has occurred, and the 10-year yield is down approximately 15%. The meeting must have signaled to markets that the Fed would prioritize a recession over inflation.

Fed Funds Future Market
as of 6/24/2022



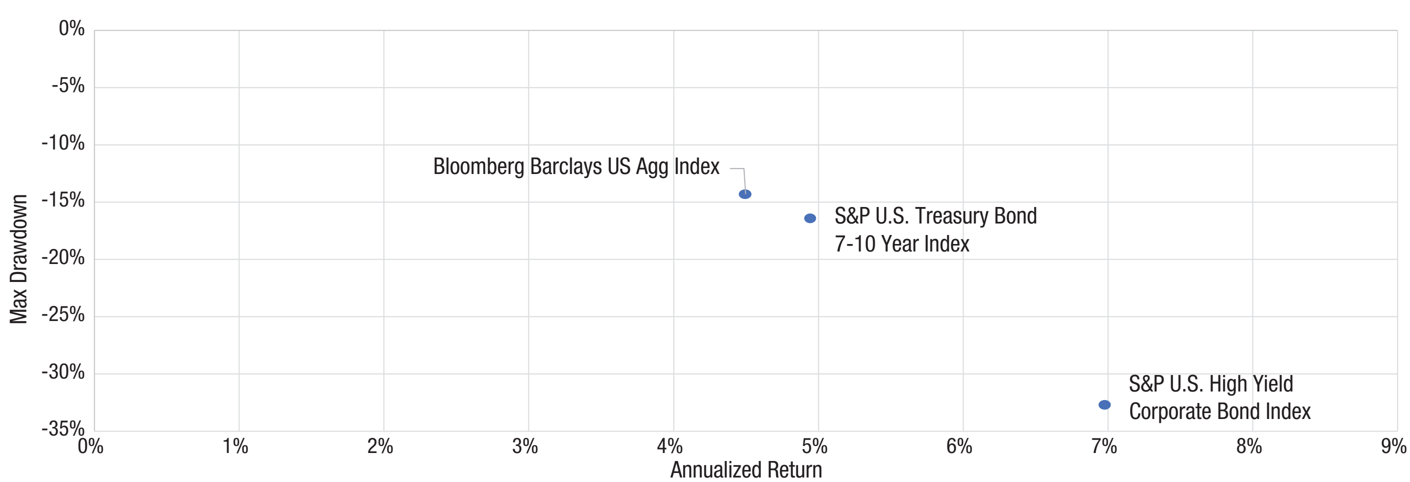
Source: Bloomberg. Forecasted figures are not definite and may not occur.

Unfortunately, even the most sophisticated investors on Wall Street don't have a crystal ball. They cannot perfectly forecast how the Fed will react in the event of negative economic growth and high inflation.

Consequently, trend following will likely prove to be an advantageous strategy. If a recession occurs, a flight to safety may likely happen in Treasuries. The Fed may artificially lower rates, and bonds with duration risk may experience a windfall. However, if we avoid a recession and the Fed stays focused on fighting inflation, credit risk compensated through higher coupons may do a better job at insulating investors from principal losses than Treasuries will.

PTBD has struggled this year because a clear trend has not yet been established. Hence, why we've rotated so much recently. Over time, a clear trend will likely emerge, and investors may be compensated for the risk they bear, whether it's credit risk or duration risk.

Relationship Between Returns and Drawdowns by Bond Asset Classes
12/31/1995 - 6/30/2022



Source: Bloomberg

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Given its ability to rotate between credit risk and duration risk, the Pacer Trendpilot US Bond ETF may provide an opportunity for investors to limit the downside risk often associated with non-investment grade bonds.

Pacer Trendpilot US Bond ETF
PTBD

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