

## FOURTH QUARTER 2021

# PREPARING FOR LIFTOFF

### PERFORMANCE

In the fourth quarter of 2021, the portfolio returned -.20%, which was below the return from the Bloomberg U.S. Aggregate Bond Index (+.01%). Duration positioning and sector allocation slightly detracted from relative performance, while security selection was a more modest headwind.

### MARKET ENVIRONMENT

Front-end rates rose as the Fed reduced pandemic emergency measures and pulled forward its rate hike projections in response to upside inflation risks. The 2-year Treasury yield nearly tripled during the quarter. Despite elevated short-rate volatility, the long end of the Treasury curve refused to follow suit. Back-end yields fell as markets priced in more rate hikes, and longer-term inflation expectations barely budged during the quarter. Higher short rates and stubborn long-end behavior leave a flatter curve heading into 2022.

Credit spreads widened during most of the quarter as heavy supply exacerbated performance headwinds that spilled over during periods of broader market volatility.

Investment grade spreads recovered some but not all of that spread widening and ended the quarter 7 basis points (bps) wider. High yield spreads recovered all and more of the spread widening and ended 6 bps tighter. Credit risk proved to be more rewarding than interest rate risk as high yield returns outpaced investment grade returns in the quarter (and for the full year).

Core Bond Select's performance for the recent quarter was driven mainly by the underperformance of the factor-based credit holdings. The portfolio's asset allocation duration and curve positioning were basically flat. The underweight to mortgages also helped as securitized products continued to weaken in the face of interest rate volatility.

### SECTOR POSITIONING

Our largest and only overweight at the sector level is in intermediate credit. Our largest underweight at the sector level is in 1-10-year government bonds, followed by lesser underweights in mortgage-backed securities, commercial mortgage-backed securities, and asset-backed securities

### MODEL HOLDINGS

Sector	Exchange Traded Funds	Ticker	Net Expense Ratio	Est. Trailing 12-Month Yield	Weight
<b>Corporate Bonds</b>					<b>55%</b>
	FlexShares Credit-Scored US Corporate Bond Index Fur	SKOR	0.22%	2.53%	27%
	iShares Short-term Corporate Bond	IGSB	0.06%	1.82%	9%
	iShares Intermediate Corporate Bond	IGIB	0.06%	2.51%	8%
	FlexShares Credit-Scored Long Corporate Bond Index Ft	LKOR	0.22%	4.63%	4%
	iShares Long-term Corporate Bond	IGLB	0.06%	3.16%	7%
<b>Mortgage-Backed Securities</b>					<b>26%</b>
	FlexShares Disciplined Duration MBS Index Fund	MBSD	0.20%	2.41%	19%
	iShares MBS	MBB	0.06%	1.05%	7%
<b>Treasuries</b>					<b>14%</b>
	iShares 3-7 Year Treasury Bond	IEI	0.15%	0.73%	2%
	iShares 7-10 Year Treasury Bond	IEF	0.15%	0.83%	4%
	iShares 20+ Year Treasury Bond	TLT	0.15%	1.50%	9%
<b>Cash &amp; Short-term</b>					<b>6%</b>
	FlexShares Ready Access Variable Income Fund	RAVI	0.25%	0.90%	5%
	Money Market	NOGXX	0.35%	0.01%	1%
	<b>Total (asset weighted)</b>		<b>0.16%</b>	<b>2.20%</b>	<b>100%</b>

Source: The portfolio holdings, characteristics and sector allocations are for illustrative purposes only, subject to change and can vary for individual accounts. Allocations may not equal 100% due to rounding. Northern Trust Investments, Inc. products including FlexShares ETFs and Northern Funds could represent up to 100% of the portfolio holdings. With respect to such funds, NTI and its affiliates provide investment advisory, custodial, administrative, shareholder support and other services and receive fees. Such investments present a conflict of interest because NTI, an affiliate, or a related person has a financial interest in the transaction.

WHAT WORKED AND WHAT DIDN'T WORK

**Sector allocation.** Sector allocation was flat for the quarter, as Long Credit and Securitized positioning added to performance (+.02%), while 1-10yr detracted (-.02%).

**Security selection.** Security selection detracted (-.17%) from performance during the quarter. SKOR (-.044%), LKOR (-.026%) and MBSD (-.06%) underperformed the legacy indices.

**Duration and curve positioning.** During the quarter, interest rates increased led by the front end of the curve with 2yr and 5yr Treasuries up 35-45 basis points. Our positioning in the front end added 4 basis points (+.04%) while intermediate 5-10yr detracted the same.

ATTRIBUTION (BASIS POINTS)



Source: Northern Trust Asset Management

## INTEREST RATE VIEWS

Throughout the quarter, we maintained a neutral-to-slightly-longer duration profile, however we did lighten up into year-end as rates rallied on the Omicron pandemic variant. Closing out the quarter we were fairly close to home as we assess the new found hawkishness from the Federal Reserve. Most of the rate volatility remains at the front to intermediate portion of the curve as the back end has been reasonably anchored. This is indicative of market pricing of a near term active Fed and booming economy, but longer-term hesitancy over the durability.

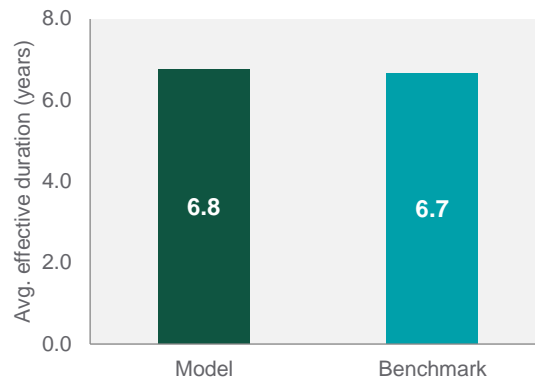
Certainly, inflation has been stickier, however we (and the market) do expect goods inflation will moderate back towards pre-pandemic trends. We have moved our interest rate ranges up on the front end and slightly more on the back end and will be positioned accordingly. In this unique environment, curves are behaving more like mid-cycle hiking not lift-off. We will pay generous attention to what this means for risk and rates into the new year. We do expect the terminal Fed Funds to be lower than previous hiking cycles.

## SECTOR VIEWS

From an allocation standpoint, we have preferred credit markets over treasuries for some time, and that was maintained during the quarter. Fundamentals continue to improve, supply is expected to slow, and defaults continue to arrive much slower than market expectations. We also remained neutral-to-underweight mortgage-backed strategies as rate volatility and pre-payment speeds became too uncertain.

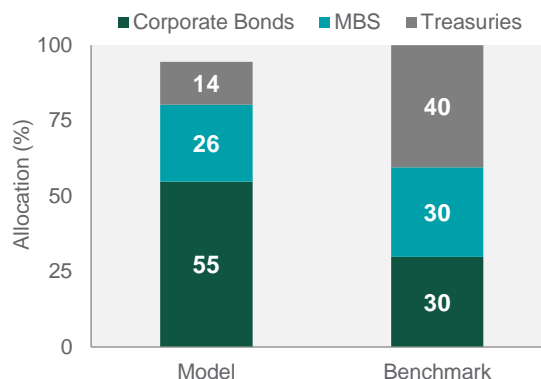
This same game plan holds, however unlike last year we have an added risk of an active Federal Reserve removing the extra-ordinary accommodation. We enter the new year still overweight credit, but cognizant that this year will look different than last. Although credit markets remain near historically tight levels on a spread basis, we do think fundamentals will carry the day for awhile longer until we can escape the pandemic influenced data, but perhaps with a bit more volatility.

## CURRENT DURATION POSITIONING



Source: Northern Trust Asset Management. Model is Core Select Bond Portfolio; Benchmark is Bloomberg U.S. Aggregate Bond Index. Current as of end of quarter.

## CURRENT SECTOR POSITIONING



Source: Northern Trust Asset Management. Model is Core Select Bond Portfolio; Benchmark is Bloomberg U.S. Aggregate Bond Index. Positions may not sum to 100 because cash allocation is not included. Current as of end of quarter.

## CONCLUSION

The fourth quarter was punctuated by two main risk events: a pivot to more hawkish central banks along with a new COVID variant that weighed on global activity. End to end marks in asset prices that were relatively flat masked higher intra-quarter volatility. For example, 5-year TIPS break-evens increased 75 basis points before falling 50 basis points. Investment grade credit gave up all its YTD excess return in November only to recover most of in December. High Yield spreads widened 75 basis points before falling near YTD tight levels. Certainly, evident of markets that are trying to find its sea legs amidst changing monetary policy.

Economically growth is naturally slowing from the booming early part of the pandemic, however it remains robust. The market's (and the consumer's, Washington's, and Central Bank's) focus is on inflation. While most of the CPI increases remain in sectors hurt worst by the pandemic, the increases have lasted longer and there have been recent elevations in housing and rent. We will monitor this closely for any inflation "stickiness". We expect economies will continue to grow, albeit at a more moderate pace, and inflation should return to more normal levels, perhaps

aided by tighter monetary policy. Longer-term structural inflation headwinds remain.

Risk markets seem fairly valued for fundamental reasons, however, will have to grapple with an evolving monetary environment. Longer maturity rates remain well anchored and forward expectations for inflation are well off their high levels. For Core Bond Select, we remain overweight risk and closer to home on interest rate risk. Risks to our view surround future fiscal policy entering restrictive territory, leading to economic underperformance. Fiscal headwinds also are more present this year however we expect this can be absorbed for now. We maintain our preference for risk and will watch for signs of interest rate stability before making any significant allocation or duration changes.

We will continue to put our skills to work at identifying medium-to-long-term turning points in interest rate, credit, and economic cycles. Maintaining a disciplined portfolio construction process that ensures our risks are intentional and compensated remains a priority. We look forward to keeping you informed of our thoughts and results going forward.

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