FUND COMMENTARY | January 2025

Wellington Opportunistic Fixed Income Fund

WELLINGTON MANAGEMENT®

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MARKET REVIEW

- Growing geopolitical tensions and tariff concerns dominated headlines. Credit spreads tightened and most sectors posted positive excess returns.
- US economic data releases were sluggish. Consumer confidence lost ground on a softer outlook for business conditions and employment. The producer price index excluding food and energy remained flat, while wholesale inventories notched a decline. The manufacturing PMI inched up into expansionary territory; meanwhile, weakness in the volatile transportation component dragged down durable goods orders. Employment data stabilized as payrolls beat expectations in December and weekly jobless claims remained rangebound. Housing data showed some improvement with increases in existing home sales despite elevated mortgage rates. However, cold weather likely induced a drop in pending home sales, most pronounced in the West region.
- Slowdowns in the German and French economies weighed down 4th quarter eurozone GDP, while eurozone manufacturing PMI remained in contraction. Germany's IFO business climate index improved as assessment of current conditions and expectations both gained, though election uncertainly lingered. UK's manufacturing PMI lifted compared to the prior month's level but remained in contraction.

FUND PERFORMANCE AND ATTRIBUTION

- The portfolio generated positive total returns for the month of January.
- Over the month of January, positive total returns were driven by our strategic sector and tactical positions. Relative value positions had a negative impact during the period.
- Within our Strategic sector, positive performance was driven by our EM Opportunities and Activist Government theme. Within emerging markets, local markets debt outperformed external debt. Spread narrowing contributed favorably to external debt performance, and a decrease in US Treasury yields also had a positive impact. EM currencies appreciation drove the positive performance within local markets, and EM rates also benefited results.
- Within Relative value, exposure to rates and credit detracted from performance. The USD ended mixed versus major developed- and emerging-market currencies. Among G10 currencies, the USD firmed against the CAD, GBP, CHF, and SEK. The Fed left rates unchanged awaiting further inflation and jobs data, and clarity on the impact of Trump's policies. Geopolitical tensions and challenging growth outlook outside the US further boosted the dollar's strength. Conversely, the USD weakened against the JPY, NZD, and AUD. The JPY appreciated after a stronger-than-expected wage growth announcement raised expectations for another rate hike later this year. The AUD and NZD recovered after Trump agreed to pause tariffs on Mexico and Canada. In EM FX, performance was mixed. LATAM currencies, led by the BRL, generally gained versus the greenback amid tentative optimism about a delay in tariff announcements. The MXN initially fell but recouped heavy losses after a one-month tariff delay was reached.
- Within Tactical strategies, exposure to FX modestly benefited performance. Agency MBS underperformed duration-equivalent Treasuries. MBS spreads were mostly flat as the market balanced a pause in Fed rate cuts and a decrease in interest rate volatility. Within the sector, conventional mortgages underperformed GNMAs.

FUND POSITIONING AND OUTLOOK

- Historically, the Opportunistic Fixed Income portfolio has performed well in more volatile periods, where markets present opportunities to take advantage of mispricings across global credit sectors, rates, and currency. For example, in the third quarter of 2024 we were able to monetize volatility across global rates, global credit sectors, and global currency and outperformed all fixed income sectors with considerably less volatility. In our view, the continued momentum in credit, US rates, and the US dollar during the fourth quarter have exacerbated dislocations in these assets which we believe we can exploit in 2025. Consider the following dislocations available in the market today:
    - US forward real yields are close to 3% a level not seen since the early 2000s
    - The yield differential between forward Central Bank pricing between the Fed and ECB are at historic extremes
    - Agency Mortgage spreads relative to US corporate spreads are close to their widest level since the early 1990s
    - Japanese 30yr rates are higher than in China for the first time ever
    - There is a historic gap between EM real yields and US High Yield, inflation-adjusted yields
    - US long corporate spreads are at their tightest level since the late 1990s
    - Interest rate differentials have narrowed considerably with the Fed cutting rates by 100bps in 2024 and yet the dollar is approaching its highest level since 2021
    - Investment-Grade Emerging Market External debt spreads are at similar levels as in the mid-2000s despite recently weak currency performance
    - These are all extreme pricings that the OFI portfolio is looking to take advantage of within the coming year, which we expect to be more volatile than 2024 given the uncertainties around the policies that are going to be enacted by the incoming Trump administration

Rates

- We increased our aggregate duration position throughout the fourth quarter by 0.6 years mostly through the addition of Agency mortgages within our tactical bucket. Agency mortgage spreads remain at historic wide spreads relative to credit and actually outperformed after the election as interest rate volatility has subsided. While the conventional wisdom after the election is that President Trump will be negative for all of fixed income, if he chooses to focus his agenda more on tariffs and immigration reform compared to new fiscal stimulus, that will represent a more negative growth/higher inflation trade-off environment. This is the environment where inflation-linked bonds should outperform, and the

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portfolio has close to 2.3 years of duration coming from ILBs. Also, it is interesting to note that cyclical stocks have not outperformed defensive stocks since the election; which is very different than the 2016 election and has been most correlated with yields. In other words, despite the election, cyclical worries within equity sectors point to a more muted growth environment.

Credit

- We acknowledge the risk that spreads may stay at current levels given the high yield environment and chase for income. However, we think the market is fully pricing in a Goldilocks economic scenario and placing very little probability on other potential ways the macro environment might evolve. While we remain net short credit, we are not envisioning a dramatic slowdown in growth, but a return to a more normal spread volatility environment and some reversion towards mean. We think government bond yields globally (select DM and EM local) offer a more attractive form of yield and carry, while getting credit exposure from idiosyncratic allocations like CoCos, Hybrid Securities, and structured products where valuations are still not at extremes.

Currency

- Overall, valuations for the US dollar remain very elevated, which imply the currency should face downward pressure in the medium term. At the same time, rates have converged notably in the past year and yet the dollar remains at elevated levels. Finally, in our view expectations for the Fed to cut rates are too low at only 28bps of cuts for all of 2025 as of January 14th.

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