Birch Run Investments

Core Fixed Income

March 2022

Holding-Based Statistics

	Core Fixed Income	Bloomberg Barclays Agg. Index
Yield to Maturity	2.57%	2.90%
Effective Duration	6.20 years	6.45 years
Average Quality	AA	AA

Strategy Statistics

Trailing 12 Month Turnover	35%
Firm Assets	259.78
Product Assets	33.07

Investment Philosophy

The Core Fixed Income Strategy seeks to add value by capturing market inefficiencies with regards to security selection and sector rotation. Through rigorous credit research and thoughtful analysis of risk/reward, we seek to construct portfolios with a yield advantage to the overall market. Through the compounding of this yield advantage and by minimizing other areas of portfolio volatility, we believe we can offer clients an attractive risk adjusted return through different market cycles.

Portfolio Management Team

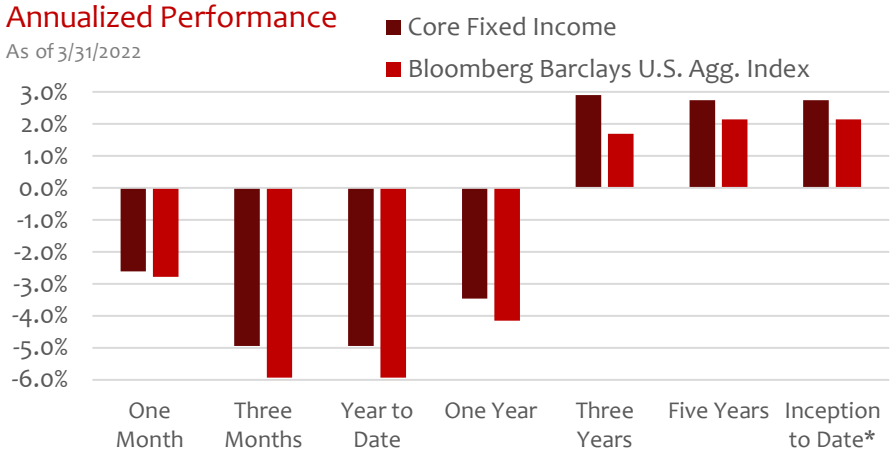
David M. Killian
Joseph D. Shacklock

Inception Date

3/31/2017

Annualized Performance

As of 3/31/2022

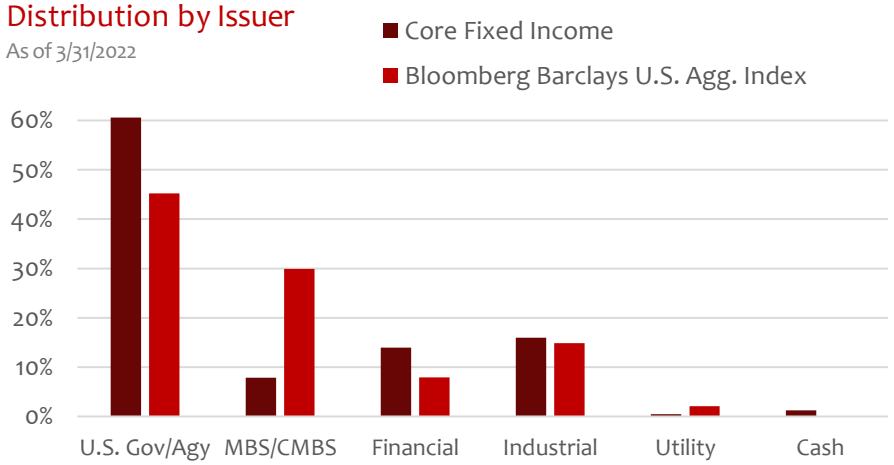


	One Month	Three Months	Year to Date	One Year	Three Years	Five Years	Inception to Date*
Core Fixed Income	-2.61%	-4.94%	-4.94%	-3.46%	2.90%	2.74%	2.74%
Bloomberg Barclays U.S. Agg.	-2.78%	-5.93	-5.93%	-4.15%	1.69%	2.14%	2.14%

* Inception 3/31/2017

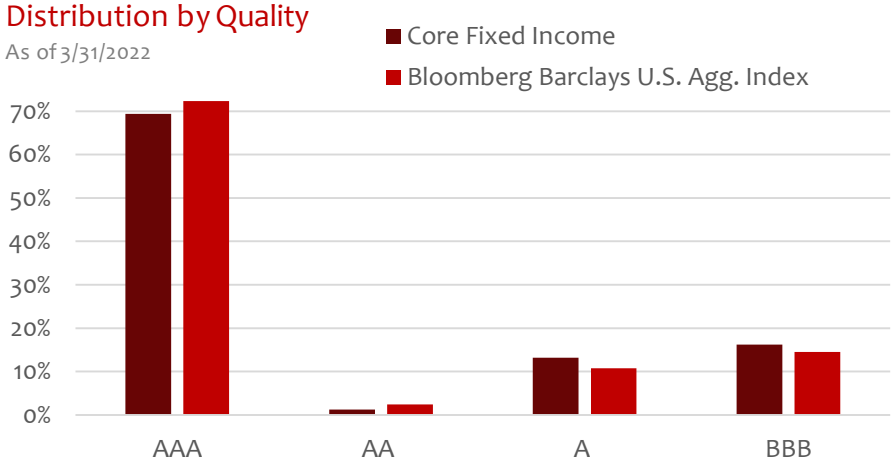
Distribution by Issuer

As of 3/31/2022



Distribution by Quality

As of 3/31/2022



Top 10 Holdings

As of 3/31/2022

US Treasury 0.125% - 10/31/22	5.48%
US Treasury 0.125% - 12/31/22	5.31%
US Treasury 0.375% - 1/31/26	4.21%
US Treasury 0.25% - 10/31/25	4.03%
US Treasury 1.625% - 11/15/22	3.44%
US Treasury 2.00% - 11/15/41	3.18%
US Treasury 1.125% - 2/29/28	2.93%
US Treasury 1.625% - 2/15/26	2.79%
US Treasury 2.875% - 8/15/28	2.77%
US Treasury 1.875% - 11/15/51	2.76%

Birch Run
INVESTMENTS

211 Welsh Pool Rd, Suite 234
Exton, PA 19341

610-321-3453
birchruninvestments.com

1Q2022 Portfolio Commentary

In response to the continued high level of inflation and the tight labor market, last quarter we highlighted that the policy setting Federal Open Market Committee (FOMC) was shifting their messaging on policy. Inflation that was once thought to be transitory was re-labeled "persistent" and "entrenched", leading to the FOMC signaling that a rate hiking cycle coupled with balance sheet reduction would be necessary to bring inflation back to a sustainable level. As we entered 2022, market pricing suggested the likelihood of four 0.25% rate increases in the coming year. Following a 0.25% rate increase at the March FOMC meeting, market expectations have shifted materially. Current forecasts now suggest that over the course of the remaining seven meetings scheduled for this year, the Fed will raise the funds rate to 2.50%, if not higher. This meaningful adjustment in yields reflects the pronounced sense of urgency from Fed officials that all forms of accommodation should be removed aggressively to combat inflation.

Contributing to the more hawkish rhetoric from Fed officials has been the ongoing strength of the economy, in particular the labor market. During the first quarter the economy continued to add a record number of jobs, with the 431,000 gain in non-farm payrolls reported in March marking the 11th consecutive month of job gains over 400,000, the longest period of growth since 1939. The unemployment rate fell to 3.6%, nearing the pre-pandemic rate of 3.5% seen in February 2020, a 50 year low. Offsetting the positive developments seen in the labor market, however, has been a high degree of inflation. As measured by the Consumer Price Index, inflation rose 7.9% in February, the highest level since 1982. The combination of an extremely strong labor market and runaway inflation is the conundrum currently facing the Federal Reserve as it seeks to achieve its dual mandate of maximum employment and price stability. Addressing this dilemma, the Chair of the Federal Reserve has indicated that the current strength of the overall economy and the health of the labor market are threatened by the current level of inflation, and all policy measures will be utilized to bring prices back to a more sustainable level. These measures will include raising the Fed Funds rate perhaps more rapidly than prior tightening campaigns and a reduction in the size of its balance sheet, which is expected to begin in May of this year.

Given the risks to the economic outlook posed by a more hawkish Fed policy, corporate bonds, along with other more risk sensitive areas of the market, trailed the performance of safe haven U.S. Treasuries. On a total return basis, the Bloomberg Barclay's U.S. Corporate Index returned -7.69% for the quarter, while the Bloomberg Barclay's U.S. Treasury index returned -5.58%. The sharp increase in yields seen throughout the first quarter has resulted in the bond market now pricing in a large number of the rate increases anticipated for this year, which has led to a continued flattening of the yield curve. Short term yields, those most sensitive to changes in monetary policy, increased sharply during the quarter, with the 2-Year U.S. Treasury increasing 160 basis points to end at 2.34%. The 10-year U.S. Treasury closed the quarter 83 basis points higher to end at 2.34%. The shape of the U.S. Treasury yield curve can provide many clues with respect to the outlook for the U.S. economy. Historically, a flattening yield curve is an early indication of a slowing economy while an inversion of the curve tends to precede a recession. The current state of the U.S. Treasury yield curve highlights the challenge facing the Federal Reserve faces in engineering a "soft landing", or a tightening cycle that does not result in damaging economic growth.

With the Fed now firmly committed to reigning in inflation, the question posed by investors is: will the actions necessary to achieve their objective push the economy into a recession? The record amount of stimulus provided during the COVID-19 pandemic reduces that likelihood, however, the outlook remains highly uncertain. To achieve their goal, our base case forecast is, at a minimum, the FOMC will raise the short term rate to a level that neither restricts nor spurs economic growth, i.e. the neutral rate. While there remains debate as to what the neutral rate is, consensus suggests approximately 2.5%. To avoid a policy mistake, the Federal Reserve must accurately forecast this neutral rate and adjust policy accordingly. Going too high above the neutral rate could push the economy into a recession while not going high enough would most likely allow inflation to remain entrenched. The current shape of the U.S. Treasury yield curve, which sits close to inversion, suggests that many investors believe that a policy mistake is likely.

As previously stated, at current levels, interest rates have already priced in a large degree of the anticipated policy adjustment from the Federal Reserve. However, we contend that perhaps this full policy adjustment may not materialize. Easing supply chain issues and an expiration of emergency fiscal policies may be factors that reduce inflationary pressures naturally, thereby lessening the need for an overly aggressive Fed response. In light of this view and the material repricing seen in the bond market this quarter, we believe yields at current levels are approaching fair value and will soon provide an attractive entry point for new investments. Given the great number of uncertainties with respect to the economic outlook and the many challenges facing the Federal Reserve, we maintain the belief that a bias toward higher quality bonds is appropriate. Our conservative approach will focus on selectively adding exposure to taxable corporate bonds of the highest quality.

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