# Victory INCORE Investment Quality Bond Fund Quarterly Commentary



As of June 30, 2022

## THE FED PIVOTS … BELATEDLY

### Q2 Summary

Rising and persistent inflation, driven by lingering supply chain disruptions, labor scarcity, inefficient regulatory policy, and the war in Ukraine, continued to push financial markets further into negative return territory as the U.S. Federal Reserve belatedly pivoted to fighting inflation in Q2. The Bloomberg U.S. Treasury Total Return Index returned -3.78% in Q2 and -9.14% year-to-date (YTD). The broader Bloomberg U.S. Aggregate Total Return Index delivered -4.69% in Q2 and -10.35% YTD, as U.S. corporate bonds, mortgage-backed securities, and asset-backed securities have all underperformed Treasurys on a duration-adjusted basis. Inflation-adjusted Treasurys, which many consider a "port in a storm," returned -3.16% in Q2—with YTD returns at -8.92%, which is worse than nominal Treasurys on a duration-adjusted basis. Risk markets moved lower as financial conditions tightened in Q2; the ICE BofA Investment Grade U.S. Convertible Index returned -7.72% in Q2 and -9.74% year-to-date, which is better than the Bloomberg U.S. Corporate High Yield Index return of -9.83% in Q2 and -16.87% YTD. The S&P 500® Index return was -16.10% in Q2 and -19.96% YTD. In a hopeful sign for inflation peaking, the Bloomberg Commodity Total Return Index returned -5.92% in Q2 but is still up 18.03% YTD.

### Outlook

In Q2, the Federal Reserve belatedly acknowledged the need to fight inflation aggressively. Chair Powell has pivoted and is making it apparent he's more concerned about the risk of failing to stop inflation than the risk of recession. In his own words, "The process is highly likely to involve some pain, but the worse pain would be in failing to address this high inflation and allowing it to become persistent." Since March, when the Federal Open Market Committee hoped gradual 25 basis point hikes combined with quantitative tightening would be enough, the committee has raised the federal funds rate two times, from a range of 0.25%–0.50% to the current range of 1.5%–1.75%; the 0.75% rise in June was the largest hike in 28 years. We expect another increase of that magnitude in both July and September. Our forecast for the terminal federal funds rate this cycle is currently 3.75%–4.00%, reached sometime in mid-to-late 2023.

In a positive sign for inflation peaking soon, the Bloomberg Commodity Total Return Index seems to have peaked in June. Additionally, a strong dollar, as well as overstocked retailers offering discounts to clear inventory, may provide some relief. However, as discussed in our previous summaries, the themes of supply chains, labor scarcity, inefficient regulatory policy, and ongoing war have not abated. We don't expect year-over-year headline inflation to return to 3% or lower until at least Q3 of 2023.

Supply chains are being redesigned for resiliency and located in regional trading blocs which are allied politically. The process is an expensive endeavor requiring years to relocate facilities and human talent, and naturally has higher embedded costs.

The ratio of 11.25 million U.S. job openings versus 5.9 million unemployed workers indicates that the labor market is tight. Companies must compete for labor talent via rising wages and increased flexibility. Corporations are increasing salaries or providing special bonuses in response. Microsoft recently announced plans to almost double its budget for merit-based raises, while Exxon Mobil gave U.S. employees a 3% bonus in June. Pilots, truckers, and longshoremen, for example, are in a much stronger negotiating position, and recent votes to unionize at Amazon and Starbucks demonstrate a shift in power to employees.

Meanwhile, lack of investment in "old-economy" energy and mining, driven by a hurried push to "go green" while imposing a punitive regulatory and legislative environment, is causing shortages and inefficiencies. Simply put, renewable energy doesn't have the capacity at this stage to replace carbon-based energy, and it will be years before the capacity is built. Furthermore, renewable-energy projects aren't immune from large cost increases for raw materials, such as aluminum and steel, or from increased shipping costs as oil prices move higher. Europe's outsourcing of energy investment and supply chains over the past 25 years has made it extremely vulnerable to energy shortages this fall due to geopolitical tensions with Russia.

In the short run, aggressive tightening of financial conditions is rarely positive for financial asset returns. Higher interest rates and a flat to inverted yield curve continue to signal an increased risk of recession. We expect the economy to continue to slow in response to tightening monetary conditions, and it will likely be in recession soon, if not already. However, our baseline expectation is that any recession or downturn should be relatively mild.

We expect the remainder of 2022 to be volatile. We believe the bulk of negative returns within fixed income have most likely occurred, as the bond market is pricing in an aggressive Fed. Our expectations are that yield spreads between corporate bonds and U.S. Treasurys will be volatile, trading in a range of 180–250 basis points, while the U.S. Dollar continues to strengthen. For convertible bonds, rising rates could pressure rate-sensitive sectors, such as financials and utilities. A neutral delta position and well-diversified portfolio should help realize both upside participation should stocks rise, while providing downside support should it be needed. We expect the S&P 500® Index will likely finish the year between 3300 and 3800. While we've reduced our exposures to corporate credit, we remain overweight relative to benchmarks as corporate credit fundamentals remain strong and quality companies are in a solid position to weather a downturn. Furthermore, we remain overweight investment grade convertibles, as they tend to outperform other fixed income in a rising rate environment.

**Performance and Attribution**

*Victory INCORE Investment Quality Bond Fund (the "Fund"):* The Fund returned -5.65% (A Shares, without sales charge) during Q2, worse than the Bloomberg U.S. Aggregate Bond Index benchmark at -4.69%. The Fund's shorter relative duration position, as well as its long dollar position versus other developed-market currencies, contributed positively to relative performance, while an overweight to convertible bonds, high yield bonds, and investment grade corporate bonds detracted from relative performance. We maintain a corporate credit overweight, as corporate credit fundamentals remain strong and quality companies are in a solid position to weather a downturn. Also, investment grade convertibles tend to outperform other fixed income instruments in rising rate environments.

| Investment Performance (%) | | | | ANNUALIZED RETURNS | | | | | Expense Ratio | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Inc. Date | QTR | YTD | 1-YR | 3-YR | 5-YR | 10-YR | Since Inception | gross | net |
| A Shares, without sales charge | 2/16/93 | -5.65 | -11.31 | -10.86 | -0.74 | 0.59 | 1.49 | 4.22 | 1.29 | 0.90 |
| A Shares, with sales charge (max. 2.25%) | 2/16/93 | -7.80 | -13.29 | -12.84 | -1.49 | 0.14 | 1.26 | 4.14 | 1.29 | 0.90 |
| Y Shares | 5/12/09 | -1.89 | -11.13 | -10.56 | -0.50 | 0.84 | 1.71 | 3.22 | 1.53 | 0.66 |
| Bloomberg U.S. Aggregate Bond Index | — | -4.69 | -10.35 | -10.29 | -0.93 | 0.88 | 1.54 | — | — | — |
| Morningstar Percentile Rank (A Shares) | — | 48 | 51 | 38 | 45 | 73 | 79 | — | — | — |
| Number of Funds in Morningstar Category | — | 638 | 633 | 607 | 566 | 504 | 361 | — | — | — |

**Past performance does not guarantee future results. The performance quoted represents past performance and current performance may be lower or higher. The investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. To obtain performance information current to the most recent month-end, visit www.vcm.com.**

Returns include reinvestment of dividends and capital gains. Fee waivers were in place for all or some of the periods shown, without which, performance would have been lower. Net expense ratio reflects the fee waivers and or expense reimbursements contractually agreed to through April 30, 2023.

Source: Zephyr and Morningstar

Morningstar Category: Intermediate Core-Plus Bond



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**Carefully consider a fund's investment objectives, risks, charges and expenses before investing. To obtain a prospectus or summary prospectus containing this and other important information, visit www.vcm.com/prospectus. Read it carefully before investing.**

**All investing involves risk, including the potential loss of principal.** Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. Bonds and bond funds will decrease in value as interest rates rise and vice versa. Credit risk refers to the possibility that debt issuers may not be able to make principal and interest payments or may have their debt downgraded by ratings agencies. High yield securities may be more volatile, be subject to greater levels of credit or default risk, and may be less liquid and more difficult to sell at an advantageous time or price than higher-rated securities of similar maturity.

Mortgage-backed securities (MBS) and asset-backed securities (ABS) are subject to credit, prepayment and extension risk and may react differently to changes in interest rates than other bonds. Small movements in interest rates may quickly and significantly reduce the value of certain MBS and ABS. The market value of a security issued on a when-issued, to-be-announced ("TBA") or delayed-delivery basis may change before the delivery date, which may adversely impact the Fund's net asset value. There is also the risk that a party fails to deliver the security on time or at all. The market price of the mortgage-backed securities ("MBS") in a mortgage dollar roll transaction may drop below their future purchase price. In addition, investment in mortgage dollar rolls may significantly increase the Fund's portfolio turnover rate. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations.

The Fund may frequently change its holdings, resulting in higher fees, lower returns, and more capital gains. Derivatives may not work as intended and may result in losses. The value of your investment is also subject to geopolitical risks such as wars, terrorism, environmental disasters, and public health crises; the risk of technology malfunctions or disruptions; and the responses to such events by governments and/or individual companies.

Not all share classes are available to all investors, as described in the Fund's prospectus.

**The Bloomberg U.S. Aggregate Bond Index** measures the performance of the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasurys, government-related and corporate securities, MBS, ABS and CMBS.

This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be construed as a recommendation or solicitation to buy or sell any security or to adopt any particular investment strategy.

The Morningstar percentile ranking is based on a fund's average annual total return (excluding sales charges) relative to all funds in the same category. The highest (most favorable) percentile rank is 1%, and the lowest (least favorable) percentile rank is 100%. Fund performance used for the rankings reflects certain fee waivers, without which Morningstar rankings would have been lower and Morningstar ratings may have been lower.



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