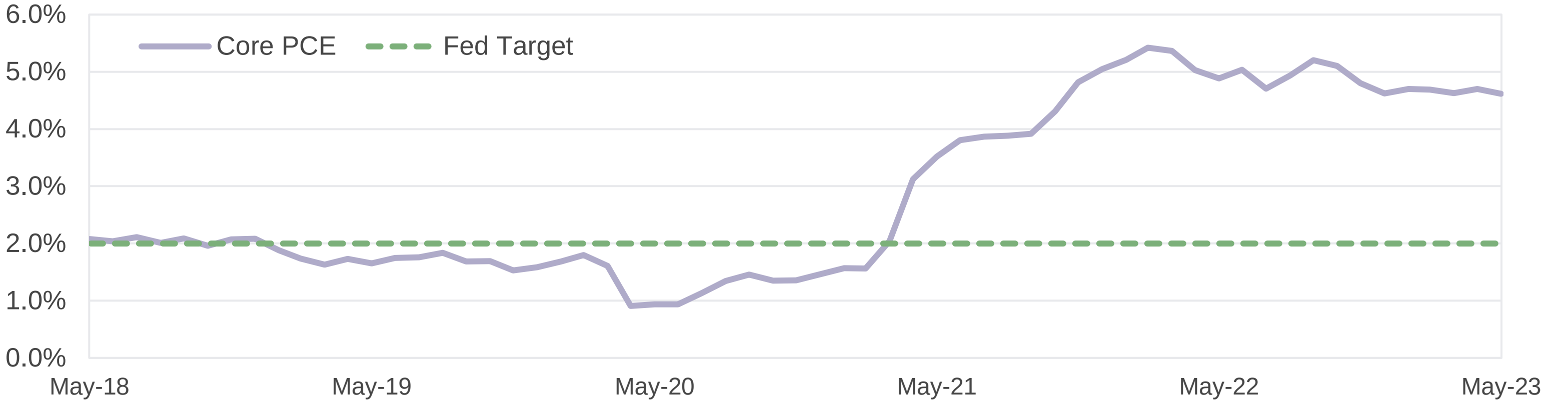
Sterling Capital Taxable Fixed Income Commentary

2nd Quarter 2023

Economic Overview & Interest Rate Outlook

U.S. Treasury yields rose during the quarter as systemic risks in the banking sector faded and the market refocused on entrenched inflationary data. Although banks reported tighter lending standards in an effort to preserve capital, little evidence of an economic slowdown emerged. Instead, economic data generally surprised to the upside. Inflation remained well above the Federal Reserve's (Fed's) stated goal of 2.0%, as Core Personal Consumption Expenditure (PCE) came in at 4.6% year-over-year in May. Jobs data remained strong, as the unemployment rate continued to hover near all-time lows at 3.60%. Non-farm payroll growth slowed but remains strong, averaging over 200K monthly job gains while unemployment insurance claims continued to signal a tight labor market.

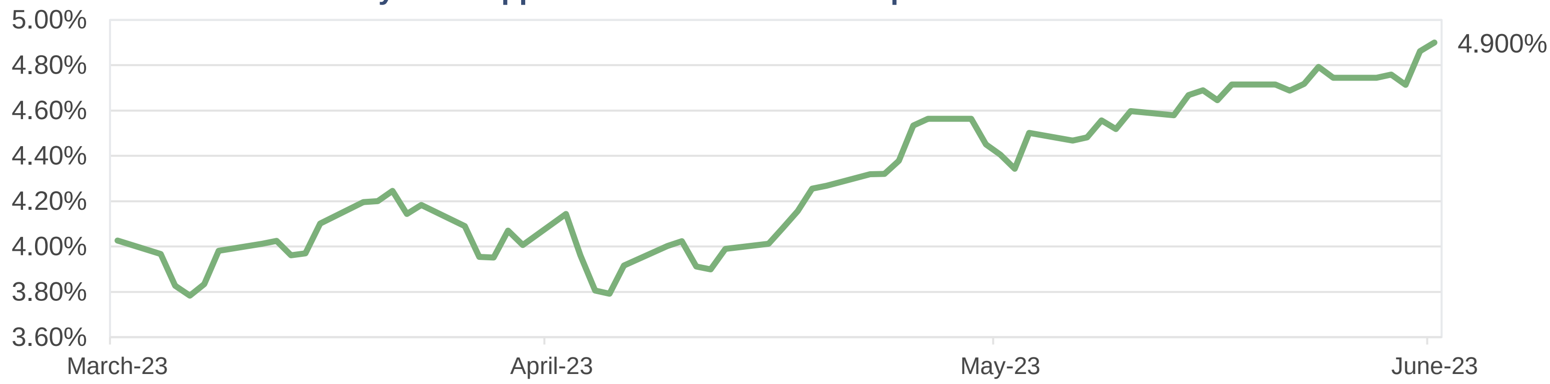
Core Personal Consumption Expenditures



The Fed raised rates for the tenth consecutive time at the April meeting but indicated that a pause in the hiking cycle may be near. During the subsequent meeting in June, the Fed did indeed pause, though its hawkish tone signaled the work was not yet done. In fact, the Summary of Economic Projections (SEP) had an average of two more hikes in 2023. The Fed also pushed the expectation for any cuts out to 2024 and increased the expectation for inflation, Core PCE, up to 3.90% for 2023.

The market was forced once again to reprice Fed activity. The odds for a hike in July increased sharply, nearing 100%, while the odds for another increase later this year also rose meaningfully. This repricing of the terminal fed funds rate was most acutely felt in the front of the curve. The yield on the 2-year U.S. Treasury note climbed 87 basis points (bps) to close the quarter at 4.90%. Benchmark rates rose across the curve, with the 5-year U.S. Treasury up 58 bps to yield 4.16% and the 10-year up 37 bps with a closing yield of 3.84%. Consequently, the yield curve inverted further, with the spread between 2-year and 10-year notes falling below 100 bps. The jump in rates resulted in negative total returns for the quarter with the Bloomberg U.S. Aggregate Bond Index down 0.84%, but still positive 2.09% year-to date.

2Y Treasury Yield Approaches 5% as Market Reprices Terminal Fed Funds Rate



Non-farm payroll refers to the number of jobs in the private sector and government agencies. It excludes farm workers, private household employees, proprietors, non-profit employees, and actively serving military. Yields are subject to market conditions and are therefore expected to fluctuate. All data referenced herein is as of 06.30.2023 unless otherwise noted. Data sources: Bloomberg L.P.; FactSet. PCE chart is as of 05.31.2023. Source for both charts: Bloomberg L.P. Charts are for illustrative purposes only.

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Our View:

While the market repriced inflation and the terminal fed funds rate higher during the quarter, we still believe the Fed has more to do to meet their 2.0% inflation goal. We acknowledge that inflation should slow in the second half of the year but will remain higher than the Fed's objective. We believe the market is still too dovish in pricing in rate cuts in early 2024, as we expect both inflation and wage growth to remain elevated. Additionally, we think the market continues to underestimate the Fed's resolve to reduce inflation by slowing the economy, which may ultimately lead to a recession. This should pressure spreads on risk assets and thus supports our up-in-quality bias.

While we think the Fed has further work to do, we acknowledge that some signs of economic weakening are emerging. The Fed cited the lagged effect of 500 bps of tightening over the last 17 months and will wait to assess incoming data. We expect rates to be range-bound in this environment, but with increased volatility the market continues to attempt to time a shift in Fed policy and focus on select economic data. Our duration bias is neutral, but we will look to tactically manage yield curve and duration exposure as this volatility creates opportunities.

Sector Performance & Exposure

Credit

The surprisingly resilient U.S. economy and a recovery in the banking sector drove strong performance for credit markets in the second quarter. The option-adjusted spread on the Bloomberg Investment Grade Corporate Index tightened from 138 bps to 123 bps, for an excess return of 1.31%. High yield spreads opened the quarter on a weaker note, but the asset class outperformed on a historical beta-adjusted basis as the issues facing the banking sector had little direct impact on high yield. The Bloomberg U.S. Corporate High Yield index spread peaked at 489 bps in early May before grinding mostly lower during the remaining weeks of the quarter to end the period at 390 bps, 65 bps tighter than at the end of March and driving excess return of 2.79%.

Following the failures of Silicon Valley Bank and Signature Bank and the forced marriage of Credit Suisse to UBS in the first quarter, sentiment in the financial sector remained somewhat fragile but improved as the quarter progressed. First Republic Bank was seized by the Federal Deposit Insurance Corporation (FDIC) in early May, causing investors to speculate about potential next victims. However, regional banks generally reported stabilizing or even improving deposit levels. While the rising cost of these deposits caused several larger regionals like KeyBank to lower future earnings estimates, the lack of further bank runs gave investors more comfort around the sector. For the quarter, banks outperformed duration-matched Treasuries by 1.51%. Non-bank financials also performed well, with finance companies, insurance companies and real estate investment trusts (REITs) generating quarterly excess returns of 2.04%, 1.60% and 1.98%, respectively.

The technology sector received a strong boost from blowout earnings reports at companies with strong AI businesses. Industrials outperformed duration-matched Treasuries by 1.25% for the quarter. Utilities struggled under the weight of heavy supply but managed to outperform Treasuries for the quarter by 0.63%. At $130B, utility issuance rose 38% year-over-year, driven by higher capital expenditures.

In high yield, among the best excess returns were seen in consumer cyclicals including retailers (7.5%), leisure (6.3%), building materials (5.0%) and home construction (4.2%), reflecting surprising strength in the consumer economy and stabilization in housing markets despite higher interest rates. Financials including finance companies (4.6%) and REITs (4.4%) also produced better-than-average excess returns as these sectors recovered from a weak first quarter of the year. Worst-performing sectors were utilities (1.0%) and consumer non-cyclicals (1.7%) as well as wireless (-1.2%), paper (-1.1%) and banking (-0.7%), although the latter represents less than 1% of the index market value.

Yields are subject to market conditions and are therefore expected to fluctuate. All data referenced herein is as of 06.30.2023 unless otherwise noted. Data sources: Bloomberg L.P.; FactSet.

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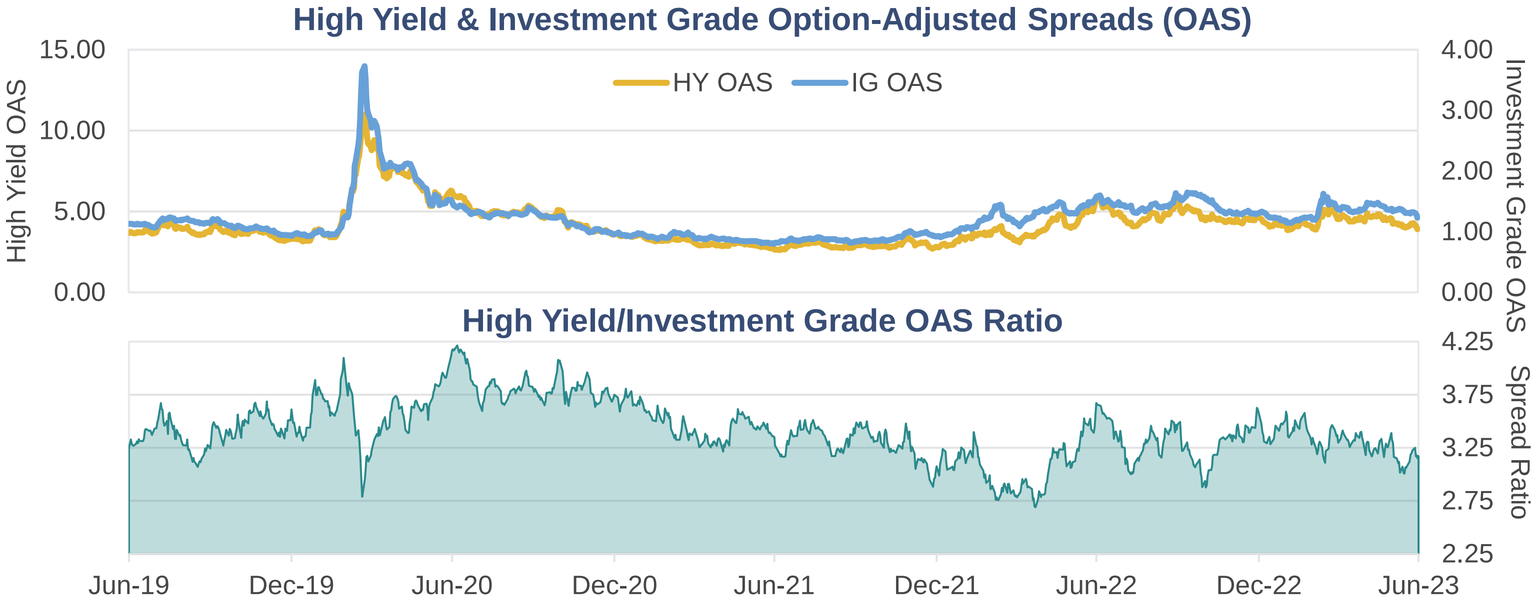

Issuance patterns played an integral part in investment grade performance this quarter. After spreads widened two bps in May following heavy supply of $153B for the month, spreads rallied 13 bps in June as issuance fell to $93B. While utility and industrial issuance continued to run ahead of the pace from last year, financial issuance fell 30% year-over-year, further boosting performance in the sector.

The high yield market continued to benefit from favorable technicals in the second quarter. Primary market issuance was $52.2B in the quarter, up 120% from the same period of 2022, and year-to-date issuance of $91.3B is up approximately 35% from the same period a year ago. However, year-to-date 2023 primary market volume is less than calls, tenders and maturities totaling approximately $70B and, annualized for the full year, is on track to total less than 50% of issuance in each of 2021 and 2020. Rising stars also contributed to favorable technicals in the first half of 2023, exceeding fallen angels by approximately $45B. These favorable technical factors have offset year-to-date high yield ETF and fund outflows of approximately $13B. Overall, the par amount outstanding of the high yield index has contracted by 2.5% so far this year, to $1,377B, following a 9.9% contraction in 2022.

Data for the first quarter of 2023 indicated that fundamental credit quality remained strong for most high yield companies. Leverage improved to a new low for this cycle, decreasing by 0.05x to 3.91x sequentially according to J.P. Morgan and reaching its lowest level since the third quarter of 2012. EBITDA margins were flat overall in the quarter at 15.6% but were off the highs from the second quarter of 2022. Margins also deteriorated for 89% of sectors, with only airlines, energy and gaming & leisure showing year-on-year growth. Interest expense increased by ~4.0% and interest coverage showed some deterioration as a result of higher interest rates, decreasing by 0.14x to a still-high 5.68x.

Our View:

The technical dynamics of the investment grade market will likely remain supportive in the near term thanks to lower summer supply and conservative investor positioning. We increased our exposure to credit in the second quarter in anticipation of spreads tightening into the slower summer period. The strong June performance for investment grade corporates left valuations near their tightest levels of this year. At 123 bps, spreads don't currently reflect a high probability of recession in the medium term. We will likely reduce our weighting to investment grade credit in 3Q if spreads continue to tighten. We expect liquidity to deteriorate later in the summer ahead of an increase in issuance in September.

A "rising star" is a bond that could be upgraded due to improvements in the issuing company's credit quality. A "fallen angel" is a bond that has been classified to "junk bond" status because its issuer's financial difficulties. EBITDA = earnings before interest, taxes, depreciation and amortization. Yields are subject to market conditions and are therefore expected to fluctuate. All data referenced herein is as of 06.30.2023 unless otherwise noted. Data sources: Bloomberg L.P.; FactSet. Chart source: Bloomberg L.P. Chart is for illustrative purposes only.

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While high yield credit metrics remain strong overall, we think they are unlikely to improve going forward as the cycle matures. Technicals should remain firm through the summer as primary market issuance is likely to remain moderate. Maturities across high yield and leveraged loans are very modest in 2023-24 at approximately $140B but increase to $350B in 2025 and to approximately $500B in each of 2026-27. This should drive an increase in refinance activity beginning in 2024, at a time when credit fundamentals may be deteriorating as the impacts of tightening in monetary conditions begin to bite. Rating agencies currently expect default rates to approximately double to the ~5.0% area over the next year. While this represents a relatively modest level of defaults historically, we think high yield spreads are currently underpricing this risk. Our positioning in high yield is light and we expect to be opportunistic in adding risk when spreads widen to more attractive levels.

Securitized Products

Agency mortgage-backed securities (MBS) got off to a rough start for the quarter following the FDIC's April 5 announcement that they had hired a liquidation agent to dispose of the securities retained as part of the Signature Bank and Silicon Valley Bank receiverships. While the sales were promised to be "gradual and orderly" and executed with an "aim to minimize the potential for any adverse impact on market functioning," the announcement nonetheless spoked investors given the combined $100B size of two portfolios. Elevated interest rate volatility compounded the pain through most of May, which helped push spreads on production-coupon MBS out near levels not seen since the first month of COVID-19 shutdowns. The extreme cheapness was short-lived, however, with the return of investor demand in June as investor optimism grew surrounding a potential pause of fed funds rate hikes. Additionally, the FDIC portfolio sales to date were executed at surprisingly strong levels and the market grew more comfortable with the idea that those dispositions won't negatively impact spreads in the broader market. By the end of the quarter, the Bloomberg MBS sector finished ahead of duration-matched Treasuries by 0.77%.

Asset-backed securities (ABS) widened significantly in March due to financial stability concerns surrounding the bank failures. Once the immediate concerns about financial stability faded, ABS spreads tightened in each month during the second quarter as both the absolute and relative value of ABS was attractive. ABS performance was historically good for the quarter, with an excess return of 0.58% being the third best quarter of performance in the last ten years. Very short ABS performed remarkably well, as traditional buyers of money market paper moved into ABS to avoid debt-ceiling concerns in the Treasury market pick up yield relative to bank deposits. While issuance took a brief hiatus during and immediately following the banking issues, late in the quarter issuance volume spiked, closing the gap between 2022 and 2023 issuance to date to ~6.0%. Despite solid demand from investors, the spike in issuance volumes has led to a wider primary/secondary spread and made new issue more attractive to investors. This resulted in clients rotating into new issuance and selling bonds in the secondary markets. Dealer balance sheet holdings of ABS have increased due to this selling pressure.

Although concerns about commercial real estate's fundamentals remained topical, non-agency commercial mortgage-backed securities (CMBS) managed to outperform duration-matched Treasuries by 0.77% during the quarter, as a result of attractive relative value and favorable technical backdrop. The sector's relative value became increasingly compelling as competing products staged impressive rebounds after the regional bank turmoil. Meanwhile, issuance was down by 60% from the same period last year. However, the fundamentals continued to deteriorate. The Trepp CMBS delinquency rate jumped to 3.09% by the end of the quarter, up from 3.09% three months ago. The May Real Capital Analytics Commercial Property Price Index was down 1.2% from April and 11.2% a year ago. This deterioration in fundamentals led to a bifurcation in performance. While higher-quality CMBS with no-to-low underlying office loans performed well, lower-quality CMBS continued to struggle. Our CMBS exposure ended the quarter slightly lower, mostly due to principal paydowns and modestly trimming our positions on strength.

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Our View:

We continued to increase our exposure to agency MBS amid the volatility early in the quarter with a focus on higher-coupon MBS, which we think offer the most attractive relative value in the agency securitized realm. While we do not expect spreads to quickly move tighter from current levels, the all-in yield and spreads remain very attractive relative to history, and we think the sector is poised to perform well as we move into a potentially slowing economic environment

Even as spreads have tightened, we still see some relative value in ABS, especially when compared to short, high-quality, non-financial corporates. Dealers will need to find buyers for the high-quality ABS that has swelled balance sheets, and this should compress the wide primary/secondary spread in the coming months. Weakening in underlying consumer fundamentals will likely continue, with student loan payments slated to resume later this year and the Supreme Court ruling against the Biden-Harris Administration's student loan forgiveness plan. This continues to favor bonds that are higher up in the capital stack and less exposed to fundamental deterioration.

We believe that the bifurcation in performance between higher-quality, low office loan CMBS and lower-quality, office loan CMBS will persist, and thus high-quality CMBS has room to further outperform as the market is still pricing in a great deal of downside risk at current levels. We continue to favor industrial and multifamily properties, which we believe are good defensive plays, and our short-duration bias will help to keep price volatility low even during turbulent times. We are comfortable with our current holdings but will reduce exposure on strength opportunistically as deteriorating fundamentals remain a concern.

Government-Related

Higher rates pushed the total return for the government-related sector to negative 0.47% in 2Q23. However, resilient macroeconomic data and growing comfort that turmoil in the banking sector would stay largely contained buoyed risk appetite as the quarter progressed. This produced strong excess returns versus duration-matched Treasuries of 0.83% for the group. While all sub-sectors contributed to the outperformance, the sovereign and local authority components were particularly strong for several reasons. BofA Research reports that 13 of the last 15 months have seen negative net issuance in external hard-currency emerging market debt. The Sovereign group was able to reverse the negative excess return generated in the first quarter and delivered excess returns of 2.48% versus duration-matched Treasuries. The market has been forced to reevaluate expectations around the timing and magnitude of an economic recession as the year has progressed. Combined with lower-than-expected supply in taxable municipal debt and balance sheets still enjoying the benefits of fiscal stimulus received during the COVID-19 recovery, the local authority sub-sector delivered another solid quarter outperforming duration-matched Treasuries by 1.27% in 2Q23.

Our View:

The local authority sub-sector, specifically taxable municipal bonds, remains our largest exposure to the government-related sector. Higher interest rates continue to make advance refunding deals less beneficial and should help contain supply. A more sanguine economic picture means the strong balance sheets built during the pandemic recovery should help buffer performance even during an economic slowdown. These technical and fundamental tailwinds continue to make the space attractive defensively versus other higher-beta sectors as the market assesses the future trajectory of growth given the Federal Reserve's current hiking cycle. While sovereign performance has been strong during 2Q23, we believe valuations are at the tighter end of their range and do not reflect the outflows from the asset class year-to-date. The negative net-issuance metric is unlikely to continue indefinitely and given current spreads the risk is growing for opportunistic issuance.

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Index Data as of 06.30.2023	3-Month Total Return	3-Month Excess Return to Treasuries[2]	12-Month Total Return	12-Month Excess Return to Treasuries[2]
Bloomberg U.S. 1-3Y Agency Index	-0.18%	-1.33%	0.57%	-3.02%
Bloomberg U.S. 1-3Y Corporate Investment Grade Index	0.27%	-0.88%	1.67%	-1.91%
Bloomberg U.S. 1-3Y Treasury Index	-0.60%	-1.76%	0.15%	-3.44%
Bloomberg U.S. ABS Index	-0.12%	-1.27%	1.18%	-2.40%
Bloomberg U.S. Agency Index	-0.44%	-1.59%	-0.40%	-3.98%
Bloomberg U.S. Aggregate Bond Index	-0.84%	-2.00%	-0.94%	-4.52%
Bloomberg U.S. Corporate High Yield Index	1.75%	0.59%	9.06%	5.48%
Bloomberg U.S. Corporate Investment Grade Index	-0.29%	-1.44%	1.55%	-2.03%
Bloomberg U.S. Government-Related Index	-0.47%	-1.62%	0.24%	-3.34%
Bloomberg U.S. Intermediate Government/Credit Index	-0.81%	-1.97%	-0.10%	-3.68%
Bloomberg U.S. MBS Index	-0.64%	-1.80%	-1.52%	-5.10%
Bloomberg U.S. Non-Agency Investment Grade CMBS	-0.56%	-1.72%	-2.08%	-5.67%
Bloomberg U.S. Treasury Index	1.15%	0.00%	3.58%	0.00%
ICE BofA 1-3Y Corporate/Government Index	-0.34%	-1.50%	0.52%	-3.07%
ICE BofA 1-3Y Municipal Index[1]	-0.11%	-1.27%	1.08%	-2.51%
ICE BofA 1-10Y Municipal Index[1]	-0.52%	-1.68%	1.83%	-1.76%

All data is as of 06.30.2023. Sources: Bloomberg L.P., ICE BofA. [1]Municipal index returns are not tax-adjusted; excess returns are in excess of the Aaa (Govt.) Municipal Yield. [2]Excess returns to Treasuries are Treasury duration-neutral. The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index. Past performance is not indicative of future results.

Important Information & Disclosures

Past performance is not indicative of future results. Any type of investing involves risk and there are no guarantees that these methods will be successful. Economic charts are provided for illustrative purposes only. The information provided herein is subject to market conditions and is therefore expected to fluctuate.

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Technical Terms: the technical terms below are sourced from Corporate Finance Institute, the Bureau of Economic Analysis (BEA), and MSCI.

The **Consumer Price Index (CPI)** is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

The **Core Personal Consumption Expenditure (PCE) Index** is a measure of prices that people living in the United States, or those buying on their behalf, pay for goods and services.

The **coupon rate** is the amount of annual interest income paid to a bondholder, based on the face value of the bond.

The **Federal Funds Rate** refers to the interest rate that depository institutions (such as banks and credit unions) charge other depository institutions for overnight lending of capital from their reserve balances on an uncollateralized basis.

Free cash flow (FCF) measures a company's financial performance. It shows the cash that a company can produce after deducting the purchase of assets such as property, equipment, and other major investments from its operating cash flow. In other words, FCF measures a company's ability to produce what investors care most about: cash that is available for distribution in a discretionary way.

Leveraged buyout (LBO) refers one company's acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. The assets of both companies may be used as collateral in the transaction.

Net leverage (also known as net debt-to-EBITDA) measures a company's ability to pay off its liabilities. It shows how much time the company needs to operate at the current debt and EBITDA levels to pay all of its debt.

Option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option. Typically, an analyst uses Treasury yields for the risk-free rate. The spread is added to the fixed-income security price to make the risk-free bond price the same as the bond.

The Real Capital Analytics' Commercial Property Price Index™ (CPPI™) measures the actual price experience of property investors, based on transaction data.

Real gross domestic product (GDP) is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year, expressed in base-year prices.

The **Tepp CMBS delinquency rate** refers to the percentage of loans within a financial institution's loan portfolio whose payments are delinquent.

Index Definitions

A Note on Indices: The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

The Bloomberg U.S. 1-3Y Agency Index is a subset of the Bloomberg U.S. Agency Index including all securities with a remaining term to maturity of more than one year and less than three years. The U.S. Agency Index includes publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government (such as USAID securities).

The Bloomberg U.S. 1-3Y Corporate Investment Grade Index is a subset of the Bloomberg U.S. Corporate Index including all securities with a remaining term to maturity of less than three years. It is composed of publicly issued U.S. corporate fixed rate, dollar denominated, bonds that are investment-grade (Baa3/BBB- or higher).

The Bloomberg U.S. 1-3Y Treasury Index is a subset of the Bloomberg U.S. Treasury Index including all securities with a remaining term to maturity of more than one year and less than three years. The U.S. Treasury Index includes publicly issued obligations of the U.S. Treasury.

The Bloomberg U.S. ABS Index is the ABS component of the U.S. Aggregate Index. It has three sub-sectors: Credit and charge cards, Autos, and Utility. The index includes pass-through, bullet, and controlled amortization structures and includes only the senior class of each ABS issue and the ERISA-eligible B and C tranche.

The Bloomberg U.S. Agency Index is an unmanaged index composited of publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government (such as USAID securities).

The Bloomberg U.S. Aggregate Bond Index is an unmanaged index composed of securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. It is not possible to invest in the Bloomberg U.S. Aggregate Bond Index, which is unmanaged and does not incur fees and charges.

The Bloomberg U.S. Corporate High Yield Index is an unmanaged, U.S. dollar-denominated, nonconvertible, non-investment-grade debt index. The index consists of domestic and corporate bonds rated Ba and below with a minimum outstanding amount of $150 million.

The Bloomberg U.S. Corporate Investment Grade Index is an unmanaged index composited of the qualifying universe of investment grade rated taxable corporate bonds. The index includes U.S.-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers.

The Bloomberg U.S. Government-Related Index is an unmanaged index composited of U.S. dollar obligations meeting certain criteria issued by native and non-native agencies, Local Authorities, Sovereigns, and Supranational organizations.

The Bloomberg U.S. Intermediate Government/Credit Bond Index measures the performance of U.S. Dollar denominated U.S. Treasuries, government-related and investment grade U.S. corporate securities that have a remaining maturity of greater than one year and less than ten years.

The Bloomberg U.S. MBS Index tracks fixed-rate agency mortgage-backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Bloomberg U.S. Non-Agency Investment Grade CMBS Index is an unmanaged index composited of SEC-registered Commercial Mortgage-Backed Securities meeting certain criteria including being rated in the investment grade category.

The Bloomberg U.S. Treasury Index is made up of the public obligations of the U.S. Treasury with a remaining maturity of one year or more.

The ICE BofA 1-3Y Corporate/Government Index is a subset of ICE BofA U.S. Corporate & Government Index including all securities with a remaining term to final maturity of more than one year and less than three years. The ICE BofA U.S. Corporate & Government Index tracks the performance of U.S. dollar-denominated investment-grade debt publicly issue in the U.S. domestic market, including U.S. Treasury, U.S. agency, foreign government, supranational and corporate securities.

The ICE BofA 1-3Y Municipal Index is a subset of the ICE BofA U.S. Municipal Securities Index including all securities with a remaining term to final maturity less than ten years. The ICE BofA Municipal Master Index tracks the performance of the investment-grade U.S. tax-exempt bond market.

The ICE BofA 1-10Y Municipal Index is a subset of the ICE BofA U.S. Municipal Securities Index including all securities with a remaining term to final maturity less than 10 years. The ICE BofA Municipal Master Index tracks the performance of the investment-grade U.S. tax-exempt bond market.

The S&P 500® Index is a readily available, carefully constructed, market-value-weighted benchmark of common stock performance. Currently, the S&P 500 Composite includes 500 of the largest stocks (in terms of stock market value) in the United States and covers approximately 80% of available market capitalization.

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