Taxable Fixed Income Commentary

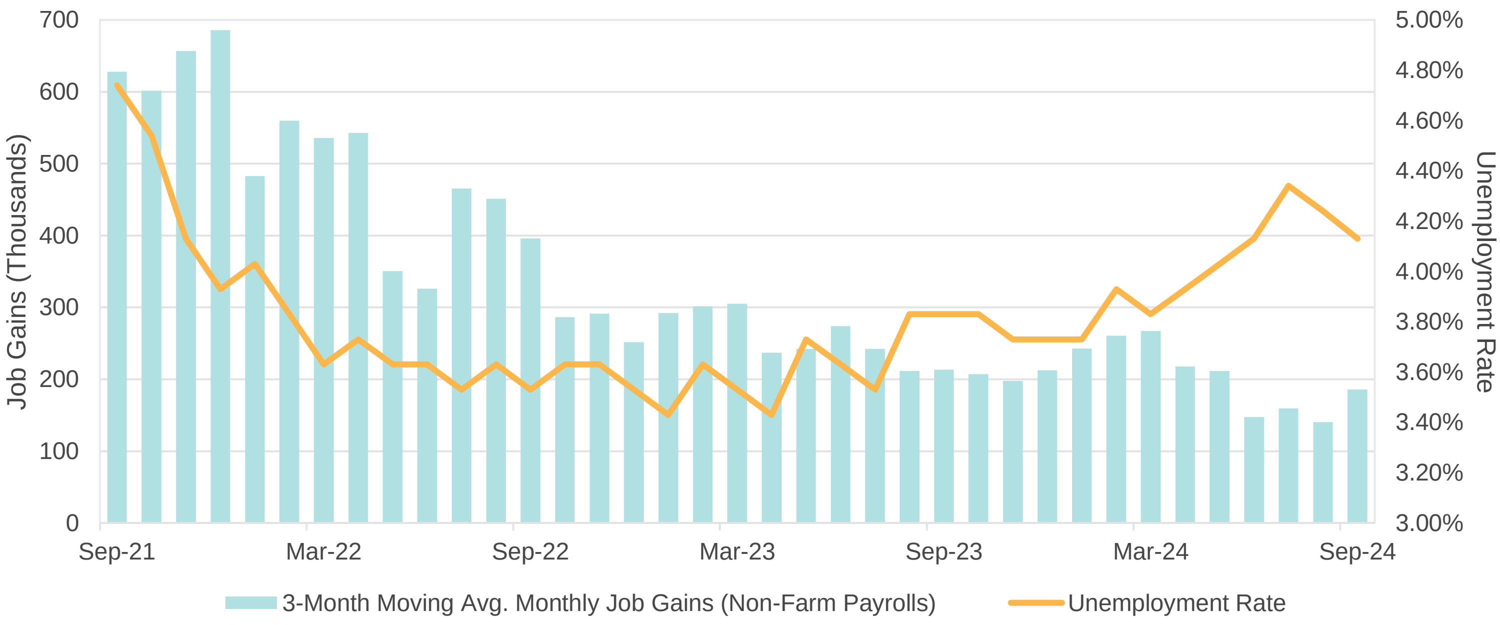
3rd Quarter 2024

Economic Overview

After 14 months of maintaining the fed funds rate at a range of 5.25 to 5.50%, the Federal Reserve opted to cut its key rate by 50 bps in September, citing progress on inflation as well as the balance of risks in the outlook. Emphasizing ongoing data dependence, Fed Chair Jerome Powell stated that the initial double-sized cut should not be viewed as an indication of future actions and that incoming economic data will guide the path for monetary policy. The evolution of the labor market year-to-date was a key factor in the decision making as the Fed downgraded its assessment of labor market health and job gains in its meeting statement from "have moderated" in July to "have slowed" in September.

The pace of job gains moderated in the third quarter relative to earlier in the year, averaging 186,000 jobs per month compared to a robust 267,000 jobs in 1Q24. The unemployment rate was 4.1% in September, representing a modest increase year-to-date but is still a healthy level. Additionally, the JOLTS layoff and discharge rate, which tracks job losses initiated by employers, remained at very low levels, indicating stable labor demand. Meanwhile, inflation concerns continued to recede into the background. While the core PCE Index remained over the Fed's 2.0% target on a year-over-year basis in August at 2.7%, ongoing improvement in monthly data painted a benign near-term picture, with rolling 3-month and rolling 6-month annualized core PCE readings at 2.1% and 2.4%, respectively.

Labor Market



Despite the steady moderation in the labor market and inflation metrics, overall GDP growth continued to hum along. Final 2Q24 GDP growth clocked in at a strong 3.0%, while the end of quarter reading from the Atlanta Fed's GDPNow growth estimate for 3Q24 of 3.1% signaled that overall activity remained robust. Furthermore, annual revisions to benchmark GDP data revealed that the U.S. consumer was in a notably better position than previously estimated. Prior to the revision, data indicated that consumers had largely spent down savings, with the savings rate falling from 4.5% last year to 3.2% in 2Q24. However, the updated data shows that the savings rate actually increased from 4.7% in 2023 to 5.2% in 2Q24.

The Fed's Summary of Economic Projections reflected the ongoing resiliency in economic activity with a forecasted real GDP of 2.0% this year and next, while the unemployment rate was expected to remain in the low to mid four percent range as inflation gradually declined to the target rate. The median Fed forecast for the fed funds rates was 4.25-4.50% by year end and 3.25-3.50% by year-end 2025, representing 50 bps of additional easing this year and 100 bps of total easing next year.

Yields are subject to market conditions and are therefore expected to fluctuate. All data referenced herein is as of 09.30.2024 unless otherwise noted. Chart sources: Bureau of Labor Statistics; Sterling Capital Management Analytics. Textual data source: Bloomberg L.P. PCE = Personal Consumption Expenditures; Fed = Federal Reserve; bps = basis points; GDP = Gross Domestic Product; JOLTS = Job Openings and Labor Turnover Summary.

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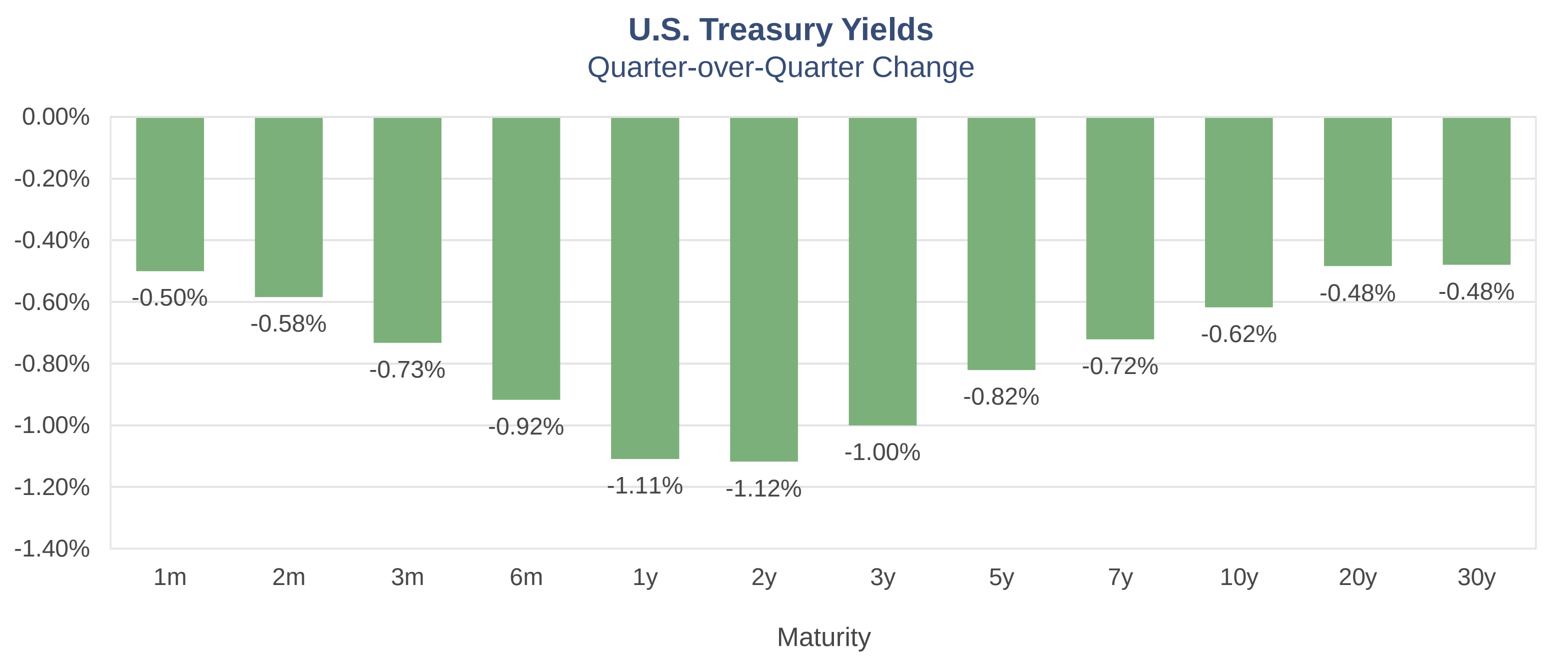
Economic Overview

Outlook

The economy continues to turn in solid performance, and we expect full year 2024 growth of 2.0-2.5%. While the Fed may have surprised some market participants with its initial rate cut, we believe the Fed delivered an outsized cut to quickly recalibrate its policy stance after weaker-than-expected jobs reports in July and August. Chair Powell admitted that the Fed may very well have cut rates at its July 31 meeting had it had the pending July jobs report in hand, which was released just two days later. In our view, a more proactive and assertive Fed at the onset of a rate cut cycle increases the odds of avoiding a recession. We expect more interest rate-sensitive sectors of the economy, particularly housing and manufacturing, to benefit quickly as the Fed continues to reduce its policy rate, and for lower-income cohorts who have disproportionately felt the adverse effects of higher rates to experience some relief in the near term. Furthermore, we believe the economy at large remains on solid footing with a well-balanced labor market, stable corporate sector, and a buoyant consumer spending impulse that continues to drive economic activity.

Portfolio duration will be managed neutral relative to benchmarks as we believe that the Fed's rate cut cycle is fully priced by the market. Additionally, we place a greater emphasis on relative curve positioning. The yield curve slope, as measured by the yield difference between the 2-year and 30-year U.S. Treasury yields, steepened significantly during the quarter. At the beginning of the quarter, the yield curve was inverted by 20 bps, only to end the quarter at a positive 58 bps. We believe that the yield curve will continue to steepen in the coming quarters as the Fed continues to reduce its key rate. Our baseline expectation is that the yield curve will steepen via both lower front-end yields, reflecting a lower expected policy rate, as well as through higher longer-term yields, due to higher long-run growth expectations. In either scenario, a greater allocation to bonds with intermediate maturities relative to shorter or longer maturities may benefit fixed income portfolios.

Despite a more proactive Fed, the outlook is not without risks. The economy remains bifurcated between those with a high stock of savings, significant asset holdings, and fixed rate mortgages, as well as those who felt the burden of both high inflation and high interest rates more acutely. Further deterioration in lower-income cohort household fundamentals bears watching. Meanwhile, predicting the outcome of a heavily contested presidential election is extremely difficult, and we feel the policy outcomes of the winning candidate are likely to have a meaningful impact on the economy. Finally, we believe an ever-expanding conflict in the Middle East has the potential to further jeopardize international shipping lanes and consumer confidence at large should it broaden into a regional war.



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Taxable Fixed Income Commentary

3rd Quarter 2024 | Sector Performance & Exposure

Corporate Credit

A rather tumultuous quarter for corporate bonds saw the sitting president drop out of the race less than four months before the 2024 election, rising tensions in the Middle East, a spike in volatility that saw the CBOE Volatility Index hit its highest level in almost four years, and a surprising 50 basis point cut in the fed funds rate. To boot, investment-grade companies issued nearly $400B in new bonds, a record for the third quarter, and issuance kept on pace to exceed any prior annual total outside of 2020. However, due to unrelentingly strong demand, the corporate bond market largely remained unperturbed. Credit spreads spiked briefly in early August after the release of the July payroll report, but investors quickly filled the void and valuations soon returned to their previous levels. Corporates rallied over the back half of September following the rate cut to finish the quarter in positive territory. The OAS on the Bloomberg U.S. Corporate Index tightened five basis points for an excess return of 0.77% while the Bloomberg U.S. High Yield Index saw spreads tighten 14 bps for an excess return of 1.72%.

Despite valuations that ranked in the bottom decile over the last 20 years, demand for corporate bonds remained remarkably high this quarter, presumably as investors looked to lock in longer-term yields ahead of a potentially protracted rate cut cycle. Data from Lipper showed that retail investors added $98B to fixed income mutual funds and ETFs, while estimates from JPMorgan showed that approximately $41B of these flows moved into the corporate bond market. Meanwhile, dealers reported elevated net demand for corporates from overseas investors and a significant preference for extension trades from insurance companies. Meanwhile, positioning across the investment manager universe remained relatively clean, with Bank of America reporting that this cohort maintained only a small net overweight to the asset class. Despite the record issuance total, new deals were well-received and new issue concessions, as measured by the spread difference between new bonds and a company's existing bonds, turned negative by quarter end. Estimates of dealer inventories turned negative as well, another bullish sign for valuations.

Within the investment-grade universe, relatively attractive valuations, a relatively benign wildfire season, and strong investor preference for longer-duration securities helped the utility sector outperform both financials and industrials. Utility spreads tightened 11 bps for an excess return of 1.50%. Financials turned in another strong quarterly performance, led by REITs, and saw spreads tighten seven basis points for an excess return of 0.84%. Industrials were weighed down by the weaker performance of the automotive and energy sectors, where profit warnings from some European automakers and weaker oil prices pushed spreads wider.

Within high yield, quarterly excess returns were concentrated in lower-rated and distressed segments of the market, driven by idiosyncratic events. CCCs produced excess return of 6.72% compared to 1.13% for single-Bs and 0.55% for BBs. Among notable events in the quarter, Verizon announced its intention to acquire Frontier Communications (unsecured debt, rated Caa2/CCC+/BB-), driving tightening in Frontier's secured and unsecured bonds. Towards the end of the quarter, DirecTV announced its intended acquisition of DISH DBS for $1 plus assumption of DISH's debt, which drove tightening in DISH's capital structure. Overall, CCC spreads were 166 bps tighter in the third quarter with gains concentrated in the communications sector. With the high-yield new issue market wide open, even for lower-rated names, the default rate outlook remains relatively benign. In its base case scenario, S&P expects the U.S. speculative-grade default rate (which includes leveraged loans) are likely to decline from a recent peak of 4.6% in June 2024 to 3.8% in June 2025.

Our View

We added modestly to our small overweight position in corporate bonds in the immediate aftermath of the September FOMC meeting. This was driven by our belief that supply/demand dynamics would continue to outweigh valuations in the near term, as investors move money from the sidelines to lock in yields in the bond market, specifically in the corporate bond market. Additionally, the FOMC's renewed focus on weakness in the labor market and apparent willingness to ease rates more aggressively could boost growth and reduce the chances of a near term recession. However, we acknowledge the relative lack of upside at current levels and are therefore unwilling to commit to a larger overweight. We see better value in securitized credit. Within the investment-grade corporate universe, we favor utilities despite their recent outperformance, as they still have room to compress versus other sectors and may outperform if growth does falter at any point. We also remain overweight financials, particularly life insurance and finance companies, two rare sub-sectors with solid fundamentals that still offer room for spreads to compress. In high yield, with spreads at the very tight end of historical valuations, our focus is on companies with potential for debt reduction while avoiding problem credits.

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Taxable Fixed Income Commentary

3rd Quarter 2024 | Sector Performance & Exposure

Securitized Products

Securitized product performance was strong during the third quarter, with agency MBS, CMBS, and ABS all outperforming duration-matched Treasuries. On the agency front, MBS saw significant demand in July and August, particularly for middle and lower coupons, as investors sought to add longer-duration profiles as rates moved lower. The highest coupons did not participate in the outperformance as falling mortgage rates throughout the quarter appeared to concern investors about the prospects for rapidly increasing prepayment rates, which would dampen returns for higher coupon pools trading above par. Nonetheless, the Bloomberg U.S. MBS Index as a whole showed OAS compressing by nine basis points on the quarter, helping the sector to post robust excess returns of 78 bps.

Non-agency CMBS posted excess returns of 0.50% during the quarter, largely driven by gains in September following the Fed's decision to implement a larger-than-expected 50 basis point rate cut. Elevated interest rates have posed a significant challenge for commercial real estate over the past few years. With the rate-cutting cycle now underway, market participants appear optimistic that many of the challenges posed by high rates will soon be alleviated. This perspective was supported by the most recent August Real Capital Analytics Commercial Property Price Index, which rose by 1.5% over the last three months. Pricing across all property types, except offices, either increased or remained relatively stable. However, central business district office properties continued to face challenges, with a 4.5% decline over the same period. Further, fundamental stress is not over yet as evidenced by the Trepp delinquency rate creeping higher over the quarter, finishing at 5.7%, up from 5.35% at the end of June. Issuance in the sector remained well ahead of last year's pace, though demand appeared robust and was easily absorbed.

ABS spreads widened marginally during the quarter across most segments of the market, with much of the movement coming in early August. Credit card ABS bucked the broader trend by tightening a few basis points. Demand for ABS has been resilient against the backdrop of a brisk pace of new issuance in 2024 with volume at $277B year-to-date, up 24% over 2023. Higher yields, solid economic growth, reasonably good credit performance, and attractive spreads relative to high-quality corporates continue to drive demand for ABS. Despite slightly wider spreads on average, the higher yields offered on ABS relative to Treasuries allowed ABS to outperform similar-duration Treasuries by 0.17% for the third quarter and by 0.88% on a year-to-date basis.

Our View

Following the strong performance of agency MBS in the third quarter, spreads are now at the tighter end of the range for the past 18 months, though are still closer to fair value over a longer-term horizon. Our preference remains for middle- and higher-coupon MBS, which offer more yield relative to the lowest coupons. While prepayment risk is certainly rising, we find that the higher spreads currently offered in the premium coupons is more than adequate compensation for the additional risk. In CMBS, we added exposure to new issue senior tranches during the third quarter and expect to continue adding selectively, with a focus on high-quality assets. The rate challenges facing the sector may be less of a headwind moving forward and valuations remain attractive relative to other high-quality alternatives. However, we expect supply to remain elevated and fundamental challenges to take time to work through, so we are keeping our up-in-quality bias for the sector. On the ABS front, we expect spreads to remain rangebound through the end of the year. Many ABS issuers are reported to have front-loaded their issuance needs in anticipation of potentially higher market volatility around the election, which could leave supply somewhat limited later in 2024. Even if spreads do not tighten, the relative value offered by ABS over corporate bonds is still attractive to us given the higher starting yields and potential for outperformance. There have been signs of weaker credit fundamentals in delinquencies and defaults in certain segments of the ABS market, most notably in subprime auto and unsecured consumer loans, as employment has slowed. This environment continues to favor investment in higher-rated tranches of ABS capital structures where investors are better insulated from credit deterioration.

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Taxable Fixed Income Commentary

3rd Quarter 2024 | Sector Performance & Exposure

Government-Related

Total returns were strong for the government-related sector in the third quarter at 4.63%, driven by falling yields as the market repriced monetary policy expectations. The longer-duration profile of the local authority and sovereign subsectors was particularly beneficial due to greater interest rate sensitivity, propelling each to total returns of 5.45% and 6.37%, respectively. While there was an appetite for risk and a desire to lock in yields before the shift in monetary policy, excess returns versus duration-matched Treasuries highlighted just how much of the total return environment was driven by the underlying rate move. Excess returns were only 0.02% for the local authority subsector, while the sovereign group led the way with excess returns of 0.74% during the quarter. Even this performance metric is a little misleading, in our view, as Panama's OAS versus Treasuries compressed over 31 bps while the rest of the subsector components were closer to either side of where they started the period.

Our View

The government-related sector is a broad tent that covers some of the safest, highest-rated issuers as well as some of the riskier, higher beta issuers in the Bloomberg U.S. Aggregate Bond Index. We continue to look at sector components on a case-by-case basis, rather than having a blanket view on any single subsector. While the local authority segment remains our largest exposure to the government-related sector, we have long viewed the space as a source of funding when more attractive investment options are available. Agencies are our second-largest exposure to the group. As they have become a smaller weight to the overall universe, issue size and liquidity continues to constrain our ability to put large trades on across mandates. Larger bid/ask spreads also reduce performance when rotating exposures, therefore our holding periods tend to be longer and less flexible in order to realize expected returns.

Supranational issuers typically offer strong credit profiles, but with an OAS of only nine basis points we prefer the efficiency and liquidity of holding U.S. Treasuries. Sovereign performance was similar to investment-grade corporate bonds in excess return terms during the quarter, but notably was helped by a duration profile over a year and a half longer than the corporate sector. While some issuers offer spreads wider than other risk assets, these spreads also represent structural and political uncertainty that confound long-term return forecasting. Persistent outflows from the hard-currency emerging market debt space have further complicated the space in recent years, though 3Q24 saw a slight improvement over recent quarters on this front, a development we are monitoring closely.

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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 Atlanta Fed's **GDPNow** forecasting model provides a running estimate (rather than an official forecast) of the official GDP estimate prior to its release by estimating GDP growth using a methodology similar to the one used by BEA. There are no subjective adjustments made to GDPNow.

The **CBOE Volatility Index (VIX)** is a real-time market index representing the market's expectations for volatility over the coming 30 days.

The **core Personal Consumption Expenditure (core PCE) Index** is a measure of prices that people living in the U.S., 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 **fed 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.

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.

Prepayment risk is the risk that the repayment of a mortgage will occur sooner than expected.

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.

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.

The Fed's **Summary of Economic Projections** is a summary of FOMC participants' projections for GDP growth, the unemployment rate, inflation, and the appropriate policy interest rate.

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

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. 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 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. MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). It is formed by grouping the universe of individual fixed rate MBS pools into generic aggregates.

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