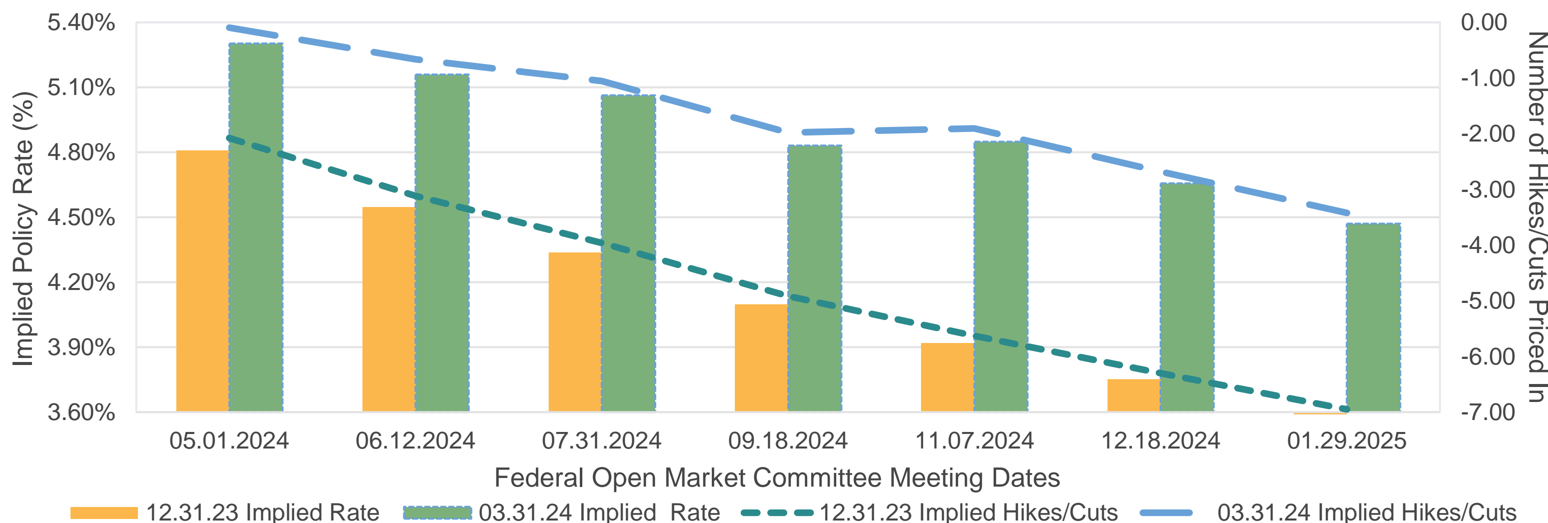
Sterling Capital Taxable Fixed Income Commentary

1st Quarter 2024

Economic Overview & Interest Rate Outlook

The strong end-of-year 2023 rally in U.S. Treasury bonds rapidly reversed course in the first quarter of 2024, spurred by stronger-than-expected economic growth and a reignition of inflationary data. Market expectations for future monetary policy changes quickly adjusted, as the six cuts expected at the beginning of the year fell to two to three cuts by the end of 1Q2024. Job gains continued to defy expectations of a slowdown as the economy added an average of almost 300,000 new workers per month in the first quarter, while the unemployment rate inched modestly higher to 3.90%. Strong consumer growth led to the U.S. economy expanding at a higher-than-expected 3.40% fourth quarter GDP pace with consumption growth up a robust 3.30%. The Fed's preferred measure for inflationary data, the core Personal Consumption Expenditure Index (Core PCE), slowed to 2.80% on a year-over-year basis, but recent month-over-month core PCE gains were consistent with 2.50-3.00% year-over-year inflation in contrast to the Fed's 2.00% target.

There was still no change in Fed policy during the quarter as the fed funds rate remained unchanged in a range of 5.25-5.50%. The March 20 Fed statement was little changed except for an acknowledgement that jobs gains "remained strong", an improvement from January's "moderation". While the median forecast year-end policy rate for 2024 remained unchanged, implying three expected rate cuts this year, the Summary of Economic Projections forecast for full-year 2024 economic growth jumped from 1.40% to 2.10% and core PCE was forecast at 2.60%.



The markets' digestion of fewer fed rate cuts and stronger inflationary data caused U.S. Treasury yields to climb higher across the curve for the quarter. The pushing out of rate cuts impacted the shorter end of the yield curve slightly more as the two- and three-year notes rose the most by 37 and 40 basis points (bps), respectively yielding 4.62% and 4.41%, while longer rates rose by around 30 bps. The yield curve has remained inverted now for a record 640 days, with the spread between two- and ten-year notes at negative 42 bps, down from its peak of over 100 bps of inversion. This rise in yields was the driver of a negative total return to start the year with the Bloomberg U.S. Aggregate Index down 0.78% on a total return basis.

Chart data is as of 03.31.2024. Yields are subject to market conditions and are therefore expected to fluctuate. All data referenced herein is as of 03.31.2024 unless otherwise noted. Source for chart and textual data: Bloomberg L.P. Charts are for illustrative purposes only. Fed = Federal Reserve; GDP = Gross Domestic Product.

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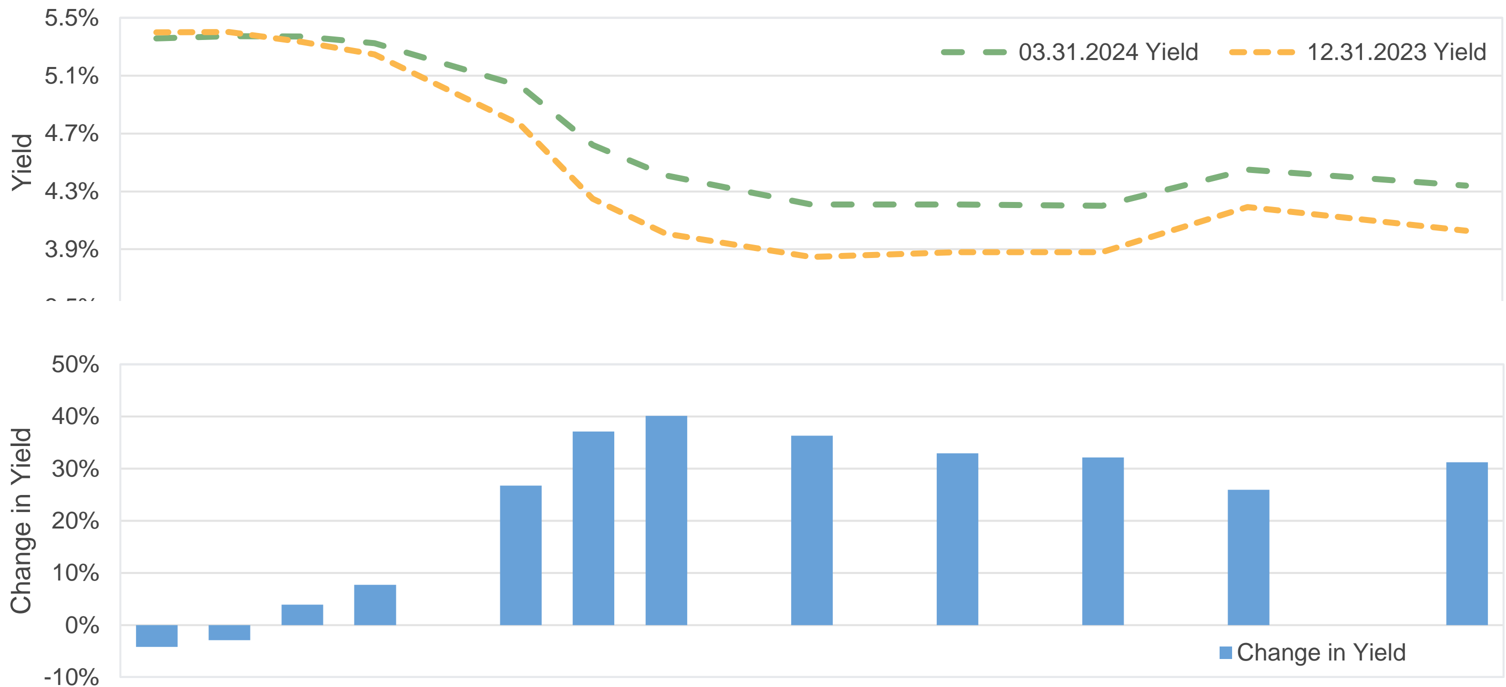

Our View

We entered the year believing the market was far too optimistic about the potential for monetary policy easing. However, after substantial market moves in the first quarter, we now view current market pricing of two to three cuts this year as appropriate and in line with our own outlook. We expect steady economic growth over the course of the year, and slow and uneven improvement in inflation. We look for the Fed to initiate its policy normalization process later this year, but acknowledge that resilient economic growth and inconsistent progress towards the inflation target risk rate cuts starting later than expected. As such, we are managing portfolio durations approximately neutral versus benchmarks, as we balance reinflation risks on one hand and attractive all-in yields on the other.

In the short term, we expect rates to remain above the lows seen in December 2023 as the Fed remains cautious of a dovish policy mistake that may be premature. Despite spreads in credit hovering near historically tight levels, we are positioned slightly overweight as both technicals and absolute yield levels are positive for the sector. We remain overweight up-in-quality securitized products relative to U.S. Treasuries. Risks include a Fed policy mistake, downturn of the consumer, and tensions escalating in the Middle East.

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Sector Performance & Exposure

Credit

Higher-than-expected inflation readings and a surge in issuance did little to dent the strong momentum of credit spreads during the first quarter of 2024. Supported by a Fed seemingly committed to cutting rates later in the year and overwhelming demand, the option-adjusted spread on the Bloomberg Investment Grade Corporate Bond Index tightened nine bps while high yield spreads tightened 24 bps. At 90 and 299 bps, respectively, investment grade and high yield spreads closed the quarter near their tightest levels since 2021. For the quarter, investment grade bonds outperformed duration-matched Treasuries by 0.89% while high yield bonds outperformed by 1.59%.

Attractive yields, above 5.00% for investment grade and above 7.50% for high yield, continued to drive strong demand for corporate bonds during the quarter. Per Lipper, fixed income mutual funds and ETFs saw average weekly inflows of $6.1B, nearly three times the weekly average for 2023. While more difficult to track, dealers also reported elevated demand from yield-based investors like life insurance companies, likely driven by a surge in annuity sales. Overnight buying from overseas investors in Asia also ticked up recently as USD hedging costs finally began to decline with the Bank of Japan’s move to end negative rates.

The strong demand for credit was clearly demonstrated by the statistics around investment grade issuance this quarter. Corporate bond issuance typically follows demand, and this quarter was no different. Investment grade companies issued a record $542B in new debt, a 37% increase over 1Q2023 and $130B higher than the previous five years’ average. However, despite the massive surge in issuance, demand statistics for these new deals were remarkably firm. On average, new investment grade bond deals were 3.8x oversubscribed and priced with just a 3.4 basis point concession to existing bonds, an improvement from 3.6x and 7.4 bps for the same period a year ago.

With valuations squeezed tighter, investors generally “reached for yield” by seeking wider trading sectors and names, causing spreads between lower quality and higher quality bonds to compress. BBB-rated bonds outperformed single-As by 0.30% for the quarter while in high yield, CCC-rated bonds outperformed single-Bs by 0.70%. Financials and more cyclical sectors like energy outperformed as recession fears faded further. With so much demand coming from long-term investors like insurance companies and pension funds, the gap between shorter- and longer-maturity spreads continued to compress as well, with the 10Y-30Y spread curve reaching a multi-year low of just eight bps.

U.S. Investment-Grade Corporate Issuance

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Our View

On a pure spread basis, both investment grade and high yield corporate bonds look unattractive at current levels. In our view, the risks of both a reacceleration in inflation that causes a re-think of the Fed's current playbook as well as a slowdown in growth that threatens recession are reasonably high and not reflected at all in credit markets. Fundamentals are also deteriorating slowly as companies refinance old debt at higher rates and management teams become less conservative as confidence in the economy grows.

However, we feel investors must respect the incredibly strong technicals that have gotten us to this point and are likely to persist, at least in the near term. There's no denying that while spreads are unattractive, all-in yields look very attractive versus recent history and, in our view, could represent a fleeting opportunity if the Fed opts to cut rates later this year. History tells us that these periods of lofty valuations can persist for several quarters or even years without some sort of crisis to disrupt things. Therefore, we maintain a small overweight to credit that allows portfolios to earn a yield advantage while leaving some room to maneuver if valuations do improve at some point.

With very little upside present in current spreads, particularly among higher quality companies, and with CEO confidence rising, we are focused on avoiding M&A-related event risk. To that end, we prefer BBBs to single-As and financials (particularly non-banks) and utilities to industrials. In high yield, we are similarly focused on avoiding problems while targeting attractive opportunities where those exist. These tend to be situation-specific rather than thematic in nature.

Securitized

Agency mortgage-backed securities (MBS) underperformed to start the year as higher-than-expected inflation prints and resilient economic data challenged the narrative that the Fed would be able to quickly shift to rate cuts. As interest rates rose across the yield curve, lower-coupon 30-year MBS, which have the longest duration and make up a large portion of the index, lagged duration-matched Treasuries materially and resulted in first quarter index excess returns of -0.14%, despite a March rally led by higher coupons. Higher coupons, which have shorter duration and higher nominal spreads, benefited from increased investor demand and managed to post positive excess returns on the quarter as spreads tightened.

A strong rally in spreads during the first quarter brought asset-backed securities (ABS) valuations back to the tighter end of historical ranges in many sectors, and generally inside the levels seen before the bank failures of March 2023. Trading in secondary markets has been orderly, allowing spreads to maintain their tightening bias. The relative attractiveness of spreads during the quarter led to booming investor demand which caused ABS to outperform Treasuries by 25 bps in January and 22 bps in February. Momentum in spread tightening slowed in March, and ABS have since added six bps of excess returns and now stand at +54 bps for the quarter. Record-high new issue volume for the quarter was easily absorbed. ABS issuance year-to-date stands at $89.1B, a 37% increase over 1Q2023. Issuance was again dominated by auto-related ABS, mainly prime auto loans, but credit cards and auto leases also contributed to year-over-year increases.

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Non-agency commercial mortgage-backed securities (CMBS) experienced a remarkable upward trajectory, continuously tightening throughout the quarter and outperforming Treasuries with similar durations by 240 bps. Despite frequent negative headlines about commercial real estate, investors' confidence appeared resilient, bolstered by the Fed halting interest rate hikes and the economy's enduring strength. There were also anecdotal indications that the market might be recovering, one notable example being Blackstone's decision to lift withdrawal limits on its largest commercial real estate fund as redemption requests significantly decreased. However, the underlying data revealed mixed fortunes across different property types, with office spaces facing the greatest challenges. The Trepp delinquency rate rose slightly to 4.67% at the end of March from 4.51% in December, primarily due to deteriorations in the office sector, while other property types showed signs of stabilization or improvement. The RCA Commercial Property Price Index fell by 0.80% in February from three months prior, with office properties leading the decline by over 15%, followed by multi-families, though other property categories saw minor increases. Against this backdrop, money managers increased their purchases as investors channeled more funds into ABS.

Our View

We used weakness in January and February to continue to add marginal exposure to higher coupon MBS. Following the meaningful outperformance in March, MBS valuations are back to fair value, and we expect spreads to tread water around current levels as the market waits for more clarity from the Fed. Still, given the current yield advantage relative to Treasuries, we think it makes sense to remain overweight MBS with our preference remaining for higher coupons.

Despite recent economic activity largely surprising to the upside, credit fundamentals of underlying ABS loans are likely to deteriorate as economic activity slows, with weakness more concentrated in lower quality borrowers. This supports our up-in-quality bias, as higher-rated bonds are more insulated from fundamental deterioration. Technicals are also modestly negative for ABS, as banks are pulling back from lending, leading to more non-bank lending activity. We believe these lenders are more likely to rely on the ABS market for funding. We expect spreads to trade in relatively wide ranges as the market digests large new issue volumes, providing potential opportunities for tactical investment in the sector. Relative value remains attractive for ABS compared to quality non-financial corporate bonds. This relative value disparity should provide support from money managers who regularly decide between the two sectors. We expect periods of volatility to provide opportunities to selectively add ABS.

During the quarter, we increased our allocation to non-agency CMBS, maintaining a focus on high-quality assets while carefully monitoring any exposure to office properties. We plan to continue expanding our exposure to non-agency CMBS while prioritizing high-quality assets. Our attention will primarily be on newly issued CMBS, recognizing that lenders have implemented stricter lending standards in response to a challenging interest rate environment and negative perceptions of the sector. These higher standards have resulted in better underwriting for recent issues. Many borrowers have also contributed additional capital to secure financing, reflecting their dedication to the properties involved in these transactions and their strong financial health.

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Government-Related

Monetary policy repricing during the quarter pushed total returns for the government-related sector to -0.37% for the first quarter. Sovereigns were hit particularly hard since there was no spread compression to help offset the longer duration of the sub-sector, resulting in a total return of -1.20% for the period. Inflation pressures are not the only data that remained persistent, however, with economic releases proving to be resilient as well. Solid economic growth coupled with higher rates to fuel a risk-on appetite that produced positive excess returns for the sector and all four components. The local authority sub-sector enjoyed particularly strong relative performance as the option adjusted spread for the group tightened 12 bps year-to-date resulting in a 1.17% excess return versus duration-matched treasuries.

Our View

We have reduced our allocation to the local authority segment in recent months, but it remains our largest exposure to the government-related sector. Credit fundamentals remain strong for the group and are not a driver of the reduction. Strong fundamentals, a lack of issuance, and refunding activity have driven the option-adjusted spread of the group to only 63 bps, well inside the 10-year historical average of 105 bps. We will continue to view the space as a source of funding when more attractive investment options with better total return profiles present themselves. Supranational issuers continue to offer extremely strong credit fundamentals that may benefit them during periods of volatility, but with an option adjusted spread of 12 bps the return profile is not enticing enough to give up the efficiency and liquidity of a comparable U.S. Treasury, in our view. Sovereigns continued their underperformance versus investment-grade corporate bonds in 1Q2024 and still do not offer an enticing enough expected return to justify allocating within the group. A negative net-issuance technical has been a positive for the sub-sector for quite some time, but we believe the persistent outflows realized by the group presents a more concerning trend that would need to stabilize before considering any meaningful allocation.

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Important Information & Disclosures

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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 **core Personal Consumption Expenditure (core 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 **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.

The **Federal National Mortgage Association (FNMA, commonly known as Fannie Mae)** is a government-sponsored enterprise established in 1938 to guarantee mortgages for low- to moderate-income borrowers by securitizing mortgage loans through the issuance of mortgage-backed securities (MBS).

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 **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. 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. 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.