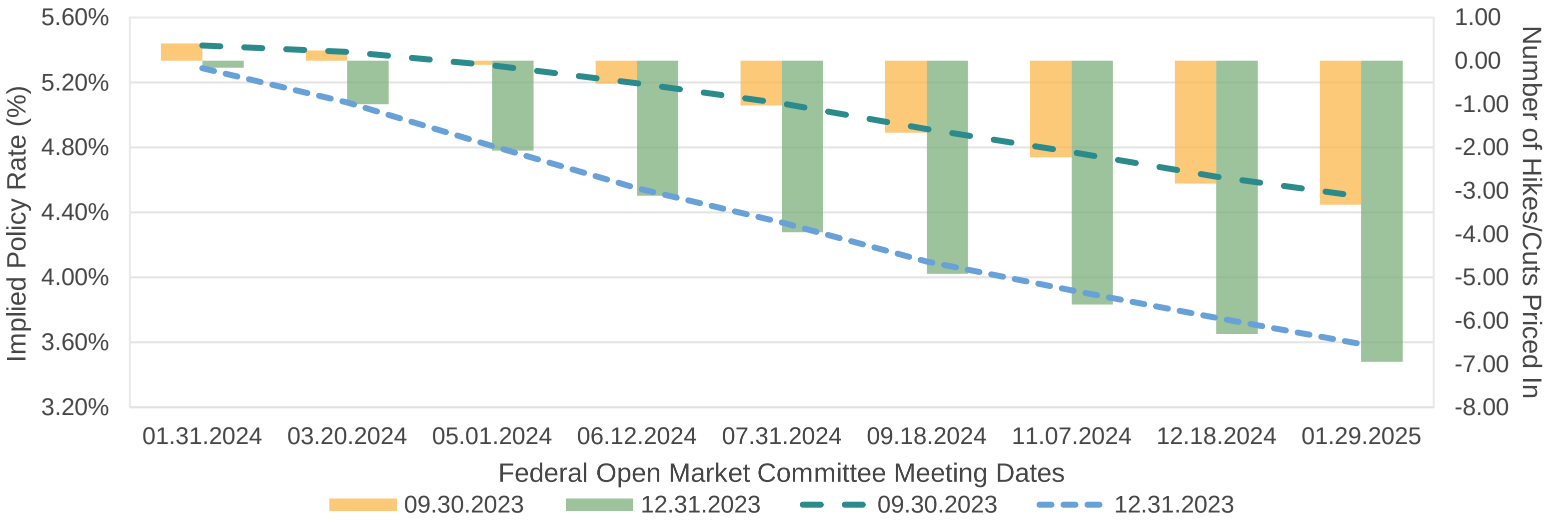
Sterling Capital Taxable Fixed Income Commentary

4th Quarter 2023

Economic Overview & Interest Rate Outlook

U.S. Treasury yields fell precipitously the last two months of the year as investors rapidly repriced Federal Reserve (Fed) monetary policy. The expectation for a shift in Fed policy to rate **cuts** gained traction even as the Fed held rates steady at its final two meetings of the year. The combination of dovish comments from Fed Chair Jerome Powell during the November press conference and the median forecast for cuts in 2024 shifting from 50 basis points (bps) to 75 bps fueled the rally.

The Fed kept rates steady during the quarter as the fed funds rate remains in a range of 5.25%-5.50%. No additional rate hikes are currently forecasted for the first time in over two years. In the November statement, there was an acknowledgement that growth has slowed, and that “inflation has eased over the past year but remains elevated.” While Chair Powell did not rule out additional rate hikes, the statement was tweaked to add the word “any.” In addressing this Powell stated, “we added ‘any’ as an acknowledgment that we are likely at or near the peak rate for this cycle.” Median forecasts for fed funds at the end of 2024 plummeted from 5.10% in September to approximately 4.60% at the December meeting, implying a median forecast of 75 bps of rate cuts in 2024.



Economic data for the fourth quarter supported the Fed’s scenario that a soft landing may be emerging as inflation cooled but job growth remained solid. The Fed’s preferred inflationary gauge, the Core Personal Consumption Expenditure (PCE) Index, fell to 3.2% year-over-year in November, down from a peak of 5.5% in February of 2022. The economy added 216,000 new workers in December while November’s data was revised lower to 173,000. The unemployment rate hovered near multi-decade lows at 3.7% in December.

U.S. Treasury bonds erased all year-to-date losses during the fourth quarter, as the yield on the ten-year Treasury note fell over 69 bps to close 2023 below 3.9%. The two-year note also rallied on fed rate cut expectations with yields falling 79 bps for a year-end yield of 4.3%. Both of these bonds were yielding over 5.0% earlier in the year. This rally reversed the yield curve inversion of two-year note yield to ten-year note yields from a high of over 100 bps to a low of less than 20 bps during the quarter. This dramatic turnaround resulted in the Bloomberg U.S. Aggregate Bond Index rising 6.8% for the quarter and reversed year-to-date losses to finish the year with a total return of 5.5% for all of 2023.

Chart data is as of 12.31.2023. Implied rate is depicted by columns and number of hikes/cuts priced in is depicted with lines. Yields are subject to market conditions and are therefore expected to fluctuate. All data referenced herein is as of 12.31.2023 unless otherwise noted. Source for charts and textual data: Bloomberg L.P. Charts are for illustrative purposes only.

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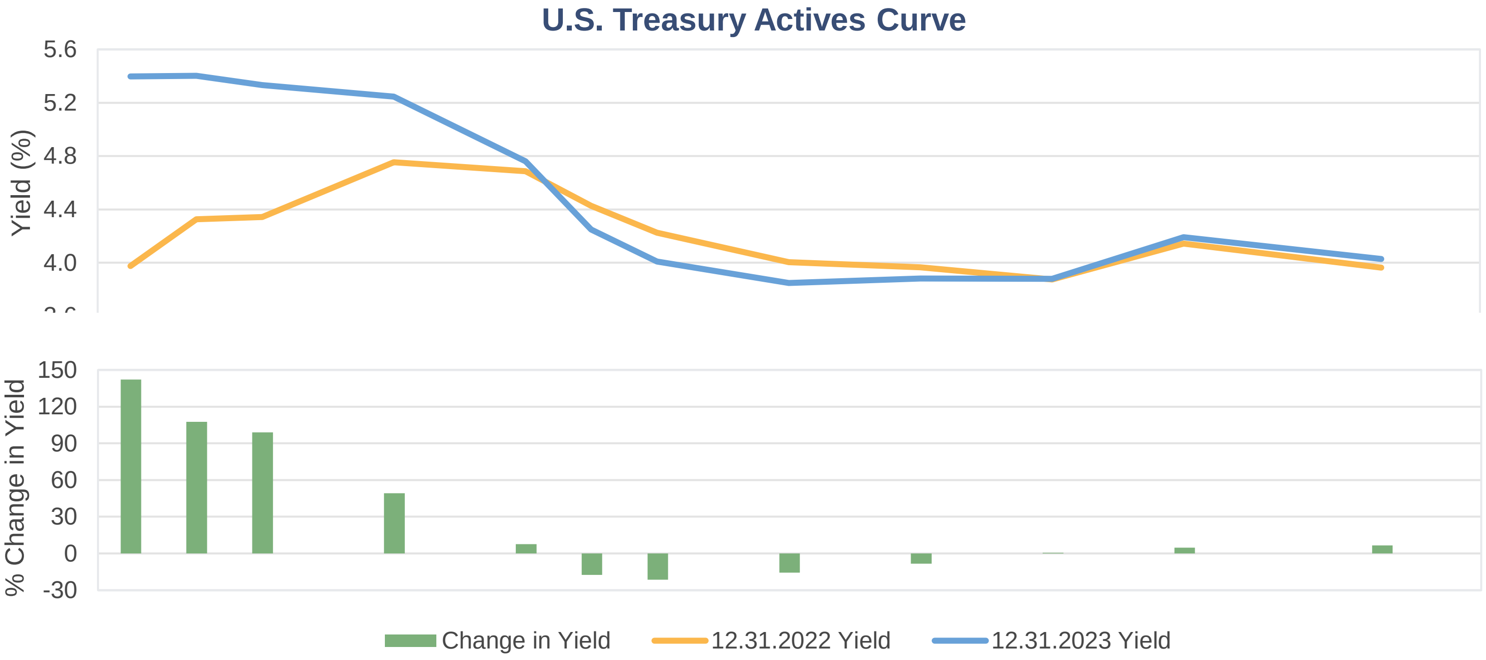

Our View

The strong rally over the last two months of 2023 drove the yield on the 10-year U.S. Treasury note down over 100 bps to approximately 4.0%. The Fed has yet to change policy and given the magnitude and speed of this yield drop, we are entering the year relatively neutral in duration positioning. While we acknowledge that the Fed's next move is most likely a pivot to cut rates, the market still appears to be too dovish in positioning for close to 150 bps of rate cuts in 2024. Inflation has moderated from its highs but remains well above the Fed's 2.0% target as 2024's reduced Fed forecast is still at 2.4%. Additionally, growth remains strong as even the Fed's lowered projections have 2024 gross domestic product (GDP) at 1.4%. The rally in rates from the mid-October highs has been swift. We do expect a slower economy in 2024 but are currently more aligned with the Fed's forecast versus the market's 150 bps of cuts. While we remain underweight Treasuries relative to credit, we acknowledge that further spread tightening is likely limited from current levels. We see value in securitized products, which may provide an up-in-quality alternative to U.S. Treasuries with attractive spread pickup, and we remain overweight these sectors.

Given the remaining momentum of the economy and market pricing of a soft landing, risk assets may still outperform in the near term, creating short-term opportunities for investment. Over the longer term, though, we believe the balance of risks may be skewed to the downside as the market may be vulnerable to any economic or inflation print that challenges the "soft landing" narrative.

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Sector Performance & Exposure

Credit

Corporate bonds posted a strong fourth quarter, triggered by strong technicals, lower inflation readings, and a dovish November Federal Open Market Committee (FOMC) meeting that held rates steady and pointed to cuts in 2024. Corporate bonds were among the largest beneficiaries of the grab for fixed income assets that occurred as investors sought to lock in longer-term yields. The option-adjusted spread (OAS) on the Bloomberg U.S. Investment Grade Corporate Index tightened 22 bps for the quarter to finish at 99 bps, the tightest level for the series since January 2022, outperforming duration-matched Treasuries by 2.0%. Lower-quality bonds within the investment-grade universe outperformed as well as investors reached for yield, with BBBs outperforming single-A bonds by 0.4%. Below-investment-grade bonds performed even better. Fourth quarter excess return for the Bloomberg U.S. Corporate High Yield Index was 3.3%, taking the full year 2023 total to a very respectable 8.9%. Fourth quarter total return for high yield was an even more impressive 7.2% as the high-yield OAS tightened by 71 bps to 323 bps, a level not seen since spring 2022. As high yield outperformed investment grade, BB spreads compressed towards BBB's, the difference between the two groups ending the quarter at 79 bps, a low for the year. Within rating buckets, CCCs posted the best quarterly excess return of 3.4%, while both BBs and single-Bs saw excess returns of 3.3%. The CCC excess return far exceeded most market participants' expectations for the year, posting 2023 excess return of 15.3% compared to 7.1% for BBs and 9.1% for single-Bs.

Supply and demand dynamics remained supportive of both the investment-grade and high-yield markets this quarter. Despite a drop in all-in yields for the investment-grade index of over one percent this quarter, issuance stayed within historical norms for the fourth quarter at $214B. Meanwhile, demand for new issues increased, allowing many issuers to price new offerings near or at even tighter spreads than existing issues. The average new issue concession (the excess yield issuers pay to price new bonds) fell from as high as ten bps earlier this year to just over five bps this quarter. Technicals in the high-yield market were firm as outflows moderated and primary issuance, while higher than in the third quarter, remained modest by historical standards. The new issue market for high yield printed $41.5B, taking full-year supply to $176.5B, up 73.5% from 2022 but still well below issuance of more than $400B in each of 2020 and 2021. After large outflows of $8.4B in October, ETF and mutual fund flows flipped to large inflows after the FOMC meeting in early November, taking in $14.3B in November and December for a net quarterly inflow of $5.9B.

Based on Q3 earnings, credit fundamentals continued to deteriorate modestly but appeared to remain in "good enough" territory for credit investors. Revenue, EBITDA and margins for investment-grade companies declined year-over-year while debt rose slightly, pushing up gross leverage by 0.2x year-over-year to 3.1x. Rising yields pushed up interest expense a record 17.1% year-over-year, causing interest coverage for investment-grade companies to fall 3.0x to 9.9x, its lowest level since early 2021. High-yield credit fundamentals also showed some minor deterioration based on third quarter disclosures but remain relatively strong by historical standards. Revenues and EBITDA were flat year-on-year, while leverage ended the quarter just under 4.0x, up from 3.8x a year ago. Interest coverage decreased sequentially for the seventh consecutive quarter but remains healthy at just over 5.0x.

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 12.31.2023 unless otherwise noted. Source for textual data: Bloomberg L.P.

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Our View

Our current view is that spreads and yields have moved too far, too fast and we may see a modest pullback in the new year. With investment-grade spreads beginning the year inside 100 bps, there is limited upside at current levels. Lower yields are likely to bring out issuers waiting for an opportunity to refund maturities while encouraging higher M&A activity, signs of which were already emerging this past quarter, particularly in the pharmaceutical industry. We also expect the economy to slow in the coming quarters, putting additional pressure on fundamentals. However, while we see more downside than upside for valuations, we expect continued strong demand for fixed income to limit the extent of spread widening that may occur and thus we maintain a small overweight to investment-grade credit. We think financials should continue to benefit from lower interest rates and remain overweight the sector. We believe that utilities offer compelling value as spreads remain wide versus industrials while providing more defensive characteristics in the event of an economic slowdown.

The high-yield OAS ended the year at the 8th percentile over the last ten years, with BBs and single Bs each in the 2nd percentile. We believe lags in the transition of tighter monetary policy will lead to some deterioration in credit fundamentals in 2024. We also think the market is currently underpricing default risk as we expect more lower-rated companies to come under pressure as they refinance into a higher interest rate environment. There are very modest maturities in high yield in 2024, but maturities increase considerably in 2025 and beyond and prevailing market yields for companies rated B3 or lower are well in excess of coupons, especially for CCCs. While all-in yields remain attractive and may provide some cushion for spread widening, we think it will be difficult for the market to repeat its strong 2023 performance in 2024.

Securitized

Agency mortgage-backed securities (MBS) got off to a rough start in the fourth quarter as interest rates continued to move higher amid elevated volatility, with the MBS index lagging Treasuries by 0.6% in the month of October. However, as inflation data surprised to the downside and economic activity slowed in November, rates quickly retreated lower, accompanied by a surge in demand for MBS from money managers and other investors, which drove spreads sharply lower in November and allowed the sector to post excess returns of 1.3% for the month. This positive momentum continued in December as investor confidence grew that the Fed's rate hiking cycle may be over, lending further support for MBS and resulting in December excess returns of 0.6%, which put the sector ahead of Treasuries by 1.3% on the quarter.

After underperforming Treasuries in October, asset-backed securities (ABS) rallied to end the quarter and outperformed duration-matched Treasuries by 0.4% over the quarter. High issuance, higher interest rates, and broader market volatility in October caused ABS to begin the quarter on its back foot. New issue volume in the fourth quarter was up 12.0% versus the same period last year. Issuance for the full year stands at $256B, up roughly five percent year-over-year. Issuance was dominated by auto-related and prime auto loan ABS in particular. However, the market rallied significantly in the last two months of the year as the soft-landing narrative gained traction in the market and investors increased their appetite for risk assets. For the year, ABS outperformed Treasuries by 1.2%. This marked the best annual performance for the ABS index since 2012.

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In the initial month of the quarter, non-agency commercial-mortgage-backed securities, (CMBS), exhibited volatility due to a surge in interest rates. However, the sector rebounded as rates stabilized and began to fall from their peak levels. By quarter-end, non-agency CMBS outperformed duration-matched Treasuries by 73 bps. The recent moderation in rates played a key role in the solid performance. Emerging indicators of stabilization in commercial real estate prices, apart from the office sector, also bolstered investor confidence. The Real Capital Analytics Commercial Property Price Index remained unchanged in November, maintaining a consistent level over the past three months. Supply technicals continued to be supportive this quarter. Although there was a significant increase in issuance compared to the same quarter of the previous year, overall issuance for the year decreased by 53.6% relative to last year. Moreover, the secondary market supply remained subdued throughout most of the quarter. We reduced our non-agency CMBS exposures, shifting our focus towards agency mortgages, which underperformed competing products including non-agency CMBS significantly during the initial month of the quarter.

Our View

We continued to add MBS exposure in October as the sector was trading cheap to other investment-grade sectors and from a historical perspective. However, following the sharp outperformance of MBS in the past two months, spreads are back to what we consider fair value. We still see the potential for outperformance in 2024, particularly for higher coupons, though largely as a function of the sector's yield advantage relative to Treasuries rather than from significant additional spread compression.

In ABS, we expect fundamentals of underlying loans likely will deteriorate as economic activity slows, with weakness more concentrated in lower-quality borrowers. This supports an up-in-quality bias as higher-rated bonds are more insulated from fundamental deterioration. Technicals are also modestly negative for ABS. Banks are pulling back from lending, leading to more non-bank lending activity. These lenders are more likely to rely on the ABS market for funding. Spreads are likely to trade in relatively wide ranges as the market digests large new issue volumes, potentially providing opportunities for tactical investment in the sector. Relative value remains attractive. ABS still look particularly attractive relative to high quality non-financial corporate bonds, however we do not expect to see the robust excess returns achieved in 2023.

We believe that non-agency CMBS continue to hold appeal based on historical relative value relationships, particularly in the context of a potential plateau in interest rates for this cycle. Our strategy going forward includes a measured increase in exposures. Our investment approach will continue to favor high-quality assets and will be particularly cautious about adding office exposure as a full recovery in commercial real estate fundamentals remains remote, as interest rates remain at heightened levels despite the recent easing. The delinquency rate, as reported by Trepp, escalated to 4.6% in November. This represents an increase from 4.3% observed three months prior, predominantly attributable to a rise in office sector delinquencies. Additionally, office properties are likely to face persistent challenges as the trend towards remote work appears to be more permanent post-pandemic.

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Government-Related

The perceived pivot on the future rate path by the FOMC set the stage for a strong end to 2023 for the government-related sector. With rates falling across the curve, total returns jumped dramatically in 4Q23 and finished positive for all sub-sectors on a quarter- and year-to-date basis. Duration was the largest driver for total returns during the quarter, with the longer sovereign and local authority groups notching 8.8% and 7.8%, respectively, while the shorter maturity profiles of the agency and supranational spaces constrained their total returns to 3.9% and 3.8%, respectively, across the same period. For the quarter, the sovereign sub-sector posted the highest excess return within the group at 1.0% versus duration-matched Treasuries, however that substantially lagged comparable asset classes like investment-grade corporate bonds, which saw 2.0% excess return versus duration-matched Treasuries.

Our View

Local authorities remain our broadest exposure to the government-related sector, however given their strong performance in 2023, the OAS of the sub-sector ended the fourth quarter at 75 bps. That is well inside the ten-year average of 107 bps and therefore we continue to view the space as a source of funding for more attractive options when they present themselves. Supranational issuers continue to offer strong credit fundamentals that benefit them during periods of volatility, but with an OAS of 11 bps, the return profile is not enticing enough to give up the efficiency and liquidity of a comparable U.S. Treasury. Sovereigns underperformed investment-grade corporate bonds during 2023. Volatility remains a key concern. Idiosyncratic events like the Israel/Gaza situation and Panama's closure of the Cobre Panamá mine remind us how external forces can quickly change the investment thesis of the issuers in that space.

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 **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 **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).

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 **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.

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