Taxable Fixed Income Commentary

2nd Quarter 2024

Economic Overview

Market participants appeared to breathe a collective sigh of relief as incoming economic data in the second quarter showed that the surge in inflation to start the year did not persist into the spring. After increasing at a three-month annualized rate of nearly 5.0% in 1Q24, the core CPI moderated to a three-month annualized rate of 3.7% through May, while the year-over-year core CPI rate fell from 3.9% to 3.4%. Meanwhile, the core PCE Index, the Fed's preferred measure of inflation, showed steady incremental improvement, falling from 2.8% year-over-year in March to 2.6% in May.

Meanwhile, the labor market moved into better balance, as the ratio of job openings per unemployed worker, a metric often cited by the Fed, fell to 1.2, a level broadly consistent with the 2018-2019 pre-pandemic average. As the labor market continued to normalize from post-pandemic trends, the economy still added an average of 177K jobs per month during the quarter. The unemployment rate ticked up to 4.1% despite the steady pace of job gains, as the prime age labor force participation climbed to a two-decade high of 83.7%, continuing a longer-term trend of a labor market normalizing after overheating in 2023. Importantly for households, workers realized steady wage gains, as year-over-year average hourly earnings came in at 3.9% in June. For context, average hourly earnings ended 2019 at 3.0%. As households have largely spent their excess pandemic savings, consistent wage gains will be key for driving consumption in the coming quarters. As fixed income markets digested incoming data during the quarter, investors faced a volatile interest rate environment. While increasing 20 bps during the quarter, the 10-year Treasury yield traded in a 50-bps range, reaching as high as 4.7% in late April before reversing course to end the quarter at 4.4%. Meanwhile, market pricing of Fed rate cuts slowly fell during the quarter, as market expectations shifted from three cuts to two cuts by the end of the quarter.

At its June meeting, the Fed reinforced its data-dependent stance in guiding monetary policy. While inflation has improved from the first quarter, the Fed stated that it needs greater confidence inflation is moving towards its 2.0% target before it can adjust its policy rate. Consequently, in its post-meeting Summary of Economic Projections, the Fed indicated a median forecast of just one rate cut this year compared to a previously expected three cuts in March, while also forecasting four interest rate cuts in 2025. In the longer run, the Fed's median fed funds rate forecast inched higher from 2.56% to 2.75%. The Fed tweaked its economic forecasts slightly, increasing its expected core PCE rate for 2024 from 2.4 to 2.6, implicitly acknowledging the strong price gains of 1Q24. GDP and unemployment rate forecasts were left unchanged at 2.1% and 4.0%, respectively, for the year.

Outlook

We expect the economy to turn in solid albeit slower growth in 2024. We look for approximately 2.0% real GDP growth this year. Overall, the labor market remains on solid footing, and as long as wage gains remain steady, we expect consumption will be sufficient to support economic growth. We do not see an imminent deterioration in the labor market and view the recent rebalancing in labor supply and labor demand to be healthy for the economy at large. We push back against the view that the recent uptick in initial jobless claims is a harbinger of things to come. While the rolling four-week average of initial jobless claims has risen from 198K in September 2022 to 236K as of June 27, it is now exactly in line with its pre-pandemic trend at the end of 2019. Meanwhile, we expect inflation to remain above the Fed's 2.0% target throughout the balance of the year.

Yields are subject to market conditions and are therefore expected to fluctuate. All data referenced herein is as of 06.30.2024 unless otherwise noted. Data source: Bloomberg L.P. CPI = Consumer Price Index; PCE = Personal Consumption Expenditures; Fed = Federal Reserve; bps = basis points; GDP = Gross Domestic Product.

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While inflation gains have slowed in recent months relative to the start of the year, further progress this year will be difficult; monthly core PCE inflation prints in 2H23 were rather benign, creating a low hurdle for continued year-over-year gains this year. Taking it all together, our base case is for just one Fed rate cut this year, as the Fed seeks to balance its need for better confidence in the trend of inflation while maintaining the economy at full employment. Portfolio durations will be managed approximately neutral versus benchmark durations, while maintaining a bulleted yield curve structure as we expect the curve to normalize over the coming quarters.

The outlook is littered with additional risks this year, in our view. Election season is heating up as the country looks toward the general election, weighing two known quantities with divergent policy outcomes. We remain attuned to the tariff and trade policy risks proposed, while budget deficits are likely to continue to increase with either candidate in the White House. Immigration, a key source of labor supply, represents a divergence between former President Trump and President Biden, and future policy choices increase risks to labor market balance as well as inflation. Finally, we have a watchful eye on the bifurcation developing within the economy. The bulk of remaining excess savings from the pandemic resides largely with the top 20% of income earners, while below-median income earners have inflation-adjusted savings at or below pre-pandemic levels. Meanwhile, the top 20% of income earners account for nearly 40% of all consumer spending. As such, while consumer spending in the aggregate has held up, it has been driven by a smaller cohort of the economy. We are carefully monitoring whether weakness in lower income cohorts trickles up to higher income earners, impacting consumer confidence and the durability of the economic expansion.

Sector Performance & Exposure

Corporate Credit

Following several months of relative calm, investment-grade corporate bonds weakened modestly at the end of the second quarter, as falling yields softened demand and European politics injected some volatility into the market. The OAS on the Bloomberg U.S. Investment-Grade Corporate Index, which began the quarter at 90 bps, widened from its low of 85 bps on May 31 to close at 94 bps for a quarterly excess return of negative 0.04%. The weakness in investment-grade spreads was concentrated in longer-duration, higher-quality sectors typically favored by more yield-sensitive buyers. Bonds maturing inside of ten years actually outperformed duration-matched Treasuries by 0.23%, while longer maturities underperformed by 0.57%. While French and other European banks underperformed following President Macron's decision to call snap elections in France, their small size relative to the broader index did not prevent financials from outperforming industrials again this quarter. BBB-rated securities outperformed both duration-matched Treasuries and single-A rated securities by 0.10% and 0.21%, respectively.

High yield spreads traded in a narrow range in the second quarter, as the economy and company fundamentals remained generally strong, although trending slightly weaker over the past several months. The OAS on the Bloomberg U.S. Corporate High Yield Index widened by 10 bps to 309 bps, still towards the very low end of the 10-year range. The asset class generated an excess return of 0.36%, mostly reflecting carry. Total return for the quarter was 1.09%. With the 5-year Treasury yield increasing 16 bps in the quarter, yield-to-worst on the index ended the quarter at an attractive 7.91%, up from 7.66% at the end of the first quarter.

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Supply and demand dynamics appeared to remain relatively firm for corporate bonds this quarter. Investment-grade supply slowed 36% from its blistering 1Q24 pace to $335B, leaving the year-to-date total issuance of $860B ahead 23% of the previous year. Strong demand in the high yield market, supported by net retail inflows of approximately $5.5B so far this year, helped to absorb steady primary market issuance that totaled $77.6B this quarter. While year-to-date issuance of $160.2B is up more than 70% versus the same period last year, strong demand for yield and riskier assets drove the ratio between high yield and investment-grade spreads from 3.65x at the end of 1Q24 to 3.29x at the end of 2Q24.

Default rates have increased slowly but steadily from cycle lows in late 2021, as the effects of Fed tightening are increasingly felt by borrowers. Relatedly, the high yield market has seen some decompression between higher- and lower-quality segments of the market, with CCC spreads underperforming during the period. Excess return for CCCs was negative 0.83% in the quarter compared to 0.24% for single-Bs and 0.65% for BBs. Including loans and bonds, Moody's Investor Services estimates the U.S. issuer-weighted speculative grade default rate for bonds at 3.6%, while for loans the default rate is close to 6.0%. Moody's estimate includes distressed exchanges and thus overstates the actual amount of defaults experienced by investors, as it includes all debt of companies that execute distressed exchanges on only some of their debt. Moody's dollar-weighted U.S. default rate for bonds and loans in May was approximately 2.5%. In their baseline forecast for the next 12 months, Moody's expects the global issuer-weighted default rate to decline to approximately 3.0% from 4.7% in May. However, even as default rates have trended higher, they remain moderate compared to previous cycle highs, and are expected to improve somewhat over the next 12 months.

Outlook

With investment grade and high yield all-in yields still attractive in our view, we remain constructive on corporate risk in the near term. However, with spreads at the very low end of 10-year ranges, we see very limited upside for spreads and an increasing potential for the extended period of low volatility to come to an end as the effects of "higher-for-longer" interest rates are increasingly felt in the economy. Prospects for a "soft landing" may have increased, but tail risks are also increasing in the form of geopolitical risk, domestically and abroad. While we believe a modest overweight in corporate bonds remains appropriate at this time, we reduced overall risk by shortening duration within our allocation. We remain focused on avoiding problem credits and capturing favorable risk/reward trade-offs without sacrificing significant amounts of yield.

Securitized

Securitized performance was mixed on the quarter, with CMBS and ABS outperforming Treasuries, while agency MBS lagged. MBS started the second quarter under pressure, as higher-than-expected inflation and economic data in April resulted in rates moving sharply higher and mortgage spreads resetting wider amid the volatility, as the sector lagged duration-matched Treasuries by 0.61% for the month. However, as inflation data began to improve in May, interest rates bounced back and MBS investors re-engaged the market at wider spreads, helping the sector to post excess returns of 0.49% in May and an additional 0.06% in June, though the sector trailed Treasuries by 0.09% on the full quarter.

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Non-agency CMBS outperformance slowed from the heated pace of the first quarter, yet still managed to top duration-matched Treasuries by 0.21% in the second quarter. Heavy new issuance was partly to blame for that downshift, as approximately $30B of new deals hit the market during the quarter, nearly five times the issuance levels from the same quarter last year. Fundamentally, the sector still faces challenges. The RCA Commercial Property Price Index showed that average commercial real estate prices dropped an additional 0.6% on the quarter, led by the office sub-sector. Further, delinquencies continue to tick up, currently at 5.35%, up from 4.67% three months ago, as measured by CMBS analytics provider Trepp.

Spread tightening in ABS continued uninterrupted in the first two months of the quarter with increased demand for risk assets driven by higher all-in yields, economic resilience, and spreads that still looked attractive in terms of relative value versus high quality corporate bonds. Demand for new issue ABS remained high despite a deluge of supply that brought 1H24 issuance to $191B, representing a 32% increase over the first half of last year. However, investor focus on new issue meant reduced appetite for secondary paper, causing dealers to increase their inventory holdings. The spread tightening reversed slightly in June, due partly to bloated dealer balance sheets and partly to the decline in Treasury rates that made all-in yields less attractive. Still, ABS outperformed similar-duration Treasuries by 0.17% for the quarter by 0.71% on a year-to-date basis.

Outlook

Despite the volatility of the second quarter, our outlook for MBS in the medium term is largely unchanged. We think valuations for the sector are reasonable, with OAS for the index sitting just under 50 bps, which is historically attractive and supports a small overweight to the sector. We still prefer middle- to higher-coupon MBS, which have higher yields relative to the lowest coupons, where we remain underweight. In CMBS, we remain constructive on the sector as valuations are compelling relative to historical averages. We believe the challenges facing commercial real estate, particularly office properties, will not disappear anytime soon, but opportunities can still be found within the sector. We plan to add to our non-agency CMBS exposure opportunistically while focusing on high-quality assets with measured office exposures. We are particularly interested in adding new issue deals as these underlying borrowers appear to have demonstrated their ability to secure financing amidst a challenging fundamental backdrop, limiting downside risk if the rate environment remains challenging going forward. In ABS, we see more limited potential for additional near-term spread compression given bloated dealer inventories. Still, we believe ABS can outperform Treasuries due to their higher starting yields, even if spreads move sideways or widen slightly, and the relative value offered by ABS over high quality corporate bonds is still attractive enough to warrant being overweight the subsector. We expect the fundamentals underlying ABS to continue to weaken over the balance of the year, with delinquencies and defaults likely to be driven higher by increasing unemployment as the economy slows. This favors investment in the upper tranches of the ABS capital structure where investors are better insulated from credit deterioration. There may be periods of spread widening when issuance overwhelms investor demand temporarily, and we would view those as opportunities to selectively increase exposure to the subsector.

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Government-Related

The government-related sector began the second quarter on firm footing. An optimistic economic picture combined with higher rates appeared to keep market participants engaged with attractive all-in yield levels across risk sectors. Inflows seemed inexhaustive as the first several weeks of the quarter got under way. A pervasive “buy-the-dip” mantra emerged and acted as a backstop to the slightest hint of underperformance. Sentiment changed quickly, however, as both core PCE and CPI data releases once again led to the market repricing the Fed monetary policy path for 2H24. A sharp rate rally ensued, and when the dust settled, the 10-year U.S. Treasury yield had fallen 34 bps in the course of a week. Accustomed to buying dips, the sudden drop in achievable yields sent incremental buyers to the sidelines. As other sectors, such as investment-grade corporate bonds, underperformed duration-matched Treasuries, the higher beta subsectors of the government-related group, such as local authorities and sovereign issuers, weakened in sympathy. As 2Q24 ended, the OAS finished flat at 46 bps over duration-matched Treasuries, producing an excess return of 0.03% and a total return of 0.30% for the quarter. Performance was bifurcated between the lower-duration and higher-quality subsectors. Agencies and supranationals outperformed with positive excess returns for the group, while the longer-duration and higher-beta subsectors of local authorities and sovereign issuers both produced negative excess returns relative to duration-matched Treasuries.

Outlook

While our local authority segment allocation is lower than historical periods, it remains our largest exposure to the government-related sector. The OAS of the group only widened to 65 bps, remaining well inside the 10-year historical average of 105 bps. Without a more substantial change in valuation, 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 strong credit fundamentals, but with an OAS of 10 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 2Q24, but still do not offer a large enough expected return to justify allocating within the group. Credit quality of the subsector continues to trend downward, and political uncertainties in both Latin America and Europe continue to give us pause. A negative net-issuance technical has been a positive for the subsector for quite some time, but the persistent outflows realized by the group appears to present a more concerning trend. Hard currency emerging market funds did receive one of the largest inflows seen in several quarters at the end of June, but we would need to see a consistent positive allocation to the basket before we feel comfortable outflows have bottomed.

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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 **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 (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.

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.

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