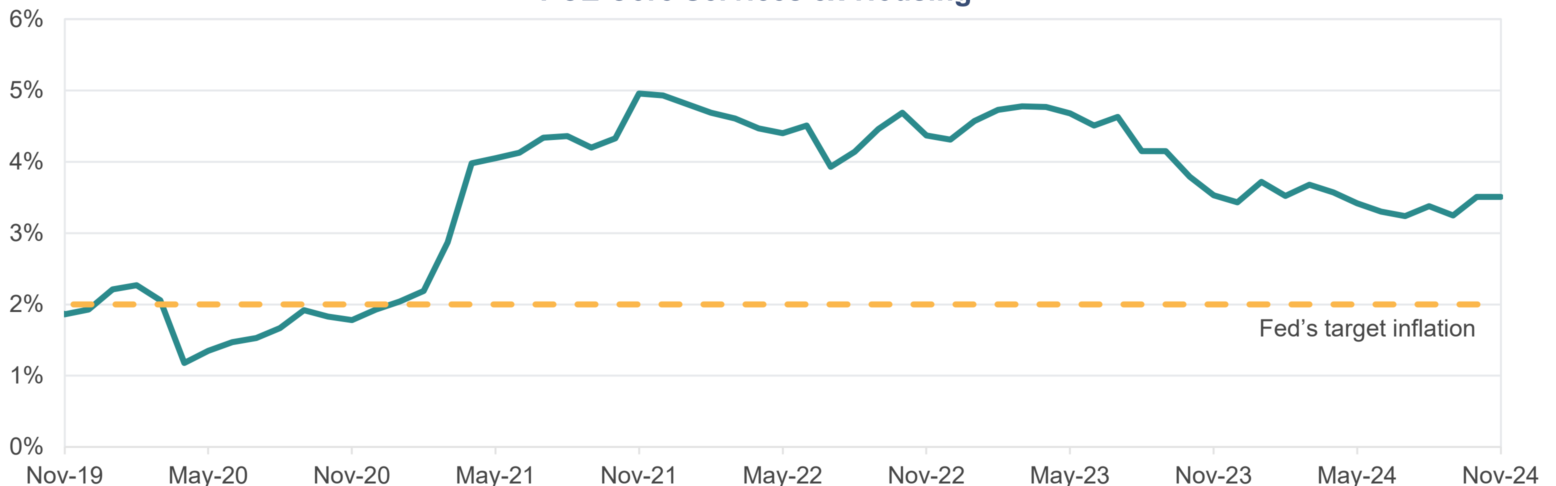
Taxable Fixed Income Commentary

4th Quarter 2024

Economic Overview

While final data points are still pending for 2024, it is clear that the economy outperformed expectations during the year. Concerns of an impending slowdown were short-lived, as GDP expanded in the first three quarters by 1.6%, 3.0% and 3.1%, respectively, and continued to deliver strong growth at an approximate 3.0% rate in the fourth quarter, (according to the Atlanta Fed's GDPNow model) at year end. The labor market steadily normalized throughout the year yet raised some caution flags for market participants. While the unemployment rate inched higher from its starting point of 3.7% at the beginning of the year, it proved to be stable to close out the year, tracking in a tight range of 4.1-4.2% in the final seven months of the year. Looking through the volatility in the data caused by catastrophic hurricanes in the early fall, the economy added on average 165K jobs per month in 2H and 170k jobs per month in Q4, a decline from the average monthly jobs gain of 207K in 1H24, yet consistent with a balanced labor market at roughly full employment. Average hourly earnings continued their steady strong gains of 3.9% year-over-year in December.

Meanwhile, inflation remained stubbornly above-target for the Fed with little sign of continuing its progress towards 2.0%. The core PCE Index, the Fed's preferred measure of inflation, came in at a year-over-year rate of 2.8% in November. While goods pricing remained in flat-to-deflationary territory for much of the year, ongoing momentum in services drove steady above-target inflation throughout 2024.



Top chart source: Bureau of Labor Statistics. Bottom chart source: Bureau of Economic Analysis. Both charts are as of 11.30.2024, the latest available data. Yields are subject to market conditions and are therefore expected to fluctuate. All data referenced herein is as of 12.31.2024 unless otherwise noted. Textual data source: Bloomberg L.P. PCE = Personal Consumption Expenditures; Fed = Federal Reserve; bps = basis points; GDP = Gross Domestic Product.

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Outlook

The key theme over the past year for the U.S. economy has been resiliency. The economy has continued to perform well despite the Fed holding at 5.5% through September, and now that the Fed has provided 100 bps of easing into a 2.5-3.0% growth environment, we expect the economy to respond with another solid year in 2025. We look for economic growth of approximately 2.25%, with a stable labor market and persistent above-target core inflation. Based on our current outlook for economic growth, employment, and inflation trends, we look for just two more 25bp cuts from the Fed, most likely later in the year.

Meanwhile, the election of Donald Trump to a second presidential term represented a shift from the outgoing Biden administration, with a policy mix that could both help and hurt the economy. On the positive side, the promise of a lighter regulatory touch is a positive for the small business community. In his first term, Trump was keen to lighten the regulatory burden on the economy, and the business community cheered the efforts. The surge in the NFIB Small Business Optimism Index in December indicated similar optimism for the incoming administration. However we believe, it will take some time for the benefits of a lighter regulatory regime to work their way through the economy. Meanwhile, Trump has promised to deliver another round of tax cuts beyond simply extending the 2018 Tax Cut and Jobs Act tax rates. Time will tell the extent to which new tax cuts can pass Congress; however, the notion that taxes are likely not going up is a net positive for the business community.

On the flip side, some of Trump's key policy proposals represent potential risks for the economy. First, his promise to impose a baseline 10% tariff on all U.S trading partners and potentially up to 60% tariffs on Chinese imports represents a tax increase that is borne by the U.S. consumer. The tariffs would reduce the purchasing power of U.S. households and ultimately hurt aggregate consumption. Trade policy largely resides with the White House, and it remains to be seen whether tariffs will be used to the full extent possible or whether Trump and his team will use them mostly as negotiating leverage over trading partners. The second-order risk of tariffs is whether U.S. trading partners respond in-kind and levy tariffs on U.S. imports, ultimately reducing total global trade and economic activity. Some trading partners responded in kind during Trump's first term, which was a drag on economic activity. While the Fed has said that a one-time price increase is not inflationary, a trade war with ever increasing tariffs and thus prices would be a major risk to the outlook. Meanwhile, Trump's desire to stem immigration into the U.S. has the potential to restrict the productive capacity of the U.S. economy via fewer workers, which in turn increases wages and thus prices as well as restrains growth over time. The severity of any potential immigration restrictions remains to be seen and bears close monitoring.

Taking it all together, portfolio durations will be managed neutral to slightly short benchmark durations, while portfolios will maintain a bulleted yield curve structure. We expect continued normalization and steepening in the slope of the yield curve, via a modestly lower fed funds rate on the front end of the curve and high longer-term yields, driven by economic resiliency and the unsustainable path of the U.S. federal budget. Despite historically tight valuations, we remain modestly overweight risk assets such as corporate bonds and CMBS, as fundamentals remain strong and all-in yields are attractive for investors.

SCM does not provide tax or legal advice. You should consult with your individual tax or legal professional before taking any action that may have tax or legal implications. Yields are subject to market conditions and are therefore expected to fluctuate. All data referenced herein is as of 12.31.2024 unless otherwise noted. Textual data source: Bloomberg L.P. NFIB = National Federation of Independent Business; CMBS = commercial mortgage-backed securities.

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4th Quarter 2024 | Sector Performance & Exposure

Corporate Credit

A year characterized by incredibly strong demand for credit due to attractive yields, easier monetary policy and strong economic growth went from good to great in the fourth quarter of 2024. The wave of risk taking experienced across most U.S. financial markets in the wake of the November elections drove corporate bond spreads to their tightest levels in decades. In the investment grade market, the Bloomberg U.S. Corporate Index saw option-adjusted spreads tighten nine basis points, from 89 to 80, while touching 74 bps along the way – the tightest level on the index since 1998. High yield bonds saw a similarly strong performance, tightening all the way to 253 bps on November 12 from 295 bps at the end of the 3rd quarter before widening modestly in December. In excess return terms, investment grade bonds outperformed duration-matched Treasuries by 0.82% while high yield outperformed by 1.17%.

FOMC rate cuts continued to add fuel to the fire that supported demand for corporate bonds over the last two-plus years. And while overnight rates fell with the federal funds rate, expectations for more pro-growth policies from the incoming administration and worries about federal deficits and overall fiscal health conspired to push longer term Treasury yields higher this quarter. Despite corporate spreads falling, all-in yields actually rose 0.55% to finish the year at 5.33%, just off their highest level since July. The lower fed funds rate also lowered USD hedging costs for foreign investors, making USD-denominated credit even more attractive. As such, JPMorgan's foreign attractiveness of USD IG bonds survey hit its highest level in a year near quarter end. These tailwinds for demand led to continued strong inflows into retail fixed income products this quarter, with an estimated $4B per week continuing to flow directly to U.S. investment grade corporate bonds.

Corporate issuers continued to take advantage of the strong demand environment and issued $135B worth of new investment grade bonds this quarter, bringing the total for 2024 to $1.5T, a 25% increase from 2023 and the highest total since 2020. Higher yields in the long end of the curve limited long maturity issuance again this year, with just 14% of investment grade issuance coming in maturities beyond 10 years. High yield issuance was $45B in the fourth quarter, slowing from $74.3B in the third quarter but up 8.5% on the same quarter of 2023. Full-year high yield issuance of $278.9B is up 59% year-over-year but remains well below recent peaks seen in 2020 and 2021. Net of flows, coupons, calls, tenders, maturities and net rising stars, JP Morgan estimates a 2024 supply deficit for high yield of just over $63B.

Compression remained the dominant theme within the corporate universe, with lower quality, wider-trading sectors and names outperforming. BBB bonds outperformed single-As by 0.65% on an excess return basis while sector performance was led by finance companies, office REITs, airlines, and media. Expectations for a much less onerous regulatory environment for U.S. oil producers also boosted excess returns for BBB names in the independent and midstream energy companies. Less cyclical sectors like consumer products, food & beverage, and healthcare saw spreads tighten but underperform the broader index. In high yield, the spread between the Bloomberg U.S. Corporate High Yield Index and the Bloomberg U.S. Corporate Index ex-financials narrowed to 57 bps in mid-November, the lowest level since early 2020, before widening slightly to 80 bps at year-end.

Our View

Despite already-lofty valuations, we added to our corporate bond exposure immediately following the election in anticipation of further tightening into year-end. We believe that this is the sort of environment where risk premia for corporate bonds should be low – economic growth and relatively conservative management behavior continues to support corporate fundamentals, attractive yields support demand, and easier monetary policy loosens financial conditions. We expect to see more compression between riskier and higher quality securities and sectors in the near term as the demand picture shows few signs of weakening.

Given the historically tight level of current valuations, we recognize the limited scope for further tightening in overall spreads. Corporate supply is typically robust in January and could soften the technical picture. Significant uncertainty remains over the incoming Trump administration's policies and how they may impact the economy and specific industries. However, we believe that until there is a significant downshift in U.S. economic growth, weakness in corporate bond spreads will be relatively short-lived and likely to represent buying opportunities. We maintain a small overweight to credit and look to take advantage of opportunities to adjust positioning as volatility increases or decreases.

Yields are subject to market conditions and are therefore expected to fluctuate. All data referenced herein is as of 12.31.2024 unless otherwise noted. Textual data source: Bloomberg L.P. FOMC = Federal Open Market Committee; USD = U.S. dollar; IG = investment-grade; REITs = Real Estate Investment Trusts.

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4th Quarter 2024 | Sector Performance & Exposure

Securitized Products

Securitized performance was mixed in the fourth quarter, as agency MBS underperformed duration-matched Treasuries, while consumer ABS and non-agency CMBS outperformed as demand for risk assets remained robust in the wake of continued economic resilience. Agency MBS got off to a rough start in October as interest rates surged, with the 10-year Treasury climbing 50 bps during the month after having finished the third quarter at 3.78%. With rates and volatility moving higher, we saw increased selling of MBS from a variety of investors, resulting in underperformance relative to Treasuries of 51 bps for the month of October. November saw market demand come roaring back following more stability in the rates market as well, as increased investor optimism following the U.S. Presidential election, though by early December, rates started moving materially higher and the MBS market reversed course yet again. By the time the MBS roller coaster came to a stop, the sector trailed Treasuries by 17 bps for the full quarter, though the year-to-date figure was still positive at 37 bps.

In ABS, the fourth quarter saw robust new issuance, with the market absorbing $60B in new supply. This total was front-loaded, with over $40B in issuance in October, as many issuers sought to avoid issuing directly before or after the election. Issuance for 2024 as a whole was enormous, with full-year issuance volume of $338B, up 20% over 2023 and a post-financial crisis record. Despite the heavy issuance calendar, the supply was easily absorbed by investors, who were drawn in by attractive relative value in ABS. Despite outperforming Treasuries for the first three quarters of the year, ABS lagged the strong performance in corporate bonds. This caused the relative value of ABS over corporates to become increasingly compelling. Early in the fourth quarter, AAA-rated ABS bonds offered an additional 25 bps of spread than high-quality short corporate bonds. Besides the relative value, concerns about consumer health abated as inflation cooled, the FOMC began to cut interest rates, and data revisions showed consumer savings and balance sheets were in even better condition than previously thought, all of which drove strong performance in ABS and allowed the sector to outperform duration-matched Treasuries by 61 bps in the fourth quarter and 153 bps for the full year.

Non-agency CMBS delivered strong performance relative to duration-matched Treasuries, outperforming by 102 bps during the quarter. This strong performance occurred in an environment that was seemingly challenging for non-agency CMBS. Treasury yields surged and issuance more than doubled compared to the same period last year. However, investors interpreted the higher Treasury yields as a sign of optimism about a stronger economy in the future, expecting that growth prospects will outweigh the negative effects of higher rates. Notably, the increase in rates has not significantly impacted commercial real estate prices so far. According to the latest RCA Commercial Property Price Index, commercial property prices rose by 0.5% over the three months ending in November. Trepp LLC, a commercial real estate data provider, reported that the overall U.S. CMBS delinquency rate climbed to 6.4% in November—an increase of 96 bps over the last three months. This rise was largely driven by office delinquencies, which increased by 2.4%. However, trouble in the office sector was largely anticipated and optimism remained for the sector, as investors believed the worst had already passed. This positive sentiment boosted demand for non-agency CMBS, as the sector remained attractive on a relative value basis at the start of the quarter. As a result, despite a substantial increase in issuance, demand outpaced supply, leading to significantly tighter spreads relative to Treasuries.

Our View

The outlook for MBS is a bit uncertain as we enter the new year, though on net we think the sector has room to outperform and warrants a small overweight. On the positive side, spreads remain attractive relative to many other high-quality sectors such as investment grade corporates, particularly for higher coupon MBS. Additionally, we expect demand to improve as more banks re-engage with the sector after a two-year hiatus given continued deposit growth and the fact that many have taken steps to improve their balance sheets. Further, with mortgage rates elevated, supply should remain manageable and driven by purchase activity, with most borrowers still far away from being in-the-money for a mortgage refinance. However, on the negative side, interest rate volatility is likely to remain elevated as the market digests the many and varied implications of President-Elect Trump’s policy goals. We ultimately expect compelling valuations to win out, though anticipate ample trading opportunities throughout the year amidst the volatility and will remain nimble within the sector.

Yields are subject to market conditions and are therefore expected to fluctuate. All data referenced herein is as of 12.31.2024 unless otherwise noted. Textual data sources: Bloomberg L.P.; Mortgage Bankers Association. MBS = mortgage-backed securities; ABS = asset-backed securities.

Taxable Fixed Income Commentary

4th Quarter 2024 | Sector Performance & Exposure

Securitized Products | Taxable Municipals

The relative value of ABS over short high-quality corporate bonds has largely dissipated after the outperformance of ABS in the fourth quarter. However, given a benign outlook for economic growth and consumer health, ABS should remain attractive to investors relative to Treasuries. The ABS Index spread over Treasuries is currently 44 bps, allowing the sector to outperform Treasuries merely from its higher starting yields without the need for additional tightening. We expect a significant increase in issuance for the first quarter of 2025, as many issuers issued earlier than usual at the end of 2024 to avoid election-related uncertainty. Consequently, there will likely be a January rush to tap the markets for financing. There may continue to be negative headlines about the state of the consumer as delinquencies in auto loans, unsecured consumer loans, and credit cards have risen more than expected with a low unemployment rate. However, our outlook for fundamentals in high-quality ABS remains positive given the strong structural supports offered by the sector. Also, much of the increase in delinquencies seen thus far can be attributed to looser lending standards in past vintages and post-pandemic inflation of FICO scores for consumers that would likely have had more delinquencies or defaults if not for the pandemic-era stimulus and the forced savings of lockdowns. This effect is normalizing as consumers revert to prior spending patterns. In short, we do not anticipate a significant spike in consumer delinquencies and defaults from here unless the economy falters.

On the commercial side, we continued to add to our exposure to non-agency CMBS during the quarter, focusing on securities issued in the high-rate environment of the past couple of years. We remain cautious about seasoned bonds issued in the earlier ultra-low-rate environment, as those borrowers are more likely to face refinancing challenges if rates stay elevated, which appears increasingly likely. Although the sector's recent outperformance has made it less attractive on a historical basis, there are still pockets of opportunity offering compelling relative value. To the extent we see material weakness, our bias is to add as we remain optimistic about the overall direction of the sector. While challenges persist, we believe that commercial real estate fundamentals remain on an improving trajectory, even in the context of elevated rates.

Taxable municipal securities provided 101 bps of excess return during the quarter, as municipal credit spreads tightened 9bps at the index level. The sector benefitted from the broader risk-taking environment in capital markets during the quarter as well as from muted new issue supply. Total new issue supply was a scant $9.7B for the quarter and $34.1B in total for the year, representing negligible supply growth from 2023. The diminutive pace of supply was consistent with the past several years in which municipal issuers shifted back to the tax-exempt market due to better economics, creating a supply dearth in the taxable market and thus providing support for overall performance.

Sturdy credit fundamentals persisted during the quarter. Moody's upgraded the State of Pennsylvania to Aa2 from Aa3 and adjusted the outlook on the State of California from negative to stable, citing satisfactory budget management and favorable revenue performance in both cases. Moody's also reported stable outlooks in all public finance sectors with the exception of public K-12 school districts, reflective of their slowing revenue growth and secularly declining enrollment trend. The National Association of State Budget Officers (NASBO) reported in their Fall 2024 Fiscal Survey of the States that the median rainy day fund balance of (as a percentage of spending) is projected to grow for the fourteenth consecutive year in the year ahead, though total balances are likely to decline for the second consecutive year as states spend down unanticipated surplus proceeds.

Our View

Taxable municipals remain a fundamentally strong asset class that provides diversification benefits to portfolios; however, due to valuations, we have reduced exposure over time in favor of better opportunities elsewhere. We do not see much upside at current levels, but view it is a core holding for those accounts that are limited in other asset classes such as corporate bonds or securitized products.

Yields are subject to market conditions and are therefore expected to fluctuate. All data referenced herein is as of 12.31.2024 unless otherwise noted. Textual data source: Bloomberg L.P. FICO = Fair Isaac Corporation.

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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.

The NFIB Small Business Optimism Index is a composite of ten small business economic trends that provides a monthly, summary data point for the state of the small business economy. It is a coincident indicator of the national economy, though it also offers direction for the small business sector’s immediate prospects.

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 **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. 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.

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