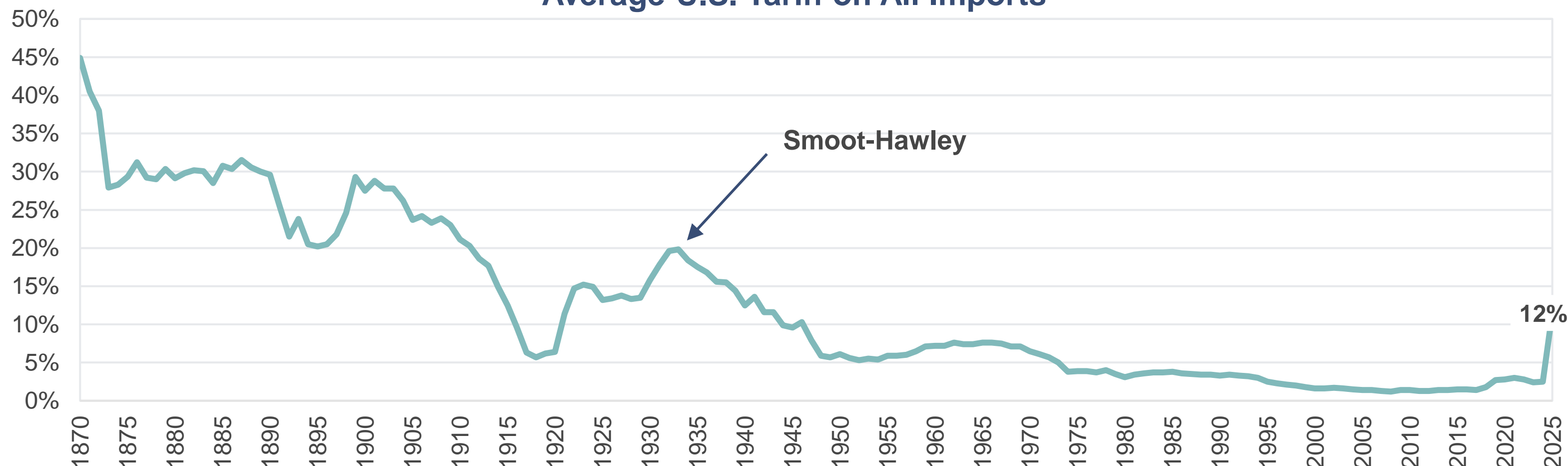
Taxable Fixed Income Commentary

1st Quarter 2025

Economic Overview

The economy entered the year on solid footing after an unexpectedly strong 2024, as markets were buoyed by optimism that the Trump administration would support further expansion via business-friendly policies. Risk premia tested multi-year lows, and the 10-year U.S. Treasury yield approached 5% early in the quarter as market participants expected continued economic strength. However, initial optimism following the election faded as the Trump administration's trade and government efficiency policies came into sharper focus. Steady reports of thousands of federal workers losing their jobs coupled with looming tariffs eroded consumer and investor confidence in February. The NFIB Small Business Uncertainty Index spiked to a near all-time high in February, second only to October 2024 prior to the election, on policy uncertainty. Meanwhile, consumer confidence metrics showed a deterioration in consumer sentiment. The University of Michigan Consumer Sentiment Index fell sharply in March, primarily driven by a meaningful increase in consumer inflation expectations on tariff concerns, which increased to levels last seen at the height of post-pandemic inflation. While so-called economic 'hard data' held up relatively well versus survey data, the rising uncertainty and lack of confidence overshadowed steady labor market performance with an unemployment rate of 4.2% and average monthly job gain of 152,000.

Trade policy concerns were fully realized on April 2 when the White House announced sweeping tariffs against U.S. trading partners. The announcement was more severe than expected and represented a seismic shift in U.S. trade policy, bringing the estimated average tariff rate levied by the U.S. on foreign good to approximately 12%, a level not seen in over a century. Uncertainty underscored the announcement, as capital allocators and investors alike wait to see the degree to which countries retaliate as well as how long the tariffs will remain in place. Reflecting that uncertainty, the Bloomberg Economics Global Trade Policy Uncertainty Index spiked to an all-time high following the announcement.



Fiscal policy overshadowed monetary policy in the first quarter, as the Fed struck a data-dependent tone at its March meeting. The Fed left its key policy rate unchanged at a range of 4.25-4.50%, noting that "uncertainty around the economic outlook has increased" and that it is "attentive to both sides of its dual mandate," implying risks to both its inflation and its employment mandate in the current environment. Importantly, the Fed decided to slow the pace of balance sheet runoff by $20B. It will now allow $5B in Treasury securities to run off each month, down from $25B, while maintaining the monthly runoff rate of a maximum of $35B in MBS, underscoring the Fed's preference to continue reducing its MBS holdings. Finally, the Fed updated its economic projections, revising down its 2025 growth outlook from 2.1% to 1.7%, and revising its unemployment rate outlook from 4.3% to 4.4% and its core PCE forecast from 2.5% to 2.8%.

Chart data is as of 04.14.2025. Source: Tax Foundation. All data referenced herein is as of 03.31.2025 unless otherwise noted. Yields are subject to market conditions and are therefore expected to fluctuate. Textual data source: Bloomberg L.P. NFIB = National Federation of Independent Business; Fed = Federal Reserve; MBS = mortgage-backed securities; PCE = Personal Consumption Expenditures. Please refer to the last page for important definitions and disclosures.

Taxable Fixed Income Commentary

1st Quarter 2025

Outlook

We have downgraded our outlook for growth for the year, as the Trump administration's trade policy has proven to be more severe than previously expected. The tariffs will dramatically increase the price of foreign goods and thus erode consumers' real purchasing power. Meanwhile, continued policy uncertainty will keep capital allocators on the sidelines, as businesses and consumers alike take a more cautious approach to spending. We now look for real economic growth of approximately 1.5% this year, with the caveat that the current environment remains highly uncertain. President Trump has previously shown a penchant to negotiate and reverse course, and if tariffs were to be reduced or removed after a short period of time, the growth impact would be positive. However, the longer tariffs remain in place, the greater the risk of an economic slowdown. Trump's tariffs represent a complete reordering of global trade policy, and the longer-run impacts remain highly uncertain.

Meanwhile, the tariffs present a real challenge to the Fed via potentially higher inflation coupled with lower growth. How the Fed conducts monetary policy this year will be highly dependent on which of its two mandates is more impacted. Higher inflation with a relatively stable labor market likely would mean fewer cuts than the two we, and the Fed, currently expect this year. However, a material deterioration in labor market conditions coupled with a growth scare would likely be disinflationary enough to allow the Fed to cut rates to support the economy. In light of current heightened uncertainty, portfolio durations will be managed neutral to benchmarks.

Corporate Credit

Markets opened 2025 with a positive tone amid optimism for a more business-friendly environment following the election of Donald Trump as President. Credit spreads traded close to year-to-date lows for much of January and February. However, the tone soured markedly beginning late February, as the new administration rolled out policy initiatives centered around tariffs, noting their belief in the need for an economic "reset" to address global trade imbalances. The OAS on the Bloomberg U.S. Corporate index ended the quarter at 94 bps, 14 bps wider in the quarter, as the sector underperformed duration-matched Treasuries by 0.85%.

High yield generated an excess return of -1.13%, with decompression the main theme as a risk-off tone began to dominate. The OAS on the Bloomberg U.S. Corporate High Yield Index widened by 59 bps to 346 bps. BB spreads widened by 40 bps, with single-Bs 69 bps wider and CCCs 119 bps wider.

Within investment grade, concerns around growth, inflation, and idiosyncratic events drove substantial dispersion in performance at the industry level. Financials outperformed, generating an excess return of -0.52% in the quarter led by banks. Industrials slightly underperformed with an excess return of -0.94% driven by weakness in the consumer cyclical sub-sectors. The on-again, off-again tariffs on imported automobiles and goods from Canada and Mexico weighed particularly heavily on the automotive industry given the inter-connected nature of the North American auto supply chains. The auto sector consequently underperformed Treasuries by 1.35% in the quarter. Amid growth concerns and an announcement from OPEC that it intends to return production to the oil market beginning in April, energy posted excess return of -1.10%. Utilities slightly underperformed the market in the first quarter as well, driven by damaging fires in California that directly impacted one utility and could potentially deplete the California Wildfire Fund, increasing the risk of financial stress in the event of future damaging fires.

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Taxable Fixed Income Commentary

1st Quarter 2025

Market technicals held up well for most of the quarter before deteriorating into quarter end. Investment-grade issuance was $561B, comparable to the same period last year. Meanwhile, flows were positive but lower on a year-over-year basis, with the asset class taking in an average of $4.1B per week in the quarter, down from $5B per week during 1Q24. In high yield, issuance of $68B was approximately 36% below the same period in 2024, while inflows amounted to approximately $7.5B.

While the outlook for corporate credit fundamentals may be clouded by currently high levels of uncertainty, data for the fourth quarter of 2024 showed that companies entered 2025 with solid fundamentals. According to JP Morgan, balance sheets for high-yield companies show leverage decreased 0.07x to 3.98x while interest coverage improved 0.08x to 4.51x, both better than long-term averages.

Our View

While noting the solid financial condition in which most companies started the year, we are concerned that policy uncertainty may lead to slowing economic growth while the use of tariffs as a major policy tool may bolster prices in the near term. Amid a high level of uncertainty in corporate board rooms that seems likely to lead to reduced investment and slower growth in the near term, we have reduced corporate credit exposure across investment grade and high yield. Despite widening to some degree in the first quarter, spreads remain towards the lower end of historical ranges with minimal pricing of recession risk, offering a somewhat unattractive risk/reward to us. We expect markets to remain volatile as government policies and economic data evolve, and we expect to be opportunistic in adding risk back at wider levels.

Securitized Products

Securitized performance was negative during the first quarter as agency MBS, consumer ABS, and non-agency CMBS all lagged duration-matched Treasuries amid elevated volatility and policy risks. Agency MBS managed to start the quarter on solid footing, with the sector posting excess returns of 21 bps through February's close. This outperformance was short-lived, however, as the market rolled over in March once it became clear that new administration's tariff policies were more aggressive than initially feared and risked materially slowing U.S. growth. March excess returns for MBS came in at -27 bps, which pulled the YTD figure into negative territory at -7 bps. Despite elevated rate volatility, higher coupons outperformed the bottom half of the coupon stack, as the higher initial starting yields and lower spread duration helped offset the negative price impact from spread widening. This quarter also witnessed the installation of Bill Pulte as the new Director of the Federal House Finance Agency (FHFA), the regulator that oversees Fannie Mae and Freddie Mac (the "GSEs"). With the new administration and new Director, there has been increased chatter about potential efforts to reprivatize the GSEs, though actual details have been non-existent to date, and the MBS market has not yet priced any movement there. Positively, both FHFA Director Pulte and Treasury Secretary Bessent have noted that any changes would be made with the safety and soundness of the U.S. housing finance system in mind and that they didn't want to adversely impact mortgage rates. Clearly, the devil is in the details, and we will be following developments closely.

ABS spreads widened meaningfully during the first quarter as market participants repriced risk, with much of the movement coming in early-to-mid March. The AAA on-the-run segments of the market widened 13 bps, while subordinated bonds widened 28 bps and esoteric sectors widened 16 bps. These risk-off moves are related to tariff policy and its potentially adverse economic effects, which produced the first material spread widening in ABS in about a year. Nevertheless, demand for ABS has been resilient against the backdrop of a brisk new issue pace in 2025, and late in March there was a modest recovery in spreads in auto and credit card ABS.

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Taxable Fixed Income Commentary

1st Quarter 2025

First quarter new issue volume stands at $94B year-to-date, which is nearly equal to the record primary market pace set in 2024. Secondary trading activity continues to run at higher-than-average levels, and wider secondary spread levels partly reflect the increase in dealer inventories. Market volatility and risk-off moves in fixed income markets caused ABS to underperform similar-duration Treasuries by 0.29% for the first quarter.

Non-agency CMBS underperformed duration-matched Treasuries by 0.21% during the first quarter. This underperformance was due to a deteriorating economic outlook driven by trade wars along with unfavorable supply technicals, as issuance more than doubled compared to the same period last year. That said, the sector's fundamentals remained largely stable, with CRE prices increasing by 1.4% for the three months ending in February, according to the most recent RCA Commercial Property Price Index. Further, the overall U.S. CMBS delinquency rate, reported by Trepp LLC, a CRE data provider, also indicated some stability after a period of rapid increases over the past couple of years, rising only modestly to 6.65% in March, up from 6.57% three months earlier. Both reports aligned with the view of many investors that the worst of the CRE downturn is likely behind us, which should bode well for the sector.

Our View

The outlook for agency MBS remains bifurcated. Yields are attractive for higher coupon pass-throughs and the sector has historically outperformed other risk products such as corporate bonds in periods where risk sectors are lagging. However, elevated interest rate volatility is likely to keep many buyers on the sidelines, at least until we get past this period of peak policy uncertainty. Additionally, the sector remains exposed to headline and execution risk surrounding any potential GSE privatization efforts, though with so little information to go on it is difficult to handicap odds of any action on that front. Outside of privatization, we do expect to see the FHFA make some changes around the margin to reduce the GSE footprint within the housing finance system, potentially increasing guarantee and loan-level fees to increase profitability and better price underlying risks. For now, we are holding onto a moderate overweight in agency MBS exposure, focused on higher coupon pass-throughs for yield and seasoned CMOs for stability and still view the sector as a high-quality alternative to other spread sectors.

In consumer ABS, we expect spreads to remain rangebound in the second quarter as the economic environment evolves and the effects of tariffs become evident. Even if spreads do not tighten, the relative value offered by ABS, with its wider spreads versus short corporate bonds, is still attractive given the higher starting yields and potential for outperformance. The all-in cost of funds for most ABS issuers fell in the first quarter as interest rates declined. This, along with solid loan demand so far this year, should mean continued strong supply of new ABS bonds. There is a chance that loan demand and the supply of ABS could slow later in the year if economic growth disappoints. Such a slowdown in employment has the potential to weigh on ABS credit fundamentals in delinquencies and defaults, particularly in subprime auto and unsecured consumer loans. This environment favors investment in the highly rated tranches of robust ABS capital structures where investors are better insulated from potential credit deterioration.

On the commercial side, we reduced our exposure to long non-agency CMBS positions, which tend to exhibit higher price volatility. This decision was driven by concerns about the broader economy, which is facing heightened uncertainty due to trade wars that proved more disruptive than anticipated. That said, we remain generally constructive on the sector, as its fundamentals have remained stable or are gradually improving, and the sector continues to offer attractive risk-adjusted returns. We believe non-agency CMBS will likely outperform competing products, such as investment-grade corporate bonds, in a risk-off environment, just as they did this quarter. Accordingly, we maintained our overweight but shifted toward a more conservative positioning by limiting exposure to longer-dated bonds in anticipation of possible economic fallout.

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Taxable Fixed Income Commentary

1st Quarter 2025

Taxable Municipals

Taxable municipal securities underperformed duration-matched Treasuries by 0.70% during the quarter, as spreads widened 10 bps in sympathy with the broader sell-off in risk assets. Relative to corporate credit, the sector continues to benefit from its high-quality nature as well as being relatively insulated from trade policy uncertainty. Issuance was again muted, with total taxable issuance coming in at $6.8B, as municipalities continue to favor the tax-exempt market.

Credit fundamentals remained broadly sound to start the year, though sector-specific strains emerged during the quarter. Moody's reported that upgrades outpaced downgrades in full-year 2024 by a margin of more than two-to-one, underscoring the overall stability of municipal credit. However, non-for-profit healthcare and higher education bucked the trend, with each sector experiencing more downgrades than upgrades over the same period by the agency. Furthermore, credit pressures related to federal funding policy in higher education and Department of Government Efficiency (DOGE) terminations led to Moody's revising to a negative outlook on both the higher education sector, the only sector not on stable, and various District of Columbia related credits due to an outsized federal employment concentration. Despite these pockets of concern, state-level fiscal health remained historically strong. According to the National Association of State Budget Officers, states ended fiscal 2024 with a record-high median fund balance of 14.4% of spending, and projections point to continued growth in fiscal 2025. Consumer activity remained stable yet at a more measured pace during the quarter, as Transportation Security Administration (TSA) data showed an average daily passenger throughput of 2.3MM, with total passengers for the quarter growing approximately 1.6% year-over-year, the lowest quarterly growth since 2021.

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 as a core holding for those accounts that are limited in other asset classes such as corporate bonds or securitized products.

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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 **Bloomberg Economics Global Trade Policy Uncertainty Index** is a measure of global trade policy uncertainty, derived by analyzing the text of major media articles to measure the frequency with which trade policy volatility is mentioned.

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 **Federal Home Loan Mortgage Corporation** (FHLMC, commonly known as Freddie Mac), is a federally-backed government-sponsored enterprise created in 1970 to broaden the secondary mortgage market and deflate interest rate risk for banks.

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).

The **NFIB Small Business Uncertainty Index** is a composite of ten seasonally-adjusted components used as an indicator of U.S.-based small business health.

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 **Smoot-Hawley Tariff Act of 1930** increased U.S. imports tariffs by an average of 40-60% in an effort to protect U.S. farmers during the Great Depression.

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

The **University of Michigan Consumer Sentiment Index** measures public views on the economy, personal finances, business conditions, and buying conditions.

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. 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.

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