MERGANSER
CAPITAL MANAGEMENT

# PRODUCT COMMENTARY

## CORE AGGREGATE COMPOSITE

Second Quarter 2024

### MERGANSER TODAY

Merganser Capital Management is a best-in-class boutique fixed income manager with a fundamentals-based investment approach. Formed in 1985, Merganser is an SEC registered investment advisor focused on the needs of institutional clients.

### MARKET OVERVIEW

The second quarter of 2024 began with significant interest rate volatility, as hotter than expected inflation data forced investors to swiftly recalculate their expectations for the Federal Reserve's (Fed's) ability and willingness to ease monetary policy this year, causing US Treasury (UST) yields to spike higher in April. Subsequent inflation prints released in May and June were more encouraging and UST yields retraced somewhat, but still ended the quarter higher. The 2-Year, 10-Year and 30-Year UST yields increased by 13, 20 and 22 basis points (bps) during the quarter, respectively. Entering the quarter, our portfolios were conservatively positioned, as spreads approached historic tights, which we believed priced in little room for error. While difficult to identify the specific catalyst for spread volatility, we continue to believe that there is a myriad of potential exogenous shocks that are not being priced into current valuations. In June, the surprise announcement of snap elections in France provided an insightful litmus test for this thesis. French banks were immediately quoted substantially wider, and that weak tone quickly spread to global banks and eventually percolated across US Investment Grade (IG) fixed income sectors. The struggles of a large Japanese agricultural cooperative bank added to the risk-off tone. From our perspective, the weakness in June appeared to be more of a sympathy sell-off and some acknowledgement that spreads had tightened too much through the end of May. According to Bloomberg US Aggregate Index data, performance was mixed for IG spread sectors during the quarter. CMBS was the star performer. Agency and non-Agency CMBS produced 28 and 21 bps of excess returns, respectively. A reasonably strong economic outlook and expectations of rate cuts have all helped CMBS spreads continue to tighten. ABS outperformed USTs by 17 bps. Agency RMBS underperformed, as the sector was hampered by interest rate volatility. Among corporate credit, financials outperformed USTs while utilities and industrials both underperformed.

### POSITIONING CHANGES

After reducing risk in Core portfolios for several quarters in a row, positioning changes were relatively muted during the second quarter. The theme of reducing risk is not a reflection of a draconian view of the prospects for the US economy, but rather, a belief that IG fixed income markets are expensively priced and there will be better opportunities to add risk in the future. Relative to the index, we ended the quarter equal weight 30-year passthroughs and underweight 15-year passthroughs. Agency RMBS

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valuations whipped around amid continued interest rate volatility. We are favoring the middle of the coupon stack to insulate our holdings from refinance risk, especially given that the last time there was an interest rate environment conducive to mass refinancing, you couldn't apply for a mortgage on your smartphone. We do not hold any private label RMBS. We increased the weighted average quality of our CMBS allocation. We continue to believe that discipline is warranted in the sector given the potential for spread volatility and headwinds facing commercial real estate. Our allocation to ABS was unchanged. Relative to the first quarter, the ABS new issue market began to feel more crowded and offered fewer attractive opportunities to add. There was issuance in non-traditional ABS subsectors such as art-backed deals and whole business securitizations, which we do not see value in. Recent bank earnings also revealed an up-tick in delinquencies and some cracks in the subprime market. We are avoiding the subprime market entirely and focusing on the highest quality collateral. Our credit allocation also stayed flat QoQ, and we remain underweight vs. the index. The option adjusted spread for the corporate credit portion of the index ended the quarter tight to its long-run average. Thirty-year credit continues to look exceptionally rich and is our largest underweight in terms of key rate durations. From our perspective it appeared as though "yield buyers" such as insurance companies and pension funds were piling into long credit in anticipation of lower rates. The likelihood of debt funded M&A increased during the quarter, and in many subsectors, there is inadequate compensation for that risk.

## OUTLOOK

Despite a weak housing market, broader economic growth has remained strong and postponed any rate cuts. Yet signs of softening have emerged, and recent data has been missing expectations since early May. The employment picture has softened slightly with higher continuing claims and the unemployment rate up to 4%, but overall remains historically strong. A soft landing with slower growth and no recession over the next six months remains our base case absent any number of potential known or unknowable exogenous shocks. As always, the Fed remains data dependent to reverse restrictive monetary policy. Recent data has reinforced their view that policy has been working. As of the most recent June meeting, the median expectation was for one rate cut but more than a few Fed officials penciled in two. Inflation looks to be flattening out and sets up for potential easing in September. Interest rate volatility at the long end of the curve has been dramatic with a 125 bp range for the 10-year UST yield in the last 12 months. We expect rate volatility to remain in place until the market reaches a consensus on the path and end point of the assumed imminent easing cycle. We remain cautious that inflation data has not provided definitive indications of the continuation of the disinflation trend. While not our base case, if the market shifts to expecting the next stop to be higher rather than lower, rates are primed to spike.

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While off recent tights, Corporate Credit spreads remain historically expensive despite robust supply as many are forecasting the remaining new issue calendar to be light. News flow from financials has remained on balance positive, tightening spreads ahead of new capital rules before year-end. While many sectors are executing well and maintaining stable credit metrics, we remain highly selective and prefer shorter securities. Agency RMBS has been trading in a tight spread range since the start of the year with spreads moving in response to changes in volatility and absolute rate levels. Spreads are likely to remain rangebound until the Fed delivers promised rate cuts. As spreads remain tight across the investment grade capital markets, we continue to favor government guaranteed securities and will look to add as relative value dictates. The Asset Backed sector remains stable. Collateral performance in prime receivables has shown modest increase in delinquencies albeit from very low levels while certain subprime shelves and unsecured consumer loans have deteriorated noticeably and bear watching. Many banks remain reluctant to lend on commercial real estate as they deal with 'legacy' issues, and many borrowers are loathe to borrow, but CMBS is open for the 'winners' who can transact. Higher rates and work-from-home have created many 'losers' but it will be a long process to realize losses at new valuations. Loan modifications remain a common strategy and transaction volume is low. A reasonably strong economic outlook and expectations of rate cuts have all helped spreads continue to tighten. The CMBS market has embraced the single borrower/asset model (70% of YTD CMBS total issuance) and replaced what used to be the bread and butter 'conduit' market.

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