PRODUCT COMMENTARY

STB 1-3 YEAR GOV/CREDIT COMPOSITE

Second Quarter 2024

MERGANSER CAPITAL MANAGEMENT

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

During the second quarter, we continued to reduce risk in our Short Term Bond 1-3 Year Government/Credit portfolios through reductions of corporate credit holdings and increased allocations to government guaranteed securities. 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. Our largest allocation change was

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within CMBS. We opportunistically sold AAA rated defeased conduit CMBS at spreads approximately 80 to 110 bps tight to where we purchased them. We deployed the proceeds in Agency CMBS backed by multifamily housing. Relative to the 15-year Agency RMBS in our Short Term Bond portfolios, the Agency CMBS are more bulleted, with more predictable cashflows and narrower prepayment windows. In addition, these securities offered more attractive spreads than Agency RMBS during the quarter. We modestly reduced our corporate credit exposure through maturities and opportunistic sales during April and May. There was robust issuance in corporate credit due to consistent issuance by banks, M&A activity in tech and pharma, and some deals being pulled forward to avoid proximity to the US presidential election. We did not add any lower quality corporate credit exposure during the quarter. We modestly increased our allocation to ABS. The primary market has offered opportunities to add ABS exposure with attractive new issue concessions versus the secondary market. We are avoiding the sub-prime market entirely and focusing on the highest quality collateral. Our allocation to Agency RMBS stayed flat. After increasing Agency RMBS allocations for several quarters in a row, valuations have reached a level where we are comfortable pausing. We view this allocation as dry powder that we can sell and deploy into other risk sectors at more attractive entry points.

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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