PRODUCT COMMENTARY

STB 1-3 YEAR GOV/CREDIT COMPOSITE

Third 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

For US Investment Grade (IG) fixed income investors, the third quarter marked the beginning of a new chapter, as the Federal Reserve (Fed) executed its much-anticipated policy reversal in hopes of achieving a soft landing. Entering the year, futures markets were predicting between six and seven interest rate cuts in 2024, but for the first half, the US economy and labor market proved resilient enough for the Fed to remain focused on battling inflation. This changed during the third quarter. In early August, US labor market data revealed that hiring slowed substantially in July and the unemployment rate increased to 4.3%, elevating recession concerns. Shortly thereafter, the Bureau of Labor Statistics revised its estimation of the number of jobs created for the 12-month period ending 3/31/2024 downward by 818,000, bolstering the case for a September cut. Concurrently, inflation continued to show signs of cooling towards the Fed's 2% target. In late August, at the Jackson Hole Economic Symposium, Fed Chair Powell candidly stated, "the time has come for policy to adjust". The FOMC ultimately cut rates by 50 bps at its September meeting and the accompanying Summary of Economic Projections suggested 50 bps more of easing this year. The 2-Year, 10-Year and 30-Year UST yields decreased by 111, 82 and 44 bps during the quarter, respectively, fueling positive total returns for IG fixed income. After over two years of inversion, the 10-year UST yield ended the quarter 14 bps higher than the 2-year. IG fixed income spreads generally tightened during the quarter. There was a brief and violent spike in volatility in early August amid fear that a large scale unwind of the Yen "carry trade" could cause global contagion. This fear abated relatively quickly and was further thwarted by Powell's comments at Jackson Hole. Despite increased geopolitical tensions and an uncertain US presidential election, spreads for most IG sectors ended the quarter near cycle tights.

POSITIONING CHANGES

During the third quarter, we continued to reduce risk in our Short Term Bond 1-3 Year Government/Credit portfolios by reducing conduit CMBS and lower quality corporate credit holdings and deploying the proceeds in 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 markets are expensively priced and there will be better opportunities to add risk in the future. After aggressively reducing our conduit CMBS exposure during the first half of the year, our allocation ticked down modestly via paydowns and opportunistic sales. We deployed the proceeds

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in Agency CMBS backed by multifamily housing. Our corporate credit allocation stayed relatively flat during the quarter. Within corporate credit, our focus was on reducing lower quality holdings, where compensation per unit of risk became less attractive as the quarter wore on. Within financials, we reduced our allocation to REITs. Spreads for front-end bank paper widened from their 2024 tights, which gave us an opportunity to add several of our preferred names in the secondary market. We expect continued spread volatility for Yankee and regional banks and remain constructive on those deemed “too big to fail”. Although spreads for some front-end industrials appear exceptionally rich, a deluge of issuance in September (much of which funded M&A) presented some opportunities to add. We modestly increased our exposure to utilities. The sector presents a trade-off between reduced liquidity and favorable technicals due to limited issuance at the front-end of the curve. We favor domestic utilities, which are more insulated from geopolitical and commodity price instability via rate-base adjustments. We decreased our allocation to Agency RMBS as both nominal and option adjusted spreads for seasoned 15-year mortgages tightened due to strong demand for government guaranteed securities. We deployed the proceeds in ABS. Primary market spreads in the traditional ABS segments provided a considerable spread concession versus secondary market opportunities. While there has been some deterioration in collateral performance, deals remain well enhanced. We avoided the more esoteric ABS subsectors such as unsecured consumer loans. In terms of duration positioning, our focus was maintaining neutral positioning (+/- 5% relative to the benchmark). Our key rate duration positioning did not change meaningfully during the quarter.

OUTLOOK

Absent a post-election confidence shock, our base case remains a soft landing. A new easing cycle is unfolding on the heels of GDP growth surprising to the upside, rising from 2.8% in Q1 to 3% in Q2. Housing remains soft and employment is modestly weaker, but neither suggest recessionary conditions; we view both as experiencing a hangover from prior cycles. Although they are rising, continuing claims (1,829k as of 9/19) are rather low by historical standards. Having "gained greater confidence that inflation is moving sustainably towards 2%" the Fed has pivoted to defending the labor market. Cutting 50 bps to start the easing cycle was a signal they can and will act pre-emptively to do what is within their power to avoid a sharp downturn in labor market conditions. As always, Fed Chair Powell stressed being data dependent. The latest Summary of Economic Projections (SEP) shows 50 bps of additional cuts this year towards a terminal rate of 2.9% in 2026, and expectations for a slightly higher unemployment rate of 4.4% through 2025: a modest increase from June. Volatility at the long end of the curve has been dramatic with a greater than 125 bps range for the 10-year in the last 12 months. We expect rate volatility to remain as the market interprets the speed of cuts over the next 18 months. Core PCE has fallen from a high of 5 1/2% in 2022 to close to 2 ½% now, but the pace of decline appears to be slowing. We are within the bands of the "symmetric" Fed goal around 2% inflation. Risks remain that we do not reach 2% itself or that inflation starts to trend higher again.

While off recent tights, corporate credit spreads remain historically expensive despite robust supply as many are forecasting the remaining 2024 new issue calendar to be light. The market's focus is currently dominated by a small but material cohort of large cap credits that are working through significant challenges to their businesses. Failure of any of these to execute will have outsized impacts on IG returns as well as the go forward HY universe. While many sectors are executing well and maintaining stable credit metrics, we remain highly selective and prefer shorter securities. The Agency Mortgage sector 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. The mortgage basis tightened briefly in response to a 50 bps rate cut from the Fed in mid-September and a drop in rate volatility. While spreads remain tight across the IG capital markets, we continue to favor government guaranteed securities as a source of dry powder if spreads widen. The consumer is showing signs of weakness. Collateral performance in prime receivables have shown modest increase in delinquencies albeit from very low levels while certain subprime shelves and unsecured consumer loans have deteriorated noticeably and bear watching. 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. 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 (60% of total CMBS issuance YTD) and replaced what used to be the bread and butter 'conduit' market.

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