PRODUCT COMMENTARY

CORE AGGREGATE COMPOSITE

Fourth Quarter 2024

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CAPITAL MANAGEMENT

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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 fourth quarter of 2024 brought a decisive outcome of the US presidential election which yielded a combination of optimism regarding future growth and concerns regarding inflationary pressures. The quarter began just days after the Federal Reserve (Fed) pivoted to easing monetary policy by cutting interest rates by 50 basis points (bps) at its September meeting. At that point, futures markets were predicting as many as three more 25 bps cuts in 2024, followed by four 25 bps cuts in 2025. This outlook changed markedly over the course of the quarter. The Fed delivered 25 bps cuts at both its November and December meetings. Concurrently, data revealed that inflation was coming down at a slower pace than anticipated, and market participants eyed higher future growth and inflation under the incoming administration. Fed officials responded with commentary regarding interest rates being "higher for longer" and at the end of the quarter, futures markets were predicting just two 25 bps rate cuts in 2025. Accordingly ultra-short (6-months and shorter) US Treasury (UST) yields ended the quarter lower, while those 2-years and longer moved meaningfully higher. The 2-year, 10-year, and 30-year UST yields increased by 60, 79 and 66 bps during the quarter, respectively, driving negative total returns for many US Investment Grade (IG) fixed income indices. The Bloomberg US Aggregate Index returned -3.06%. After being inverted for over two years, the yield curve steepened as measured by both the 2's vs. 10's and 10's vs. 30's curves. Among IG spread sectors, sentiment was generally risk-on during the quarter, with spreads continuing to compress from already tight levels, and higher beta names outperforming lower beta. According to Bloomberg US Aggregate index data, corporate credit posted the strongest excess returns vs. like-duration USTs. Among corporate credit subsectors, utilities outperformed the most, followed by industrials and financials. CMBS and ABS also posted healthy excess returns, while Agency RMBS modestly underperformed, as the sector was hampered by interest rate volatility.

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POSITIONING CHANGES

During the fourth quarter, we continued to reduce risk in our Core Aggregate portfolios by reducing our corporate credit and CMBS allocations and deploying the proceeds in government guaranteed and other high-quality securities. We decreased our corporate credit allocation by 3.85%, where spreads are generally rich, and we remain underweight vs. the benchmark. Debt funded M&A increased significantly during the quarter, and in many subsectors, there is inadequate compensation for that risk.

Industrial spreads tightened to levels commensurate with only the most upbeat economic forecasts. Similarly, utility spreads reflect the benefit of highly visible cash flows and are at or near full value. The banking sector saw significant tightening in 2024 as the market regained, and even surpassed, the confidence lost during the March 2023 crisis. Within banking we are focused on asset quality, profitability and supply. We remain constructive on the "too big to fail" banks and are poised to take advantage of new issuance, though we still anticipate spread volatility, particularly for Yankee and regional banks. In the REIT space, market confidence has also rebounded significantly, but this has resulted in limited compensation for risks related to funding costs and uncertainty regarding property values. The proceeds from corporate credit sales were initially parked in Treasuries and then opportunistically deployed in Agency RMBS, where we increased our allocation by 4.66%. We are favoring the middle of the coupon stack to insulate our holdings from refinance risk. We are now overweight vs. the benchmark for the first time in years. We view this government-guaranteed sector as a “safe haven” with excellent liquidity. We decreased our CMBS allocation by 0.87% via paydowns and opportunistic sales. Within CMBS, we continue to favor Single Asset Single Borrower (SASB) deals which allow for bespoke exposure to property types away from office. We believe that discipline is warranted in the sector given the potential for spread volatility and headwinds facing commercial real estate. We increased our ABS allocation by 1.74%. Primary market spreads in the traditional ABS segments offer a modest spread concession vs. secondary market opportunities. While there has been some deterioration in collateral performance, deals remain well enhanced. Our overall duration positioning was unchanged at neutral vs. the benchmark. Thirty-year credit continues to look exceptionally rich and is our largest underweight in terms of key rate durations. We are overweight the 6-7-year key rate duration, which is largely a reflection of our Agency RMBS exposure.

OUTLOOK

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The new administration in Washington inherits an economy that is by all accounts in good shape. Geopolitical tensions globally remain challenging, further girding American exceptionalism in markets as we enter 2025. That said, labor markets are softening, and cracks are building in lower income cohorts amidst rising inequality, both of which bear watching. With more questions than answers, it remains difficult to be confident in the durability of any one thesis. After 100 basis points (bps) of cuts the Fed now has fewer cuts penciled in for 2025. The latest 25 bp cut in December was a ‘close call' and taken as a 'hawkish cut' as the Fed now expects PCE will rise to 2.5% next year, up from a 2.1% forecast only a few months ago. The median, which now matches the market, calls for two additional cuts in 2025, down from four at the last meeting. As always, they promise to be data dependent as they face a divergence in their dual mandate that is likely to lead to more rate volatility in 2025. Volatility at the long end of the curve has been dramatic with a nearly 100 bp range for the 10-year since the first Fed cut in September. We expect rate volatility to remain elevated as long run policy

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expectations and inflation pressures sow discord in markets. Progress has slowed on the battle to bring inflation down to 2%. As expected, the path has not been a straight line, but it is concerning to see year-over-year Core PCE rise to 2.8% after bottoming out at 2.6% in June. Tariffs and immigration policy add potential for inflation to continue its trend higher.

Corporate Credit spreads remain historically expensive as expectations for an eased regulatory backdrop drive a strong outlook for the US corporate operating environment. M&A activity has picked up dramatically since the election, pressuring future industrial balance sheets, but setting up a strong 2025 for money center banks. We continue to prefer shorter exposures and remain circumspect when it comes to Tech, Pharma/Healthcare, Retail, and Autos. Agency Mortgage spreads remain at levels that present incremental value, particularly on a risk adjusted basis versus other spread sectors. The debate over value in current coupon rages on, but most of the universe remains well out of the money, setting the table for a less prepayment sensitive universe. We view this government-guaranteed sector as providing a reasonable rate of return and exceptional liquidity, creating strong relative value in a market with broadly stretched valuations for risk. While most consumer credit strata are showing signs of weakness, the relative weakness varies dramatically between prime and subprime. Collateral performance in prime receivables continue to show a modest increase in delinquencies. Many subprime shelves and unsecured consumer loans have deteriorated noticeably and bear watching. We are avoiding the subprime market entirely and focusing on the highest quality consumer and commercial related collateral. Positive economic data has supported commercial real estate as lending markets have thawed. 'Survive to '25' was the name of the game as borrowers awaited rate cuts; but it has not solved the problem for too many office owners and defaults will continue to mount. A building return to office trend, while positive on the margin, is unlikely to stem the tide. Spreads will follow the course of IG Credit, starting from tight levels that are a fraction of where they were at the beginning of 2024.

CONTACT INFORMATION

Merganser Capital Management
99 High Street
Boston, MA 02110
www.merganser.com

Consultant Relations & Business Development
P: 617.528.4863
info@merganser.com