PRODUCT COMMENTARY

STB 1-3 YEAR GOV/CREDIT COMPOSITE

Fourth Quarter 2024

MERGANSER
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 1-3 Year US Government/Credit Index returned -0.02%. 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 1-5 Year US Aggregate index data, front-end CMBS posted the strongest excess returns vs. like-duration USTs. ABS and corporate credit also meaningfully outperformed, while front-end Agency RMBS modestly outperformed.

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POSITIONING CHANGES

During the fourth quarter, we continued to reduce risk in our Short Term Bond 1-3 Year Government/Credit portfolios by reducing CMBS and lower quality corporate credit holdings and deploying the proceeds in government guaranteed and other high-quality 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

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down modestly via paydowns and opportunistic sales. We also reduced our SASB exposure via paydowns and opportunistic sales. We deployed the proceeds in Agency CMBS backed by multifamily housing. We decreased our allocation to corporate credit. Within corporate credit, our focus was on reducing lower quality holdings, where compensation per unit of risk continues to hover near historic lows. We deployed the proceeds in short SSA (Sovereign Supranational Agency) paper, where we found relatively attractive spreads vs. USTs for extremely high-quality names. We modestly increased our allocation to ABS. Early in the quarter, the ABS primary market offered compelling new issue concessions vs. the secondary market. These opportunities waned as primary market issuance slowed approaching the holidays. Our allocation to Agency RMBS stayed flat. In terms of duration positioning, we maintained neutral positioning relative to the benchmark (+/- 5%). In terms of key rate durations, we added to the 3-5-year duration band in response to curve steepening.

OUTLOOK

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 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.

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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

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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.

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