DUCENTA SQUARED
ASSET MANAGEMENT

Economic and Sector Summary & Outlook

First Quarter 2024

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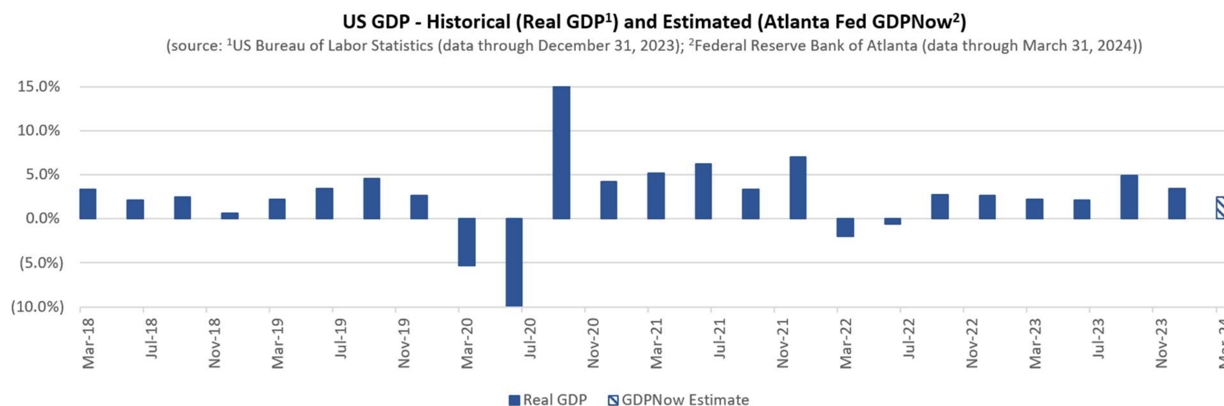
US Economy

Summary

The US economy has demonstrated remarkable strength, despite numerous challenges such as global political tensions, slower growth worldwide, and the impact of high interest rates due to strict monetary policies. We attribute the prevailing economic vigor to advancements in productivity, significant consumer spending, and a dynamic job market.

During the first quarter of 2024, the 10-year US Treasury Note yield increased 32 basis points, indicating reduced expectations for Federal Reserve rate cuts. Initially, investors anticipated six rate cuts totaling 157 basis points for the year 2024, as reflected by the federal funds futures market. However, investor sentiment shifted significantly in recent weeks and federal funds futures now reflect only two rate cuts in 2024 totaling 62 basis points. The yield on the 2-year US Treasury Note also rose by 37 basis points, reflecting a shift in market sentiment regarding economic growth and inflation. As a result, the entire US Treasury Note yield curve rose during the period.

Economic data released in the last three months suggests that the economy is growing, consumers remain active, unemployment remains low and inflation remains stubborn. Each of these trends supports a "higher-for-longer" trajectory in the federal funds rate. On March 28, 2024, the US Bureau of Economic Analysis revised fourth quarter real GDP growth to 3.4% from an earlier estimate of 3.2% (quarter-over-quarter, seasonally adjusted annual rate). Last year's real GDP growth of 3.1%, when compared quarter-over-quarter, aligns with the historical average growth rate since 1948. On April 4, 2024, the Federal Reserve Bank of Atlanta's GDPNow model estimated that the economy would grow 2.5% in the first quarter of 2024 (see chart, below); while the level represents a decline from the growth rate experienced in the fourth quarter of 2024, it's sufficiently strong to dissuade talk of any imminent economic downturn, for now.



Consumer expenditures comprise approximately 68% of nominal GDP. Within the category, services consumption has increased from 30% in 1970 to 45% today, while goods consumption accounts for the remaining 23%. Real consumer spending increased by 2.7% in 2023, slightly below the average rate since the late 1940s but strong enough to suggest that consumer activity continues to support economic growth.

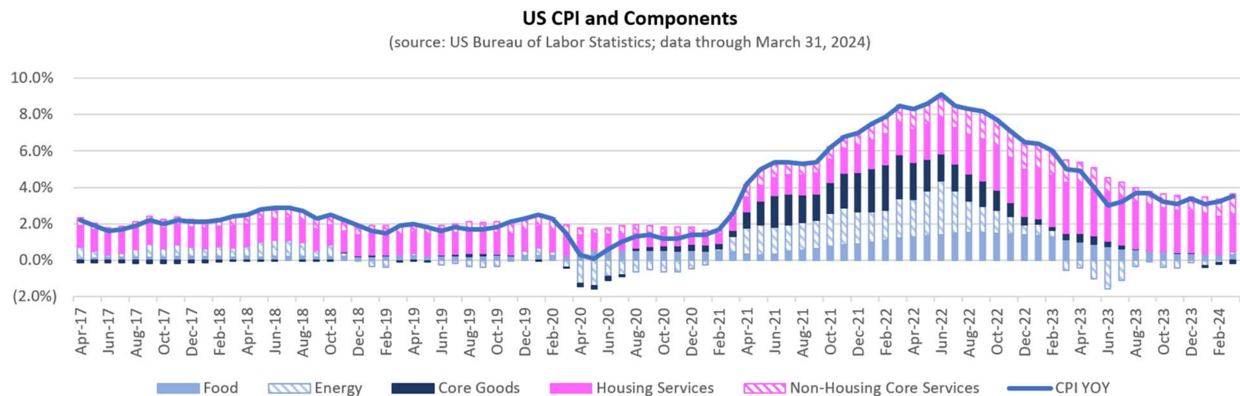
Job market trends have remained positive, with three million new jobs created last year amidst a substantial decrease in inflation. The first quarter of 2024 alone saw the creation of 829,000 jobs, marking the highest three-months of job growth since the first quarter of 2023.

Although inflation is showing signs of moderation, it remains above the Federal Open Market Committee's (FOMC) target of 2%. February's headline inflation rate stood at 2.5% over the past twelve months, as measured by the Personal Consumption Expenditures Index, down from 5.2% a year earlier. Core inflation, which excludes food and energy prices due to their volatility, reached 2.8% in February 2024, a decrease from 2.9% in January 2024 and 4.8% in the prior year period. Despite these improvements, inflation remains persistent.

Outlook

Economic Growth and Monetary Policy

We maintain our view that nominal GDP growth will hover around 2.5% in 2024. The Real Federal Funds Rate, which represents the difference between the federal funds rate and Core Personal Consumption Expenditures (PCE), stands at 2.7%, the highest level observed since 2006 and one that significantly surpasses the long-term average of 1.54% dating back to 1970. This tight monetary stance, as frequently pointed out by Federal Reserve Chair Jerome Powell, could potentially dampen demand, especially in sectors sensitive to interest rates. We anticipate the Federal Reserve will adopt a cautious "wait-and-see" approach towards rate adjustments throughout the year. Achieving the 2% inflation target appears challenging due to various factors, including robust employment figures, persistent service sector inflation (see chart, below, “Housing Services” and “Non-Housing Core Services”), fluctuations in the housing market, and the commodity sector's volatility. Premature rate cuts risk reigniting inflationary pressures, potentially unsettling the markets, while excessive delays could tip the economy into recession. Nonetheless, we are optimistic that the economy can maintain steady growth under the current restrictive policy framework, likely leading to a more delayed rate cut than the market currently anticipates.



Employment and Inflation Trends

The job market's expansion remains robust, with job openings, as per the Job Openings and Labor Turnover Survey (JOLTS), consistently around 8.8 million positions. With the labor participation rate increasing to 62.7% in March 2024 and unemployment remaining below 4%, we expect wage inflation to stabilize at approximately 4%.

Initially, goods inflation surged during the post-pandemic recovery, fueled by supply chain bottlenecks and pent-up demand, with significant price hikes in sectors like automobiles and electronics. However, recent indicators suggest a moderation in goods inflation, attributed to the easing of supply chain disruptions and a return to normal demand patterns.

Conversely, services inflation appears sticky and resilient, driven by a tight labor market and wage inflation. Key sectors contributing to core inflation include healthcare, education, and housing – areas that, due to their intrinsic nature, exhibit resistance to quick adjustments and remain critical inflation drivers.

Sector Specific Views - Services and Housing

We anticipate sustained growth within the services industries, propelled by the retirement of Baby Boomers and their significant net worth of $76 trillion. This demographic has historically influenced various societal aspects, including education, employment, and, more recently, the retirement and healthcare sectors. Their increasing demand for services – ranging from food and recreation to travel and healthcare – is expected to reach new heights.

Despite higher mortgage rates, the housing market's resilience is noteworthy, with the S&P CoreLogic Case-Shiller US National Price Index showing a 6.03% increase over the past year. Mortgage rates hovering around 7% have

not deterred home price appreciation, contributing to the sustained elevation of the owner's equivalent rent at 6%, thereby moderating the pace of housing price declines.

Corporate Earnings and Market Valuations

Strategists forecast S&P 500 companies to report a modest 3.9% year-over-year profit growth for the first quarter, as per Bloomberg Intelligence. This projection, potentially conservative, mirrors the underestimation observed in the previous quarter when actual growth significantly outperformed the expected 1%. Given this context, while current valuations in fixed income spread sectors might appear stretched by historical standards, we believe the market is positioned to support relatively high valuations over an extended period.

Conclusion

In summary, our outlook for 2024 suggests cautious optimism, underpinned by a detailed analysis of monetary policy impacts, inflation dynamics, and sector-specific growth trajectories. As economic indicators and market sentiments evolve, our strategy emphasizes flexibility, vigilance, and a readiness to adapt to the changing economic landscape so that our portfolios remain well-positioned to capitalize on emerging opportunities while mitigating potential risks.

Sector Analysis

US Interest Rates

In the first quarter of 2024, US Treasury Note yields climbed significantly, reversing the rally experienced in the final quarter of 2023. The US Treasury Index posted a -0.96% total return for the period, highlighting the challenges faced by bond investors in recent periods.

Notably, the yields on 2-year and 10-year US Treasury Notes increased by 37 basis points to 4.62% and 32 basis points to 4.20%, respectively. This movement led to a slight flattening of the 2-year / 10-year yield curve by five basis points, concluding the quarter with a continued inversion of 42 basis points. Persistent inflation, fueled by rising oil prices among other factors, along with a minor uptick in unemployment to 3.8%, reflected the complex economic backdrop. These elements, coupled with a modest rise in the 10-year US Treasury Note term premium, were instrumental in driving the increase in rates observed during the quarter.

Amid these conditions, adjustments in market expectations and strategy became evident. The anticipation of interest rate cuts underwent a considerable recalibration, with federal funds futures now signaling only two of the six rate cuts previously expected at the year's outset. In response to the evolving macroeconomic landscape, investors modestly shortened duration positioning to align closely with benchmarks. Furthermore, there's been a strategic pivot in curve positioning, with a greater emphasis on preparing for a potential steepening of the curve. This adjustment reflects a broader anticipation of increasing term premiums and the economy's progression through the later stages this cycle, underscoring the dynamic nature of financial markets and the strategic shifts undertaken by firms to navigate these changes.

Securitized Products

As noted above, in the first quarter of 2024, stronger than anticipated economic trends led investors to reduce their outlook for FOMC rate cuts in 2024 to only two cuts, versus previous expectations for as many as six. As a result, interest rates rose across the yield curve and risk spreads generally tightened.

Mortgages underperformed other spread sectors during the quarter. The MBS Index returned -1.04% as the OAS widened 2 basis points to 49 basis points resulting in an excess return of -14 basis points. This compares to the 23 basis points of excess return generated by the Bloomberg US Aggregate Bond Index. The 30-year mortgages sector modestly outperformed 15-year mortgages. Across the coupon stack the best performing coupons included the 5.5s and 6.0s, while the worst performing coupons included the 2.0s and 2.5s.

We positioned portfolios overweight MBS relative to Index exposure throughout the quarter. Our core and core-plus portfolios started the year approximately 4% overweight MBS and currently target a modest 1% overweight. Our repositioning was driven by recent spread compression and relative value versus other sectors.

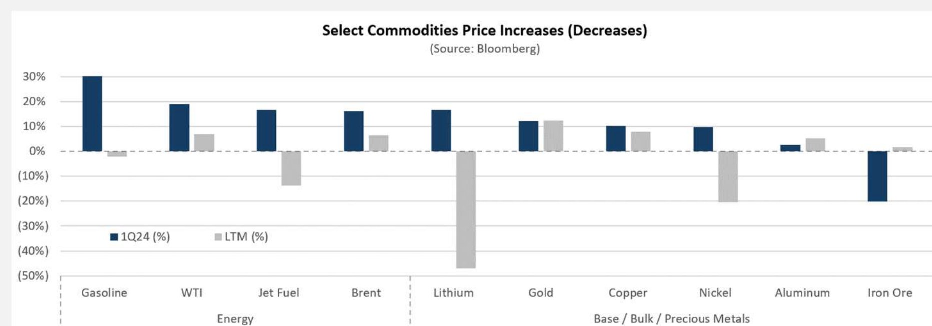
The ABS sector continued to benefit from a healthy consumer that has been supported by a strong labor market. These strong fundamentals contributed to a 13-basis point tightening in ABS Index OAS from 68 basis points at the beginning of the quarter to 55 basis points at period end. The ABS Index generated 54 basis points of excess return in the period relative to duration matched Treasuries. The short average life of ABS securities insulated the sector from the higher rates experienced in the quarter allowing the ABS Index to generate 68 basis points of total return. The continued inversion of the yield curve provides a strong positive technical support for the sector as investors look for absolute yield. We continue to position portfolios with a slight overweight to the sector as we anticipate both fundamental and technical support for ABS will continue.

The CMBS sector continued its recovery from overly pessimistic fundamentals assumptions last year. During the first quarter of 2024, the CMBS Index OAS tightened 30 basis points to end the period at 96 basis points, versus the October 2023 wide of 140 basis points. This spread tightening generated 145 basis points of excess return relative to Treasuries and a total return of 85 basis points despite increasing interest rates. During the quarter we began adding selectively to the sector via CMBS conduit deals. Commercial real estate fundamentals will continue to be challenging, however, the prospect of continued strength in the economy and what could be peak in interest rates presents an opportunity to add quality spread product to the portfolios.

Credit Spotlight

Commodities – Prices Rise to Start the Year 2024

In the first quarter of 2024, a combination of unique macroeconomic and microeconomic factors led to an increase in prices for various critical commodities, both hard and soft. This rise contributed to persistent inflation concerns and impacted the financial performance of both businesses and consumers.



Metals market prices experienced notable gains due to increased manufacturing activities in key economies (with US and Chinese PMI figures indicating expansion), a surge in demand over the long term, and beneficial supply-demand conditions.

Copper prices increased 10% in the first quarter of 2024. Copper prices moved higher due to a number of factors, including; 1) the ongoing halt of operations at the Cobre Panama copper mine (the world's 14th largest), 2) a first quarter 2024 coordinated production cut by Chinese smelters, and 3) an outlook for stable worldwide demand (as evidenced by a 24% year-to-date increase in Chinese copper demand and a 2.7% forecasted increase in overall 2024 global demand). Additionally, the growing importance of copper in emerging technologies such as Artificial Intelligence and clean energy (including copper's critical role in electric vehicles) provide further long-term price support.

Lithium and nickel prices increased 17% and 10%, respectively, in the first quarter of 2024. Lithium and nickel, essential for electric vehicle batteries, saw remarkable price increases in the period following the pandemic, driven by disrupted supply chains and soaring demand. However, by 2023, improvements in supply chains, lower-than-anticipated electric vehicle demand, and increased production capacity led to a substantial price correction. The first quarter of 2024, however, marked a turnaround with a mid-teens percentage rise in Chinese lithium prices, fueled by tighter supply concerns and a growing consensus that market prices had bottomed out.

Aluminum prices increased only 3% in the first quarter; however, price performance exceeded investor expectations, driven mainly by robust demand from China for solar capacity expansion and electric vehicle production. Similar to copper, manufacturing growth in the US and China bolstered aluminum demand forecasts for 2024. Supply constraints in China and energy cost-driven production cuts in Europe were notable on the supply side. For the year 2024, analysts expect a modest increases in worldwide aluminum supply, offset slightly (i.e., creating a slight supply deficit) by increased demand from the aerospace, packaging, and automotive sectors.

Credit Spotlight (continued)

Gold prices increased 12% in the first quarter, amidst an environment of rising interest rates and increasing government deficits. The price action underscores gold's enduring appeal and resilience as an investment asset and / or hedge vehicle. Typically, investors expect gold prices to underperform in a rising rate environment because higher interest rates tend to boost yields on interest-bearing assets like bonds, making them more attractive compared to non-yielding assets like gold. However, several factors contributed to gold's counterintuitive rally during this period:

1. Diversification and Safety: Investors often turn to gold as a safe haven during times of economic uncertainty or when inflation expectations are high, despite rising interest rates. Gold's historical positioning as a store of value can make it an attractive option for diversifying investment portfolios.

2. Central Bank Purchases: Central bank purchases have long been a cornerstone of the market, offering substantial support and stability to gold prices. In recent years, emerging market economies, notably China and India, have been at the forefront of this buying trend. For instance, China's central bank has consistently added to its gold reserves, marking a 17-month streak of purchases, culminating in a significant increase of approximately 300 tonnes over four years. These strategic acquisitions underscore a broader trend among central banks, particularly in emerging markets, to bolster gold reserves.

3. Inflation Hedge: Even in a rising rate environment, gold retains its appeal as a hedge against inflation. If investors believe that real interest rates (the interest rate adjusted for inflation) will remain negative or that central banks might be behind the curve in combating inflation, gold's allure increases as a protective asset against eroding purchasing power.

4. Geopolitical Tension and Economic Uncertainty Hedge: Ongoing geopolitical conflicts and economic instabilities can drive investors towards gold. Its status as a "safe haven" asset means that in times of global distress, demand for gold can rise, supporting its price even when traditional economic models would suggest otherwise.

5. Market Sentiment and Speculative Demand: Speculative demand driven by market sentiment can also play a crucial role in gold's performance. In periods where investors are bullish on gold, driven by macroeconomic trends or speculative interests, this can lead to price increases independent of traditional interest rate dynamics.

6. Currency Fluctuations: Gold is often seen as an alternative to holding currencies, especially in times when there is a lack of confidence in the global monetary system or in specific fiat currencies. If the dollar weakens, for example, gold prices in dollar terms can rise as it becomes cheaper for holders of other currencies to buy gold.

The energy sector witnessed a notable rally in the first quarter of 2024, driven by a confluence of factors that propelled the prices of WTI and Brent crude oil higher, prompting analysts to revise upward their price forecasts for the year. This surge in oil prices was underpinned by several critical dynamics:

1. Low Oil Stocks: The period was characterized by low levels of oil inventories globally. This scarcity in available stock contributed to upward pressure on oil prices as demand outstripped supply. Lower inventories are often a signal of tighter markets, which can lead to higher prices if demand remains consistent or increases.

2. OPEC+ Production Cuts: Decisions by OPEC+ to reduce production further exacerbated the tight supply situation. These strategic cuts are aimed at balancing the market and supporting oil prices. When the consortium of oil-producing nations limits supply, it can significantly impact global oil prices due to the group's substantial share of world oil production.

3. Better-than-Expected Global Growth: The first quarter saw more robust than anticipated global economic growth, which in turn fueled higher demand for energy. Economic expansion typically leads to increased consumption of oil and gas as industries ramp up production, and transportation needs grow. This increase in demand, against a backdrop of constrained supply, contributes to rising oil prices.

Investment Grade Credit

During the first quarter of 2024, the OAS on the Bloomberg US Corporate Bond Index tightened nine basis points to finish the period at 90 basis points. The 10-year US Treasury Note yield rose by 32 basis points during the quarter, contributing to an -0.39% total return for the Bloomberg US Corporate Bond Index.

Looking back into the fourth quarter of 2023, both rates and corporate spreads rallied as bond investors embraced with near certainty that the "Fed Pivot" was imminent. At the end of 2023, the futures market was pricing in an 85% probability of an FOMC rate cut by the end the March 2024 meeting. This cut never materialized, and now the series of cuts expected to occur in mid-2024 seems very unlikely. During the first quarter of 2024, the total number of cuts priced-in for 2024 rapidly dropped from six to just over one cut by the end of the year.

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Despite the reduced expectations of for a dovish FOMC, investor appetite for corporate bonds remained robust due to demand from "yield buyers" who simply want to receive the larger coupons offered in the investment grade market. During the fourth quarter of 2023, the average duration of the Bloomberg US Corporate Bond Index dropped slightly from 7.09 years to 7.04 years. The Yield to Worst of the Bloomberg US Corporate Bond increased to 5.30%, attracting insurance and pension funds seeking to lock in higher yield over the long run, causing spreads to tighten.

In the first quarter of 2024, lower-quality BBBs outperformed the rest of the benchmark, returning -1.92% while A-rated bonds returned -2.43%. Financials (1.37% excess return) outperformed both utilities (1.42% excess return) and industrials (0.99% excess return) due to better sentiment regarding bank earnings potential given the record high amount of bond underwriting activity during the quarter.

New issuance in the investment grade bond market broke all previous records as the market priced $529 billion of new high-grade bonds. Investor appetite for new issue was robust, as coupons approaching and sometimes exceeding the 5.50% to 6% range enticed "buy and hold" investors to throw caution to the wind despite reduced expectations for rate cuts.

Valuations appear tight as spreads on the Bloomberg US Corporate Bond Index hover around 90 basis points, but higher coupon yields have drawn crossover buyers from non-traditional areas and kept both primary and secondary issues well supported. We currently maintain an overweight portfolio target on investment grade credit and see value in industries that should benefit from the rate regime, including REITs, BDCs, aircraft lessors, and technology.

High Yield

After a slow start to 2024, a solid March drove the US high yield market to a 1.47% return in the first quarter (as measured by the Bloomberg US Corporate High Yield Bond Index) as resilient economic fundamentals, expectations that the Federal Reserve would begin cutting rates, and relatively attractive yields (near 8% for much of the quarter) remained supportive of the market. High yield spreads tightened 24 basis points to 299 basis points, and reached an intra-quarter low of 292 basis points that was the tightest level since January 2022. Compression remained a key theme in the quarter, with CCCs (2.14% total return) outperforming Bs (1.36%) and BBs (1.13%). At the sector level, retail, healthcare and energy led the market with gains of 5.0%, 2.9% and 2.5%, respectively, while communications (cable / media / telecom) dramatically underperformed (-1.9%) as secular challenges (i.e., cord cutting) weigh on over-leveraged credits.

Better-than-expected US economic growth continues to underpin solid corporate credit fundamentals. High yield credit metrics remained in good shape through the fourth quarter of 2023 (latest available data), except for interest coverage, which continues to deteriorate as companies adjust to the higher rates environment. EBITDA growth resumed (+5% yoy) in the fourth quarter of 2024 after flatlining for much of 2023, and leverage declined to 3.9x, below the long-term average of 4.3x. High yield defaults remain manageable, ending the quarter at 2.6%, down from 2.9% at year-end 2023 but up from 1.9% a year ago. With fundamentals solid and spreads relatively tight, issuers flooded the market with $88 billion in new issuance in the quarter, more than double the level of the first quarter of 2023, with a large portion (approximately 70%) directed to refinancing near-term maturities. Supply was easily absorbed, in part due to $2.6 billion of retail fund inflows during the quarter. The refinancing transactions that hit the market in first quarter of 2024 will go a long way toward reducing the maturity wall overhang that had been a dark cloud on the horizon at the end of last year.

High yield investors continue to confront historically tight spreads – particularly for the BB- and B-rated portions of the market, but for the time being, attractive yields, healthy fundamentals, and solid technicals are driving market activity. Unless one or more of these themes reverses, we anticipate continued coupon-like returns as spread tightening appears limited, with the exception of CCCs (where dispersion of returns is likely to remain high). We continue to overweight in less-cyclical industries, but also favor the energy sector, which is enjoying better-than-expected supply / demand trends and remains a partial hedge for ongoing geopolitical risks. Against a resilient US economic backdrop, we continue to look to selectively add lower-rated bonds that offer attractive yield opportunities.

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Leveraged Loans

The US leveraged loan market picked up where it left off at the end of 2023, posting a solid 2.52% return in the first quarter of 2024 (as measured by the Credit Suisse Leveraged Loan Index). The gain outperformed other fixed income asset classes that were negatively impacted by higher US Treasury rates. Lower-rated loans outperformed in the quarter; CCCs returned +6.2%, beating Bs (2.5%) and BBs (1.9%). Loan spreads (3-year discount margin) compressed 19 basis points in the quarter to 509 basis points, while the average loan yield increased 29 basis points to 9.30%. Like the high yield market, the leverage loan market enjoyed strong technicals during the first quarter as CLO issuance hit $48 billion (up 43% year-over-year) and retail inflows totaled $2.8 billion, the highest quarterly total since the first quarter of 2022. This demand was more than enough to absorb approximately $318 billion of new issuance ($165 billion net of refinancings), the second highest quarterly total on record.

Fourth quarter earnings (latest available data) show mixed credit trends for leveraged loan issuers. EBITDA increased 5% year-over-year, resulting in a decline in leverage to 4.8x (from 5.1x in the fourth quarter of 2022), a post-pandemic low. However, higher interest rates continue to squeeze interest coverage, which dropped to 3.4x (from 3.8x in the fourth quarter of 2022). Over a third of issuers – mostly private, lower-rated credits – have coverage at 2x or below. During the first quarter, the loan default rate improved to 1.9% (down 20 basis points from the fourth quarter of 2023), but it should be noted that when distressed exchanges are included, that rate jumps to 3.5%, with the 1.6 percentage point gap being the largest on record.

With yields and spreads well in excess of the high yield market, the US leveraged loan market continues to appear highly attractive on a relative value basis. This is particularly the case as investors continue to reduce the number of Federal Reserve rate cuts priced into the market for 2024. While high yield spreads tightened to two-year lows in the first quarter, loan spreads remained approximately 80 basis points above their January 2022 levels. We remain cognizant that loan default rates could climb in coming quarters, but a strong US economy should at least partially offset the negative impact that a "higher for longer" Federal Reserve policy environment will have on highly-leveraged loan issuers. As such, we continue to prefer issuers that have capital structures and cash flow resiliency to withstand high interest expense over coming quarters.

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The MOVE Index is a measure of US interest rate volatility that tracks the movement in US Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries.

The Bloomberg US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

The Bloomberg US Credit Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

The Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1 / BB+ / BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

The Credit Suisse Leveraged Loan Index tracks the investable market of the US dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's / S&P ratings of Baa1 / BB+ or Ba1 / BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.