DUCENTA SQUARED
ASSET MANAGEMENT

Economic and Sector Summary & Outlook

Fourth Quarter 2024

555 W. 5th Street, Suite 3700
Los Angeles, California 90013
www.ducentasquared.com

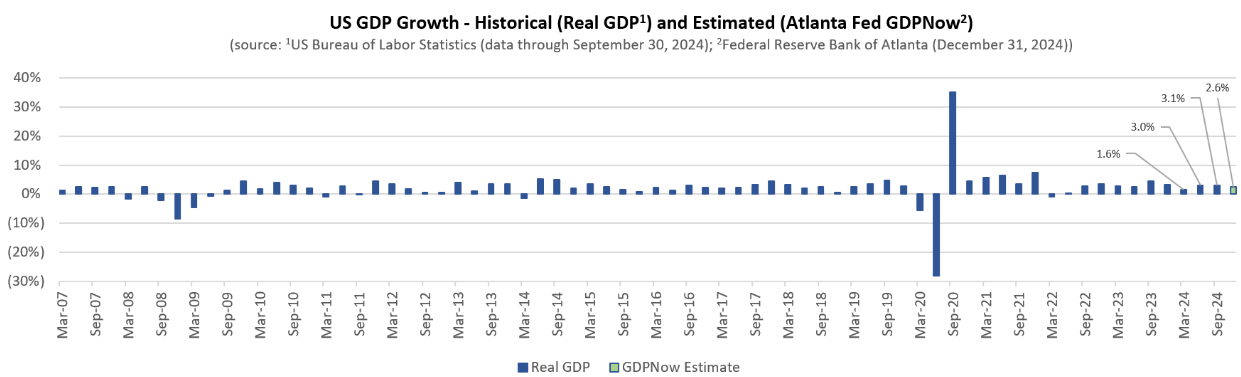
US Economy

Summary

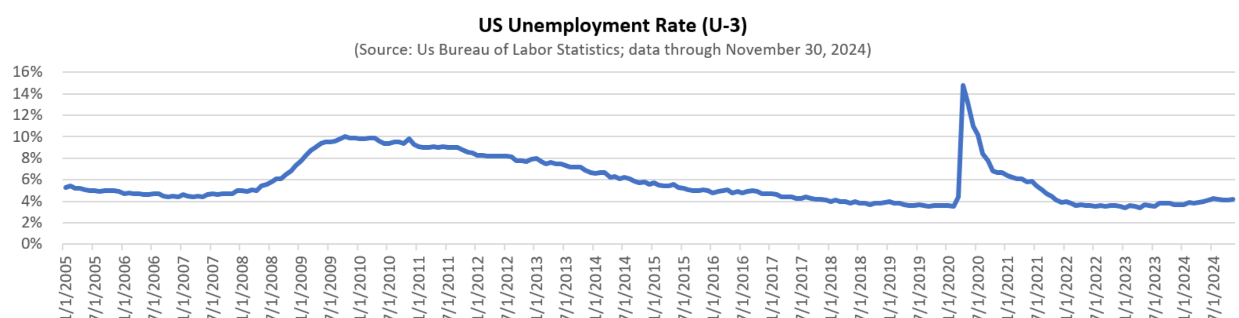
While the election of Donald Trump as the 47th President of the United States dominated news flow in the fourth quarter of 2024, his administration hasn't yet affected the country's economic trajectory. Nevertheless, following the election, investors assessed Donald Trump's potential policy initiatives and placed their bets accordingly, affecting broad markets modestly (i.e., the "Trump Effect") and more substantially the equity market pricing of companies operating in industries expected to be favored (e.g., banking and financial services, US-based manufacturing, defense and aerospace, domestic energy production) or unfavored (importers of manufactured goods) in his second term.

The effect of potential tariffs, tax cuts, and regulatory policies, as well as the Republican control over the House of Representatives and Senate, all figure largely into these investor expectations. But investing on that basis at this early stage involves significant uncertainties as the implementation of new policies remains uncertain and the efficacy of utilizing tariffs to accomplish economic gains remains a hotly debated issue. In addition, Republicans will control the House of Representatives by a slim margin, and that could dampen the Trump administration's ambitions to the extent that new policy initiatives require legislation.

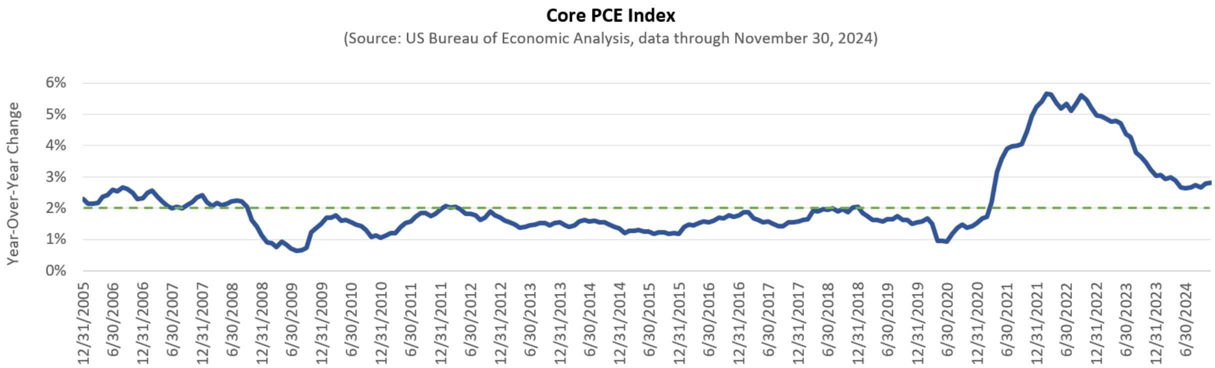
With regard to actual economic trends, US GDP has maintained a relatively consistent pattern of growth following some weakness in 2022 due to the Federal Reserve's rate hikes and fight against inflation. Most recently, US GDP grew 3.1% in the third quarter of 2024, and the Atlanta Federal Reserve's GDPNow estimate expects economic growth of 2.6% in the fourth quarter of 2024.



Employment trends also appear within an acceptable range. Although the unemployment rate surpassed the 4.0% threshold slightly in the past few months, it likely remains within an acceptable range from the perspective of the Federal Reserve. If current trends persist, unemployment won't cause the Federal Reserve to slow its rate cut cadence.



Inflation remains the sticking point as the Core PCE Index trended upward again in recent months, despite continuing rate cuts. Higher-than-expected inflation readings in the second half of 2024 caused the Federal Reserve to backtrack on its number of expected 2025 rate cuts to one-and-a-half, currently. Market pricing suggests that investors have significantly scaled back on what appears to have been overly optimistic expectations regarding the pace of Federal Reserve rate cuts. Overall, the federal funds futures market pricing implies that investors have eliminated approximately four to five rate cuts previously expected to occur in the eighteen-month period ending December 2025.



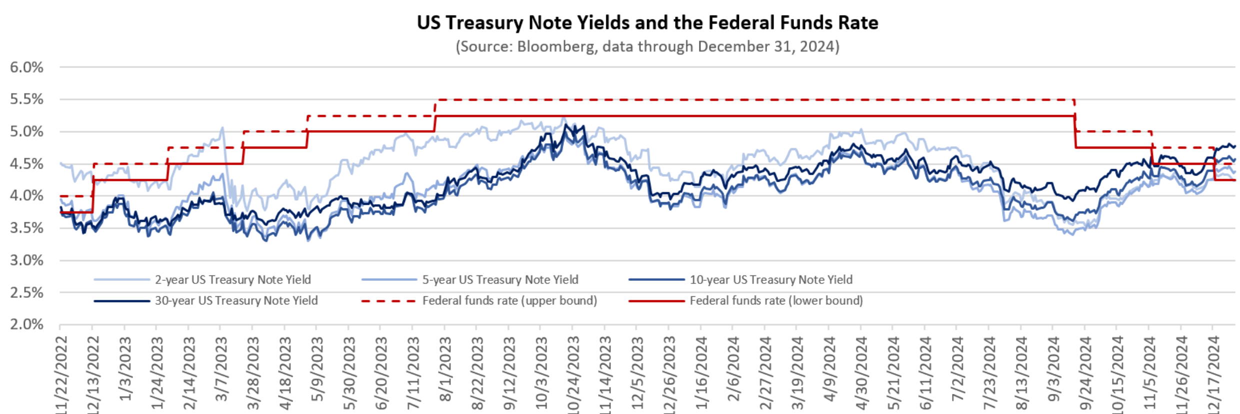
Outlook

We expect continuing US economic growth, a modest reduction in rates and a steepening yield curve over the near term. Risks include the degree to which Donald Trump is able to enact effective policies that promote the US economy. In addition, the US Treasury expects to issue a record amount of debt in 2025, a move which could pressure rates higher and confound the Federal Reserve's effort to fight inflation.

Sector Analysis

US Interest Rates

In the third quarter of 2024, the Federal Reserve announced two 25-basis point cuts to the federal funds rate. However, during that time, inflation declined less than expected, causing FOMC members and investors to reduce their expectations regarding the pace of future rate cuts. Consequently, US Treasury Note yields US Treasury Note yields actually increased since September 2024 by approximately 62 to 90 basis points, even though the Federal Reserve has implemented 100 basis points in cumulative federal funds rate cuts.



The US Treasury curve steepened in the fourth quarter of 2024, as indicated by the spread between the 2-year and 10-year US Treasury Note, which increased approximately 26 basis points in the period.

Additionally, analysts expect 2025 to represent a record year for US Treasury Notes issuance. As a result, the interest rates that prevail during that time will directly affect the US budget. While the US government budget isn't necessarily within the purview of the Federal Reserve, the interest rate on these new government borrowings may feed into headlines warning of an increasing interest burden on US government debt.

We expect one or two rate cuts in 2025, and a modest steepening of the US Treasury Note curve, so long as GDP growth persists and employment trends remain balanced.

Securitized Products

Interest rates sold off during the fourth quarter of 2024 due to above target inflation, continued above trend growth in the economy, and the results of the US Presidential and Congressional elections. By the end of the quarter interest rates had increased 60 basis points to 80 basis points across the yield curve despite two 25 basis point rate cuts by the FOMC during the period.

Mortgages struggled for much of the fourth quarter as interest rates sold off and monetary policy uncertainty increased. The OAS of the MBS Index traded as wide as 49 basis points and as tight as 38 basis points. The OAS of the MBS index closed the quarter at 43 basis points, one basis point wider than it started. This resulted in -13 basis points of excess return versus US Treasuries for the quarter. Given the significant sell-off in interest rates during the quarter, the MBS Index provided a total return of -3.16% and 1.20% for the fourth quarter of 2024 and the year 2024, respectively. Up-in-coupon outperformed on the 30-year coupon stack for both conventional and Ginnie Mae mortgages for the quarter. For the year, the MBS Index modestly outperformed duration weighted US Treasuries, creating 37 basis points of excess return.

In the fourth quarter of 2024, we overweighted securitized products in client portfolios. Mortgages continue to look attractive on an outright and relative value basis. The nominal current coupon spread remains elevated on a historical basis with the potential to tighten significantly. Option adjusted spreads for mortgages look attractive versus other sector spreads on a relative value basis. Our agency MBS exposure included CMOs with a focus on long-duration, positive-convexity structures. On the coupon stack, we maintained our underweight to lower-coupon pass-throughs and continue to view production coupon Ginnie Mae as attractive.

During the quarter, the ABS sector experienced spread tightening and healthy excess returns, as spreads on the ABS Index tightened 20 basis points and ended the quarter at 44 basis points. This spread tightening resulted in 61 basis points of excess return for the quarter. For the entire year, the ABS sector performed very well, creating 153 basis points of excess return. It should be noted that the ABS Index comprises only registered securities, mostly plain vanilla auto and credit card deals which represent a relatively small portion of the overall ABS market. The larger portion of the ABS market is comprised of 144(a) unregistered deals that tend to utilize more esoteric collateral. In fact, these unregistered deals generally outperformed the more plain vanilla registered deals, reflecting the general health of the economy and collateral performance. Current spreads for the sector are tighter than the 10-year average and don’t look attractive versus mortgages. As a result, we are not looking to add exposure. We will monitor the sector’s performance and look to add exposure at more attractive levels.

In a similar manner to ABS, the CMBS sector performed well during the fourth quarter and for the year. The CMBS Index generated 66 basis points of excess return during the quarter and 280 basis points for the year. A generally positive environment for spread product and a favorable supply / demand technical environment contributed to the sector’s favorable performance. The fundamental backdrop for the commercial real estate market remains very challenged. Occupancy rates for office buildings remain depressed while traditional brick and motor retail continue to face headwinds. Additionally, the increase in interest rates has put upward pressure on cap rates in the sector, which negatively impacts valuations. During the quarter we took advantage of the spread tightening in CMBS and reduced our exposure to zero. We will monitor spreads in the coming months with an eye toward reentering the investment space.

Investment Grade Credit

The Bloomberg US Corporate Bond Index (the “Corporate Index”) generated a total return of -3.02% in the fourth quarter and 2.13% for the year 2024. US Treasury yields tracked a volatile path in the second quarter of 2024, ultimately driving negative total returns on the Corporate Index in October and December, offset somewhat by positive returns in October. Nevertheless, a risk-on environment prevailed, culminating in an excess return on the Corporate Index of 82 basis points in the fourth quarter and 246 basis points for the year 2024. Lower quality corporate bonds outperformed higher quality categories as Aa-rated bonds, A-rated bonds, and Baa-rated bonds, total returns of -3.94%, -3.56% and -2.57% respectively, in the fourth quarter of 2024, and 0.24%, 1.63% and 2.97% for the entire year 2024.

Investment grade issuer credit fundamentals remain supportive through the third quarter of 2024 (last reported date). JPMorgan [1] recently noted that revenue and EBITDA growth continues at rates near or above the pace of nominal GDP, while overall debt growth remains subdued; and it estimates investment grade issuer leverage at 3.2x, up 0.1x year-over-year. However, interest coverage and leverage trends continue to weaken investment grade issue credit profiles, particularly as higher coupon debt refinances maturing lower coupons. Nevertheless, year 2025 earnings growth estimates in the 10% range suggest that credit metric should remain stable or slightly improve.

Every industry sector in the Corporate Index generated a negative total return in the fourth quarter of 2024, as the risk-free rate (i.e., the yield on US Treasury Notes) increased during the period, despite two 25 basis point cuts in the federal funds target rate. Nevertheless, a risk-on attitude prevailed and all but one investment grade industrial sector (Health Insurance, -4 basis points of excess return) posted positive excess returns in the fourth quarter of 2024; and all sectors generated positive excess returns for the year 2024. Industry sector leaders include Supermarkets (excess return of 223 basis points and 373 basis points for the fourth quarter and year 2024, respectively), Cable Media & Satellite (excess return of 211 basis points and 279 basis points for the fourth quarter and year 2024, respectively), and Media & Entertainment (excess return of 193 basis points and 171 basis points for the fourth quarter and year 2024, respectively). Underperformers include Health Insurance (excess return of -4 basis points and 52 basis points for the fourth quarter and year 2024, respectively), Consumer Products (excess return of 32 basis points and 105 basis points for the fourth quarter and year 2024, respectively), and Construction Machinery (excess return of 35 basis points and 57 basis points for the fourth quarter and year 2024, respectively).

We expect investment grade issuer credit trends to remain supportive of current spreads, yet valuations appear tight. We remain focused on industries, activities (such as M&A) and other attitudes (e.g., energy independence) that may be affected by Donald Trump's second term agenda. Currently, however, specifics remain limited, beyond a general theme of less government, a potential for tariffs on foreign goods and freer commercial playing fields in the US.

High Yield

The Bloomberg US High Yield Corporate Bond Index (the "High Yield Index") generated a 0.18% total return in the fourth quarter of 2024. As was the case in investment grade, lower-rated issues performed better than those with higher ratings; subsectors rated Ba, B and Caa generated total returns of -0.48%, 0.32% and 2.25%, respectively, in the fourth quarter of 2024 and 6.30%, 7.38% and 15.09% the entire year 2024. Bond prices remained volatile in the period as investors continued to reevaluate the pace of Federal Reserve rate cuts, creating negative total returns in October and December, and a positive total return in November.

High yield issuer credit metrics trended weaker in the third quarter of 2024 (last reported date) but leverage, which ended the period at 4.05x (up 0.7x sequentially), remains comfortably below the 4.3x long-term average and coverage ratios remain comfortably above the long-term average.[2]

The best-performing High Yield Index industry sectors included Railroads (excess return of 830 basis points and 153 basis points for the fourth quarter and year 2024, respectively), Natural Gas (excess return of 377 basis points and 731 basis points for the fourth quarter and year 2024, respectively), and Wirelines (excess return of 373 basis points and 1,576 basis points for the fourth quarter and year 2024, respectively). The worst-performing industry sectors included Healthcare REITs (excess return of -381 basis points and 633 basis points for the fourth quarter and year 2024, respectively), Packaging (excess return of -86 basis points and 138 basis points for the fourth quarter and year 2024, respectively), and Retail REITs (excess return of -67 basis points and 509 basis points for the fourth quarter and year 2024, respectively).

[1] JPMorgan, HG Credit Fundamentals: 3Q24 Review, December 18, 2024
[2] JPMorgan, 3Q24 High Yield Credit Fundamentals, December 16, 2024

Disclaimers

This report is prepared for informational purposes only. It does not consider the specific investment objective, financial situation or particular needs of any recipient. Ducenta Squared Asset Management is not soliciting any action based on this report, and the report is not to be construed as an offer to sell or solicit investment management or any other services. The information and opinions contained herein have been compiled or arrived at based on information obtained from sources believed to be reliable and in good faith, but we do not represent that it is accurate or complete and it should not be relied upon as such. Opinions expressed are our current opinions as of the date appearing on the material only and are subject to change without notice. Index returns do not reflect the effect of management fees. No part of this publication may be copied, photocopied or duplicated in any form or by any means without Ducenta Squared Asset Management's prior written consent.

Past performance is no guarantee of future results.

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.