Economic and Sector Summary & Outlook

Third Quarter 2024

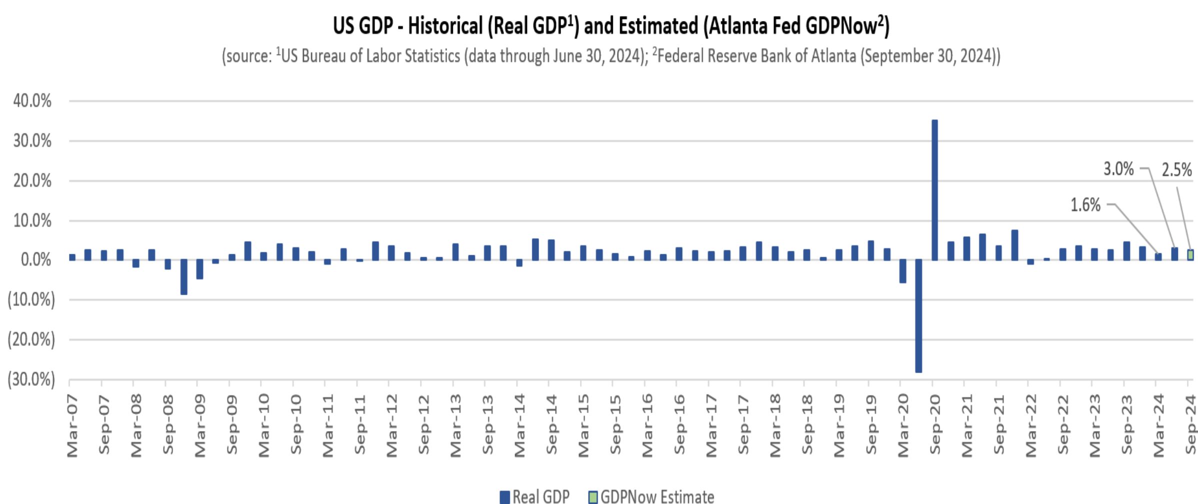
555 W. 5th Street, Suite 3700
Los Angeles, California 90013
www.ducentasquared.com

US Economy

Summary

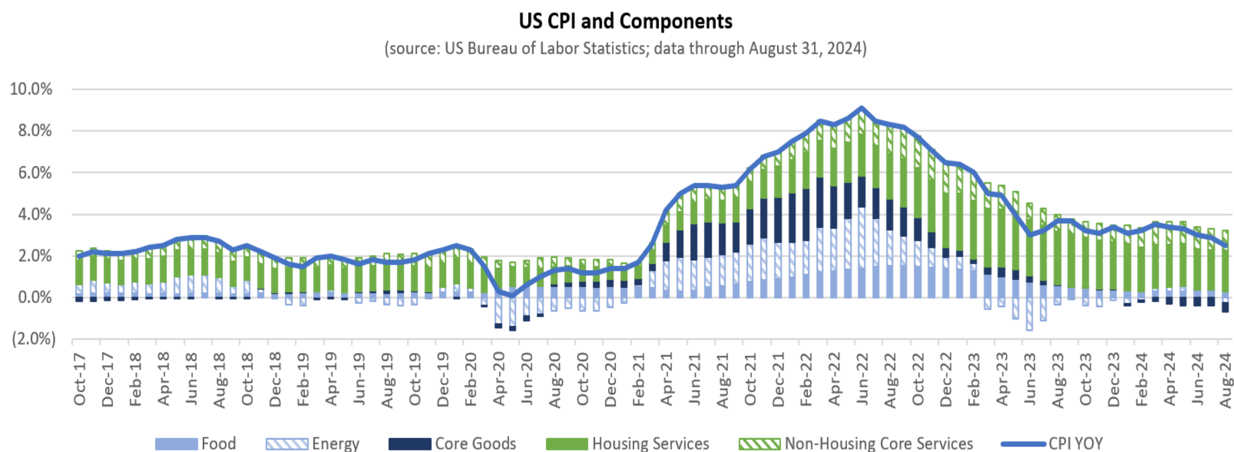
US economic activity as measured by GDP continued to expand in recent months, while inflation normalized and employment growth remained adequate. In the third quarter of 2024, the Federal Reserve pivoted monetary policy and lowered interest rates by 50 basis points. Investors have now turned their focus to the potential magnitude and timing of future rate cuts.

According to The Federal Reserve Bank of Atlanta's October 1, 2024 GDPNow estimate, US real GDP grew at an annualized rate of 2.5% in the third quarter of 2024, versus 3.0% in second quarter and 1.6% in the first quarter (see chart, below).



The US labor market appears healthy. The unemployment rate fell to 4.1% in September 2024, from 4.2% in August and 4.3% in June. In addition, on October 4, 2024, the US Bureau of Labor Statistics reported that September 2024 nonfarm payrolls reached 254,000, surpassing the consensus estimate by 104,000 and further highlighting labor market strength. The strong payroll data signaled that the Federal Reserve could moderate its rates cuts to maintain pressure on inflation.

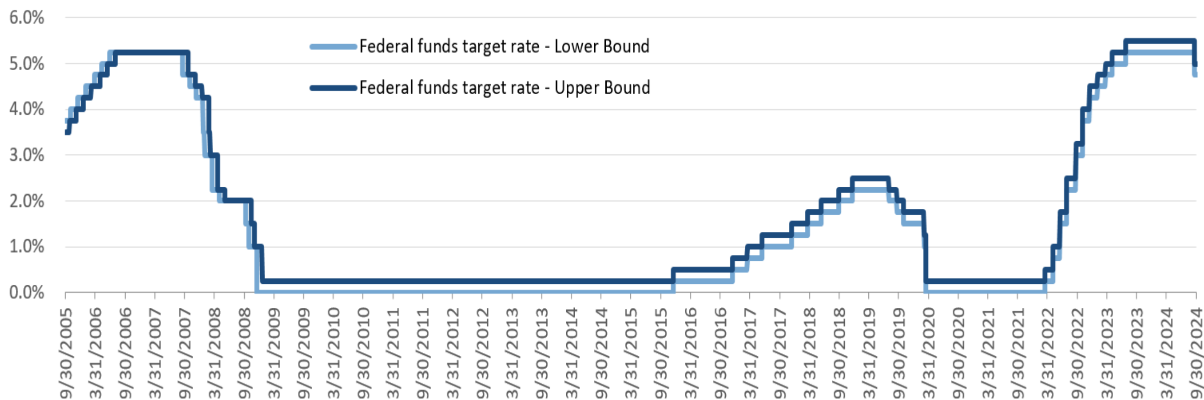
Inflation fell to 2.5% in August 2024, versus 2.9% in July and 3.0% in June. Despite the improvement, inflation remains above the Federal Reserve's 2.0% target.



In the third quarter of 2024, favorable economic growth, a healthy labor market and moderating inflation provided the Federal Reserve with ample opportunity to begin reducing interest rates – an opportunity not wasted by Chairman Powell on September 18, 2024 as he announced a 50-basis point cut to the federal funds target rate to a range of 4.75% to 5.00%. The cut follows eleven consecutive rate increases that collectively added 525 basis points to the federal funds target rate. Some analysts believe that Chairman Powell may moderate the pace of future rate cuts to ensure that inflation ultimately reaches the Federal Reserve's 2.0% target.

US Federal Funds Target Rate

(Source: Bloomberg; data through September 30, 2024)



Geopolitical tensions, war and the impending US Presidential election continue to add uncertainty to the outlook. Russia, backed by Iran and North Korea, continues its special military operation in Ukraine. Additionally, Isreal remains highly engaged on the ground with Hamas in Gaza and Hezbollah in Lebanon, while analysts expect that it will soon attack Iran in response to that country's October 1 ballistic missile attack on multiple Israeli targets. In China, slowing economic growth, aging demographics, declining real estate prices and elevated non-performing loans at the country's largest state-owned banks could further reduce China's standing as a major global engine for growth.

Nevertheless, oil prices remain surprisingly contained, especially given the backdrop in the Middle East. Likewise, the US consumer continues to spend freely, while anecdotes suggest the lower income strata ought to be at least fatigued, if not thoroughly exhausted keeping up with inflation driving up prices on food, housing, medical and other expenses, including home and automobile insurance.

With voting scheduled for less than a month from now, the outcome of the US Presidential Election remains unclear. Control of the US Senate (Republicans need one seat to control) may cede to the GOP, while the House of Representatives remains up for grabs (Democrats need four additional seats to control).

Outlook

We expect lower rates, especially at the front end and belly of the curve, while the long end might remain wide due to the expected quantity of long-term US Treasury supply.

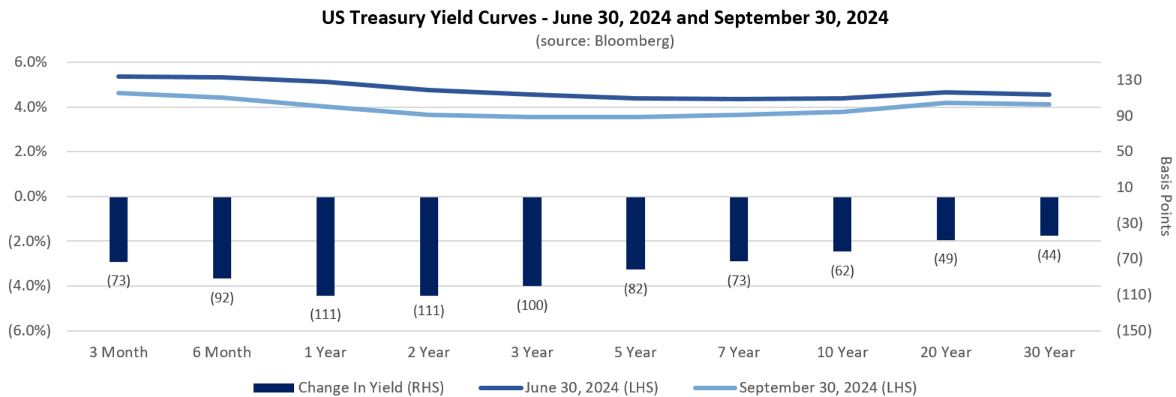
Sector Analysis

US Interest Rates

In the third quarter of 2024, US Treasury yields moved lower as investors anticipated the Federal Reserve's first rate cut following eleven consecutive rate hikes since March 2020. Following the Federal Reserve's 50-basis point rate cut in September, US Treasury yields retraced some of the move, as investors reassessed the pace of future rate cuts in light of persistent inflation and strong employment data.

As noted above, the Federal Reserve cut the federal funds target rate by 50 basis points on September 18, marking the beginning of an anticipated easing cycle aimed at addressing the slowing labor market and stabilizing inflation, which had been moderating throughout the year. The rate cut was larger than expected, as pricing in the short-term futures markets had been expecting closer to 25 basis points.

The bond market responded favorably to the positive shock, with yields declining markedly, driving strong returns across various fixed-income sectors. For US Treasuries particularly, the market adjusted significantly in a bull steepening fashion. Specifically, in the third quarter of 2024, yields on 2-year and 10-year US Treasury Notes declined 111 basis points and 62 basis points, respectively, leaving the 2s-10s yield curve to bull steepen 50 basis points.



Globally, other major central banks, including the European Central Bank, began cutting rates several months ago as inflation abroad relative to the US was running at a more tepid pace. As the US continues to move into the later stages of the economic cycle, US Treasury yields remain rangebound, as investors balance hope for further rate cuts with the concern that inflation continues to trend higher than the Federal Reserve's 2% target rate. In summary, the third quarter of 2024 marked a pivot in US monetary policy, as the Federal Reserve began what will likely become a cycle of rate cuts to support a softening economy while keeping a close eye on inflation and recessionary indicators.

Amidst this backdrop of softening employment, sticky inflation, and a late-stage economic cycle plagued with upcoming election risks, we expect these forces to continue to pressure US Treasury yields lower and the yield curve steeper. Looking into the end of the year, our updated forecast for 10-year US Treasuries targets a modest move lower in yields toward the 3.50% to 3.75% level. Accordingly, we have strategically positioned portfolios with a moderate duration overweight relative to their respective benchmark indices with a steepening bias.

Securitized Products

A bull steepener dominated market trends in the third quarter of 2024 as the rates market rallied. During the quarter, market participants priced in the beginning of the Federal Reserve's normalization of monetary policy, with the year end 2024 expectation for the federal funds rate dropping 100 basis points to 4%. In this environment, risk spreads generally contracted across both securitized and credit sectors.

The MBS Index OAS tightened 6 basis points to close the period at 42 basis points. Overall, MBS Index generated 78 basis points of excess return in the third quarter of 2024. During the quarter, the MBS Index excess returns were positive in both July and August and essentially flat in September. The MBS Index returned an impressive 5.53% in the quarter, which brought the year-to-date return to 4.50%. Across the 30-year coupon stack, discount dollar price coupons outperformed as prepay fears negatively impacted higher coupon mortgages. We observed a disparity among fairly-liquid coupons in the period. For instance, the 30-year 4% coupon generated the most excess return on the coupon stack (i.e., 135 basis points) while the 30-year 6% coupon generated a far lower excess return (i.e., only 21 basis points). During the quarter, mortgage origination increased as interest rates dropped and cashout refinancings increased. This increased supply was easily handled by the market as money managers added to their already overweight positioning to the sector.

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Our portfolios continue to target an overweight exposure to mortgages relative to the Index. The decision to overweight mortgages is driven by both absolute and relative valuations. Mortgage spreads, as measured by the current coupon mortgage versus a 5-year / 10-year US Treasury blended yield ended the quarter at 129 basis points. Although significantly tighter than the wide spreads experienced in 2023, the current spread appears wide on a longer-term historical basis, and we anticipate it will tighten as interest rate volatility declines under a more normalized Federal Open Market Committee monetary policy. On a relative basis, we observe that the relative spread between the MBS Index OAS and the Corporates Index OAS currently reside at a historical tight.

ABS issuance was strong during the quarter with the heaviest supply occurring in September. Year-to-date issuance appears approximately 25% higher than in 2023 and on pace to be close to a record year of issuance. This heavy supply widened the ABS Index OAS by 7 basis points during the quarter. The widening in ABS spreads offset some of the sector's yield advantage relative to US Treasuries, resulting in just 15 basis points of excess return for the ABS Index. Given the strong interest rate rally during the third quarter, especially in the front end of the yield curve, the ABS Index generated a 3.35% total return. We maintained relatively low portfolio exposure to the ABS sector.

Our outlook and exposure to the CMBS sector remains largely unchanged versus the second quarter of the year. Commercial real estate fundamentals remain very challenged with the office sector suffering the most and gathering the majority of negative headlines. Actual price discovery within the CRE space is hampered by low transaction volumes, thus delaying realization of downside forecasts. We maintain only a small portfolio exposure to the CMBS sector (i.e., less than 1%.) Spread performance for CMBS has been highly correlated to the investment grade credit sector while fundamentals appear much worse, as such, we anticipate continuing avoiding the sector in the coming months.

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Credit Spotlight

Boeing – Flying Through the Turbulence

The Boeing Company's ("Boeing" or the "Company") reputation as a solid investment grade issuer that epitomized American aerospace manufacturing quality has waned since 2018.

In the third quarter of 2024, a labor strike and ratings agency actions added to the Company's challenges. On September 13, Boeing's largest machinists union (representing approximately 32,000 workers, or 19% of the company's workforce) voted to strike amid demands for a 40% wage increase over the next four years. On the same day, Moody's lowered its outlook on the company's credit profile to Watch Negative.

Despite the negative headlines, several credit strengths and potential catalysts support the company's financial position and liquidity over the near and medium term. The company's credit strengths include its position as a "national champion", its significant financial resources, and the continuing robust demand for commercial aircraft.

Founded in 1916, Boeing benefits from a longstanding reputation within the commercial aerospace, defense and space industries. As the 28th largest employer in the US (employing over 145,000 people), Boeing's success is, and will likely continue to be, in the best interests of the US economy. Strong barriers to entry allow the company to also benefit from the commercial aerospace duopoly it shares with Airbus. Boeing's deep relations and experience in governmental procurement supplement its strong market positions in defense and space industries, which are bereft with tough regulatory and compliance hurdles.

In addition, the Company maintains access to significant financial resources. In the third quarter of 2024, the company's stock price declined 18.6%, nevertheless, its equity market capitalization still totaled approximately $94 billion as of September 30, which amply covers the company's $58 billion in outstanding debt as of June 30, the last reported date, by 1.5x. With over $20 billion of liquidity, the company currently maintains a cushion to manage further cash flow volatility.

Robust demand continues to support the company's fundamentals. Boeing's flagship commercial models (i.e., the 747, 777, 737 MAX) collectively represent a backlog over $435 billion (as of second quarter 2024 earnings) with the popular 737 MAX series currently requiring over 7 years to work through its current backlog.

Resolution of the labor strike, a capital raise and resumption of production (including removal of the production cap on 737 MAX aircraft imposed by the Federal Aviation Administration) represent potential near-term catalysts that could reassure investors and improve market pricing of Boeing's equity and fixed income securities.

The recent strength within public credit markets has softened the impact of negative headlines on the Company's bonds while allowing credit investors to find attractive relative value in tranches of Boeing debt, some of which is protected by coupon step-up language in the event of a ratings downgrade. In April 2024, Boeing issued $10 billion of debt across six maturities – while demand approached $60 billion, highlighting the favorable corporate debt technical factors that existed in the second quarter of 2024. Investors seeking duration and historically attractive all-in yields continue to maintain interest in Boeing securities, many of which offer a spread advantage to benchmark indices. Targeting coupon step-up, short duration and/or liquid (on-the run) notes represent prudent risk management steps for Boeing fixed income investors. The company will likely continue to represent a controversial name among fixed income investors.

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Investment Grade Credit

During the third quarter of 2024, the OAS on the Bloomberg US Corporate Bond Index (the "Corporate Index") tightened 4 basis points to finish the period at 89 basis points. The 10-year US Treasury Note yield dropped by 66 basis points during the quarter, contributing to a 5.84% total return for the Corporate Index. Corporate bonds outperformed US Treasuries, posting a 1.10% excess return as investors embraced the "soft landing" narrative of lower rates with still strong corporate fundamentals. Investor conviction regarding rate cuts was validated during the quarter by an eventual 50-basis point cut in September, with two additional cuts priced in before the end of 2024. All-in yields on Investment Grade debt remained compelling, despite dropping from 5.48% in June to 4.72% at the end of the quarter. During the third quarter of 2024, the average duration of the Corporate Index extended from 6.92 years to 7.17 years. During the quarter longer duration and higher quality bonds outperformed as rates sank. AAA-rated bonds returned 6.93% while BBBs returned 5.76%. Utilities (7.08% total return) outperformed both financials (5.38% total return) and industrials (5.90% total return) due to the rally in longer duration bonds. New issuance picked up during the quarter as companies took advantage of a precipitous drop in interest rates and lower credit spreads. Spreads on the Bloomberg US Corporate Bond Index appear tight as they hover around 89 basis points, but higher coupon yields have drawn in crossover buyers from non-traditional areas and supported both primary and secondary issues. We currently advocate for a slight overweight in investment grade credit and see value in industries that should benefit from a lower rate regime including REITs, BDCs, aircraft lessors, and technology.

High Yield

The US high yield market rewarded investors with strong returns in the third quarter of 2024 as both interest rates and credit spreads declined. The Bloomberg US Corporate High Yield Index (the "High Yield Index") returned 5.28% as spreads tightened 9 basis points from 308 basis points to start the quarter to just under 300 basis points at the end of September. Year-to-date returns on the High Yield Index now stand at 8.00% through September. In early August, high yield bonds sold off as concerns regarding the yen-carry trade hit risk markets over a three-day period. On August 5, the Chicago Board Options Exchange Volatility Index (a measure of equity volatility) spiked from 23 to an intra-day high of 66 as equity market participants sold high-beta long positions in tech company shares due to concerns regarding valuations and the unwinding of the "yen carry trade". This caused high yield bond spreads to widen quickly. The Markit CDX North America High Yield Index spiked from 348 basis points on August 1, to a high of 382 basis points on August 7. This spread weakening was short-lived however, as spreads declined back to 362 basis points by end of the week. Spreads continued to grind lower during the remainder of August and September, as the High Yield Index spread closed the quarter at 295 basis points.

The CCC-rated segment of the high yield market led the rally in the third quarter of 2024. CCC-rated bonds generated positive returns for 14 consecutive weeks through the end of September and returned 12.54% year-to-date through the end of the third quarter. The bulk of this positive return emanated in the third quarter, as CCC-rated bonds returned 10.20% over the period. BB-rated bonds returned 4.25% and B-rate bonds returned 4.53% over the same period.

A string of strong corporate earnings and enthusiasm regarding lower borrowing costs drove the strong performance in the period. The High Yield Index yield to worst dropped from 7.93% to 6.99% during the third quarter.

Issuers printed $74 billion in new supply in the third quarter, pushing the year-to-date total to $234 billion, already more than all of 2023 ($176 billion). September experienced a particularly robust new issue calendar as $37 billion of new high yield bonds priced during the month following several months of above average returns and a more benign interest rate environment.

Spreads remain at the tight end of the historical range – particularly for BBs and Bs – justified by stable credit fundamentals and attractive all-in yields hovering around 7.2%. We continue to expect coupon-like returns and remain overweight in less-cyclical industries with selective positions in lower-rated bonds that offer attractive yield prospects.

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Leveraged Loans

The US leveraged loan market continued its strong run in the third quarter, returning 2.07% (Credit Suisse Leveraged Loan Index). The year-to-date return now totals 6.61%, though enthusiasm for leveraged loans has waned somewhat as we enter a new rate cutting cycle. Loan spreads (3-year discount margin) and yields both decreased in the quarter, ending September at 498 basis points and 8.36%, respectively. Previously, loan spreads were 509 basis points and the yield offered on leveraged loans was 9.36%. Loans continue to offer a yield advantage compared to the high yield market, but following the 50-basis point cut in September the advantage has narrowed considerably. Investors anticipate two more cuts to the federal funds target rate before the end of 2024, which will further erode the all-in yield advantage of loans over high yield bonds.

Loans fundamentals also appear to be weakening somewhat, especially compared to the high yield bond universe. Increasingly mixed economic data and the stress exhibited by some lower-rated issuers suggest that an up-in-quality stance remained appropriate. As such, we continue to prefer issuers with sufficient capital structure and cash flow resiliency to withstand a slowing economy and high interest rates over coming quarters. We have trimmed our exposure to loans in the Core Plus strategy in favor of a higher allocation to high yield bonds given our expectation of lower interest rates over the next 12 to 18 months.

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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.

The indices and financial benchmarks shown are for illustrative purposes only and investors cannot invest directly in an index.