4Q 2024: Still Weakening Labor Market Is the Lynchpin of the Economy

- Following fears of deteriorating labor market conditions throughout the third quarter, concerns were partially allayed in the final months of the year as the unemployment rate edged lower from July's cycle-high of 4.3% to 4.1% in October. Moreover, despite interruptions and distortions from weather-related events, nonfarm payrolls continued to show positive month-over-month job growth throughout the quarter, which supported markets and signaled to many that summer fears may have been overdone.

- However, the positive trend in monthly payroll figures has not been driven by broad-based strength across sectors, as would be typical in a booming labor market. Instead, only a few sectors have supported the headline figure this year, including the government sector as persistent spending has translated to increased hiring, especially at the state and local level. With recent talks from the incoming administration of improved government efficiency and job cuts, this trend could reverse, putting downward pressure on payroll figures.

- Away from the government sector, more cyclical sectors, like manufacturing and transportation, have instead been shedding jobs, and private sector employment growth has turned negative year-over-year. A separate analysis of private payrolls from the ADP Research Institute has shown a similar reduction in manufacturing jobs, alongside a growing share of small businesses reducing staff.

- Meanwhile, leading labor market indicators displayed a clear weakening trend in the second half of the year, highlighted by falling job openings, lower hiring rates, and moderating quits rates, all of which have approached multi-year lows. Temporary help services have also been trending downward in a reflection of cooling labor demand, a typically reliable indicator of higher unemployment in the future.

- At the same time, data from the U.S. Department of Labor shows that continuing claims, or recurring applications for unemployment benefits, has reached the highest level in three years (1.91 million, up from 1.73 million at the start of the year). Though continued claims do not indicate a rising pace of layoffs, elevated levels do suggest it is taking out-of-work people longer to find a job.

Our View: The labor market is the key factor driving the direction of the economy in the coming year, and the continued weakening in leading indicators suggests that the pace of economic growth is likely to slow. However, the unemployment rate and the monthly payroll numbers, two of the most widely followed labor market metrics are either a lagging indicator or subject to significant revision, creating a mismatch between how the labor market and broader economy are commonly perceived, and what is truly occurring beneath the surface. Expectations are for this mismatch to become less pronounced in the coming months as activity cools and further labor market weakness flows through to a higher unemployment rate.

4Q 2024: Markets Expect Fewer Fed Rate Cuts

- Likely spurred in part by the U.S. election results, Treasury yields increased over the quarter as market participants appeared to fully price in numerous aspects of the incoming administration's platform that are expected to be conducive to economic growth, resulting in intermediate tenors of the U.S. Treasury yield curve increasing over 75 basis points (bps) while longer dated yields rose over 60 bps.

- This increase in Treasury yields occurred despite the Federal Reserve (Fed) implementing an additional 50 bps of monetary policy easing. Notably, the increase in long end of the yield curve was driven by higher real (inflation-adjusted) yields, with the 30-Year Treasury real yield crossing above 2.5% to mark the second highest level since the GFC (global financial crisis), clearly indicating a still-restrictive level of rates.

- Investors simultaneously moved to price out the number of cuts expected by the Fed in 2025, adding to the upward pressure on yields. After projecting six cuts over the next year at the start of the quarter, that number fell to two by year-end, with the Fed's latest dot plot similarly projecting only two cuts for next year (down from four back in September). Though this latest recalibration brought the Fed and market into temporary alignment, historically, the market has done a poor job at predicting both the timing and magnitude of cuts.

- Sovereign rates in other G10 countries also experienced a hawkish repricing to end the year alongside tariff considerations and political volatility in France and Germany. The rise in yields notwithstanding, most global central banks also continued to reduce policy rates over the quarter, including dovish 50 bps reductions by the Swiss National Bank and Bank of Canada that contrasted with a slower pace of easing expected for the Fed. Against this backdrop, the U.S. dollar (as measured by the DXY index) surged to gain over 7% during the quarter.

Our View: We continue to expect the Fed to cut rates more aggressively than is currently anticipated by markets. The recent backup in Treasury yields keeps rates restrictive and at levels that are likely to prove unsustainable in the long run given the potential knock-on effects throughout the real economy, most notably in elevated borrowing costs that exert continued pressure on those most in need of credit. Expectations are therefore for lower yields in the future, with the policy-sensitive front end of the yield curve (2s and 5s) the most attractive.

4Q 2024: Election Results Aren't Likely to Change the Fundamental Picture

- Risk assets responded favorably to the election results as the S&P 500 Index posted its best post-election day ever (up nearly 3% en route to a 25% annual gain), bitcoin soared to record highs, and credit spreads moved tighter. It seems that any potential market-positive aspects of Trump's campaign platform, including a focus on U.S. growth, industry, and energy production, a supportive environment for mergers and acquisitions, and a decrease in regulatory burdens, were immediately pulled forward and fully reflected in valuations.

- While all the above, once implemented, are likely to be at least marginally positive for economic activity, policy implementation takes time, and those benefits are likely to be felt with meaningful lags and with potential secondary effects that may be difficult to fully account for today. Additionally, even with control of both houses of Congress, politics remains a messy business, and there are likely to be limitations on the ability to implement a full agenda as currently envisioned.

- Regardless of the ultimate policy outcomes, based on Trump's first term, it seems clear that his negotiating style is one that fosters uncertainty among counterparts across several dimensions. When combined with the fragile state of geopolitics today and the additional uncertain implementation of a host of domestic policy initiatives, the stage seems set for heightened volatility across markets.

- Despite the potential for rising volatility, markets have largely ignored any potential downsides to a second Trump administration and discounted the risks of global uncertainty. In the parlance of statistics, whatever your view of the world from this point forward, even if the center of the distribution may be somewhat more favorable than pre-Trump, it seems clear that the tails of that distribution, both positive and negative, are notably higher than before.

Our View: There are clearly components of the new administration's agenda that have led to improved market sentiment, and which could be conducive to growth on the margin, though we would caution that election cycles do not supersede the business cycle. We expect the cumulative effect of higher rates and weakening labor markets will overwhelm the modestly positive potential effects of a Trump administration with the ongoing likelihood of further volatility.

4Q 2024: General Market Valuations: The Rich Get Richer

- Valuations moved tighter across nearly every segment of the market in 2024, supported by persistent risk-on sentiment. As yield spreads compressed ever tighter, compensation for risk eroded, leaving investors with less future upside and little protection from a change in conditions or sentiment.

- Nowhere was this more evident than in the credit market, where spreads for both the Bloomberg U.S. Credit and Bloomberg U.S. Corporate High Yield indices reached new post-GFC tight levels of 71 and 253 bps, respectively, representing the first percentile of the prior 20-year range (spreads have been wider 99% of the time over that period). Historically, this creates a challenging forward return profile, though the elevated yield levels in fixed income markets provide a measure of protection and encourage further risk-taking by investors.

- Spread tightening was not limited to just corporate credit, however, as risk-on sentiment also drove spread tightening across securitized credit. Commercial MBS was a standout performer, with spreads tightening anywhere from 30 to 300 bps depending on collateral type, deal structure, and tranche, leading to returns for the sector that exceeded those of investment grade credit on a duration-matched basis. Though not to the same extent, residential MBS and asset-backed securities also experienced improved valuations and strong returns.

- Meanwhile, though the elevated yield environment of the past two-plus years has made the income component of fixed income attractive, it has also presented challenges to certain borrowers that are heavily indebted and paying floating rate interest on that debt. Indicative of these challenges is the increased default rate among leveraged loans, which reached 4.0% in November, 100 bps above the 25-year average.

Our View: Though the income component of fixed income is relatively attractive currently, valuations at exceedingly stretched levels make it hard to justify aggressive positioning in credit markets. Such investments require faith in the “greater fool” theory, which essentially says that a security may not make sense at current prices, and I might be a fool for buying it, but there will be an even greater fool down the road who will buy it from me at an even higher price. As disciplined value investors, that is a difficult basis on which to invest client assets entrusted to us.

4Q 2024: Portfolio Construction Themes

We manage a wide variety of strategies and portfolios, many with different risk and return profiles, different construction parameters, and varying client requirements. As such, there are typically differences in implementation and allocation across sectors, nevertheless, the following themes guide the construction of all our portfolios.

Portfolio:

- Long duration overall
- In a curve steepener
  - Overweight short and intermediate tenors
  - Neutral the long end of the yield curve
- Overweight spread duration overall
  - Significant underweight to corporate credit
  - More significantly overweight securitized sectors

Credit:

- Defensive overall posture
  - Underweight cyclical industries
  - Allocations in large banks, non-cyclicals, and healthcare
  - Small allocation to below investment grade with focus on idiosyncratic stories
- Emphasis on utilities given growing demand for power
- Within below IG exposure, slight preference for bank loans over high yield bonds
  - Carry offered by loans is attractive
  - Spreads less expensive than those of bonds
- Selective allocations to European credit offering higher spreads

Securitized:

- Favor agency MBS given attractive valuations
- Focus on non-traditional ABS sectors
  - Digital infrastructure (cell towers, data centers, etc.)
- Look at single asset single borrower (SASB) CMBS
  - Targeted exposure with high quality, trophy property collateral
  - New issuance expected to pick up
  - Can get comfortable going down the capital structure
- CLOs offer liquidity and a high quality exposure
  - Positioned largely at the top of capital structure
  - Include European issues given wider spreads

Our View: When broad valuations do not support taking widespread market risk (beta), value-oriented managers can introduce carry and return potential to portfolios by leaning into bottom-up analysis to uncover idiosyncratic opportunities offering value at the issue level, and by overweighting fundamentally sound sectors that are cheap relative to other segments of the market.

4Q 2024: Credit Markets Increasingly Reflect Optimism

- Though elevated yields in October and December challenged total returns for credit markets over the fourth quarter, the ongoing compression of credit spreads helped to drive outperformance on a duration-adjusted basis for both investment grade and high yield corporates. However, full-year returns were positive, with investors' seemingly insatiable appetite for risk resulting in the Bloomberg U.S. Corporate High Yield index gaining over 8%, while the Bloomberg U.S. Credit index advanced by a more modest 2%.

- For investment grade corporates, a risk-on backdrop meant spread volatility was limited, with the Bloomberg U.S. Credit index trading in a relatively tight range of 33 bps over the course of the year as spreads tightened in a nearly linear fashion. The brief market dislocation in early August had a more pronounced effect on high yield spreads and led to trading range of 130 bps for the Bloomberg U.S. Corporate High Yield index, though positive risk tone was evidenced by CCC-rated bonds gaining over 15% for the year while BB bonds gained just 6.3%.

- The higher rate regime this year presented an interesting dichotomy in which corporate borrowers were hesitant to lock in elevated borrowing costs for long periods, leading to limited longer dated bond supply, while yield-based buyers like insurance plans and overseas investors sought to lock in elevated yields with heightened demand for longer dated bonds. As a result, credit curves reached some of the flattest levels (spread on 30-year corporates minus spread on 10-year corporates) outside of periods of severe stress.

- Meanwhile, the backup in rates and current yield levels led to a significant difference in the average coupon paid by investment grade corporate borrowers at new issuance in 2024 and the average coupon of bonds maturing in 2024, with that difference just shy of 200 bps (versus 91 bps two years ago). With estimates of nearly $900 billion in maturities next year as pandemic-era issuance rolls off, this gap is expected to persist given the low yields borrowers were able to secure during that time, potentially leading to increased debt expenses for borrowers tapping the market for the first time since then.

Our View: Valuations across both investment grade and high yield credit are not just at some of the tightest levels of the past few decades, they also reflect a significant degree of market complacency in pricing in what appear to only be potentially positive outcomes. This skews the risk and reward profile of credit exposure negative and encourages a more defensive posture with greater emphasis on higher quality and more stable issuers.

4Q 2024: Securitized Sectors Remain Relatively Attractive

- Agency mortgages struggled in the fourth quarter amid renewed rate volatility as the Bloomberg U.S. MBS index fell 3.2%, though returns for the year were positive at 1.2%. Following strong performance for low coupon 30-Year conventionals last quarter, the final months of the year saw higher coupons outperform as prepayment assumptions waned with higher rates. Such disparate performance outcomes across the coupon stack presents opportunities, and potential pitfalls, for agency MBS investors in a dynamic interest rate environment.

- Meanwhile, non-agency mortgages generally turned in strong performance for the quarter and year on sustained demand for attractive coupons in deals backed by resilient collateral given the extent of home price appreciation in recent years. While the sector has always benefitted from variety in collateral types, recent quarters have seen growth in deals backed by agency-eligible investor mortgages, residential transition loans, and closed-end second mortgages, expanding the pool of potential investments for investors in the space.

- After nearly two years of challenges, the non-agency CMBS sector rebounded in 2024 to be one of the best performers in securitized credit. Receptive capital markets and improving sector sentiment spurred a sizeable, $3.5 bn SASB transaction for the refinancing of Rockefeller Center, a landmark downtown New York office building, which was well-subscribed at issuance before spreads tightened significantly (30-145 bps) in the months following. This successful deal is likely to embolden sponsors to bring more office deals into the pipeline over the next year.

- Like other areas of fixed income markets, ABS experienced a surge in issuance as valuations improved and arrangers capitalized on demand to bring new deals to market. Credit curves also flattened as mezzanine and more junior tranches experienced the largest spread compression, reducing the relative value appeal of broad subordinated exposures. However, this benefitted returns for the sector on a total and duration-adjusted basis, with investors benefitting from attractive coupons and tighter spreads.

Our View: Agency MBS remains one of the most attractive opportunities in fixed income markets today. Outside of the agency sector, spreads have tightened across the securitized landscape, though many sectors still trade wide relative to comparable corporates. These better valuations, combined with greater complexity and constantly evolving nature of deals in the market, means there are consistent opportunities for investors willing to do detailed fundamental credit analysis, though caution is still warranted given abundant potential risks.

4Q 2024: Core and Core Plus Fixed Income Positioning Summary

We remain concerned about the potential impacts a slowing economy could have on markets, volatility, and risk premiums. We will look to take advantage of any actual volatility that does materialize.

Characteristic	Positioning	Comments
Duration	Approximately 0.8 years long versus the benchmark	Although the Fed began cutting rates in September, rates remain restrictive and above fair value, especially in an economy marked by easing inflation and a softening labor market
Curve	Expectations for a steeper curve	Overweight short and intermediate tenors of the curve given expectations that the Fed will have to ease more aggressively than markets expect
MBS	• Agency MBS – large overweight • Non-Agency MBS – maintain allocation, bias to add further	• Prefer specified pools given better convexity characteristics but maintain exposure to TBAs for liquidity • Emphasize lower coupon (<3.5%) issues for upside price potential, and middle coupons (4% - 4.5%) given a more favorable mix of spread and convexity relative to current coupons • Legacy (pre-GFC) and newer issue non-agency MBS bonds backed by legacy collateral benefit from solid fundamentals including lower loan-to-value ratios and delinquency rates given seasoned borrower profiles and home price appreciation
ABS	Moderate overweight	• Prefer AAA and AA rated CLOs that offer liquidity, robust structures, and attractive spreads • Diversified exposure across non-traditional collateral
CMBS	Small overweight	Cautious overall with targeted exposures to trophy property types via single asset single borrower non-agency CMBS deal structures
Investment Grade Credit	Large underweight	• Positioning emphasizes more defensive industries like communications and consumer non-cyclicals • Banks represent a sizeable position given attractive valuations and fundamentals, though underweight relative to the Index given potential for spread widening in a recessionary environment • Minimal exposure to cyclical credit sectors and non-corporate credit
Leveraged Finance	Minimal allocation	Target high conviction issuers and idiosyncratic credits over broad-based exposure given tight valuations
International	Small allocation	• Allocations among developed market countries favor European corporates with attractive spreads • Minimal emerging market exposure as slowing global growth typically presents challenges for EM issuers

All information is as of the date of this presentation unless otherwise indicated.

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Core Fixed Income – Strategies investing in bonds can lose their value as interest rates rise and an investor can lose principal. Mortgage-backed and other asset-backed securities often involve risks that are different from or more acute than risks associated with other types of debt instruments. MBS related to floating rate loans may exhibit greater price volatility than a fixed rate obligation of similar credit quality. With respect to non-agency MBS, there are no direct or indirect government or agency guarantees of payments in pools created by non-governmental issuers. Non-agency MBS are also not subject to the same underwriting requirements for the underlying mortgages that are applicable to those mortgage-related securities that have a government or government-sponsored entity guarantee. The strategy's investments denominated in foreign currencies will decline in value if the foreign currency declines in value relative to the U.S. dollar. The securities markets of emerging market countries can be extremely volatile. Securities prices and returns will fluctuate with market conditions, currencies and the economic and political climates where the investments are made.

Core Plus Fixed Income – High yield securities may be subject to greater fluctuations in value and risk of loss of income and principal than higher rated securities. Fixed income investments entail interest rate risk, the risk of issuer default, issuer credit risk, and price volatility risk. Strategies investing in bonds can lose their value as interest rates rise and an investor can lose principal. Mortgage-backed and other asset-backed securities often involve risks that are different from or more acute than risks associated with other types of debt instruments. MBS related to floating rate loans may exhibit greater price volatility than a fixed rate obligation of similar credit quality. With respect to non-agency MBS, there are no direct or indirect government or agency guarantees of payments in pools created by non-governmental issuers. Non-agency MBS are also not subject to the same underwriting requirements for the underlying mortgages that are applicable to those mortgage-related securities that have a government or government-sponsored entity guarantee. The strategy's investments denominated in foreign currencies will decline in value if the foreign currency declines in value relative to the U.S. dollar. The securities markets of emerging market countries can be extremely volatile. Securities prices and returns will fluctuate with market conditions, currencies and the economic and political climates where the investments are made.

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