

Focus on Short-Duration, U.S. Non-Investment Grade Credit

Strategy overview

Capital preservation emphasis, investing in high-yield corporate debt while seeking to minimize credit, liquidity, and interest rate risks.

Key takeaways

- The high yield (HY) market remains well positioned to withstand an increasingly dynamic macro environment, with particular attractiveness exhibited by shorter-duration issues due to their inherently lower interest rate risk.
- For the quarter, the Fund outperformed the benchmark on a net asset value (NAV) basis.
- Looking ahead, asset class default expectations are projected to remain low due to several supporting factors including minimal refinancing risk in 2024 and 2025.

Portfolio review

The HY bond market finished higher in the quarter, driven by a dovish shift in monetary policy that stemmed from an array of new economic data. Multiple inflation measures continued to ease, gross domestic product (GDP) growth came in well ahead of forecasts, consumer spending surprised to the upside and the service sector recovered into expansionary territory. However, some labor market measures were weaker, the manufacturing sector continued to contract, and consumer confidence declined. The simultaneous deceleration of inflation and jobs growth proved to be the catalyst for the first monetary easing campaign in four years, as the U.S. Federal Reserve cut interest rates by 50 basis points (bp) at the September Federal Open Market Committee (FOMC) meeting. In addition, second-quarter earnings results were better-than-expected, with most companies beating top- and bottom-line forecasts. Markets responded favorably, with risk assets moving broadly higher into period end to solidify mid-single-digit quarterly gains.

The ICE BofA US High Yield Index returned 5.28% for the period. CCC rated bonds returned 11.55%, outperforming BB and B rated bonds, which returned 4.28% and 4.54%, respectively. Spreads narrowed to 303 bp from 321 bp, the average bond price rose to 96.72 and the market's yield fell to 7.21%. All industries closed higher for the period. Telecoms, cable and media outperformed whereas energy, autos and capital goods underperformed. Trailing 12-month default rates declined to 1.64% (par) and 1.35% (issues). The upgrade and downgrade ratio increased to 1.7. New issuance saw 110 issues priced, raising U.S. \$74.3 billion in proceeds. Mutual fund flows were estimated at \$9.2 billion.

For the quarter, the Fund outperformed the benchmark on a NAV basis. At the industry level, financial services, utilities and air transportation made the largest contributions to performance in the period. There were no industries that detracted from performance.

Current strategy and outlook

The easing cycle has begun, with the Fed cutting interest rates by 50 bp in September as inflation normalizes and the labor market softens.

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Apart from an accommodative shift in monetary policy, potential economic tailwinds include steady consumption, continued government spending, improving productivity, increasing capital expenditures and the proliferation of artificial intelligence.

Risk to the economy may increase if these trends weaken. Other potential headwinds include escalating geopolitical tensions, prolonged labor market softening, deteriorating consumer sentiment and continued manufacturing contraction.

The U.S. HY market, yielding over 7%¹, offers the potential for equity-like returns but with less volatility. The market's attractive total return potential is a function of its discount to face value and higher coupon, which also serves to cushion downside volatility. Credit fundamental factors are stable, near-term refinancing obligations remain low, and management teams continue to prioritize debt reduction. Given these factors, the default rate has been below the long-term average with expectations for it to trend

toward the historical average in 2025. Regarding credits spreads, they can stay tight for many years. This was the case in the mid-1990s and 2000s – periods like today when HY balance sheets were healthy and defaults were low, the economy was stable and interest rates were elevated.

Longer-duration issues are the most likely to be impacted by high and volatile rates, but the overall HY market should have a dampened response due to its larger coupon relative to other fixed income alternatives. As a result, U.S. HY bonds contribute from both a diversification and a relative-performance perspective, offering a very compelling yield opportunity.

The Short Duration High Income strategy remains an attractive fixed income solution without taking excess credit risk, the shorter maturity puts securities first in line to repayment at par, and the strategy lessens price volatility that may be highly amplified in passively managed strategies.

¹Source: ICE Data Services; data as of September 2024.

The **ICE BofA 1-3 Year US Treasury Index** is an unmanaged index that tracks the performance of the direct sovereign debt of the U.S. Government having a maturity of at least one year and less than three years. **Investors cannot directly invest in an Index.**

Past performance is no guarantee of future returns. All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. All security transactions involve substantial risk of loss. Please reference your client statement for a complete review of recent transactions and performance.

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