

Seeks total return through security selection, sector allocation and risk management

Strategy overview

A total return approach, investing across full spectrum of the fixed income market including up to 20% in below investment grade securities.

Key takeaways

- Yields rallied and credit outperformed as continued disinflation allowed the U.S. Federal Reserve to shift their focus to labor market conditions and begin an easing cycle.
- The SMA underperformed its benchmark, the Bloomberg U.S. Aggregate Bond Index (the Index) on a gross- and a net-of-fees basis. Underperformance was driven by duration and yield curve decisions, while security selection decisions contributed. Meanwhile, sector allocation decisions detracted.
- While a soft landing appears likely, we favor assets with higher credit quality or shorter spread durations, as we believe spreads are too tight relative to the underlying risks.

Portfolio review

The labor market continued its path of normalization in the third quarter of 2024, with the number of job openings continuing to decline along with the quit rate reverting to pre-pandemic levels. This cooling was further evidenced by the Non-Farm Payroll (NFP) report, which missed expectations for both July and August. The substantial miss for July, reported in August, coincided with a controversial rate hike by the Bank of Japan (BoJ), unsettling markets and leading to a sharp widening of credit spreads. However, as investors digested the data, spreads eventually retraced, reflecting a more measured perspective on the total economy.

This moderation in the labor market did not significantly hinder consumer spending, which continued to advance at a decent rate. With elevated home prices and strong equity performance, the wealth effect remained in play however the moderation in the labor market may have been responsible for more measured spending growth, relative to more recent quarters. More broadly, the economy continued to advance at a reasonable pace, as evidenced by 2Q24 gross domestic product (GDP) growth, which exceeded expectations at 2.80% and was later revised to 3.00%.

Inflation continued its downward trend, with core Consumer Price Index (CPI) approaching 3.00% year over year, despite the shelter component remaining stubbornly elevated. Core goods prices remained in deflation, while core services inflation decelerated significantly, partially attributable to moderating wage gains. The Fed's preferred measure, Core Personal Consumption Expenditure (PCE), displayed an even more favorable environment, reading at 2.70% YoY in August. This disinflationary environment provided the Fed with the flexibility to shift its focus from inflation concerns to labor market conditions.

A pivotal moment came in late August with Jerome Powell's speech at Jackson Hole, signaling a shift towards an easing cycle. The Fed, acknowledging the softening labor market, opted for a 50 basis points (bp) cut at their September meeting, larger than the previously anticipated 25 bp reduction. Powell's influence was evident, with only one Federal Open Market Committee member dissenting. This decision underscored the Fed's proactive approach to preserving a healthy labor market and broader economic stability.

Credit spreads began the quarter at tight levels, reflecting a macro environment that balanced disinflation with stable growth. Despite the early August volatility, driven by labor market data and the BoJ's actions, spreads finished the quarter at similarly tight levels as the disinflationary trend allowed the Fed to begin an easing cycle.

Yields rallied in response to continued disinflation, with front-end rates falling more significantly than long-end rates. This bull steepening of the yield curve was driven by expectations of the Fed's easing, which prompted front-end rates to aggressively rally, while a stable growth outlook translated to a more measured decline in the long end.

In conclusion, the third quarter of 2024 was characterized by a gradual moderation in the labor market, further easing of inflation and a proactive shift in monetary policy by the Fed. These factors positively influenced market dynamics, resulting in a period of strong returns for fixed income investors.

For the quarter, the SMA underperformed the Index.

Underperformance was driven by duration and yield curve decisions, given our shorter duration profile in a period of falling rates. Our overweight to credit and underweight in Treasuries broadly contributed, with our allocation to high yield (HY) as the largest individual contributor. Meanwhile, our underweight in agency mortgage-backed securities (MBS) detracted, as the sector continued to move directionally with rates and outperformed over the quarter. Selections within asset-backed securities (ABS) also contributed, driven by collateralized loan obligations (CLO) which carry better yields relative to benchmark subsectors.

Outlook

As we look ahead to the fourth quarter of 2024, we expect the theme of "normalization" to continue shaping the economic landscape. We anticipate growth will stabilize close to trend levels, remaining positive but likely decelerating from the robust pace seen in recent quarters. This dynamic will be driven largely by consumer spending, which, while expected to slow, will continue

to be supported by a relatively strong (albeit moderating) labor market and a favorable wealth effect stemming from elevated asset prices.

We project inflation will continue its decline, but at a slow pace and ultimately settling above the Fed's target. Goods inflation is expected to remain at 0% or lower, as consumption growth moderates from historically high levels. Services inflation is likely to continue decelerating as the labor market continues to rebalance and wage growth eases further. Additionally, we anticipate that the shelter component of inflation will eventually align more closely with real-time indicators from sources like Zillow, Apartment List and Yardi, further contributing to the easing of inflationary pressures.

While all this points to a soft landing, markets appear to have priced in this scenario with a high degree of certainty. Investment-grade (IG) corporate spreads are currently below 100 bp, while HY spreads hover around 300 bp. These levels suggest that markets are highly optimistic that disinflation can continue without a recession materializing. While we tend to agree this is a likely outcome, there remains a risk of more rapid deterioration in the labor market, particularly if corporate margins face further pressures.

Given these tight valuations, we favor assets with higher yields and shorter spread durations. While we remain confident in the fundamental factors that support the economy, we want to be prepared to add risk during time of volatility. In keeping with the theme, we reduced our overweight to public IG, while maintaining off-benchmark allocations to higher yielding sectors such as non-agency residential mortgage-backed securities (RMBS) and CLOs.

On the interest rate front, following the substantial rally in 3Q24—particularly at the front end of the curve—the market is now pointing to the Fed reaching its terminal rate roughly one year ahead of the most recent dot plot projections. We believe this reflects a skew of potential outcomes related to monetary policy. Specifically, we believe that the likelihood of reacceleration of inflation that prompts the Fed to reverse course is significantly lower than the probability of a faster cutting cycle if the labor market deteriorates more rapidly. Because of this, our duration profile remains only slightly below the benchmark.

In summary, as we enter the final quarter of 2024, our economic outlook is characterized by a continued normalization process, with stable growth supported by consumer spending and a moderating labor market backdrop. While we maintain a cautious optimism, we remain vigilant, ready to adjust our positioning in response to an evolving landscape.

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