

Dynamic Core Bond Strategy

Strategy overview

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

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Key takeaways

- Risk assets performed, and risk-free assets struggled in 1Q24.
- The Strategy outperformed its benchmark, the Bloomberg U.S. Aggregate Bond Index (the Index) on a net asset value (NAV) basis. Security selection, sector allocation added, with security selection being the largest contributor, while duration and yield curve decisions were a small detractor.
- While spreads for many sectors appear tight, all-in yields remain historically attractive, allowing investors to capture high quality yield without overstretching into risk.

Portfolio review

For the quarter ended March 31, 2024, the Strategy outperformed the Index on a NAV basis. Security selection and sector allocation added, with security selection being the largest contributor, while duration and yield curve decisions were a small detractor.

Risk assets performed and risk-free assets struggled in 1Q24. The first quarter of 2024 witnessed a series of positive data points indicating a continuation of strong economic growth that characterized much of 2023. As a result, the S&P 500 Index experienced strong performance, delivering a return of over 10%, and excess returns for most fixed income sectors finished in positive territory. This robust showing indicated investor confidence and optimism in the overall economic outlook. Meanwhile, despite strong excess returns, high-quality bond markets, as represented by the Bloomberg US Aggregate Index, posted modestly negative total returns driven primarily by the move higher in interest rates.

The labor market continued to exhibit signs of strength to start the year. With an exceptionally low unemployment rate and continued job gains, economic growth remained on a positive trajectory. However, there were indications of a gradual shift towards a more balanced labor market, characterized by a decline in the quit rate and a deceleration in wage gains. These developments were welcomed by market participants due to their potential implications on inflation. That said, inflation remained elevated throughout the quarter while the disinflation dynamic that characterized 2023 lost momentum. Additionally, it became apparent that a majority of the disinflation was due to the deflation of goods prices, and that services inflation would also need to be tamed in order for broader measures of inflation to reach the U.S. Federal Reserve's 2% target. Because of this, the Fed signaled a cautious approach to monetary policy, reiterating their commitment to maintaining a restrictive policy stance until further progress was achieved. Markets converged with the Fed' guidance, suggesting a growing consensus on the future direction of monetary policy and a rejection of a more significant pivot that was priced in at the start of the year.

Non-government sectors outperformed Treasuries, with agency mortgage-backed securities (MBS) the exception. The positive backdrop of financial markets led to strong excess performance for most non-government sectors, while nominal returns were mixed and weighed down by the rise in interest rates. Once again, non-agency residential mortgage-backed securities (RMBS) posted a strong quarter of performance,

as housing markets stood firm, supported by elevated levels of homeowner equity and the “golden handcuffs” effect, where many homeowners locked in mortgages with highly affordable rates below 5%. However, this dynamic did not translate to the agency MBS sector as rate volatility and a delay in Fed cut expectations was a headwind for the period. Meanwhile, commercial real estate began its recovery journey, with generous yields helping to offset the impact of rising interest rates. Commercial mortgage-backed securities (CMBS) benefitted from this recovery with spreads rallying across the stack. However, challenges persisted within the office property segment due to elevated vacancy levels. Asset-backed securities (ABS) remained anchored by a strong consumer supported by a robust labor market, healthy financial asset balances and manageable debt levels. However, lower-income consumers (aka sub-prime borrowers) continued to face difficulties due to the cumulative impact of inflation over the past two years. On the corporate front, fourth quarter earnings were well received with a significant portion of companies beating expectations. Moreover, positive rating trends were observed, with a series of positive upgrades, reflecting the overall health and resilience of corporate balance sheets. These developments underscored the confidence in the corporate sector’s ability to navigate challenges associated with restrictive financial conditions, and resulted in both high yield (HY) and investment grade (IG) spreads rallying to their tightest levels in over a year as well as a meaningful portion of the senior loan market making its way back to par.

Security selection and sector allocation added, with security selection being the most notable contribution, while duration and yield curve decisions were a small detractor. The continued risk rally in 1Q24, meant our overweight to credit sectors and underweight in Treasuries contributed broadly. Securitized sectors represented the largest contributions to relative performance, with allocations to non-agency RMBS benefiting from the robust housing market and despite lingering concerns, CMBS also contributed as the sector started to show signs of a trough. ABS also added, but to a lesser degree given the lower beta nature of the sector. Corporate sectors including IG and HY also added but was more muted given our modest overweights. Agency MBS was the exception as rate volatility and debates on the Fed weighed on the sector and modestly detracted from performance. Security selection added nicely over period. The largest gain was sourced from agency MBS, with investments in collateralized mortgage obligation, including interest-only tranches faring well in an environment of low prepayments. Elsewhere in securitized, ABS security selection that included off-benchmark subsectors and higher yielding collateralized loan obligations (CLO) contributed as well as CMBS security selection in more credit sensitive investments. IG corporate selection also contributed supported by our preference for A and BBB rated issuers. During the period, the most notable change in allocations included a reduction in

exposures to Treasury and cash, with the largest deployment into CLO tranches that we believe offer attractive relative value and all-in yields. We also took advantage of the new issue market to add to IG corporates across financial and industrial sectors. Other changes were modest increases to CMBS and emerging market sovereign debt. Duration and yield curve decisions, in aggregate, represented a small detraction. Given market optimism in Fed action at the start of the year, we began the quarter underweight duration and then added duration as market expectations were tempered and rates rose, presenting an attractive entry point.

Current strategy and outlook

While the Fed’s hiking cycle is done, the first rate cut remains a source of debate. Looking ahead, we expect economic growth in the U.S. to slow from 2023, but continue to grow close to trend levels, supported by robust consumer spending as real income and the wealth effect bolster economic activity. Meanwhile, we expect inflation to stabilize above the Fed target, due to the slowing disinflationary trends in the goods sector and continued stickiness in the services sector, the latter of which has been a product of a tight labor market. We are seeing early signs of softness in the labor market, notably a decline in the quits rate. We expect wage growth to moderate, which would also be a positive for inflation. With this backdrop, along with recent strength in economic data, the Fed’s case to remain patient on rate cuts has been bolstered. However, the Fed’s data-dependent stance will provide flexibility in adjusting policy measures in response to evolving economic conditions, ensuring a balanced approach to supporting economic growth while addressing inflation concerns.

While spreads for many sectors appear tight, all-in yields remain historically attractive which allows investors to capture high quality yield without overstretching into risk. Corporate bonds illustrate this dynamic, where spreads are tight but nominal yields are enticing yield-based buyers and fundamental factors can continue to support the sector. Agency MBS valuations remain appealing given muted prepayment risk and the headwind of Fed rate hikes behind us. The outlook for non-agency RMBS is also positive as fundamental factors continue to support risk-taking in this sector. CMBS continues to exhibit cheap valuations, offering the most compelling relative value compared to other fixed income sectors. Moreover, outside of the office property type, fundamental factors in commercial real-estate are showing early signs of improvement. The additional cushion provided by higher nominal rates compels us to lean into higher-quality spread opportunities and remain underweight U.S. Treasuries. We will continue to monitor market developments, assess sector fundamental factors, and stay attuned to macroeconomic trends to capitalize on opportunities in this dynamic and evolving market environment.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is a widely recognized, unmanaged index of publicly issued investment grade U.S. Government, mortgage-backed, asset-backed and corporate debt securities. The Index does not reflect fees, brokerage commissions, taxes or other expenses of investing. **Investors cannot invest directly in an index.**

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