

FIXED INCOME | DECEMBER 31, 2024

Investment Grade Corporate Market Review and Outlook

	OAS TSY	QTD OAS Δ	YTD OAS Δ	QTD Total Return	YTD Total Return	QTD Excess Return*	YTD Excess Return*
U.S. Aggregate Index	34	-2	-8	-3.06%	1.25%	0.18%	0.78%
U.S. Credit Index	77	-7	-16	-3.04%	2.03%	0.72%	2.23%
U.S. Corporate Index	80	-9	-19	-3.04%	2.13%	0.82%	2.46%
Industrials	78	-9	-12	-3.40%	1.17%	0.89%	2.07%
Financials	82	-7	-29	-2.22%	3.91%	0.62%	2.88%
Utilities	82	-10	-23	-3.67%	1.74%	1.16%	3.40%
Non-Corporate Credit	48	0	0	-2.74%	1.70%	0.01%	0.65%
Quality							
A	68	-5	-16	-3.31%	1.63%	0.53%	1.95%
Baa	97	-13	-24	-2.58%	2.97%	1.18%	3.15%
Maturity							
Intermediate	71	-8	-19	-1.40%	4.22%	0.60%	2.10%
Long	98	-9	-18	-6.20%	-1.95%	1.25%	3.10%

* Bloomberg. As of December 31, 2024.

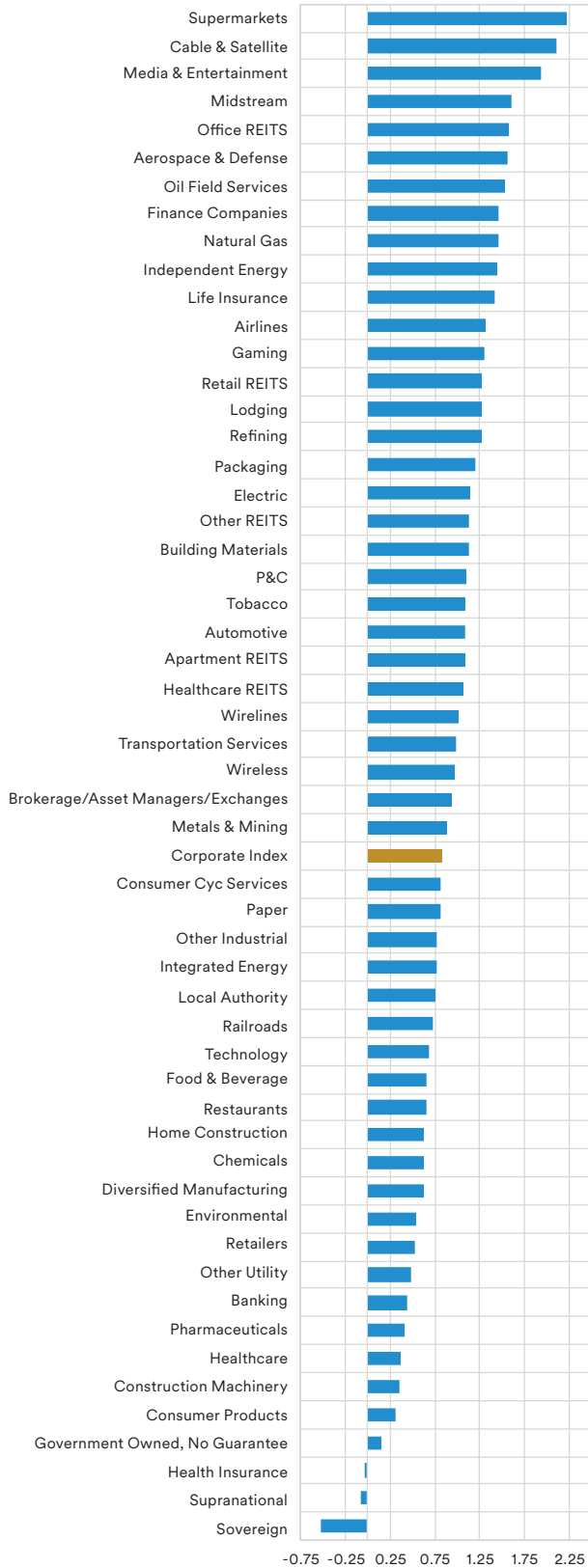
Fixed income performance in the fourth quarter was mixed with higher interest rates eroding total returns yet spreads steadily tightened bolstering excess returns both on a quarter-to-date and year-to-date basis. Across credit, corporates outpaced the non-corporate segment as lower quality BBBs (+1.18% excess return) outperformed single As (+0.53% excess return). The longer duration and higher beta Utilities (+1.16% excess return) and Industrials (+0.89% excess return) sectors outpaced Financials (+0.62% excess return). One of the larger events this quarter was the outcome of the U.S. Presidential election which brought a risk-on tailwind to already strong asset performance as measured by excess returns, but at the same time also introduced another set of uncertainties regarding tariffs, fiscal spending, tax policy, and other elements proposed during President-elect Trump's campaign. After an initial rise in U.S. Treasury yields due to expectations of increased government spending, yields stabilized in early December, and rate volatility declined, continuing into the end of the year.

The 10-year Treasury yield pushed higher throughout the period despite a brief minute in late November into early December before closing the year at 4.57%. The 2-year Treasury followed a similar path as the market continued to weigh the forward path of inflation and growth. The 2-year Treasury finished the year at 4.24%. The 2s/10s Treasury curve once again touched an inversion prior to reaching a 2024 high of 33 basis points reflecting the delicate inflection point between monetary policy and the new administration's policy implications on the U.S. economy. With a busy quarter of market moving events, credit performance mirrored much of what was observed throughout the year; spreads that grinded tighter and tighter alongside persistent demand. Stronger consumer confidence and continued labor market strength supported compression in October. In November following the U.S. election outcome and solid U.S. economic data prints spreads again reacted positively. Over December the compression abated to a degree as corporate spreads traded in a tight range and end the year at 80 basis points, giving back two basis points in the final week of trading. Further underpinning the historically tight levels in spread has been robust U.S. growth and strong corporate fundamentals (at both the investment grade and high yield levels) alongside steadfast demand from yield-oriented investors in addition to persistent mutual fund and ETF flows.

Overall, credit fundamentals haven't deteriorated as some have feared given the tighter financial conditions throughout most of the year. While the fed adjusted the overnight rate, longer dated rates remained elevated muting further activity in rate sensitive markets such as housing and asset financing activity. Additionally, data that highlighted a rise in auto-loan delinquencies among lower credit cohorts and increased credit card utilization, would typically signal a weakening consumer base. However, this has not yet materialized as consumer confidence and retail sales figures indicated a positive backdrop. U.S. Credit spreads closed the quarter 7 basis points tighter at the index level and delivered +0.72% excess return versus duration matched treasuries. Unsurprisingly, sectors with the greatest excess returns this quarter were those higher-beta segments and those with longer duration notwithstanding the headwinds rising rates. Supermarkets saw strong performance despite Kroger's acquisition of Albertsons being called off. Other sub-sectors with strong excess performance were Cable & Satellite, buoyed by Time-Warner Cable, Media & Entertainment with 2024 storied credits such as Paramount Global and Warner-Brothers Discovery and Office REITS supported by a slow recovery in underlying commercial real estate and lower interest rate backdrop.

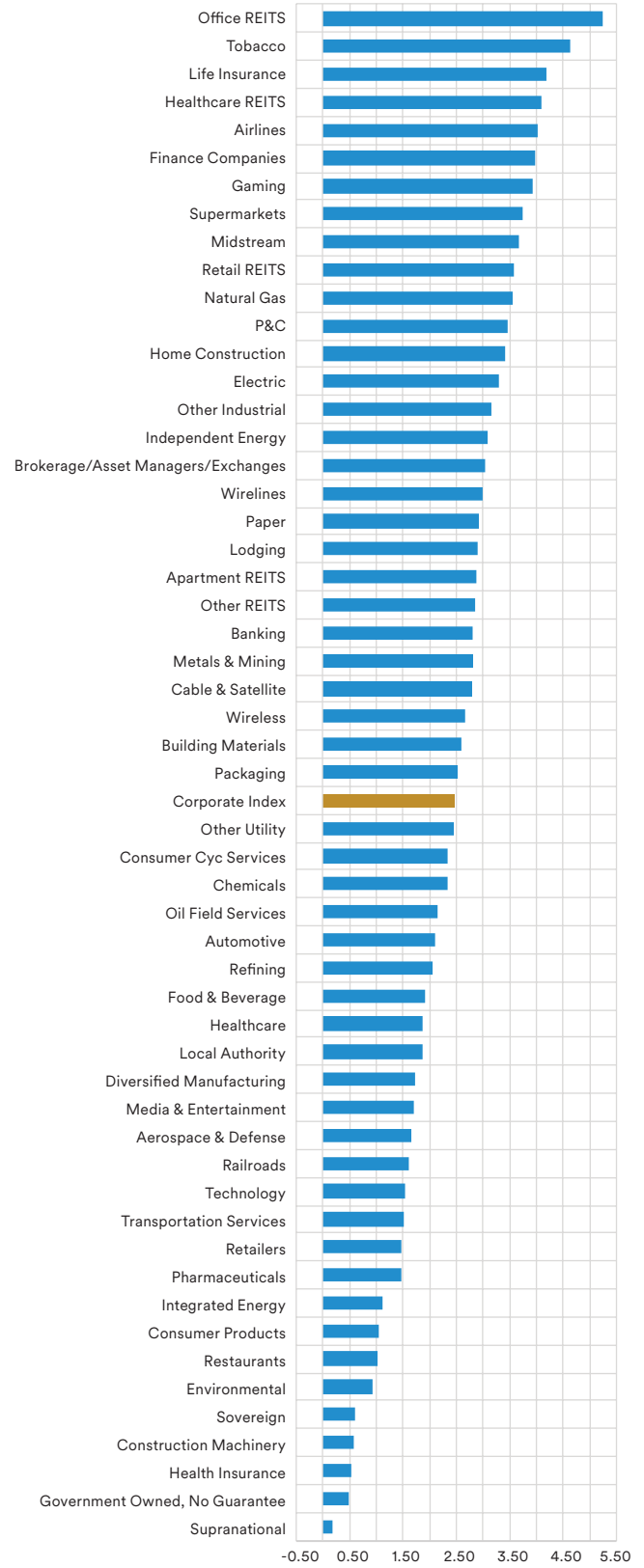
Conversely, areas with challenged performance were HealthCare where pharmacy benefit managers remain in the cross-hairs of congressional disputes, Pharmaceutical companies dealing with the new administrations goal of lower prescription drug prices in addition to more affordable healthcare pressuring the Health Insurance space. Spreads relationships, while still tight relative to historical norms, saw both the 3s5s and 5s10s flatten while the 10s30s credit curve slightly steepen. Cross-sector relative value relationships were relatively unaffected in the fourth quarter with the financials-industrials and financial-utilities spread relationships both roughly 2 and 3 basis points wider, respectively. Within Industrials, the BBB/A spread pickup compressed 9 basis points to 34bps over the quarter, with BBBs -13 basis points tighter to Single As -5 basis point move. This relationship at the beginning of the year was a 49 basis point differential.

Figure 1 | 4Q 2024 Credit Excess Return (%)



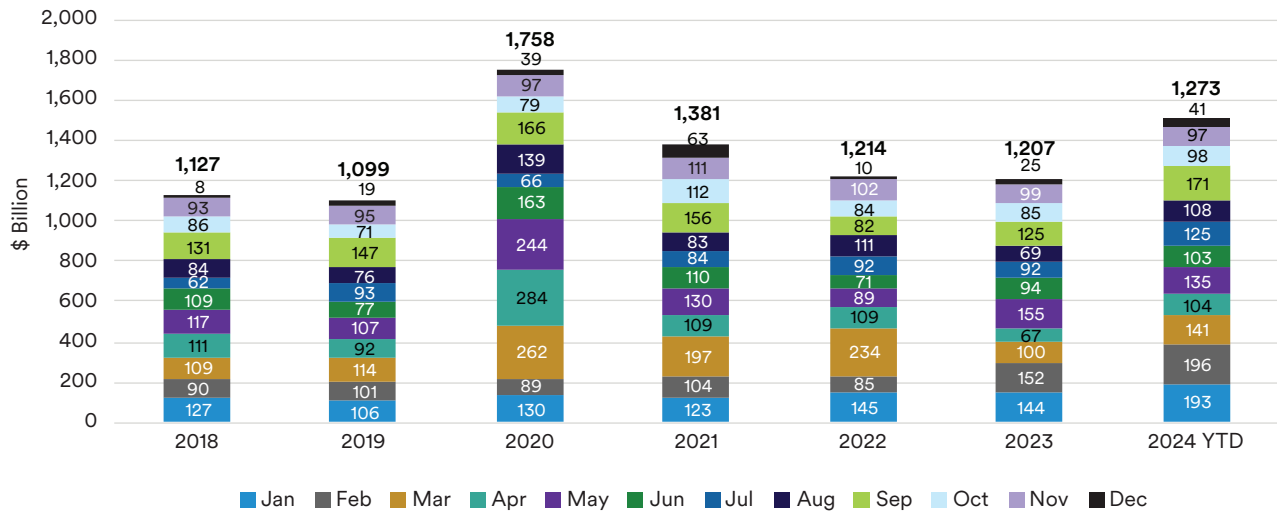
Source: MIM, Bloomberg L.P. As of December 31, 2024.

Figure 2 | 2024 Credit Excess Return (%)



Source: MIM, Bloomberg L.P. As of December 31, 2024.

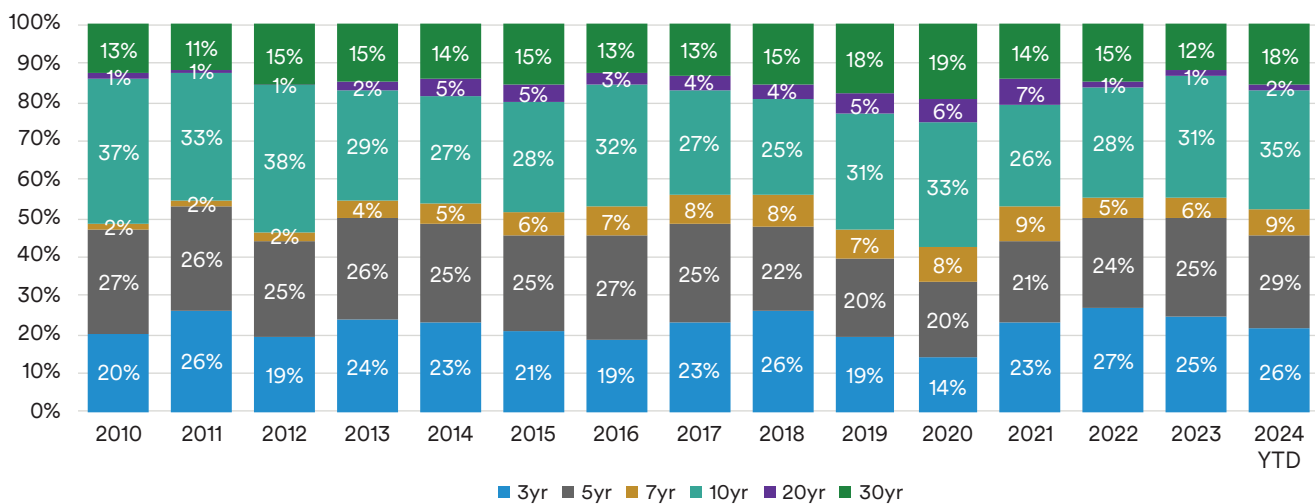
Figure 3 | Robust Monthly Issuance Was a Persistent Theme Throughout 2024



Source: JP Morgan. As of December 31, 2024.

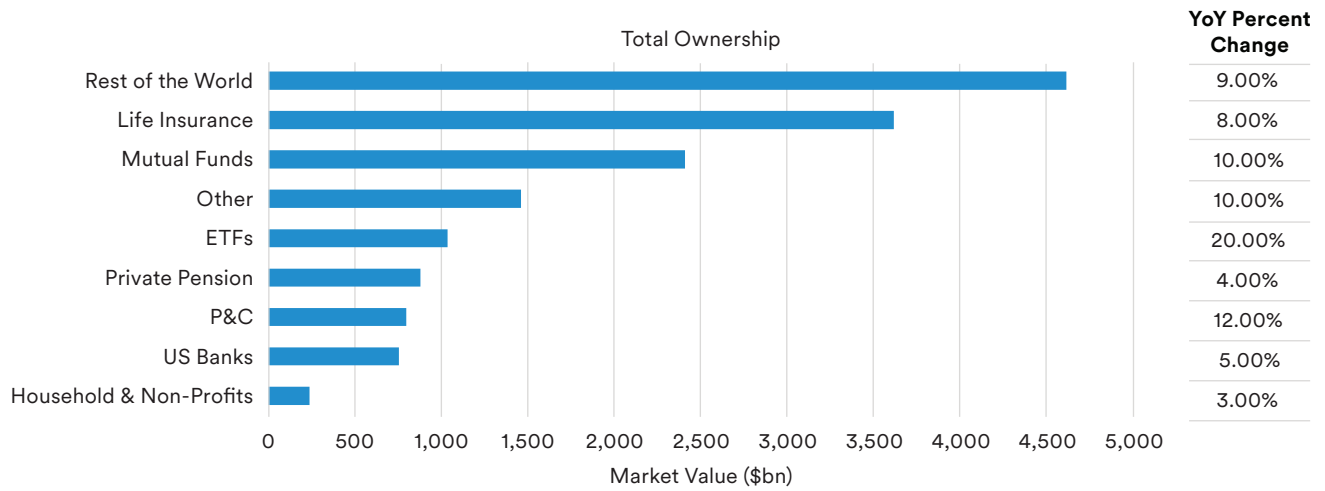
U.S. corporate issuance finished the year a bit softer with only \$236 billion coming to market over the fourth quarter. totaled \$1.5 trillion on the year, a 25% increase YoY. Non-financial issuance made up 60% of total issuance while M&A issuance accounted for 13% of total issuance, the highest activity since 2018. In non-financials, the largest issuing sectors were Healthcare/Pharmaceuticals (\$143bn, 9.4%) and Utilities (\$129bn, 8.5%). However, from an overall sector perspective, Yankee Banks (\$226bn, 15% share of total supply) and US Banks (\$208bn, 14%) were the largest issuers this year. By tenor, long-end issuance picked up after two years of being subdued as 10yr+ issuance tallied \$253bn or 17% of supply. By quality, BBBs share of issuance was up to 44%, the highest since 2021. We believe, this was likely due to the BBB-A spread difference which was close to record tight for a large part of 2024 making it an opportune time for BBB issuers.¹

Figure 4 | Across the Curve, Longer Dated New Issues Dominated 2024



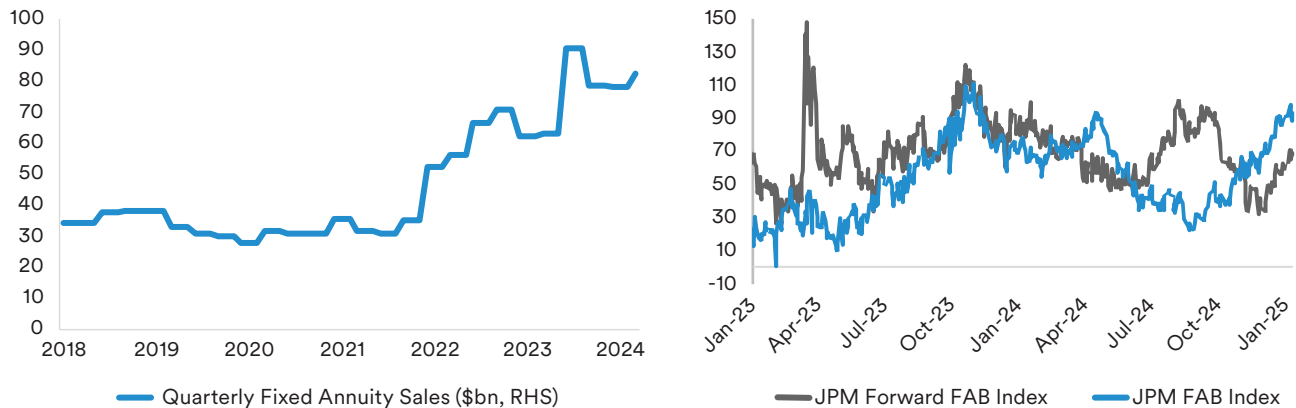
Source: JP Morgan. As of December 31, 2024.

Figure 5 | Meeting Robust Supply Has Been Healthy Demand for Investment Grade Fixed Income From a Variety of Investor Types



Source: JP Morgan. As of December 31, 2024.

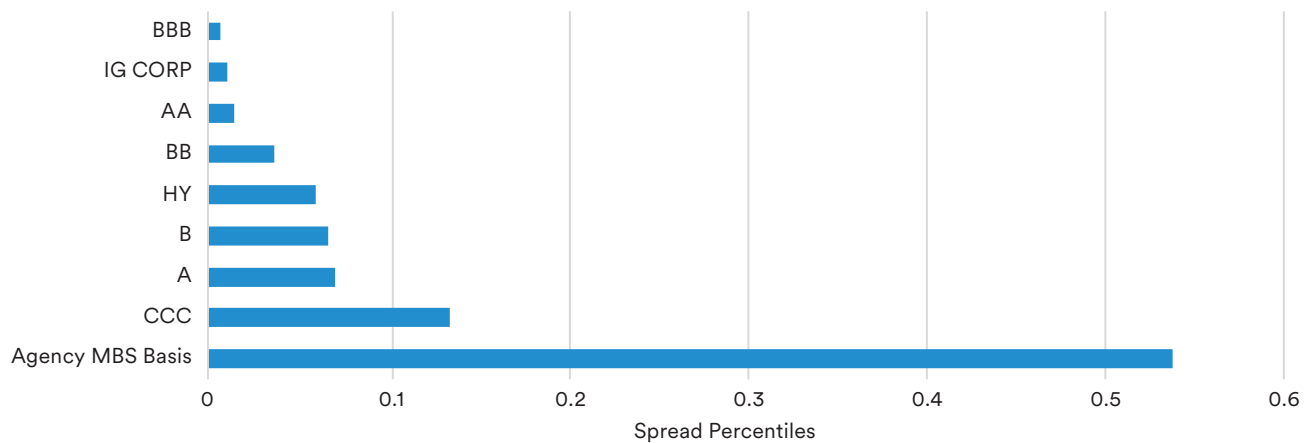
Figures 6 and 7 | An Uptick in Annuity Sales in Addition to More Attractive U.S. Dollar Hedged Yields Has Driven Flows Into IG Fixed Income



Source: Barclays

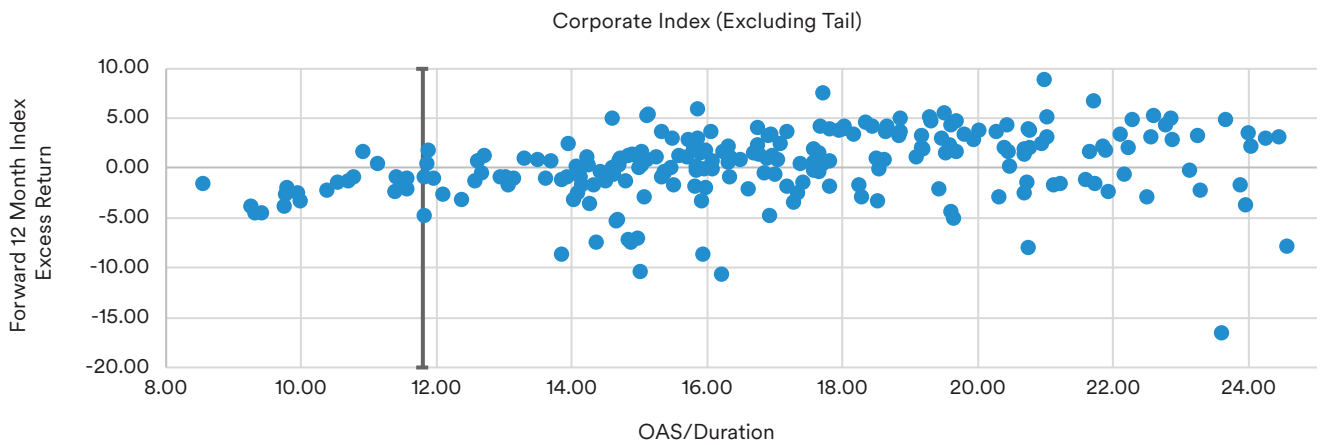
Source: JP Morgan

Figure 8 | U.S. Investment Grade Corporates Screen Rich To Other Credit Assets



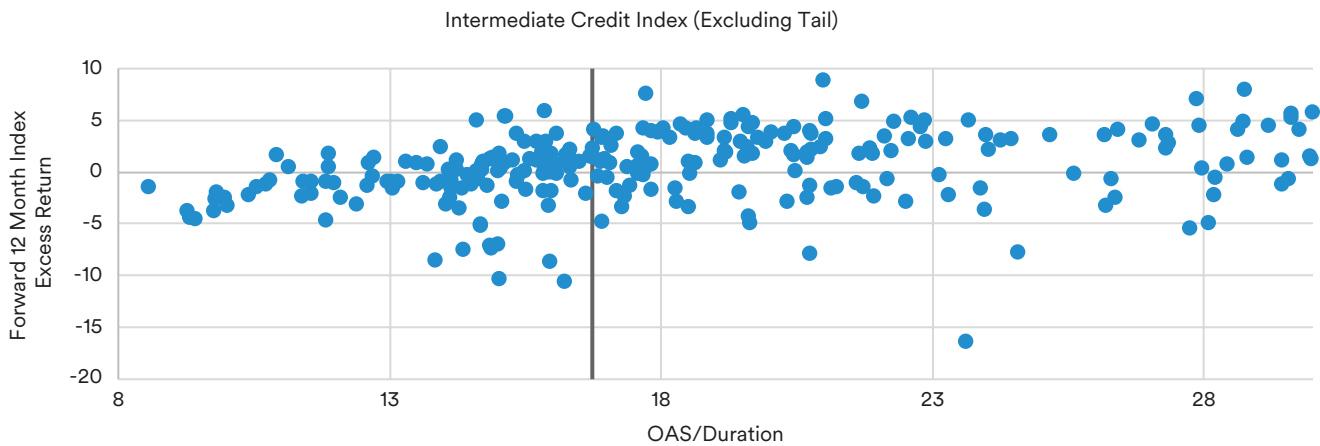
Source: MIM, Bloomberg L.P. (20- year historical lookback)

Figure 9 | From a Technical Perspective, the Upside Appears Limited From These Starting Levels of Spread (OAS)

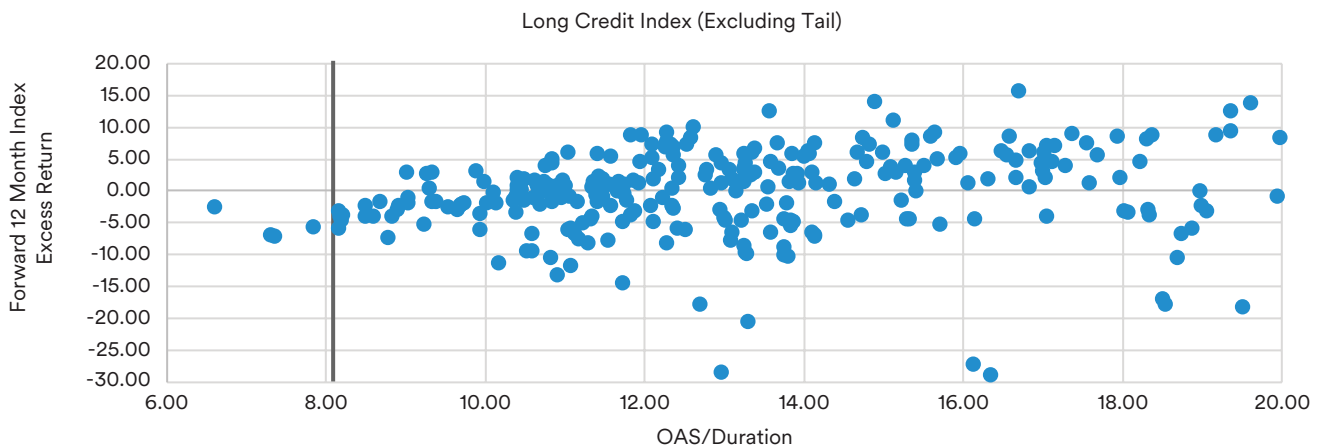


Source: MIM, Bloomberg L.P.

Figures 10 and 11 | However, When Looking Across the Curve, We Find a Better Opportunity Set in the Intermediate Segment of the Market

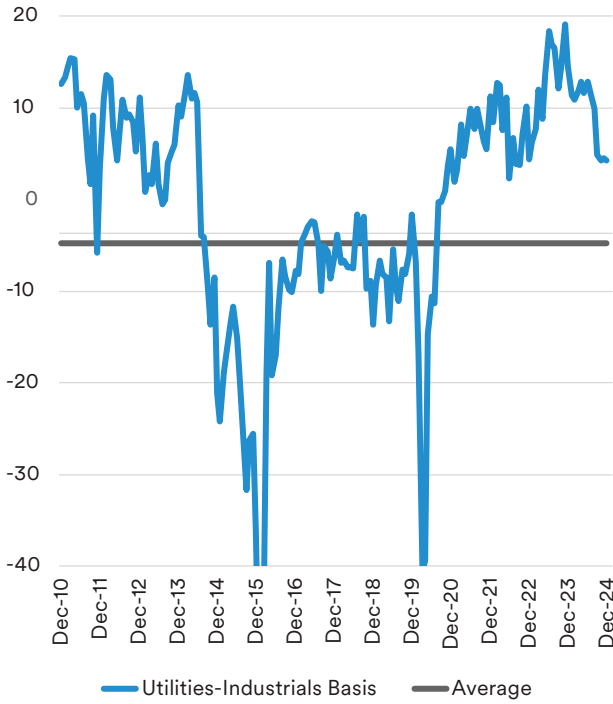


Source: MIM, Bloomberg L.P.



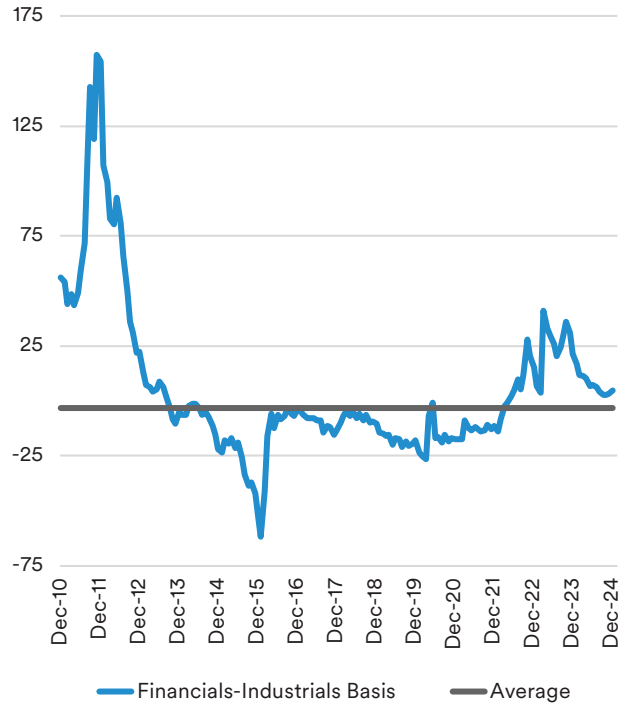
Source: MIM, Bloomberg L.P.

Figure 12 | IG Utilities Compressed to Industrials



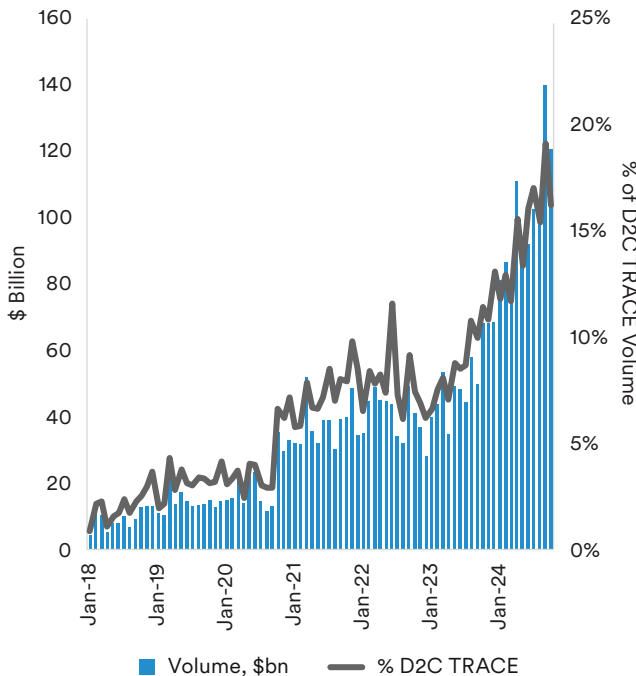
Source: Bloomberg

Figure 13 | IG Financials Compressed to Industrials



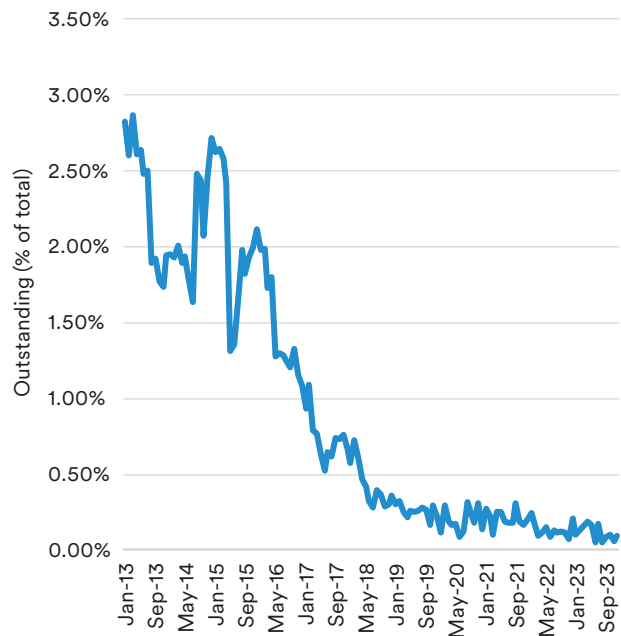
Source: Bloomberg

Figure 14 | Portfolio Trading Has Grown From 0% to 20% of Dealer to Client Activity



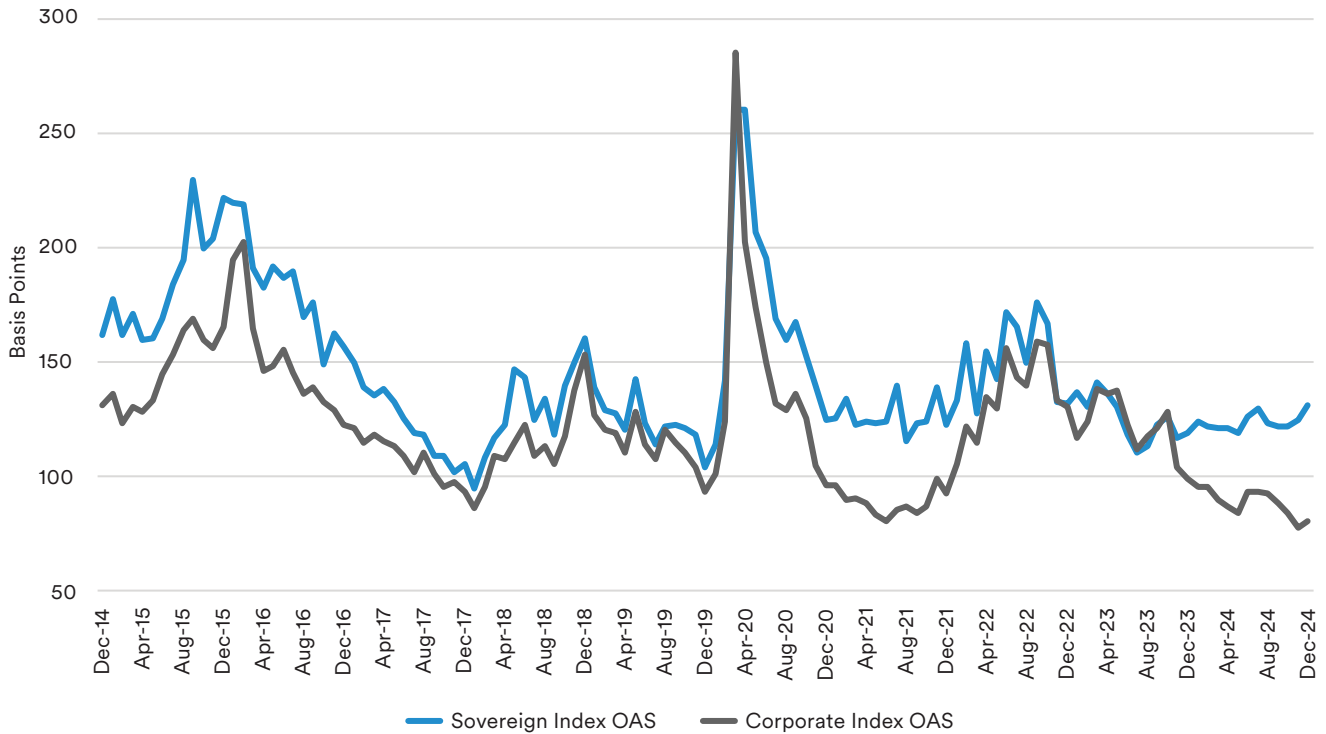
Source: Barclays, FINRA

Figure 15 | Percentage of Bonds Not Trading Each Month Has Plummeted to Nearly Zero



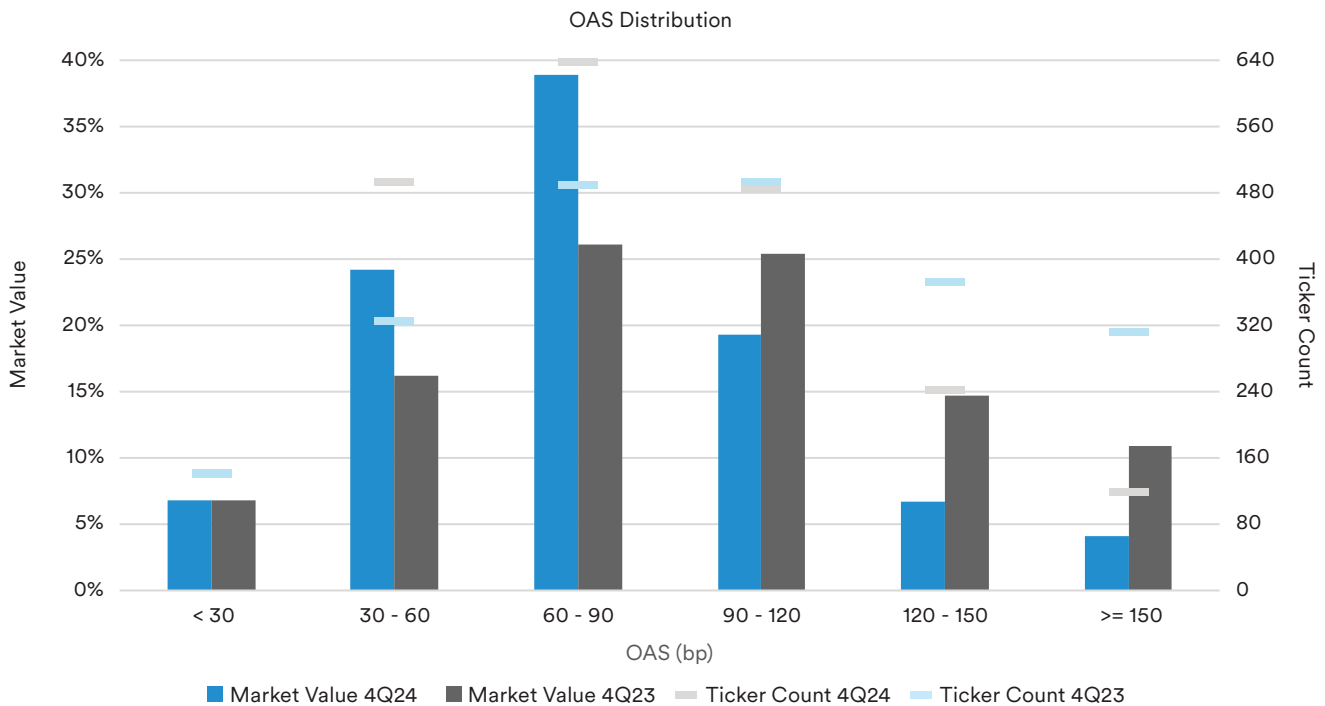
Source: Barclays, FINRA

Figure 16 | Sovereigns Screening as Cheap to Corporates Compared to Historical Spreads



Source: MIM, Bloomberg, L.P.

Figure 17 | Within the Index, Many of the Wider Trading Issuers Have Migrated Leaving Less Names To Pick From Across Those That With More Spread



Source: MIM, Bloomberg, L.P.

Before we attempt to polish off the crystal ball for what 2025 has in store, we believe it is helpful to devote some real estate to reflecting upon our performance in 2024. Beginning with the negatives (we are bond investors after all), our biggest shortcoming was our lack of conviction in the durability of the economy, and the impact that it would have on investor demand. Growth moderated, but so did inflation, with the trajectory of both forecasted to land at levels generally thought to be constructive for credit. This benign macro backdrop failed to exert any downward pressure on corporate bond yields, which catalyzed sustained demand for the asset class. Our failure to appreciate the powerful nature of these technicals led to a risk bias which was more defensive than we would have liked in a year when credit generated solid excess returns. We believe the underappreciated value in credit investing however, lies in the fact that macro prognostication is not a prerequisite to generating alpha, and we believe 2024 validated that fact. We were able to take advantage of a number of micro trends within the market that contributed nicely to performance. Compression was a key theme in the market, and implementing that theme via securities and sectors that we believe were poised to outperform the market was the primary driver of alpha. This alpha was not solely attributed to picking the winners in the market, but also avoiding the losers (some of which were bellwether names in the index). Having a down-in-quality bias proved to be a helpful ballast against our defensive Treasury holdings. Taking advantage of the lofty front end yields that were available to us, coupled with a preference for the belly of the curve relative to the long end, were areas of the corporate credit curve that offered attractive relative outperformance. To summarize, we did not capitalize on every opportunity, but certainly connected on enough of them to generate solid alpha in 2024.

Looking ahead to 2025, we would hardly be alone in characterizing valuations today as unattractive. Valuations alone, however, are not necessarily enough of a catalyst for spread widening. So what else could push spreads wider? We agree that a bevy of pro-business policies could materialize and would generally be supportive for risk appetite—but we could certainly envision a scenario where that increased risk appetite comes at the expense of bondholders. The rise of “animal spirits” and a more friendly regulatory environment could unlock more aggressive corporate behavior in the form of elevated M&A activity. Identifying those companies willing to sacrifice the health of their balance sheets (as well as those who may be the beneficiaries of such activity) will be top of mind for our team. At a higher level, it remains to be seen how (and if) a new agenda is implemented. Tariffs will seem to have a prominent role, and we will be focused on not only how that impacts the individual companies we follow but also how that may impact the broader inflation backdrop. The economy thus far has seemed on course for the vaunted “soft landing”, but the likelihood of a hiccup that new tariff and immigration policies may have on growth, labor, and inflation cannot be dismissed.

The upcoming change in the administration has seemingly fueled a sense of optimism in the market. This is most evident in equity forecasts, which unlike credit, are untethered by a spread to risk-free assets. The calculus and (and forecasts) for credit assets are a bit more tempered. Corporate bond valuations (as measured by OAS) will begin the year at the tightest level since 1997. It is also worth noting that for the 3rd consecutive year investment grade bond yields will be above 5% to start the year—with the 2-3% range that defined much of the previous decade becoming an increasingly smaller dot in the distance. In 2023, a 130 OAS starting point and 31bp of spread tightening resulted in a lofty 4.55% excess return. That tally was almost halved (2.46% excess) in 2024, despite another rally in spreads to the tune of 19bp from a starting point of 99 OAS. So the natural question then becomes, with such a tight starting valuation, where will the excess return come from?

Despite the potential headwinds we contemplated above, we are very mindful of the powerful demand technicals. Elevated yields will likely continue to support insurance and retail demand, while the value proposition of the U.S. corporate bond market for foreign investors is turning more favorable. Absent any shifts in the underlying drivers of this demand, this may be a year where carry is an important arrow in the quiver—and so security selection will once again be a driving force in where we intend to generate alpha. That being said, it is rare that a calendar year is devoid of bouts of volatility. Even a ‘carry year’ such as 2021 saw spreads trade in a 21 basis point range during the year, allowing for periods of time where opportunistic trades proved fruitful. We discussed in previous quarters our preference for decompression trades, and this will remain the predominant theme. The compression theme which has defined the credit market for 2024 has pushed relative value relationships to levels we believe are too stretched. We will continue to look to take advantage of opportunities where can move into more defensive credits, swap into lower \$ securities, and gain liquidity where such opportunities require minimal sacrifice of yield. We believe this to be a very prudent playbook given the macro backdrop.

A sole bias towards decompression though will likely not be enough to drive the alpha we seek for client portfolios. We believe an important complement to this approach will be getting a number of the higher beta credit stories 'right'. As of year-end, only 20% of the Corporate Index traded with a OAS above 100bp. Only 4% of the index trades above 150bp. Many of these are small capital structures that trade 'cheap' for a reason and require more intensive credit work—an area where we believe we have a competitive advantage. Picking the winners of this cohort will drive alpha in 2025. At the other end of the spectrum, we believe the aforementioned animal spirits could create further momentum behind a key 2024 lesson, which is the alpha that can result from underweights to large high quality issuers who may now be emboldened to sacrifice credit ratings for transformational M&A. We endeavor to avoid these underperformers.

To summarize, we believe that security selection will once again be the most important driver of alpha in 2025. The macro backdrop still remains uncertain at best, headlined by potential changes enacted by the new administration, and bouts of volatility like the 18bp of spread widening over 3 days in August are not out of the question. Maintaining an ample Treasury allocation to take advantage of such occasions is still prudent. Positioning for decompression in overly-stretched relationships, augmented by key high conviction credit ideas down the quality spectrum, will be our preferred playbook for the new year. Out-of-favor areas of the market like emerging market credit may also offer value. There is no doubt that the path to continued strong excess returns from IG credit is more challenged from this starting point, but we stand ready to take advantage of whatever opportunity set is presented to us.

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Excess Returns are measured against similar duration treasuries.

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