FIXED INCOME | December 31, 2024

Short Duration

Q4 2024
Portfolio Actions & Outlook

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Q4 2024 Sector Takeaways

Investment Grade Credit

- Current valuations are deemed less than compelling given corporate bond credit spreads have moved to levels not far above record tight levels for U.S. corporate bond indices, dimming the outlook for generating meaningful sector excess returns in an environment with a very rosy forecast implicitly priced in
- Our positioning reflects an up-in-quality bias based on valuations and lack of adequate spread pickup to move down in credit quality, although issuer credit fundamentals have shown signs of improvement, which has prompted us to add risk on a selective basis
- We favor the Banking, Finance/Aircraft Leasing, and Technology subsectors in addition to short-dated Automotive Finance exposure and less cyclically exposed subsectors like Insurance, Communications, Consumer Non-cyclicals, and Electric Utilities

Treasuries / Agencies

- Key initiatives under the Trump administration, including tax cuts, trade and tariff measures, and stricter immigration enforcement, are expected to contribute to higher deficit spending and potentially elevate inflationary pressures
- Projected increases in deficit spending will likely necessitate larger Treasury auction sizes to fund government operations and fiscal priorities
- The yield curve is anticipated to steepen further, driven by a combination of rising long-term rates and solid economic growth. Consequently, term premiums are expected to increase as investors demand greater compensation for holding longer-term debt amid heightened fiscal and economic risks

ABS

- High volumes of ABS issuance continued (surpassing 2023 levels) but was readily absorbed by investors
- We maintain our preference for liquid, defensive tranches such as credit cards and prime auto sub-sectors
- We expect further deterioration in collateral performance as the bifurcation of various consumers financial strength becomes more apparent

CMBS

- CMBS spreads tightened as commercial real estate prices increased over the quarter
- SASB deals continued to dominate non-agency new issue supply
- We avoided adding agency CMBS and instead opportunistically added seasoned conduit tranches that have stable principal repayment profiles

RMBS

- Mortgages posted negative excess returns in Q4
- A new administration and possible policy changes may increase volatility in the residential mortgage space
- We find non-agency spreads attractive versus other sectors, especially securities collateralized by high FICO / Prime borrower loans

Municipal

- Fourth-quarter taxable municipal supply was 22% lower on a year-over-year basis
- States return to a more typical budget environment
- We expect an increase in Airport bond issuance to fund capital improvement projects over the next year

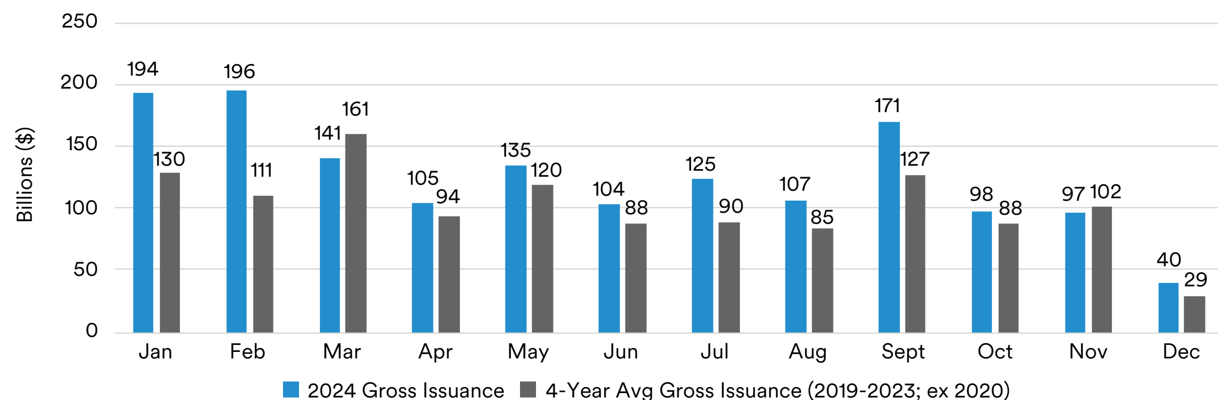
Investment Grade Credit

Recap: The fourth quarter began with benchmark yields moving higher in the face of evidence of better-than-expected economic growth persisting as seen in the strong September nonfarm payrolls print in early October. That reading and other accumulating supportive data like stubbornly sticky inflation measures helped investors, as well as Federal Reserve members, materially reduce forecasts for the decline in the fed-funds rate through 2025. Somewhat surprisingly, that shift did not really dent market enthusiasm for risk assets, enabling corporate bond spreads to largely continue their grind tighter. Credit spreads also overcame the tick up in volatility heading toward the U.S. elections as equities wavered a bit before enjoying a post-election outcome upward bias if not full-on rally to close out the year. Overall, spreads generally hung in well in the fourth quarter helped in part by the rise in interest rates, as robust investor demand met and readily absorbed healthy new issue supply at attractive all-in yields. Aside from the surprising results of the presidential election (to some), this came about despite macro concerns on multiple fronts, including the ongoing war in Ukraine, China's flagging economic picture, collapses of both the French and German governments after no confidence votes, escalating energy prices in Europe, and the forever unsettled Middle East, which saw the unexpected rout and fall of the Syrian government. From our seat, we ascribe December's modest spread widening to spreads having moved effectively to the tighter end of a trading range and lighter, less meaningful bond market activity often characteristic of the last month of the year.

Third-quarter earnings reports that printed throughout the fourth quarter painted a picture of improving corporate health underpinned by steady credit metrics as demonstrated by little material change in leverage. At a high level, third-quarter year-over-year earnings growth was 5.8% for the S&P 500 Index's constituents, led by continued strength from communications services, health care, consumer discretionary, technology and financials subsectors, according to FactSet.

Turning to corporate bond market technicals, the trading environment remains extremely supportive, although experience has taught us numerous times that prevailing positive conditions can turn negative very quickly in the event of a market shock or unexpected upheaval such as occurred in March 2023 surrounding the troubles at Silicon Valley Bank and Credit Suisse. The U.S. corporate bond market closed out the year with $1.511 trillion in high-grade issuance, trailing only 2020's COVID-driven spike in activity to $1.758 trillion. Fourth-quarter supply was a healthy $235 billion and was readily absorbed by domestic and foreign investors eager to put money to work.

High Grade Bond Issuance
(as of December 31, 2024)



Source: J.P. Morgan

Portfolio Actions: Based on our view that corporate credit spreads did not offer significant incremental spread tightening potential, we had been cautious in adding spread risk at prevailing valuations coming into the fourth quarter. Nonetheless, despite the Fed evidently scaling back its rate-cutting forecast in being more comfortable remaining in arguably restrictive territory, we saw the resilience of U.S. economic growth, sustained strength of the consumer, incremental improvement in corporate credit fundamentals, and more attractive all-in yields combine to compel us to lift our investment corporate bond sector weightings slightly across strategies in the fourth quarter, most visibly in our shortest strategies.

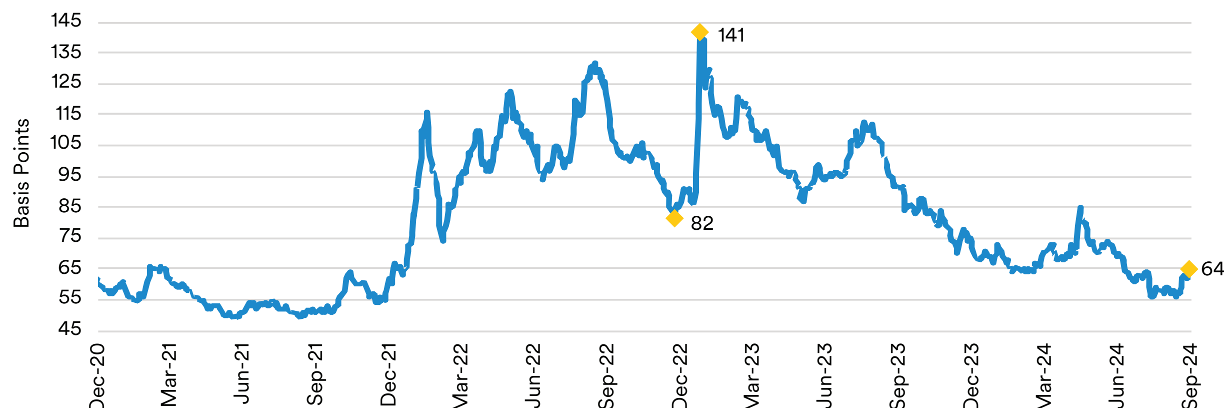
In the Cash Plus strategy we increased our sector weighting by adding selected floating-rate new issues from a Canadian bank, Japanese auto OEM's finance arm, U.S. custodian bank, and U.S. utility as a hedge on the Fed moving less expeditiously to trim their policy rate than the market had priced in. Fixed-rate secondary purchases included two aircraft lessors, selected Yankee banks, German and South Korean auto OEMs' finance arms, a pharmaceutical royalty payment stream issuer, and a U.S. retail pharmacy/health insurer in the 1-2 year duration range to lock in what we deemed to be attractive all-in yields. In the Enhanced Cash strategy portfolios, our sector weightings also moved higher as we added the aforementioned new issue U.S. custodian bank's floater as well as selected Yankee banks, a South Korean auto OEM's finance arm, a pharmaceutical royalty payment stream issuer, an aircraft lessor, a U.S. super-regional bank, and domestic insurance company's secured funding agreement-backed 1-2 year duration bonds. In the 1-3 year strategy portfolios, we slightly raised our sector weighting by buying mainly two plus-year duration secondary issues of a U.S. utility holding company, U.S. money center bank, Canadian bank, and a pharmaceutical company in addition to new issue three-year bonds issued by a U.S. waste collection services company and a global insurance and risk services solutions provider to finance in part pending acquisitions and two-year new issues from a truck producer's finance arm and a utility sector issuer focused on generation. These purchases were funded in part by selling some remaining one-year duration bonds. We also lifted our sector weightings modestly over the quarter in the 1-5 year strategy portfolios by adding the three-year new issue bonds issued by a U.S. waste collection services company and a global insurance and risk services solutions provider plus purchased in the secondary market bonds from a wireless telecommunications company, utility sector issuer focused on generation, aerospace and defense manufacturer, and U.S utility operating company as part of an effort to execute duration-extension trades to capitalize on rate moves to lock in attractive yields. These purchases were funded by selling roughly one-year duration bonds.

Outlook: Despite front-end corporate credit spreads reversing course in December with them moving higher for only the second month of widening in OAS seen on the year, spreads still ended a bit tighter overall in the fourth quarter. Accordingly, we continue to view risk/reward as skewed against loading up on risk by dramatically raising our sector weighting, extending duration, or broadly moving down the credit ratings ladder given stretched valuations despite improved credit fundamentals heading into 2025. The fourth quarter marked the tenth consecutive quarter of positive excess returns for the overall corporate bond market with the rise in benchmark yields enabling domestic and international investors to take advantage of attractive all-in yields and fueling solid demand for U.S. corporates and other spread product. This friendly backdrop also helped the market absorb the second busiest corporate new issue volume year on record, trailing only the COVID-driven issuance jump observed in 2020. We are also benefiting from what seems to be continued U.S. exceptionalism characterized by enduring strength in economic growth compared to other regions, most notably Europe and China, where central banks have been more aggressive in cutting policy rates to avert a more pronounced slowdown while the Federal Reserve, facing stickier inflation, has dialed backed its trajectory for policy easing over the next year dovetailing with the market's expectations.

Looking ahead, we anticipate corporate bond spreads will remain range-bound over the near term; however, they may prove vulnerable in the short run to shocks or potentially disruptive policy shifts telegraphed by the incoming U.S. administration, specifically on the trade or tariff front. In President-elect Trump's first term, short-term spread widening moves or dislocations often represented attractive entry points or buying opportunities and may do so again under such scenarios in 2025. Corporate credit fundamentals have demonstrated sustained resiliency, which we expect to carry into the new year with the analyst community's consensus forecast of 14.8% year-over-year earnings growth for the S&P 500 Index in 2025, according to FactSet. While last year's comparable earnings growth is expected to clock in at 9.4%, powered in large measure by the so-called Magnificent 7 issuers, 2025's forecast sees the other 493 companies in the index generating 13% earnings growth vs. 2024's estimated earnings growth just above 4%. If that forecast is realized, it would reflect a marked broadening out across the U.S. corporate landscape and protect against a gapping out in credit spreads.

In terms of where we see value in the U.S. corporate bond sector, we will continue to favor more up-in-quality issuers given BBB's remain near the tighter end of the historical range in terms of OAS or spread compared to single-A corporates, especially in subsectors more protected against spread widening in the event the credit cycle turns negative. In fact, front-end BBB corporates have produced higher excess returns than single A issues for seven consecutive quarters, which dims prospects that streak will extend meaningfully. If current valuations were broadly more attractive, we would be more inclined to increase our risk positioning in more cyclically exposed subsectors, but the relative paltry incremental spread pickup argues against that shift. Consequently, we will maintain a disciplined approach while opportunistically participating in new issue offerings where we see attractive relative value. We will also look to capitalize on periodic interest rate backups or temporary dislocations to add exposure selectively to lock in higher yields for longer across strategies. In the short run, we anticipate holding a reduced investment grade credit sector weighting and spread duration vs. historic norms, especially in our longer 1-3 year and 1-5 year strategies to the extent spread compensation above risk-free Treasuries remains relatively *de minimis*.

ICE BofA 1-5 Year U.S. Corporate Index OAS
(as of December 31, 2024)



Source: ICE Data Services

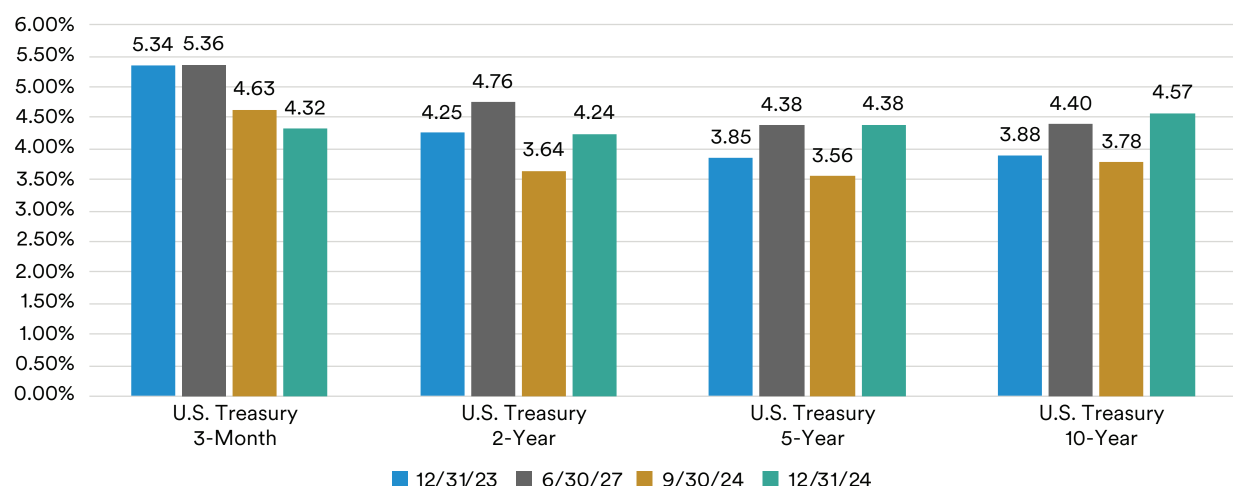
Performance: The investment grade credit sector contributed positively to relative performance across all strategies in the fourth quarter vs. Treasury benchmark indices. Positive excess returns from the sector were driven by security selection in addition to credit spreads moving a bit tighter. Credit spreads tightened in October and November before retracing somewhat in December with the ICE BofA 1-5 Year U.S. Corporate Index, our benchmark front-end credit index, seeing its OAS tighten 5 basis points over the quarter to close the year at 64 basis points. The index's quarterly total return and excess return were -0.37% and +0.34%, respectively, after the fourth quarter's modest spread tightening. Strongly performing investment grade credit subsectors that drove positive excess returns across strategies included Banking, Finance Companies, Insurance, Automotive, Food & Beverage, Health Care, Pharmaceuticals, Technology, and Electric Utilities..

Treasuries / Agencies

Recap: In the fourth quarter, U.S. Treasury yields experienced a notable increase with several key factors contributing to the sell-off. The Fed cut 25 basis points at each of their November and December meetings, bringing the year's total reductions to 100 basis points to the 4.25%-4.50% target range. During the December meeting Cleveland Fed President Hammack voted against the decision as she favored holding rates steady, the second such dissent since the Fed began lowering rates in September. While such cuts would typically lead to lower yields, the market's focus shifted to robust economic data and persistent inflation. Markets reassessed the trajectory of interest rates, anticipating the Fed might adopt a more cautious approach to future rate cuts due to economic strength and concerns surrounding inflation. The U.S. presidential election in November introduced uncertainties regarding future fiscal policies. Expectations of potential inflationary policies and possibly boosting the federal deficit under the new Trump administration also contributed to the rise in yields. The incoming administration has clearly shifted expectations for 2025. Chair Powell noted that some Fed officials have started incorporating the potential new policies into their forecasts but their impact on the economy remains uncertain. Powell also said the Fed will now cut rates when it sees further progress on inflation. He declined to lay out a more precise path for cuts in 2025, saying that it depends on how the economy evolves.

The major surprise came from the Fed's updated policy projections. While economists had anticipated a slowdown in 2025, policymakers projected just two rate cuts compared to the three widely expected. Additionally, the Fed now projects inflation will not return to its 2% target until 2027, a shift from its previous estimate of 2026. The FOMC also nudged up its forecast for the benchmark rate over the long haul, also known as the neutral rate. The median forecast is now 3%, up from 2.9%. The Fed's statement maintained language saying risks to achieving employment and inflation goals "are roughly in balance" and stated that "in considering the extent and timing of additional adjustments" to rates, officials will assess incoming data, evolving outlook, and balance of risks. The Fed also announced a 30-basis point reduction in the rate it pays lenders using the overnight reverse repurchase (ON RRP) facility, effectively lowering it by 5 basis points relative to the federal-funds target range. Powell emphasized that this technical adjustment to the ON RRP rate does not influence monetary policy. This larger cut to the ON RRP rate, 30 basis points instead of 25 for the federal-funds rate essentially reverses a technical adjustment the Fed implemented in June 2021. At the time, the ON RRP facility was modified to address concerns about excessive liquidity driving overnight money market rates below the Fed's desired range. Originally, the ON RRP was designed to serve as a floor for interest rates.

U.S. Treasury Yields
(as of December 31, 2024)



Source: Bloomberg

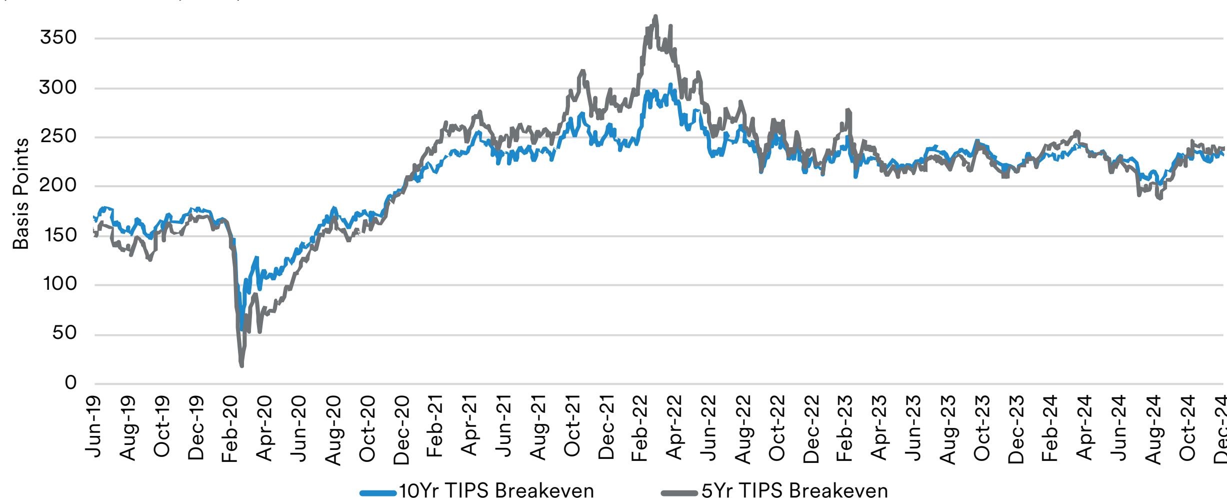
In the very front end of the maturity spectrum where we operate, short Treasury bill yields were notably lower in yield over the fourth quarter. One-month, three-month and six-month bill yields declined by 54, 30 and 14 basis points, respectively, during the quarter. In contrast, further out the curve, yields moved markedly higher as we saw the two-year Treasury move 60 basis points higher, ending the quarter at 4.24%. The five-year Treasury yield rose 82 basis points and closed the quarter at 4.38%, while the ten-year Treasury increased by 79 basis points to finish the year at 4.57%. The spread between the 10-year Treasury and the 2-year Treasury steepened from +14 basis points at the start of the quarter to +33 basis points at the end of the quarter. The spread between the five-year Treasury and two-year Treasury also steepened from -8 basis points at the start of the quarter to +14 basis points at quarter-end.

Treasury Inflation-Protected Securities (TIPS) breakeven spreads increased during the quarter. Five-year TIPS breakeven spreads moved higher to 239 basis points from 209 basis points at the start of the quarter while the ten-year TIPS breakevens moved up to 234 basis points from 219 basis points over the same period. The five-year real yield increased from 147 basis points at the beginning of the quarter to 198 basis points at the end of the quarter. The ten-year real yield also advanced from 159 basis points to 223 basis points over the quarter.

Front-end Government-Sponsored Enterprise (GSE) agency spreads marginally widened over the fourth quarter as the OAS of the ICE BofA 1-5 Year U.S. Bullet (fixed maturity) Agency Index ended the quarter at 2 basis points, a basis point wider from the start of the quarter. In the SSA (Sovereigns, Supranationals & Agencies) subsector, U.S. dollar-denominated fixed-maturity security spreads were 6 basis points wider and finished the quarter on average at 32 basis points over comparable-maturity Treasuries. Agency callable spreads relative to Treasuries were tighter as short-dated and short-expiry volatility in the upper left portion of the volatility surface pushed lower over the quarter. Two- and three-year maturity "Bermudan" callables, which feature quarterly calls with lockout periods of three months, saw spreads over Treasuries dramatically tighten from 100 and 118 basis points at the start of the quarter to 39 and 57 basis points at the end of the quarter, respectively.

Portfolio Actions: During the fourth quarter, in our shorter Cash Plus and Enhanced Cash strategies, we slightly lowered our allocation to Treasuries while increasing weights in the corporate and structured products sectors.

5-Year and 10-Year TIPS Breakeven
(as of December 31, 2024)



Source: Bloomberg

In our longer 1-3 and 1-5-year strategies we sold half of our five-year TIPS positions in November and hedged the duration of the sales with duration-matched nominals when five-year breakeven spreads were 243 basis points. We also executed extension trades to add duration during the quarter to maintain a slightly long bias vs. benchmark indices. In our shorter Cash Plus strategy we participated in a new issue Freddie Mac two-year callable with a six-month lock at a spread of 60 basis points over two-year Treasuries. The decrease in the agency sector weighting in our Cash Plus and Enhanced Cash strategies was due to selling shorter duration callables to add duration in the various spread sectors.

Outlook: In the year ahead, the question will be whether the U.S. economy can maintain the prevailing positive momentum amid the crosscurrents of risks on the macroeconomic horizon. The ability of consumers to sustain the remarkable pace of spending demonstrated in 2023 and 2024 will face scrutiny in the coming quarters as the effects of the Fed's restrictive monetary policy continue to permeate the system. The resilience of the U.S. consumer has not only been the most unexpected development of this cycle but has also provided the FOMC with the necessary flexibility to persist in its battle against inflation with minimal concerns about slipping into a recession. The key uncertainties

are the potential for inflation to reaccelerate and whether the U.S. labor market's resiliency will be maintained. We anticipate President-elect Trump will introduce a range of targeted tariff increases upon his return to the White House. While U.S. Treasury coupon issuance is expected to remain steady in the near term, the outlook assumes continued deficit spending. Future issuance will be heavily influenced by the fiscal policies enacted by the Trump administration. We also anticipate larger Treasury auction sizes in the latter half of 2025, especially out the maturity spectrum.

10-Year Term Premiums
(as of December 31, 2024)

Source: FRED

As the year begins, we have already seen the ten-year Treasury's term premium rise to levels not seen since July 2015. Often described as the additional yield investors require to hold longer-term debt instead of rolling over shorter-term securities, the term premium serves as a gauge for pricing in uncertainties or unforeseen risks such as inflation and other economic shocks, beyond expectations for the trajectory of near-term interest rates. The recent surge likely reflects heightened concerns over the U.S. deficit, increased Treasury supply, persistent inflation, and robust economic growth, all of which have pressured longer-dated bonds. We believe the term premium has room to climb further as deficit spending likely increases under the incoming administration's policies. We are monitoring technical support levels for two-year Treasuries in the 4.35–4.40% range and five-year Treasuries above 4.60% to tactically extend portfolio duration. Additionally, we believe the potential for higher tariffs and hawkish immigration policies may support wider breakevens for TIPS in 2025. We anticipate spreads for GSEs and SSAs will remain range-bound with SSAs having a slight bias towards moving wider on new issue supply. SSAs generally follow a predictable issuance pattern where issuers front-load their annual needs in January.

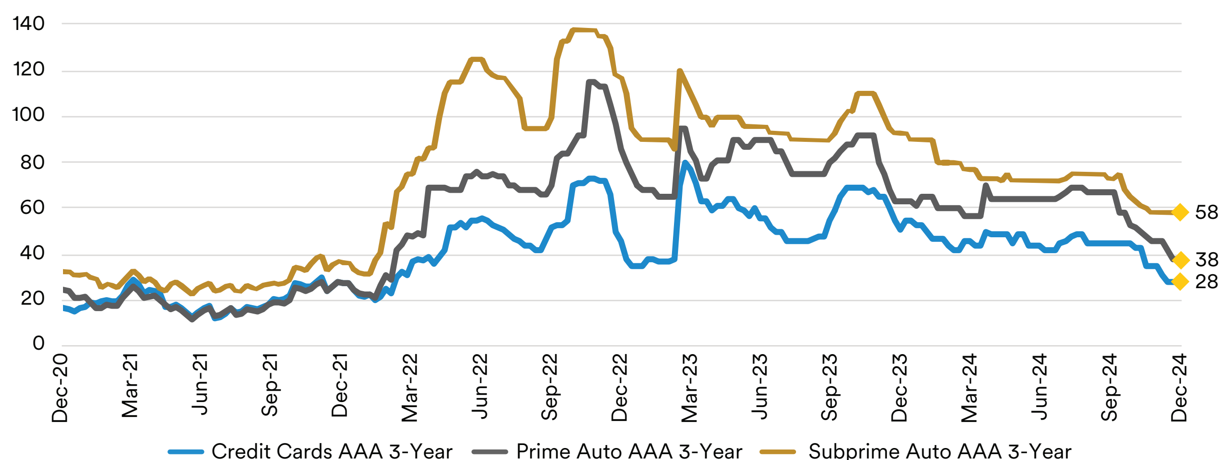
Performance: As rates sold off throughout the quarter, our slightly long duration bias relative to benchmark indices generated slightly negative excess returns across our strategies apart from our Enhanced Cash strategy where duration was a positive contributor to return. Our yield curve positioning detracted from performance across all strategies. Additionally, agency sector returns were neutral across all strategies except for our 1-5-year strategy where it was slightly positive.

ABS

Recap: The new issue calendar was busy throughout the fourth quarter as issuers continued to make their way to the market. Auto issuance was the main contributor comprising $39 billion of the total $77.5 billion of new deals. Following autos were the “Other ABS” subsector (a “catch-all” category which includes deals collateralized by cell phone payment plans, timeshares, mortgage servicer advances, insurance premiums, aircraft leases, etc.) with almost $18 billion of new issuance and the equipment subsector with $8.3 billion of new issuance. The last month of the quarter was the busiest the primary market had seen since January with year-to-date issuance reaching $256 billion, the same amount issued in the entirety of 2023. New deals have remained in high demand, with many ending up multiple times oversubscribed across various sectors and rating buckets. ABS spreads ended the third quarter largely unchanged to slightly wider. Three-year, fixed-rate AAA-rated credit card and subprime auto tranches ended the quarter at spreads of 45 basis points and 73 basis points over Treasuries, respectively, 1 basis point wider in both cases. Three-year fixed-rate AAA-rated prime auto tranches ended the quarter at a spread of 67 basis points over Treasuries, 3 basis points wider. Three-year, floating-rate AAA-rated private student loan tranches ended the quarter at a spread of 88 basis points over SOFR, 3 basis points wider.

Short Tenor AAA ABS Spreads

(as of December 26, 2024)

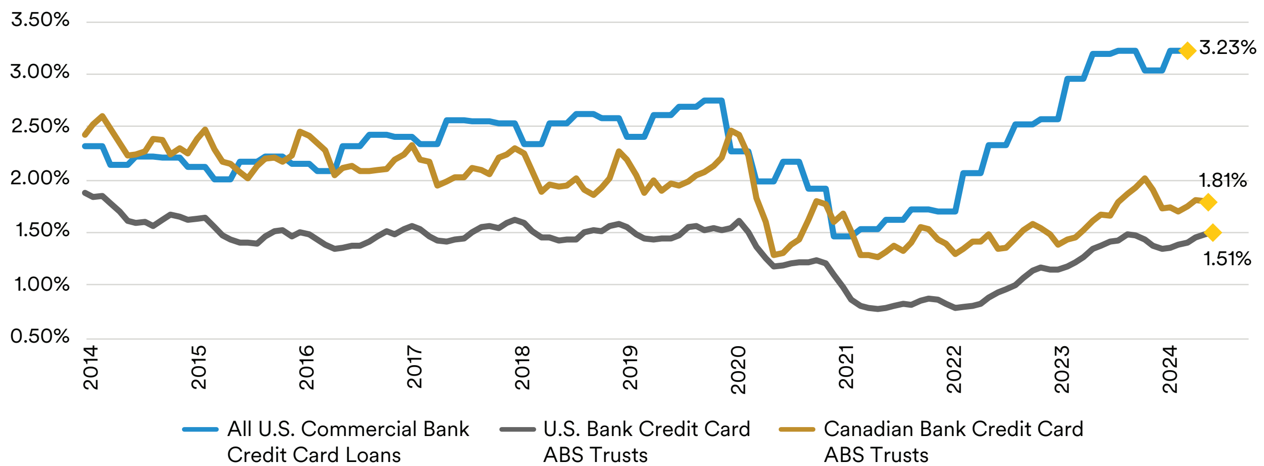


Source: Bloomberg, MIM

Credit card trust performance metrics showed signs of slight deterioration over the year but stayed relatively unchanged throughout the fourth quarter. Data from the JP Morgan credit card performance indices reflecting the December remittance reporting period showed charge-offs on bank credit card master trusts falling 1 basis point during the quarter but rising 29 basis points on a year-over-year basis. The increase in 60+-day delinquencies was the same for the quarter and year, 9 basis points. However, as we have noted in previous commentaries, we do not anticipate a material impact on our credit card holdings due to their robust levels of credit enhancement as charge-offs and delinquencies remain well below historical norms. In addition, we believe that securitized ABS credit card trusts are likely to perform better than broader credit card portfolios due to their more seasoned accounts.

Credit Card Delinquencies

(as of December 19, 2024)

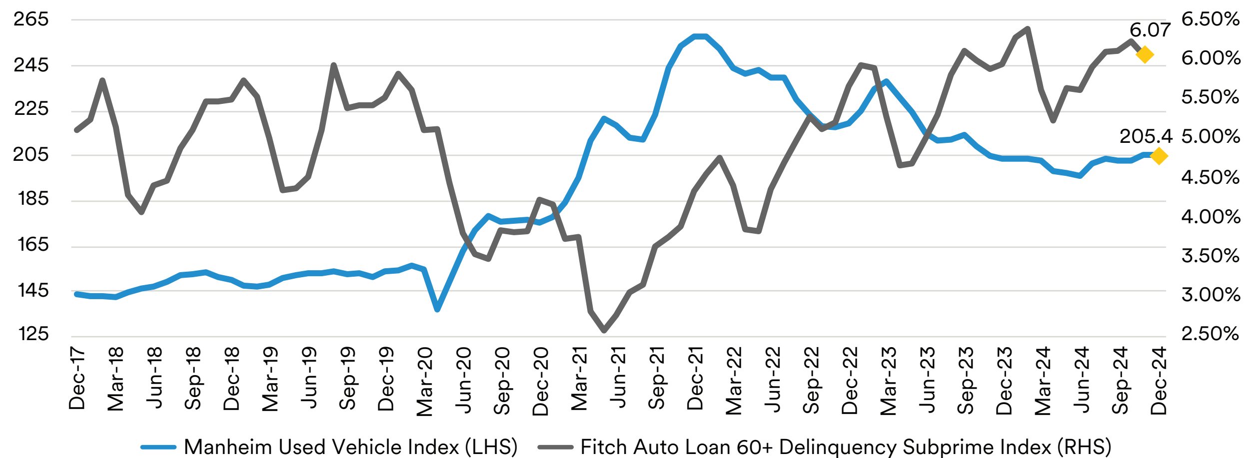


Source: Bloomberg, J.P. Morgan

Even with high sales prices, automakers sold close to 16 million vehicles in the U.S. in 2024, 2.2% higher than in 2023, and the highest since 2019. New vehicle retail sales saw an upward trend in December, unusual for this time of the year, and used car sales remained stable. The supply of new and used vehicles showed mixed trends, with new vehicle supply higher year over year but declining in December, while used vehicle supply rose slightly in December but was down year over year. Gas-electric hybrids continued to rise in popularity with just over 1.6 million vehicles sold, a 36% increase over 2023. General Motors finished the year with the most sales, posting a 4.3% increase for the year, its best performance since 2019. Toyota reported a 3.7% sales jump, while Ford sales rose 4.2%. Honda saw an 8.8% increase in sales. In contrast, Jeep, and Ram maker Stellantis, which battled much of the year with too many high-priced vehicles on its dealer lots, saw a 14.8% sales decline. Nissan, Hyundai, and Kia sales were up 2.8%, 4.8% and 1.8% for the year, respectively.

Manheim Used Vehicle Index & Fitch Auto Loan 60+ Delinquency Subprime Index

(as of December 31 , 2024)



Source: Bloomberg

The most recent Fed Senior Loan Officer Opinion Survey, reflecting sentiment as of October, showed a significant net share of banks reporting standards tightened for credit card loans and remained basically unchanged for auto and other consumer loans, while demand weakened for auto and other consumer loans and remained steady for credit card loans. Banks reported that they were more likely to approve credit card loans to prime or super-prime borrowers and less likely to approve credit cards for lower FICO-score borrowers, compared with the beginning of the year. They also reported that the level of demand for credit card loans was stronger in the third quarter of 2024 than before the pandemic (end of 2019) across most credit score categories and they forecast further strengthening in demand over the next six months, with an expected increase in borrower spending.

Portfolio Actions: Over the course of the year, we materially increased ABS weightings across all strategies. With ABS exposure at high levels relative to historical norms, our fourth-quarter activity varied across our strategies. In our Enhanced Cash and 1-5 year strategies we continued using paydowns and sales to opportunistically add liquid, defensive tranches. We continued to favor adding to our credit card holdings to bolster the liquidity profile of the portfolios. In contrast, in our 1–3 year strategy, we chose to reinvest the majority of the cash from paydowns and sales into other spread sectors, thus reducing our ABS weighting. Our purchases occurred in both the new issue and secondary markets. As in the third quarter, we continued to purchase the front-pay “CP” tranches of various auto and equipment deals in our shorter strategies as these tranches stand at the top of the payment waterfall and carry short-term commercial paper ratings equivalent to AAA. Since they are structured to receive the first principal payments from these deals, they are the safest tranches in ABS deal structures from a credit perspective. In our longer portfolios we focused on one-year to three-year AAA-rated senior tranches. These securities have a favorable liquidity profile due to their short average lives. Within the Other ABS subsector, we increased our device payment weightings across all strategies by participating in both primary and secondary deals. For example, we purchased a new issue 2.5-year AAA device payment tranche that priced at 70 basis points over Treasuries.

Within the Other ABS subsector, we increased our device payment weightings across all strategies by participating in both primary and secondary deals..

Outlook: We maintain our previous outlook of coming slightly softer economic conditions as well as continued easing from the Fed. Accordingly, given we anticipate deterioration in ABS credit metrics we will continue to prefer liquid, defensive tranches, and more resilient subsectors of the market. As in the prior quarter, ABS spreads remain relatively attractive compared to other spread sectors, but we are unlikely to materially increase our weightings. Instead, we are likely to use sales of existing ABS holdings to fund new purchases. We reiterate our preference for prime borrowers over subprime. While we still believe that in a recessionary economic environment, leveraged loans will suffer heightened downgrades, we are open to adding CLOs at an opportunistic level given the ample levels of credit enhancement and structural protections for the AAA and AA attachment points where we are likely to participate.

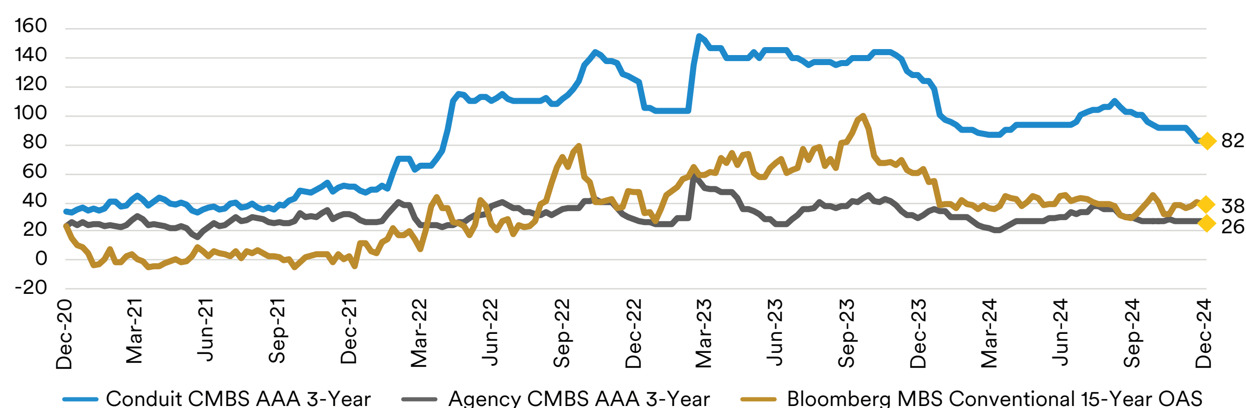
Performance: Similar to the last few quarters, after adjusting for their duration and yield curve positioning, our ABS holdings posted strong positive excess returns across all our strategies. All subsectors were positive, with notable strength coming from the Other ABS and fixed-rate auto buckets. Top performers within the Other ABS subsector were device payment deals and floorplans. In auto ABS, a major U.S. multi-location auto retailer's tranches performed well including our holdings in their inaugural subprime shelf which we purchased earlier in the year.

CMBS

Recap: Short-tenor CMBS spreads tightened across the board and even with the expected slowdown during the holiday season issuance remained strong, surpassing $60 billion for the quarter. Aggregate issuance for the year totaled $219 billion, a 35% increase from last year's $161 billion. Private-label CMBS issuance amounted to $113 billion, almost one and a half times greater than 2023's $47 billion of private-label supply. This was largely due to the increased production of floating-rate SASB deals which totaled $9 billion last year and grew to $48 billion this year. At the end of the quarter, spreads on three-year, AAA-rated, conduit tranches stood at 82 over Treasuries, 18 basis points and 46 basis points tighter than the start of the quarter and year, respectively. Spreads on five-year, AAA-rated, conduit tranches were 85 basis points over Treasuries, 20 basis points and 55 basis points tighter than the start of the quarter and year, respectively. Three-year Freddie Mac "K-bond" agency CMBS tranches ended the quarter at a spread of 26 basis points over Treasuries, 1 basis point tighter. Three-year, AAA-rated, floating-rate single asset, single borrower (SASB) tranches ended the quarter at a spread of 122 basis points over SOFR, 26 basis points tighter. For the year spreads were also tighter with the three-year K-bond and floating-rate SASB 2 basis points and 23 basis points tighter, respectively.

Short Tenor AAA CMBS Spreads

(as of December 26, 2024)

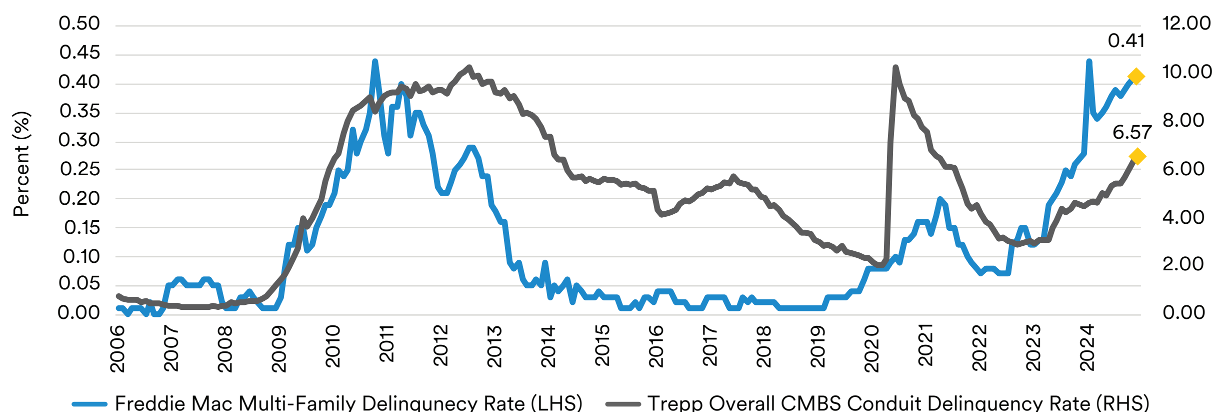


Source: Bloomberg, MIM

Continuing to trend higher, CMBS delinquencies (as measured by the Trepp 30+-day delinquency rate) rose to 6.57%, 87 basis points higher than the prior quarter. The top contributors to this increase were office properties whose delinquency rate jumped to an all-time high of 11.01% from 8.36% at the beginning of the quarter after more than $2 billion in office loans became newly delinquent. Prior to this, the high in office delinquencies was 10.70%, seen in December 2012. The all-time high in the overall delinquency rate was 10.34% registered in July 2012 and the more recent COVID-19 high in June 2020 was 10.32%. Delinquencies in the industrial and lodging segments saw 3 and 9 basis point

declines from last quarter, respectively. The multifamily subsector delinquency rate rose 125 basis points, ending the quarter at 4.58%, and the retail delinquency rate was 7.43%, 36 basis points higher than three months ago. The percentage of loans that are seriously delinquent (60+ days delinquent, in foreclosure, REO, or non-performing balloons) is now 6.31%, 78 basis points higher than September's 5.53% level.

CMBS Delinquencies
(as of December 31, 2024)



Source: Trepp, Bloomberg

Commercial property prices continued to creep up for the sixth month in a row in November, although prices were still lower compared to last year. The December release of the RCA CPPI National All-Property Composite Index showed prices had fallen 0.5% year over year through November to 143.8. Apartment properties were the worst performing and only subsector that saw quarterly and yearly price declines, with apartment prices falling 0.9% and 5.7%, respectively. Central business district ("CBD") offices saw prices drop 12.3% for the year, while suburban office prices fell 0.8%. Although office properties still had a year-to-year decrease of 4.2%, the recent push in return-to-office policies saw office properties rise 0.2% over the last three months. Retail properties saw the highest price increase over the quarter with a rise of 1.2%, while the highest year-over-year price growth was in industrial properties with a 4.7% increase.

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The most recent Fed Senior Loan Officer Opinion Survey, reflecting sentiment as of the third quarter, showed that banks reported tighter standards and weaker demand for all commercial real estate (CRE) loan categories. Large banks reported that lending standards were basically unchanged for all types of CRE loans while other banks reported tighter lending standards. Our interpretation is that this disparity reflects the greater pressure that local and regional banks are facing from their generally higher exposure to commercial real estate loans relative to larger financial institutions. Historically, tightening lending standards precede periods of rising delinquencies and charge-offs for CRE loans.

Portfolio Actions: During the quarter we increased our CMBS exposure in our Cash Plus and Enhanced Cash strategies and decreased it in our longer strategies. We continued to favor short-tenor investments in both agency, more stable conduit ASB, and SASB tranches. The reduction in CMBS exposure in our 1-3 year and 1-5 year strategies was targeted towards agency CMBS that sits further out the maturity spectrum as, in our view, spreads in that area remain relatively unappealing compared to other spread product. We used both the outright sale of agency CMBS tranches and reinvested agency CMBS paydowns into other spread products to accomplish the reduction in our longer strategies. We participated in two primary deals this quarter with both representing AAA-rated floating-rate SASBs. The first one, a $510 million deal collateralized by a portfolio of industrial properties launched at SOFR+150 basis points and the latter was a refinancing of a Florida mall priced at SOFR+145 basis points.

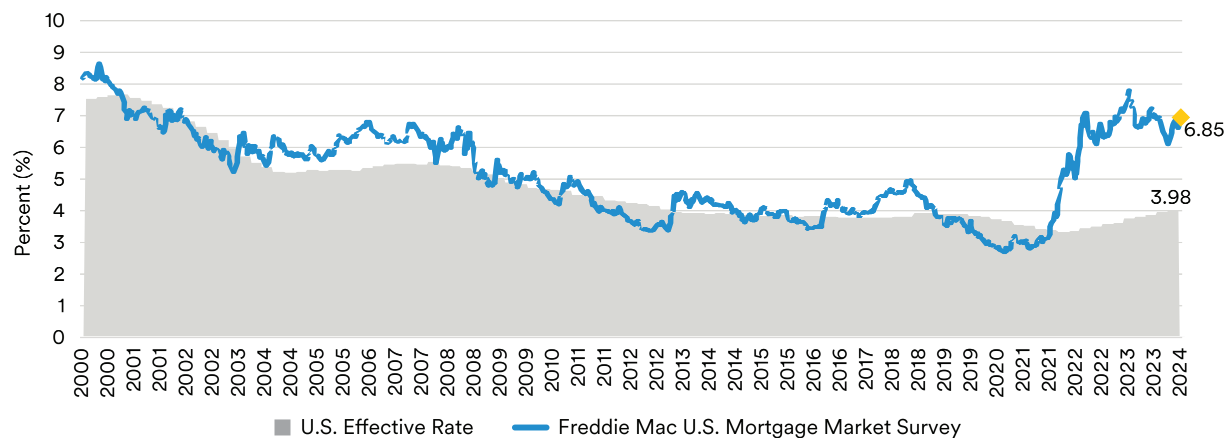
Outlook: With CMBS spreads generally tightening across the board in the fourth quarter, we expect to maintain our current portfolio weighting, only adding additional exposure if an appealing prospect presents itself. We continue to believe that the CMBS market will face headwinds for the foreseeable future and expect continued worsening collateral metrics. Although stricter return-to-office policies and a continued move lower in interest rates should help refinancing on the margin, we are not anticipating any dramatic improvement for troubled office properties.

Performance: CMBS was a top-performing sector across strategies this quarter after adjusting for duration and yield curve positioning. In general, our non-agency positions were positive, with our fixed-rate AAA-rated ASB holdings and AAA and AA-rated floating-rate SASB tranches accounting for most of the outperformance. Our agency holding excess returns, although more muted than non-agency, were also positive and mostly composed of Freddie Mac “K-bonds”.

RMBS

Recap: Residential mortgage-backed securities posted positive performance for the year but negative performance over the course of the fourth quarter due to increased volatility associated with December’s FOMC meeting, interest rates and the uncertainty surrounding policy changes from the new administration. November saw the highest returns for mortgages all year with the Bloomberg mortgage index posting a 0.56% monthly excess return, but the tide turned in December and mortgages ended the month with an excess return of -0.17%. A more hawkish dot plot for 2025 from the Fed’s December meeting caused a knee-jerk reaction sending mortgage spreads wider across the stack. Overall, generic 30-year collateral ended the quarter at a spread of 136 basis points over ten-year Treasuries (6 basis points wider) while 15-year collateral ended the quarter at a spread of 71 basis points over five-year Treasuries (5 basis points wider). Non-agency RMBS had $155 billion of issuance this year, the second-greatest volume since the GFC. This was only exceeded by 2021’s record of $206 billion. Issuance increased across all sectors, with the largest increases seen in HELOCs and closed-end second-liens. Non-agency spreads tightened over the quarter with prime borrower, front-cashflow securities ending the quarter at 160 basis points over Treasuries, 15 basis points tighter.

Outstanding Mortgage Average Rate vs. Current Rate
(as of December 26, 2024)



Source: Bloomberg

The Fed's mortgage portfolio ended the quarter at $2.23 trillion following paydowns of $15.7 billion in December, $15.6 billion in November, and $17.0 billion in October. Prepayments for the month showed 30-year Fannie Mae mortgages paying at 5.9 CPR in December, continuing the downtrend seen from 6.2 CPR in November and 8.4 CPR in October. Fifteen-year mortgages prepaid slightly faster at 6.6 CPR in December, 3% higher from the previous month. We continue to expect prepayments to drift lower over the next few months as the market adjusts to the level of mortgage rates.

With no announced nominees for various housing-related government agencies, it seems that mortgage policy is not a top priority for the incoming administration. However, a draft bill regarding GSE privatization has created some speculation among investors. It calls for the Treasury department to dispose of its senior preferred stake in the GSEs within 90 days of passage, exercise its warrants on the common stock, sell off that common stock and release the GSEs from conservatorship within two years. Fitch currently rates GSE debt with the same credit rating as the U.S. government due to the implicit guarantee, and they noted that "ending GSE conservatorship would have a direct negative rating effect on GSEs, which in turn would have an adverse impact on a substantial number of affordable housing debt ratings that have direct linkages to Fannie Mae and Freddie Mac, based on guarantees provided by these GSEs. In our view, privatization of the GSEs is unlikely in the near term as the incoming administration is likely to prioritize other matters such as immigration reform and tariff policy.

Portfolio Actions: Apart from our 1-5 year strategy, we increased our RMBS exposure this quarter. We opportunistically added exposure to several non-agency prime borrower, closed-end second-lien deals. Collateralized by full documentation, owner-occupied loans to high FICO borrowers, these deals offer attractive spreads and benefit from the positive credit fundamentals supporting the residential housing market. For our longer 1-5 year strategy, the decrease in RMBS exposure resulted from the reinvestment of mortgage paydowns into other spread sectors rather than the outright sale of our existing holdings.

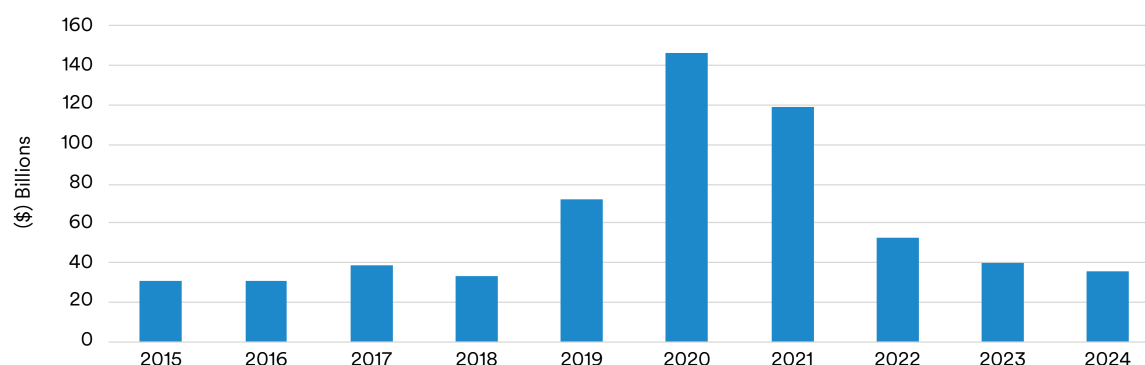
Outlook: Going forward, we expect to modestly increase our RMBS allocation across our strategies. Of course, the increase would be dependent upon mortgages trading to an attractive OAS threshold relative to other spread products. We remain predisposed to increase our exposure to second-lien deals collateralized by high FICO borrowers and owner-occupied properties. We are likely to avoid recent-vintage non-agency deals with significant exposure to investor properties due to early signs of possible worsening credit performance in that subsector. We would also likely increase portfolio exposure to agency specified pools, but at present spreads, they do not appear compelling relative to non-agencies and other spread sectors, so we are content to wait for a better entry point.

Performance: Our RMBS tranches contributed positive excess performance across strategies over the quarter after adjusting for their duration and yield curve positioning. Non-agencies were the top contributor, outperforming across all strategies. Specialized pools had muted to slightly negative performance for the quarter as they were punished by the higher levels of interest rate volatility driven mainly by the Fed.

Municipal

Recap: Total municipal new issue supply was $122 billion in the fourth quarter and as a component of total supply, taxable municipal issuance was $8.9 billion, 22% lower on a year-over-year basis for the quarter. Muted new issue supply coupled with tighter credit spreads in the front part of the municipal market yield curve resulted in positive excess returns for the sector. For the quarter, the ICE BofA 1-5 Year U.S. Taxable Municipal Securities Index had a total return of -0.41%, with its OAS tightening 11 basis points to end the quarter at 33 basis points, compared to the ICE BofA 1-5 Year U.S. Treasury Index's total return of -0.77%.

Taxable Municipal Issuance
(as of December 31, 2024)



Source: Bank of America

Credit fundamentals, as demonstrated by S&P's upgrade-to-downgrade ratio of 1.8 to 1 over the first two months of the fourth quarter, continued to be resilient. During the quarter, there were quite a few noteworthy rating upgrades across different sectors. The State of Pennsylvania was upgraded to Aa2 from Aa3 by Moody's. The rating agency's rationale for the upgrade was the State's increase in budget stabilization reserves and moderating pressure from long-term liabilities. In the Airport sector, Moody's and Fitch upgraded Greater Orlando Aviation Authority to Aa2 and AA, respectively. The agencies noted strong financial metrics which are supported by the Airport's track record for expense management, stable traffic trends, airline diversity, and capital project management. Additionally, in the Highway sector, Fitch upgraded Riverside County, CA Transportation Commission—91 Express Lanes senior debt to A from BBB+. The upgrade reflects robust traffic levels, dynamic tolling implementation, and strong debt service coverage ratios.

We continue to monitor pension funding levels that can impact state budgets with lower levels having the potential to stress balance sheets. One indicator we track is Milliman's Public Pension Funding Index, which is comprised of the 100 largest U.S. public pension plans. This index had positive momentum during the first three quarters of 2024, ending higher than the level reported for the end of 2023, which was 78.2%. The index increased to 79.9% at the end of June and then

further increased to 82.8% at the end of September due to robust investment returns. This positive momentum shifted in October as negative monthly investment returns resulted in the index declining to an estimated 81.2% at the end of the month. The index remains well below its 85.5% peak, however, reached at year-end 2021.

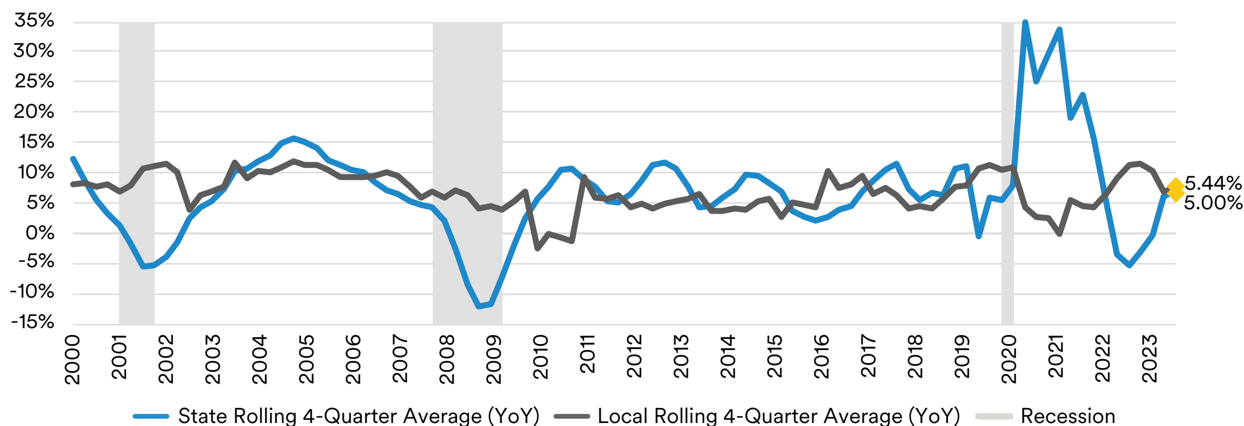
Portfolio Actions: Our allocation to taxable municipals increased in our Enhanced Cash and 1-3 year strategies and decreased in our Cash Plus and 1-5 year strategies over the fourth quarter. On the new issue front, we added to exposure in the State, Healthcare, and Local Obligation sectors. In the secondary market, we were active in adding to high-quality issuers in the Airport, Healthcare, Higher Education, Not-for-Profit, Port, and Tax-backed sectors. Regarding our sale activity, our strategy continues to focus on divesting shorter-duration bonds to capitalize on more favorable opportunities across other spread sectors where we invest.

Outlook: The National Association of State Budget Officers published their Fiscal Survey of States in December 2024. The report notes that recent trends indicate a return to a more typical budget environment for states, with limited new funding, revenue collections closely aligning with forecasts, and reserves showing modest growth in most states. This shift marks a move away from the large surpluses, record-setting revenue growth, and significant one-time expenditures experienced after the COVID-19 pandemic. Total balances, which include both rainy-day funds and general fund balances, saw a decline in fiscal 2024 and are anticipated to decrease again in fiscal 2025. This drawdown is expected, and it aligns with standard budget practices. In 2025, anticipated federal policy changes are expected to have impactful trickle-down effects on municipal issuers. Large federal budget shortfalls may force Congress to make difficult spending decisions, which could negatively affect municipalities reliant on federal funding. While many municipalities are likely to remain resilient, those heavily dependent on federal support may face increased fiscal challenges. Considering potential budget stress, we favor state and local governments that have demonstrated financial flexibility, possess diverse economies, and benefit from growing populations. Conversely, we are cautious on those states with declining revenues and tax systems susceptible to economic downturns, particularly if they carry substantial pension liabilities or other significant fixed costs. In revenue bonds, one of the sectors we continue to favor is Airports. U.S. air travel has exceeded pre-pandemic levels, with 2024 TSA throughput coming in at 108% of 2019 levels. Many of airport operator managements' forecasts made during the early stages of the pandemic showed full recovery by 2025, and enplanement growth is progressing in line with those expectations. As airports continue to recover and expand, expectations are for an increase in bond issuance to finance capital improvement projects including gate expansions, terminal renovations, parking additions, runway expansions/additions, and overall modernization efforts. Many of these projects are overdue and are needed for airports to handle additional traffic demand as well as to facilitate the larger airplanes scheduled to come into service over the next few years. After spending federal funds/grants from the pandemic (e.g., CARES Act monies) in 2024, airports have maintained their reserves which puts them in a good place in terms of financial stability as they build out and renovate their facilities. We see opportunity in the Airport sector as operators raise money in the capital markets to fund their investment plans. While the bulk of this issuance will likely be in the tax-exempt market, projects such as rental car facilities, for-profit parking structures, and certain retail space expenses will be financed with taxable bonds. Even as airports are expected to benefit from the ongoing recovery in passenger demand, they will need to navigate ongoing challenges such as labor shortages, increased costs of financing in a higher interest rate environment, and inflation-driven increases in expenses. In any case, U.S. airports function as "pass-through" entities in terms of their finances and pledge to levy fees and charges sufficient to cover expenses, including debt service. As such, we expect airports to maintain budget flexibility, supported by strong liquidity and the ability to recover debt service costs through increases in airline fees and charges.

Maintaining a defensive bias, we continue to focus on issuers and other sectors with strong or improving credit fundamentals, as well as bonds that present relative value opportunities. Given macroeconomic volatility, a shifting political landscape, and mixed economic data, we view overall spreads for taxable municipals as relatively tight compared to other spread sectors in which we invest. As a result, we remain cautious and selective in increasing our exposure to the sector.

U.S. State & Local Four Major Sources of Tax Revenue Rolling Four-Quarter Percent YoY Change

(as of December 16, 2024)



Source: U.S. Census Bureau

Performance: Our taxable municipal holdings generated positive performance across our strategies in the fourth quarter. On an excess return basis, positive excess returns were generated by Highway, Not-for-Profit, and State and Local Tax-backed issues. In addition, excess returns were positive overall in our allocation to the Airport sector, however one holding marginally detracted from this outperformance.

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