July 2024

5 Events That Caught Our Attention – 1H 2024

5 Events That We Are Watching – 2H 2024

Welcome To The 5x5

Introduction – Written by Gibson Smith

For those new to this publication, it is produced when we identify market themes that are highly debated by the team that we feel are worth sharing. It also highlights our areas of focus. We have structured this as five things we learned over the most recent period and five things we will focus on going forward as an investment team. This ad hoc publication aims to bring our clients closer to our investment process while also encouraging engagement to delve deeper into these topics with us, if interested. You may find that we utilize these themes to engage in larger or more in-depth write-ups in the future.

MARKET OVERVIEW:

Before diving into the piece, let's start with an overview of where we stand on different market segments:

- **US Treasuries:** Positive and long-duration bias.
    - **Yield Curve:** Favor barbell positioning to take advantage of bull steepening. But we recognize this may change as we get new information.
- **Agency MBS:** Positive and neutral duration bias.
- **Investment Grade Credit:** Neutral to negative with a short-duration bias.
    - **Short Credit:** Positive.
    - **Intermediate Credit:** Neutral.
    - **Long Credit:** Negative.
- **High Yield Credit:** Neutral with a bias away from low-quality/high-beta.
    - **Short Duration HY:** Positive.
- **Leverage Loans:** Positive with a bias toward security selection.
- **Preferreds:** Neutral.

We believe that we are in the later stages of the cycle where, security selection and security avoidance will be critical drivers in generating outperformance. We are spending a good amount of time focused on the yield curve and expectations around changes in the shape of the curve. We also see liquidity as an important and dominant theme in portfolios as we believe we are headed into a period of heightened volatility and uncertainty. Our defensive positioning should allow us to take advantage of the volatility.

Entering 2024: We entered 2024 with many themes at play; the most important of which was the dynamic of the Fed ending its tightening campaign and moving into a position of easing. The 2-year U.S. Treasury, a good proxy for expectations around monetary policy, has been in a range of 4.15% to 5.00% yield—yields largely below that of the target fed funds rate. Zach highlights this in his comments about the wild swings in sentiment regarding the Fed and where the economy is headed. I tend to think this volatility will be with us for a while. There is little doubt the Fed is in play headed into the back half of the year.

Washington's Fiscal Policy: Another significant theme focused on how markets would react to the ongoing (non-party-dependent) spending and borrowing policy in Washington. The lack of fiscal discipline raises concerns that both parties have embraced Stephanie Kelton's MMT mindset and abandoning traditional economic theory and practice. Niall Ferguson has warned that any great power that spends more on debt service than on defense will not stay great for long. Lindsay highlights this in her thoughts on Washington and the upcoming elections, noting a bigger risk for markets than many are acknowledging. The recent assassination attempt of Trump and President Biden stepping aside makes the election an even greater focus and promises to bring greater volatility to the forefront.

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Credit Market Debates: The ongoing debate of spreads vs. yields in credit continues to be a key theme. Jonathan and Jake shed light on the fundamentals and historical context of valuations – absolute yields are interesting, but spreads are near historical tights. A defensive posture makes sense based on their work. Garrett and Bryan provide similar insights on the high yield and leveraged loan markets and add a non-consensus view on loans. This aligns with our belief that the Fed did not have to ease aggressively this year. Owning loans has been rewarded to date. Whether high yield or investment grade, this period amplifies the importance of security selection and security avoidance. In our view, higher quality businesses with less drawdown risk will serve investors well as uncertainty proves to be more powerful than complacency. Our analyst team is focused on sector themes and outcomes, seeking individual opportunities in the late cycle stages of the credit markets.

Private Credit Markets: We do not comment on the private credit markets in this piece, but there has been significant discussion in our meetings. The market "that can do no wrong" and is showing growth rates that might just make some semiconductor companies envious is not our primary focus. I frequently remind the team and our investors that credit, public or private, is still credit. Impairments, defaults, restructurings, and recovery values are part of the business. To think that private credit is immune to these events is naive. I also remind investors that liquidity premiums can be a great source of reward at certain points in the cycle but a source of great pain in others. Don't ignore where that extra yield is coming from.

Agency Mortgages: We have strongly debated what I would call 'the great consensus trade that has not worked—agency mortgages.' As of this writing, agency MBS has underperformed almost every segment of the investment-grade market YTD. What seemed like reasonable valuations compared to high-quality credit at the beginning of the year has not resulted in the expected outcomes. This might be a timing issue, but the waiting and patience required have pressed on many investors. Eric goes into his thoughts in this piece and has me questioning if owning more U.S. Treasuries is optimal in the back half of this year—more on this in future discussions.

Inflation: Could you imagine us releasing something out that didn't touch on inflation? Inflation has been a central theme in our discussions and debates year-to-date. The debate centers around ongoing disinflation or a reacceleration over time. The reality is that we are likely settling around a higher terminal level than the Federal Reserve's 2% target, but below levels that would cause significant concern. The recent weakness in the labor markets, anchored inflation expectations (albeit above the 2% target), and some growing concerns around growth prospects 12-18 months out might result in proactive easing from the Fed. This is not our belief, as the consumer has been very resilient and corporations continue to hire and invest, but like the Fed, we remain very data-dependent and will adjust portfolios to reflect our evolving view. With little doubt, the proverbial 'Fed Put' is back in play, and the markets are overly comfortable with the fact that rough waters ahead will be greeted with friendly monetary policy. I'd add that the consensus believes that if things got really rocky, the Fed will come to the rescue with aggressive easing. Markus looks at the landscape through year-end and highlights the market's obsession with the Fed.

INTRODUCTION

Risks: Economic Direction: The big risks that keep me up at night are related to the direction of the economy. A significant slowdown or a strong re-acceleration of growth could trigger significant volatility in the near term. The loose financial conditions today, fueled by higher stock prices and tighter credit spreads, have most comfortable with the growth outlook. However, these conditions could change suddenly and create an outcome where the market is no longer doing the work for the Fed. It could be that significant changes in valuations are the trigger for the Fed. It seems Powell is getting a little nervous that the aggressive positive real rates in the front-end will ultimately serve their desired slowing, possibly pushing things a little too hard. Time will tell. We are watching closely. With this in mind, it is very clear that the Fed's focus has turned from inflation to labor.

Washington and Society: The current state of Washington and its impact on our society is another big concern of mine. The media wants us to believe there is great polarization in society today, but the reality is that most of the nation is wrapped around the center. Certain politicians drive polarization as they have figured out that the polarized ends of the spectrum have voters who can keep them in power. This is a sad state. Government has become more complicated and will be a source of volatility in the near future.

American Pride: I recently read a Gallup poll (I am generally skeptical of polls these days) that highlighted that only 41% of adults are "extremely proud" to be Americans—a 28% decline since 2004.[1] The article described different stats associated with the poll, including levels of pride and views by different parties. This grabbed my attention and made me terribly sad. How can anyone lose perspective on how great this country is? How lucky we are to be a part of this incredible country and how fortunate we are to be active participants in its greatness—freedom, democracy, capitalism, and the social care and kindness that come from most in society? I believe the decline in American pride speaks loudly to the decay in leadership in Washington. This is not just about Trump or Biden (or who will follow him), this is about broad-based leadership. The lack of trust and faith in leadership raises a myriad of social issues. I see this as a key risk factor as we head into the back half of this year. With the election at hand and all the uncertainties that have been raised, I am growing concerned about what could play out. Social issues will be a bigger risk factor for markets and something we will have to pay close attention to.[2]

Thank you for taking the time to read our thoughts and thank you for your partnership. We work in difficult markets and challenging times. With uncertainty we see opportunity. In all, we find ourselves grateful for this opportunity and proud to be part of this incredible country.

Thank you for all you do for Smith Capital Investors.

- **Gibson**

1.) Gallup poll, as of July 2nd, 2024. Link: https://news.gallup.com/poll/646655/american-pride-remains-near-record-low.aspx.
2.) This was written prior to the failed assassination of former President Trump and President Biden stepping out of the current presidential race. I am even more concerned today about the social issues and how they will impact society and markets.

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5 Events That Caught Our Attention – 1H 2024

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1 Swimming Against the Rate Cut Tide – Leveraged Loans

Written by Garrett Olson

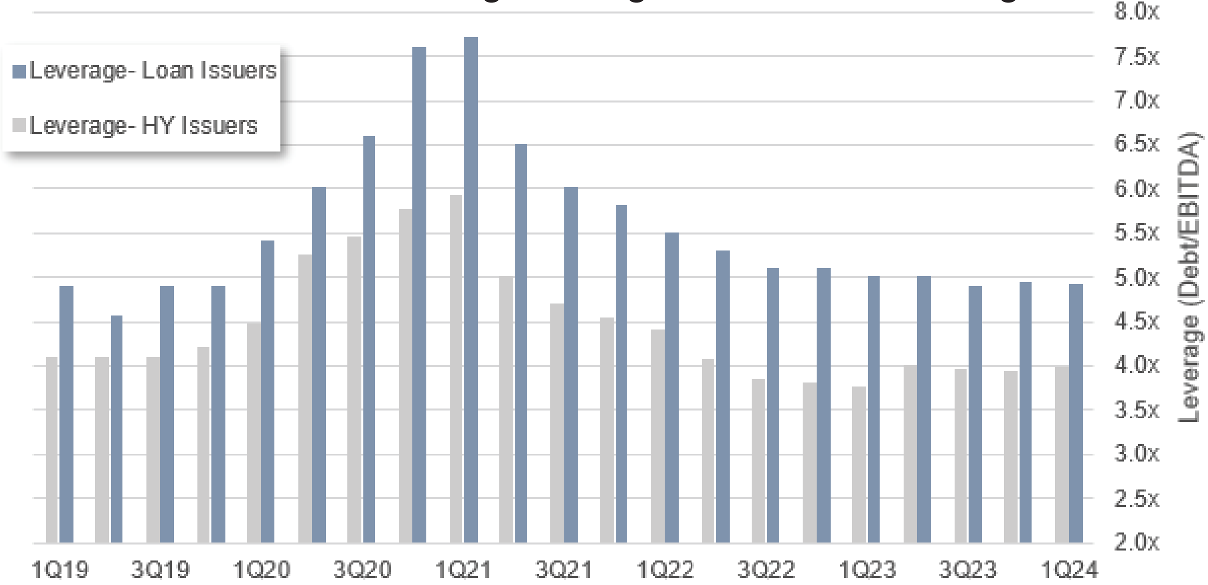
BOTTOM LINE: Leveraged loans outperformed most other credit instruments in the first half of the year, with the JPM Leveraged Loan Index returning +4.62% through 6/28/24 (Bloomberg US Corporate High Yield Index +2.58%). This strong performance has led to an increase in repricing and refinancing activity, with 2Q24 marking the most active quarter on record for gross loan issuance. This repricing wave has created pressure on loan margins/yields as well as secondary dollar prices. That said, while the opportunity set has diminished from earlier in the year, we still believe that bottom-up fundamental analysis can identify loans with attractive risk vs. return characteristics going into the back half of the year.

Keeping in line with our core focus on sector rotation, we kick off each week with a top-down discussion of asset classes and industries — fundamentals, technicals, valuation, and more. Starting in Q4 2023 and continuing into the first half of this year, this meeting focused our attention on the relative value divergence vs. historical averages between leveraged loans and high yield bonds. Pivoting to security selection, we subsequently identified what we believed were mispriced risk-adjusted return opportunities in leveraged loans, highlighted in "Moving on Up (In the Capital Structure)" 3/18/24.

- Historically, leveraged loans were viewed as less risky than high yield bonds due to their secured nature and thus, yields on loans were generally less than those on bonds. In recent years, this historical relationship broke down, with leveraged loan yields exceeding those available on high yield bonds by hundreds of basis points. The primary driver of this divergence was likely the deterioration of leveraged loan market fundamentals relative to the high yield market after years of rapid expansion. The average leveraged loan issuer is now smaller and more highly leveraged than the average high yield bond issuer, with lower interest coverage and a lower average credit rating. Nowhere is this trend more apparent than when comparing ratings actions and default rates between leveraged loans and high yield bonds. Year-to-date, the ratio of credit rating upgrades to downgrades by volume stands at 0.6x for leveraged loans and has been below 1x since 2022, indicating broad deterioration in ratings.[1] As a result, the percentage of leveraged loans rated B- or lower is close to 30%, near historic highs.[2] In contrast, the year-to-date ratio of upgrades to downgrades stands at 1.4x for high yield bonds and has been above 1x since 2021.[3] The up tiering of credit quality can be seen in the percentage of high yield bonds rated BB, which has declined off record highs following elevated rising star volumes, but at 48% remains 800bps above the long-term average.[4] Finally, the divergence in underlying fundamentals can be seen when looking at relative default rates. Including distressed exchanges, the LTM leveraged loan and high yield default rates are 3.10% and 1.79%, respectively. While default rates across both sectors are at or below historical averages, the relative gap between the default rates is the highest observed since November 2014.[5]

Sources: 1.) J.P. Morgan; Moody's Investors Service; S&P (7/12/2024). Note: Global Numbers. 2.) J.P. Morgan (5/20/2024). 3.) J.P. Morgan; Moody's Investors Service; S&P (7/12/2024). Note: US Only. 4.) J.P. Morgan (5/30/2024). 5.) J.P. Morgan, North America Credit Research (7/1/2024).

Loan Issuer Leverage vs. High Yield Issuer Leverage



Source: Smith Capital Investors, J.P. Morgan Research (6/1/2024).

- In addition to a divergence in underlying fundamentals, we felt that the elevated yield offered in leveraged loans was due in part to the market expecting the Fed to be active in cutting rates. Rate cuts would have the impact of reducing future coupons on floating rate credit instruments tied to a benchmark interest rate which could lead to underperformance vs. fixed coupon bonds.

- We believed that rate cuts were overpriced by the market and thus loans had the potential to outperform in a “higher for longer” scenario. Furthermore, through bottom-up fundamental analysis we were able to identify situations where the first lien loan significantly out-yielded pari-passu fixed instruments and even subordinated bonds by a significant margin.

Leverage Loan Yield vs. High Yield Index Yield To Worst

Source: Smith Capital Investors, Bloomberg (7/9/2024).
**High Yield YTW = Bloomberg US Corporate High Yield Total Return Index Value Unhedged USD (LF98TRUU index) Yield To Worst*
**Leverage Loan Yield – SPDR Blackstone Senior Loan ETF Class USD INC (U.S.) (SRLN US Index) Dividend Yield*

2 Remain Positive On The Consumer But Starting To See Divergences

Written by Lindsay Bernum

BOTTOM LINE: We are still constructive on the consumer but recognize that the path forward is uneven. As long as jobs remain available, lower-income tiers will maintain pre-pandemic spending levels. The higher income tiers will continue to be supported for some time by higher asset prices. Additionally, we feel any rate cut adjustment will provide looser financial conditions and not only support consumers via lower financing but also fixed income markets via Treasuries rallying.

The consumer has been the pillar of strength in the prolonged economic expansion. Job availability, wage growth, and strong personal balance sheets have elevated consumers. Financial ingenuity and fiscal stimulus throughout the pandemic and recovery plus overall loose financial conditions fostered an environment conducive to consumer spending. At this point in the cycle, we are starting to see divergences between income tiers and expect a general slowing of future consumption. That being said, the strong foundation suggests we return to pre-pandemic levels as opposed to a dramatic falloff.

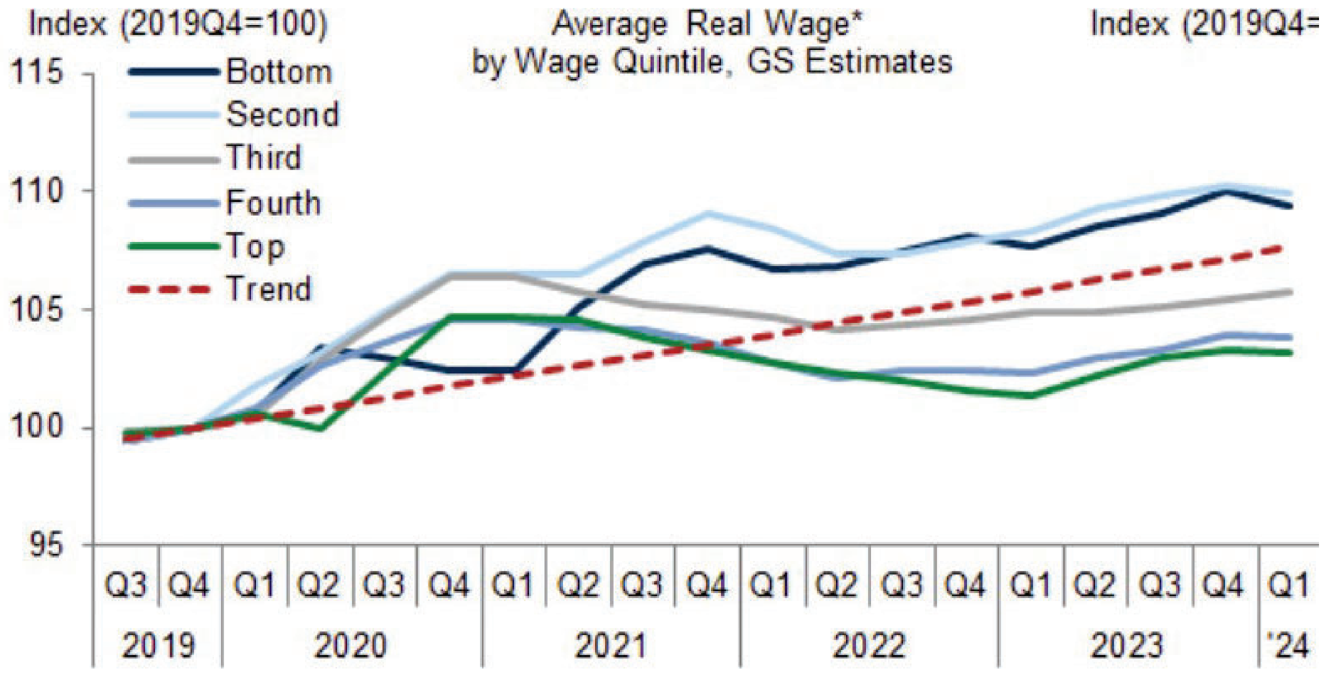
- Lower-income tiers saw the benefit of strong wage gains throughout the pandemic and recovery but have recently faced challenges due to rising financing costs. Higher-income tiers saw the opposite, smaller wage gains but larger gains from asset appreciation and interest income.

- The labor market, having softened from post-COVID strength, now sees job openings per unemployed worker back to 2019 levels at 1.2. Jobless claims and unemployment remain low but are gradually increasing. Wage growth has been robust but is showing signs of easing on the margin. Cyclical sectors have lagged in job gains, with strength concentrated in education/health, leisure/hospitality, and government sectors. Recent headline NFP and revisions have been more volatile, but generally indicate a healthy labor market that is softening but not necessarily declining.

- Consumer spending remained resilient on the back of a strong labor market, excess savings and asset appreciation. As we return to pre-pandemic levels, excess liquidity is dwindling, but job availability and access to multiple forms of credit allow for continued spending among lower-income tiers. Credit card delinquencies have started to breach pre-pandemic levels. In our view, subprime and lower-income borrowers are showing signs of weakness, having exhausted excess savings, impacting consumer spending data. On the other hand, higher-income tiers continue to benefit from asset appreciation, increasing overall wealth, and are expected to sustain average spending.

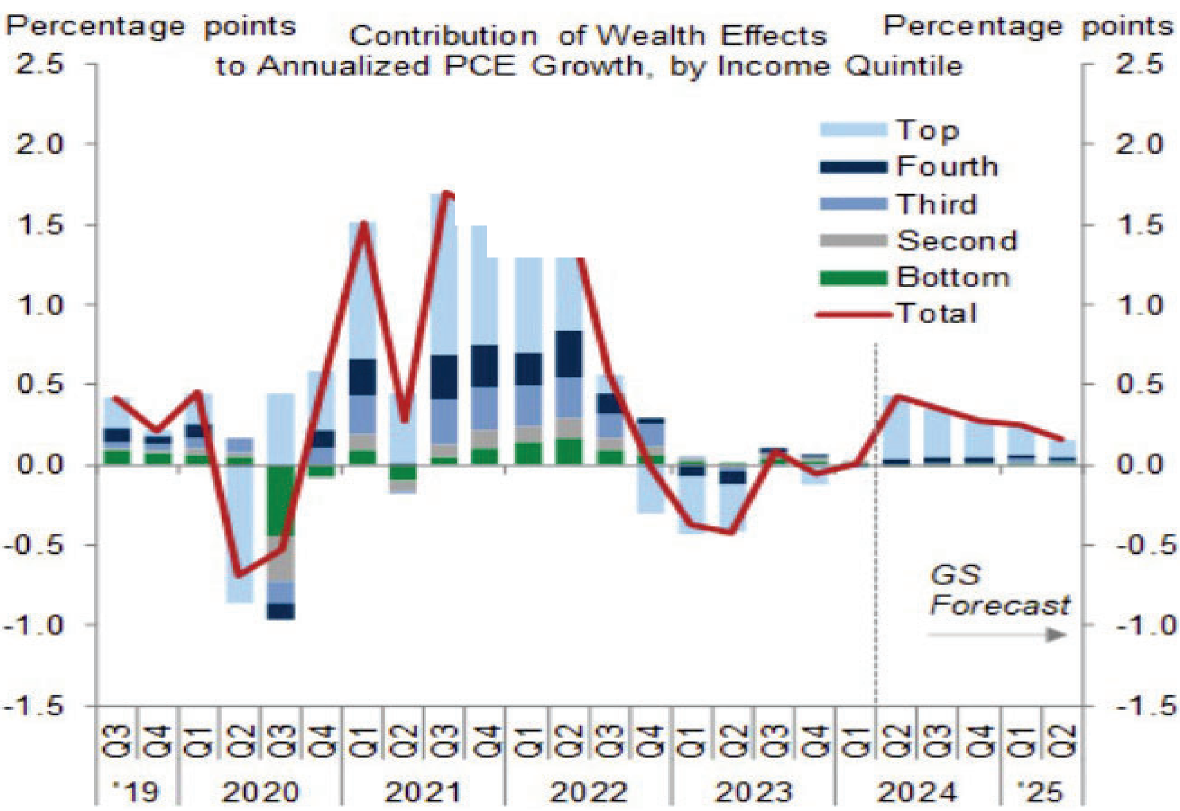
- The post-COVID recovery period differs from past recoveries, yet consumer balance sheets generically remain strong. As the recovery eventually slows and the Fed begins a rate cutting cycle, the consumer will benefit from loosening financial conditions, providing further stimulus. Fixed Income markets will also be the beneficiary of rate cuts in this environment.

Real Wages Are Modestly Above The Pre-pandemic Trend For The Bottom Two Wage Quintiles And Modestly Below Trend For The Top Three



Source: Goldman Sachs US Economic Analyst (6/24/2024).
**Based on detailed industries in the establishment survey. Composition adjusted in 2020. Trend is 1.75% per year.*

We Expect Recent Increases In Equity Prices To Provide A Modest Boost To Consumption This Year, Concentrated At Top Of The Income Distribution Where Equity Holdings Are Highest



Source: Goldman Sachs US Economic Analyst (6/24/2024).

3 Credit Spreads vs. Yields - A Fixed Income Circus Act

Written by Jake Jones

BOTTOM LINE: Effectively juggling compressed risk valuations with the opportunity to capture higher current yields will be central to forward returns. Accordingly, the largest driver for excess and total returns over the next 12 months is likely defensive, durable carry. We focus our attention on finding opportunities to move up in credit quality with little to no give in yield profiles, to set a cornerstone for future potential outperformance.

Desirable yields, yet compressed spread valuations give rise to a balancing act unique to fixed income markets, weighing attractive carry against historically slim compensation for credit risk. Simply put, the compensation for credit risk constitutes only 17% of the Investment Grade Credit Index's current yield. This highlights the limited consideration credit risk is for the marketplace (see chart below) and parallels the "growth at any cost" narrative often experienced in equity markets in times of extreme multiples, which is often a prelude to a correction in risk valuations. Within the fixed income universe, the higher rate environment has adopted a "yield at any cost" mindset. Although this may not be indicative of a near-term sell-off, at Smith Capital Investors, we recognize the limited room for error in credit spreads, while being cognizant of the current rate environment. Our focus remains on selecting fundamentally strong credit stories that will perform well in a weaker macro environment with durable yield profiles.

- Investment grade and high yield spreads are tight relative to historical valuations. The IG credit index currently sits at +89 OAS, within the 8th percentile when looking back 10 years. Meanwhile, the high yield index sits at +309 OAS, inside of the 10th percentile.

- As of July 2024, Investors are rewarded less for assumed incremental credit risk, best reflected in the spread discrepancies between ratings buckets. For example, BBs are trading only +66bps back of BBBs, which is within the 3rd percentile over the past 10 years. The same can be said about the relationship between BBBs and As, trading within the 2nd percentile over the same period.

- Not only do investors get compensated less for credit risk compared to past years, but the same is true for duration risk. Like the current inversion of the yield curve, the IG long duration to intermediate spread curve currently sits at +30bps, inside of the 10th percentile on a 10-year basis.

- Antithetical to spreads, yields are attractive given the current underlying rate environment, with IG yield to worst in the 93rd percentile over the past 10 years.

- Despite landing at very different ends of the valuation spectrum (12th and 73rd percentiles over the 20 years for IG OAS and YTW, respectively), both absolute OAS and YTW profiles are similar to where they were in the 2004-2007 period of high yields and low spreads. Incidentally, spread as a percentage of yield on the IG index has now entered this unique territory for the first time since then. Our attention thus narrows onto this past period of low and stable spreads, which we cautiously do not rule out as a possibility going forward.

IG Index Credit Risk Represented As Percentage of IG Index Yield To Worst

Source: Smith Capital Investors, Bloomberg (7/1/2024).

4 Who Knows: The Market or The Fed?

Written by Zach Tucker

BOTTOM LINE: With no clear economic indicators pointing to the “all clear” for a rate cut, at what point does predicting the path of interest rate cuts become recognizably futile? Perhaps what the Fed is training investors to think about is the value of being nimble over the value of predicting an outcome.

We entered 2024 still debating the adjective describing the type of “landing” for the economy – soft landing, hard landing… even “no landing” made its way into the argument. Nevertheless, a love letter from the market to the Fed held the singular request for a soft landing aided primarily with a spate of rate cuts on the back of an anticipated slowing of inflation and a tempering job market. That was the market’s assumption and market-implied rate cuts stood around six for 2024. Perhaps the Fed had prescribed a different course internally, but there was no overall aggressive pushback to market pricing externally that the market was able to hear.

- The chatter from strategists and economists at the end of 2023 focused on the cadence of Fed cuts in the coming year. Some of the more used lines were “a cut at every meeting starting in March” and “a cut at every other meeting”.

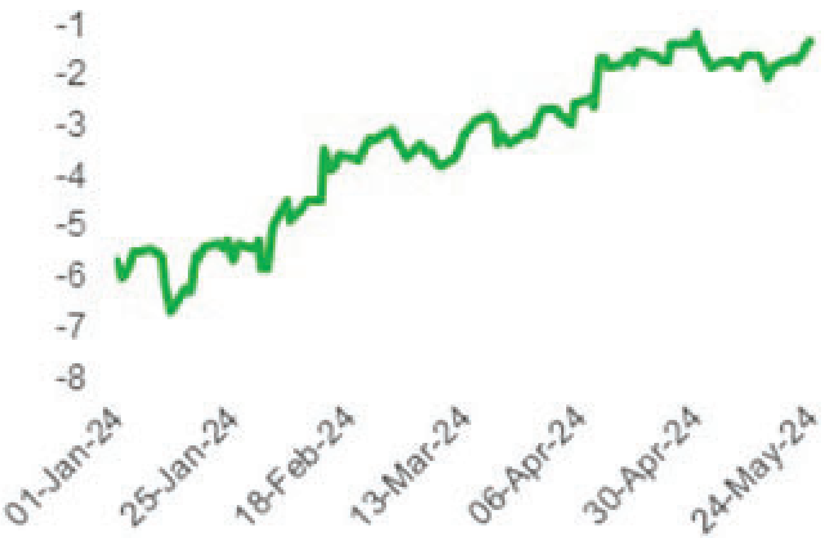
- As we close the first half of 2024, the current market-implied cut amount stands at roughly 2 for the rest of 2024 (and none having occurred so far), with the first one not being fully priced in until the September meeting.

- This drastic departure from implied vs. realized rate path has had profound effects on related markets as well as the shape of the rate curve. The 2y-10yr spread started 2024 at -37 (inverted) and has since bounced in the range of -16 and -51.

- Both the “steepness” of the curve as well as the overall level of expected interest rates are inputs to corporate and investor models that have had to be constantly adjusted as this year has progressed.

Additionally, we believe that the push-pull of the market vs. the Fed created volatility in both the shape of the curve as well as the overall level of interest rates, creating an environment that can reward active managers that look for portfolio optionality in multiple outcomes across fixed income sectors.

Rates Market Implied # of Rate Hikes in 2024



Source: Bloomberg, TD Securities (5/24/2024).

5 The Real Value of Tighter Monetary Policy—A Landscape of Changed Liquidity Profiles and Asset and Liability Sensitivities

Written by Jonathan Aal

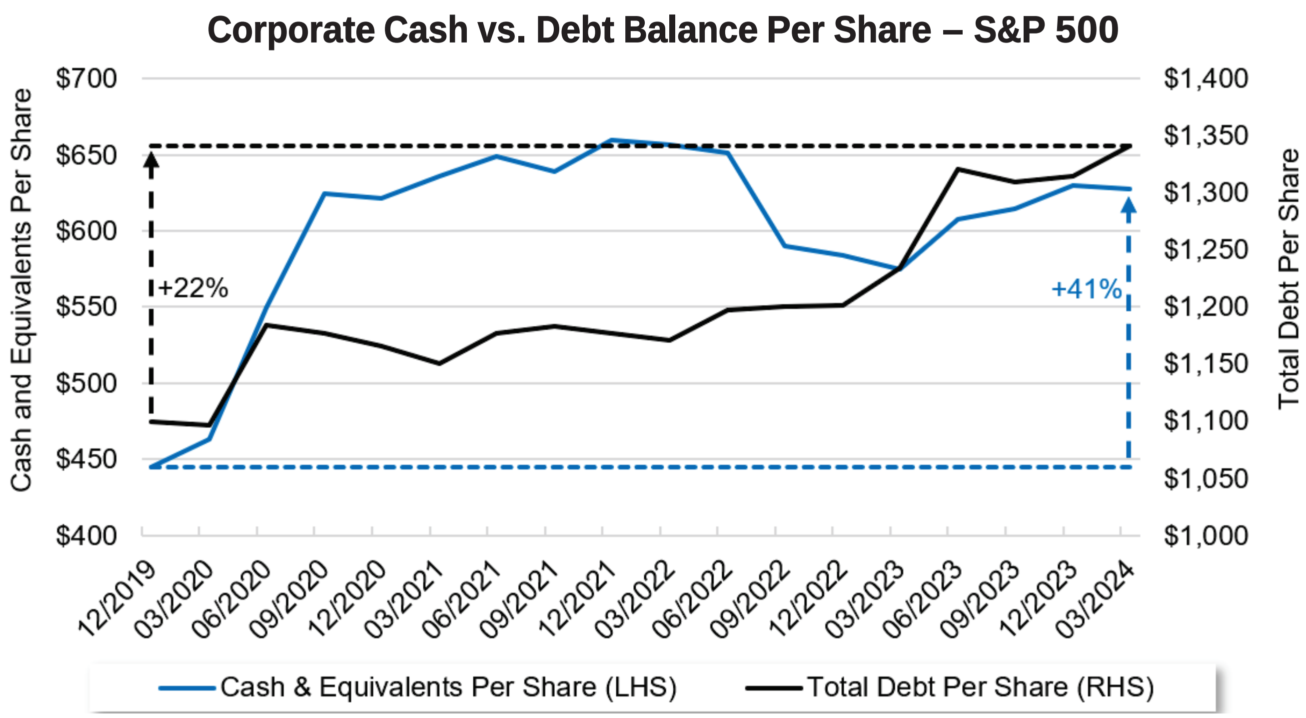
BOTTOM LINE: The real value of over 500bps of higher interest rates was significantly dampened by the ebbing and flowing landscape of changing liquidity profiles and corporate and consumer interest rate sensitivities. We find this crucial in building our portfolio mosaic and this conclusion reinforces our view that durable carry profiles in credit markets and active, nimble duration management allow us to build better portfolios.

Since the Fed's last hike in 2023, we have been asking ourselves, what is the net influence of 500+ bps of hikes? Graphically and historically, it has been a rate policy adjustment period for the record books. One without previous historical guideposts.

In the US, we have characterized this period by higher amounts of liquidity and changing asset and liability sensitivities to interest rates for both US corporates and consumers compared to previous decades.

Corporate Cash vs. Debt Balances—Interest income has grown at a quicker pace than interest payments:

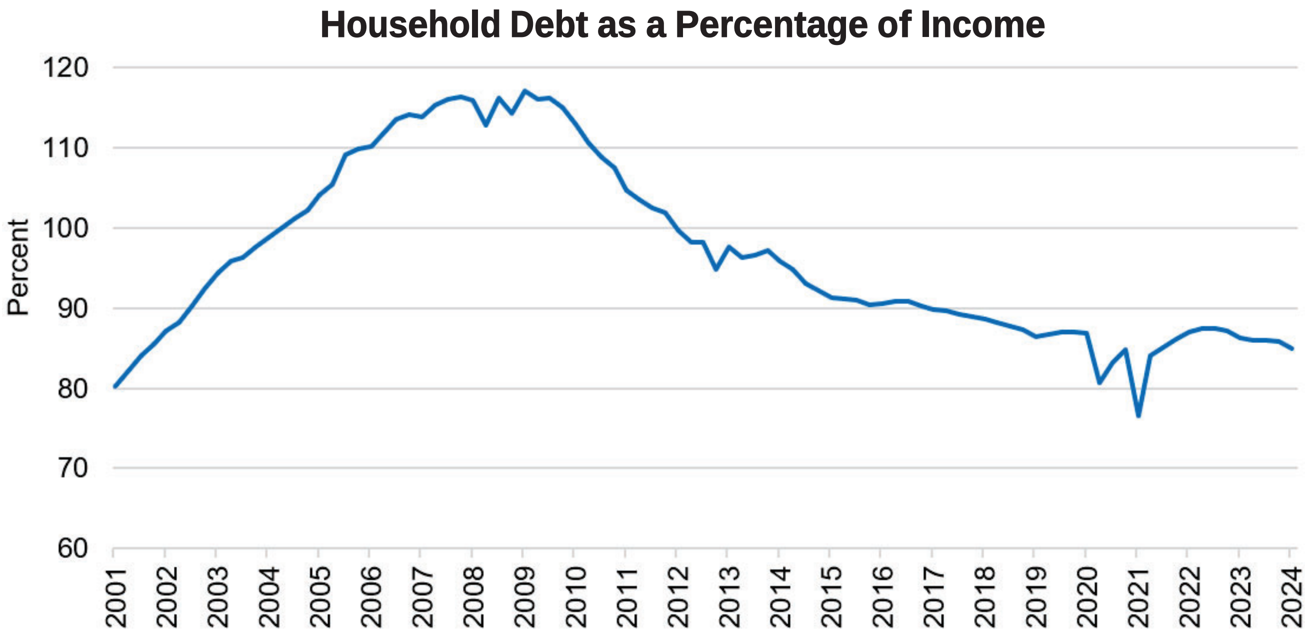
- Increased asset sensitivity (and liability insensitivity) to higher interest rates can be emphasized by decreasing net interest payments from 2019 levels for non-financial US corporates. This trend is heavily influenced by the US market disposition towards fixed-rate capital structures, and importantly the pace of cash balances (+41%) increasing faster than debt balances (+22%) over the same period.



Source: Smith Capital Investors, Bloomberg (7/8/2024).

Consumer – Deleveraging and less sensitive to higher interest rates than past periods:

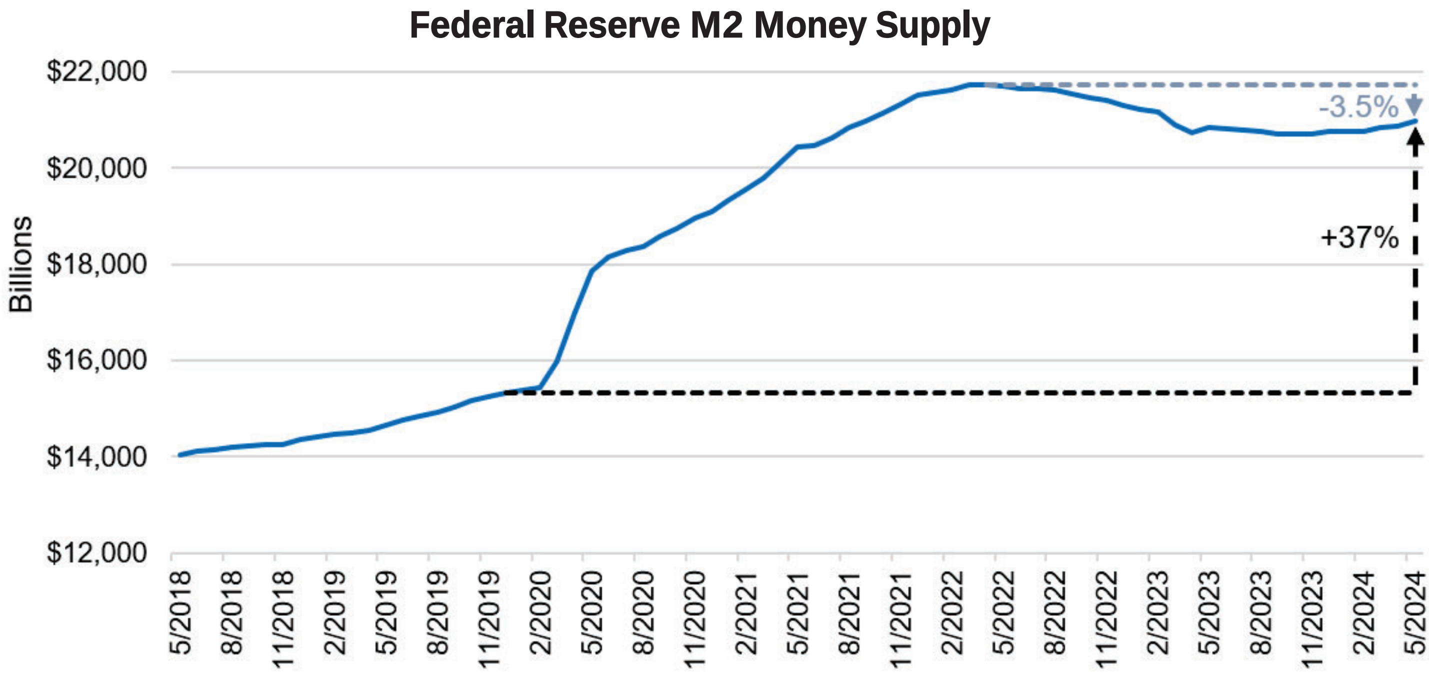
- Household debt as a percentage of personal income has steadily decreased from its peak in 2009 and is now below pre-pandemic 2019 levels. Household debt as a share of net worth has similarly trended on a deleveraging course and is now at levels not seen since the 1970s and '80s. While housing, an important component of household wealth, is typically levered to interest rates, home prices have been particularly buoyant in this cycle, contributing to consumers' reduced sensitivity to higher interest rates compared to previous periods.



Source: Smith Capital Investors, Bloomberg (7/8/2024).

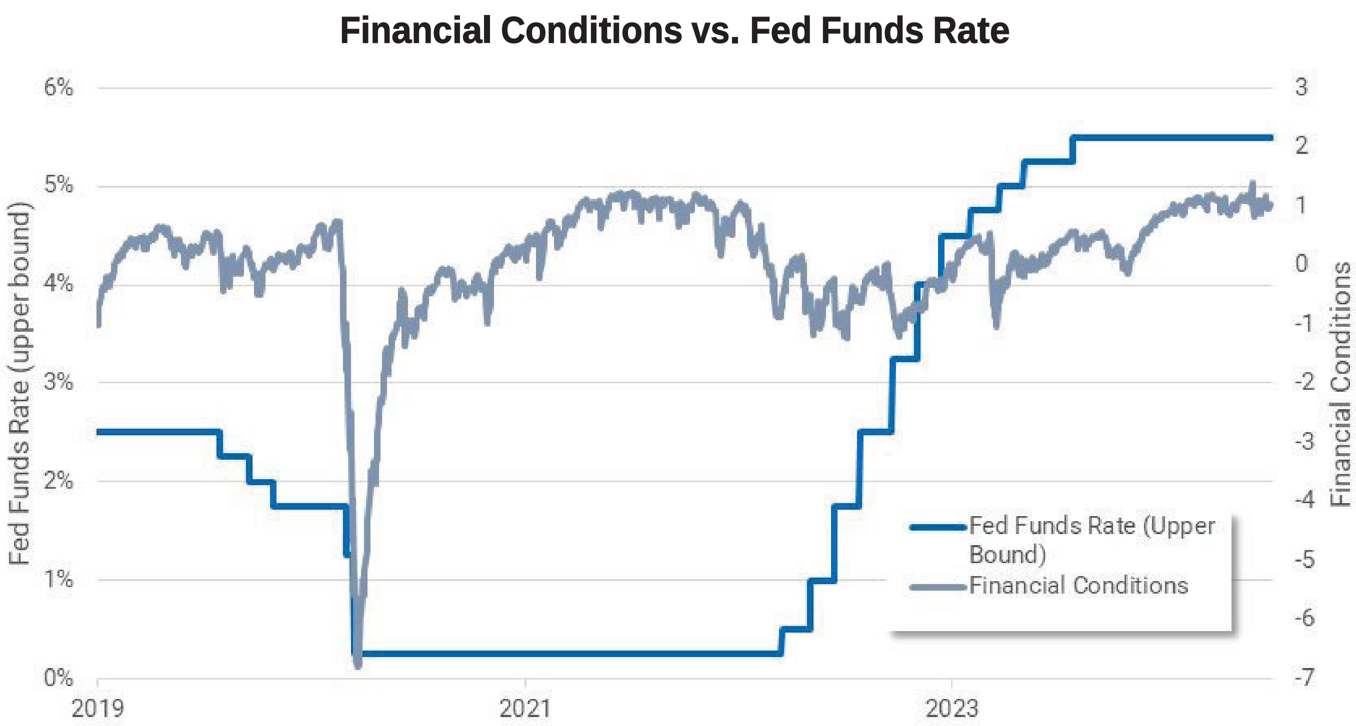
- Consumer Lock-In—Consumers are reluctant to sell their homes, preserving low mortgage rates that are likely fixed for decades. This dynamic has materially contributed to a reduction in the consumer's liability sensitivity to higher interest rates.

Amidst this changing landscape, we would be remiss not to mention the Fed's balance sheet and our country's fiscal deficits as important contributing factors. Notably, a portion of this dynamic money supply (M2) has decreased only 3.5% from its peak in 2022, still up 37% from the end of 2019, and is now starting to grow again (as of July 2024).



Source: Smith Capital Investors, Bloomberg (7/8/2024).

To further complicate matters, the Fed's next move is likely a cut and a tempering of its balance sheet reduction. Furthermore, it is likely, no Presidential candidate will have qualms with spending taxpayer dollars. Bringing this all together into one graphic, we find examining financial conditions to be quite informative: they are looser now than when the Fed began tightening in 2022. Currently, we are soaring around the post-pandemic 2021 highs when, remarkably, interest rates were zero.



Source: Smith Capital Investors, Bloomberg (7/8/2024).

1 Political Theater Is High - Election Chaos Continues

Written by Lindsay Bernum

BOTTOM LINE: Will any Presidential candidate show us that fiscal restraint is top of mind? Regardless of who wins the Presidency, the numbers mentioned below must be addressed, and fiscal restraint will be critical when our future growth outlooks are diminishing and we need fiscal capacity to prepare for a future economic slowdown. A sweep by either party, but specifically Republicans, would quickly change market sentiment in the rates market.

The 2024 election season is not for the faint of heart. In two weeks, we've moved from an assassination attempt on Trump to Biden withdrawing from the race and endorsing Kamala Harris. The immediate support behind Trump and the potential for a Republican sweep saw the US Treasury curve steepen. While the Democratic base is now trying to unify around Harris and that renewed energy saw the curve flatten in US Treasuries. Ahead of Biden's withdrawal, the polls favored Trump/Vance (and a Republican sweep); the landscape is now shifting, and the market volatility will remain high. At this point, Harris still needs to get enough delegates to become the Democratic nominee, but as of this writing, she looks to have the support. There is a lot of ground to cover between now and the election, and the political theater will remain high. However, the winner will not change the facts: our deficits are unsustainable, our debt is only increasing, and we cannot grow our way out of it.

UPCOMING TIMELINES:

- August 5: Democratic virtual vote to nominate Harris
- August 19-22: Democratic National Convention/VP announced
- August 23: Democratic nomination
- September 10: Potential debate
- November 5: Election Day
- January 2, 2025: Federal debt limit reinstated – extraordinary measures likely through summer
- December 31, 2025: Expiration of TCJA individual tax cuts and ObamaCare subsidies

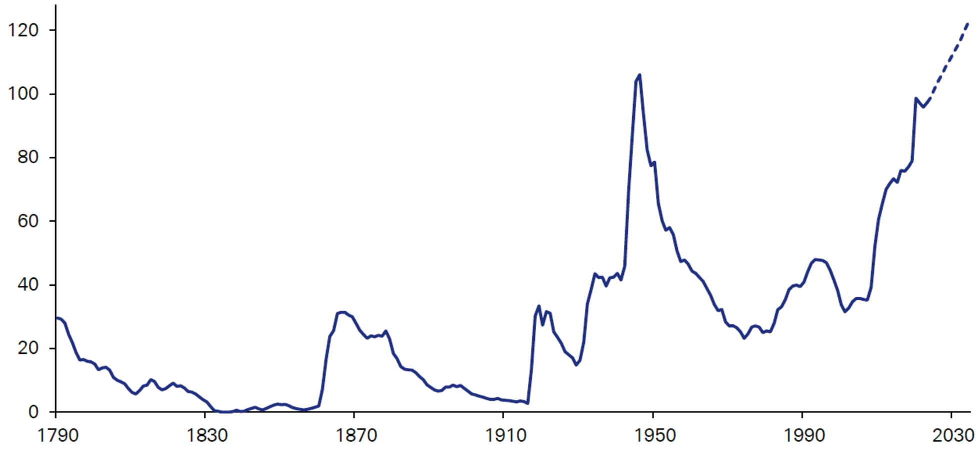
CURRENT FISCAL BACKDROP:

Stepping back from the political noise and drama surrounding the election, a common theme has emerged (under both Biden and previous Trump administrations) that reveals an unhealthy disregard for fiscal financial literacy. Both parties have significantly expanded federal deficits regardless of the broader economic landscape, with no intention to reverse course and address growing financial burdens for the U.S. According to the CBO's projections, the FY2024 deficit is expected to be nearly $2 trillion, or 6.9% of GDP, with continuous expansion to $2.8 trillion over the next 10 years. The current deficit in relation to GDP compares to an average of just 3.7% over the past 50 years. The rapid increase in rates by the Federal Reserve, along with expectations of maintaining a tighter monetary policy stance for longer, contribute to CBO projections that net interest payments alone will grow to 4.1% of GDP, and about one-sixth of all federal spending. Regardless of who wins the 2024 election, it is unlikely that these trends will reverse course.

Despite the long-term negligence toward deficit spending, markets will be preoccupied with the perceived shorter-term consequences of a potential winner. Current polling indicates that Trump is leading the race to the White House, and markets are already preparing for what this could mean for 2025 and beyond. Under the Trump administration, policies are expected to gear towards growth, with tax and rate cuts to spur economic activity and bolster consumers and businesses. A Democratic administration (formerly Biden/likely Harris) would likely lean towards continued government spending financed by higher taxes on corporations and wealthier individuals. Neither of these strategies would make material progress on reducing deficit spending, leaving a concurrently weak balance sheet at greater risk in the future.

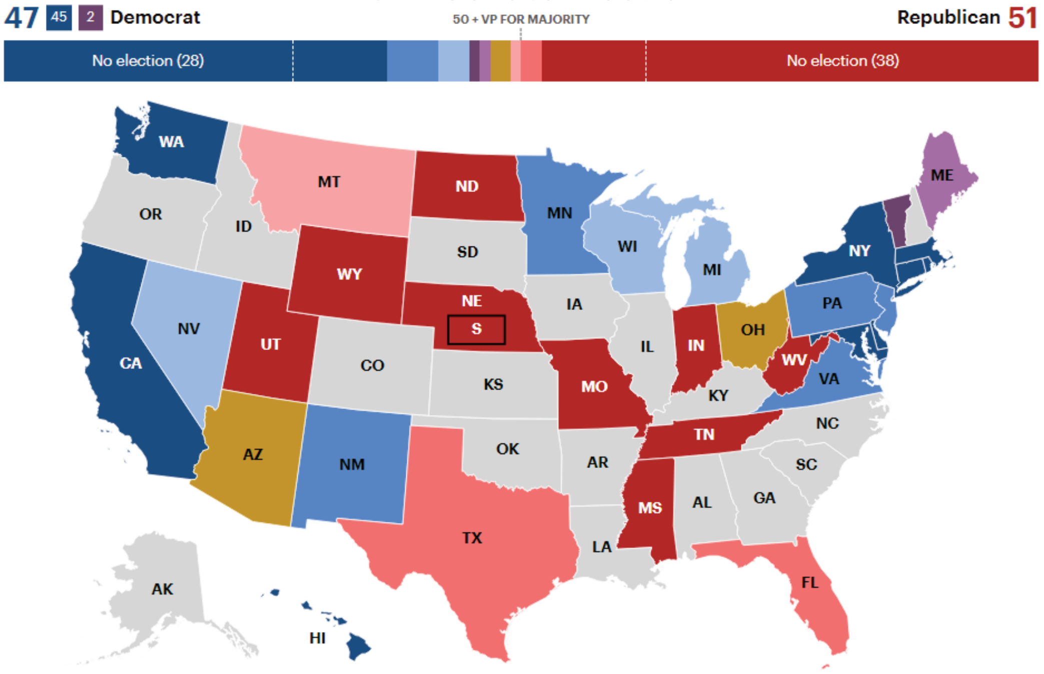
A single-party sweep would allow for the reconciliation process to return (a majority vote to enact legislation on taxes, spending, and the debt limit), likely amplifying market positioning. Gridlock from a split government typically incites market volatility due to the level of difficulty in enacting policy. At this point, the race to control the Senate and House may bring just as much excitement as the race for President. Republicans can reclaim the Senate by either gaining two seats or gaining one seat and the Presidency. Montana and Ohio are still considered toss-ups; however, Arizona, Florida, Maryland, Michigan, Nevada, Pennsylvania, Texas, West Virginia, and Wisconsin are all races to watch. Current polling estimates that 25 seats in the House are toss-ups, while Republicans currently have an edge in retaining control.

US Federal Debt Held By The Public With CBO Forecasts (% of GDP)



Source: CBO, Deutsche Bank (6,2024).

2024 Senate Election



Source: Elections2024.thehill.com (10:39 AM EDT 7/18/2024).

BOTTOM LINE: Many corporate fundamentals appear favorable or on solid footing; however, future performance isn't predicated on past success. In this vein, it is prudent to be cautious and monitor for signs of stress in corporate balance sheets and operational performance. Our process remains rooted in bottom-up fundamental analysis. In today's environment, we focus on finding resilient credits that can perform well in a variety of economic scenarios to provide stability amid tight valuations.

Equity indices continue to reach new all-time highs, while credit indices remain near historic lows, suggesting that the strength in corporate fundamentals and earnings is expected to be sustained. While the market may be excited about the future, the following fundamental data underscores the importance of maintaining a degree of caution and resilience in portfolios. This is amplified by the significant uncertainty in the future. As we begin to receive data from companies on their 2Q24 results, here are the key trends from the prior quarter:

OPERATIONAL PERFORMANCE:

- **Investment Grade (IG):** Revenues increased by 1.4% year-over-year, and EBITDA growth (excluding commodities) was 5.9%, the fastest acceleration in seven quarters. This was driven by improved operational efficiency and cost-cutting initiatives.
- **High Yield (HY):** High yield in aggregate experienced another quarter of top-line growth, though EBITDA slightly declined for only the second time since 2020.

DEBT LEVELS AND BALANCE SHEETS:

- **IG Issuers:** Debt levels have increased by 4% on average year-over-year for each of the past four quarters, reflecting reduced recession fears and a shift in capital allocation priorities away from debt reduction or cash preservation. This trend is more pronounced in higher-quality rating buckets, with A-rated company leverage up 0.2x to 2.2x, vs. up 0.1x year-over-year for BBB-rated companies at 4.0x. Overall, while balance sheets remain strong, there are signs of incremental degradation as management teams feel comfortable with their current positioning and prioritize cash flow away from debt reduction and toward other uses.

INTEREST COVERAGE:

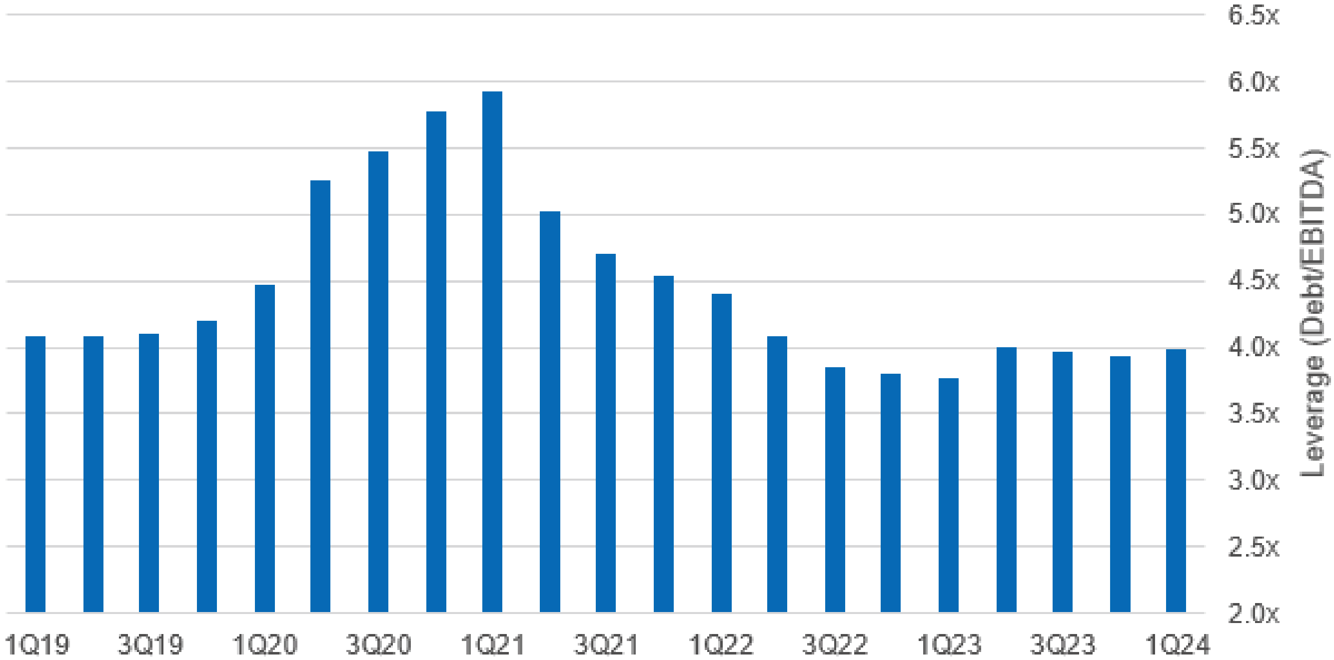
- **IG Companies:** Interest expenses increased by 15.9% year-over-year. Despite mid-single-digit EBITDA growth, interest coverage fell from 10.2x to 9.6x. However, this remains above pre-COVID levels.

EARNINGS:

- Recent moves in risk assets suggest that fundamentals are better than expected (or feared). In 1Q24, 78% of companies reported better-than-expected earnings, significantly above the long-term average of 66%. Additionally, 55% of S&P 500 companies reported both top and bottom-line beats, likely due to lower expectations rather than exceptionally strong performance.

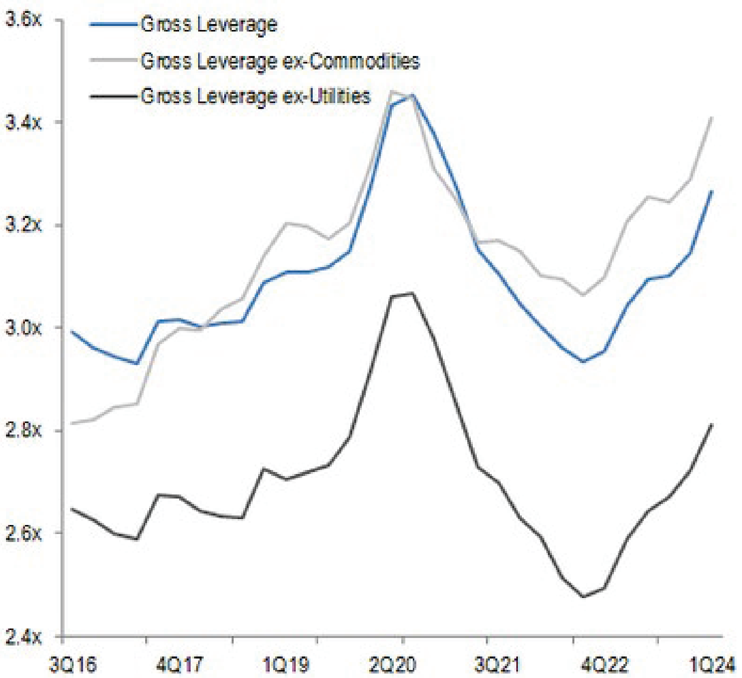
Source: sections "Operational Performance", "Debt Levels and Balance Sheets", and "Interest Coverage": J.P. Morgan (05/31/2024). Section "Earnings", LSEG, London Stock Exchange Group (6/4/2024).

HY Leverage Seeing Deterioration But Relatively Muted

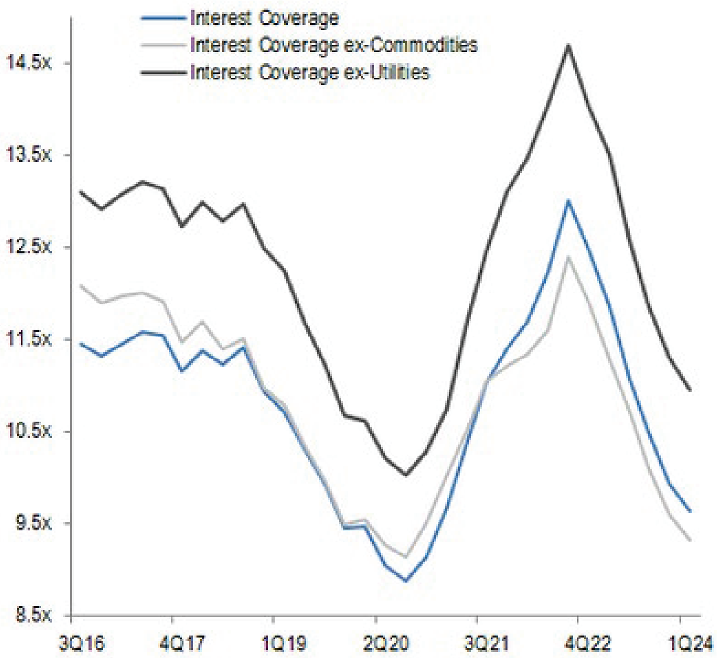


Source: Smith Capital Investors, J.P. Morgan Research (6/12/2024).

IG Leverage and Interest Coverage Continue to Deteriorate



Source: J.P. Morgan (5/31/2024).



Source: J.P. Morgan (5/31/2024).

3 The Rebasing Of Inflation - A Bumpy Ride Down

Written by Markus Manly

BOTTOM LINE: Recent inflation prints have offered encouraging support that the disinflationary trend has resumed, but consistency over the next few months will be warranted before Fed officials will likely become comfortable with starting to ease monetary policy. In our view, progress will presumably be choppy, and markets will continue to rebase expectations around the perceived Fed reaction to each print. Looser financial conditions driven by higher equities and enthusiasm around rate cuts could prove to be counterproductive to continuing disinflation, keeping the Fed on hold for longer. This can be offset by other structural trends indicating easing pricing pressures going forward. We will remain active in positioning for major shifts in this narrative but expect that markets will trade in a range as the Fed remains patient and the labor market avoids material degradation.

The Fed continues to capture the center of market attention as a primary driver of volatility. As they maintain their data-dependent stance with respect to monetary policy, markets have become especially reactionary to the key information used to influence their rate decisions. While substantial progress has been made since peaking in 2022, the Fed will need a few more soft prints to ensure that inflation is on a consistent trend downward before gaining the confidence necessary to begin cutting rates.

- Significant progress has been made on bringing both the Fed's preferred Core PCE and CPI inflation gauges down from their height of 5.6% and 6.6% YoY, respectively, in 2022, but further progress must be achieved before they can gain the confidence necessary to begin cutting rates. Market expectations around the timing and cadence of rate cuts will continue to be heavily influenced by inflation data as a primary driver of anticipated policy decisions. While the overall trend has been disinflationary, base effects will lead to volatility in the YoY numbers, leading to a natural trend downward through the summer months but will reverse course towards the end of the year. We anticipate markets to continue to reprice rate cut expectations, but as risks become more balanced between price stability and labor market conditions, there will be an increased focus on both inflation data and employment metrics.

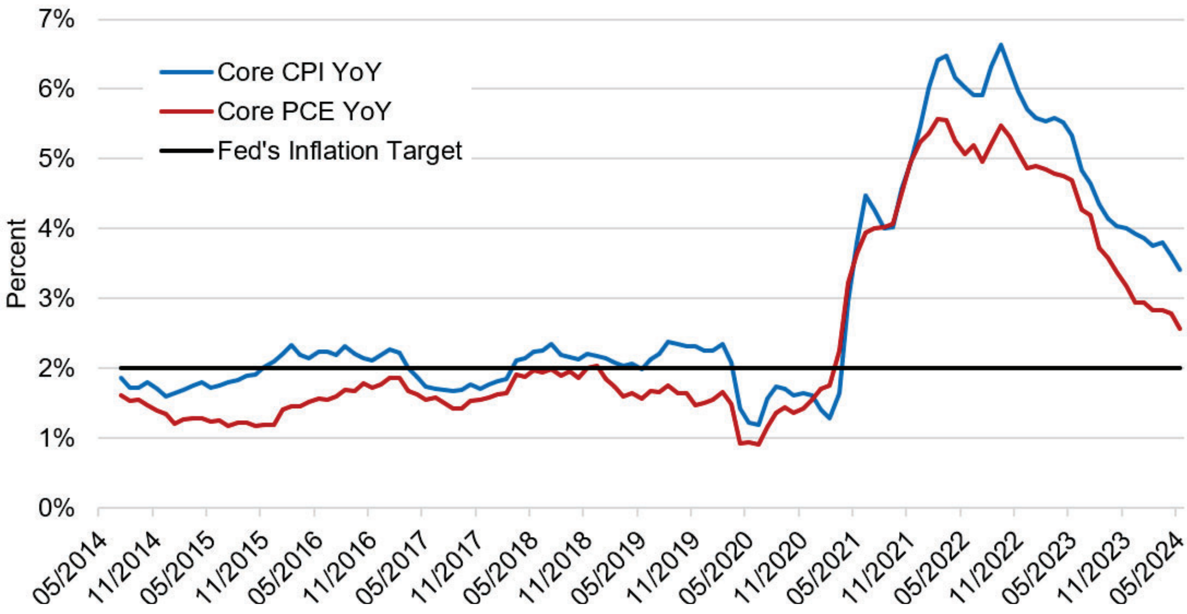
- Understanding the fundamental drivers of inflation provides insight into potential directionality, and in turn possible Fed rate paths. As we have discussed in prior detail, the shelter component has been a large driver of stickiness in inflation, especially for Core CPI due to the weighting differential in their respective methodologies. This is also the primary reason for the significant wedge between Core CPI and PCE YoY readings. Due to the lagged effects between inflation readings and real-time market rents that we have discussed prior, we expect this component to continue to soften over the next few months to catch up to current market pricing dynamics and provide some relief to core inflation numbers.

3 The Rebasing Of Inflation - A Bumpy Ride Down

(Continued)

- The Fed has remained steadfast in their messaging with respect to prioritizing returning inflation to their 2% goal, which has aided in tempering forward inflation expectations. Consumer sentiment is not only an indicator of the current pricing environment but can also perpetuate inflationary tendencies if expectations become unanchored. University of Michigan (UoM) and New York Fed inflation expectation indices highlight that forward pricing pressures are expected to ease and have nearly returned to a more normal environment of 2-3% inflation. Mean forward expectations remain elevated but are typically more volatile. While these trends are positive, more consistency in disinflation is needed to avoid an unintended upward rebasing.

U.S. Inflation YoY



Source: Smith Capital Investors (7/1/2024).

4 Navigating A Dynamic Market Environment in Leveraged Loans

Written by Bryan Owen

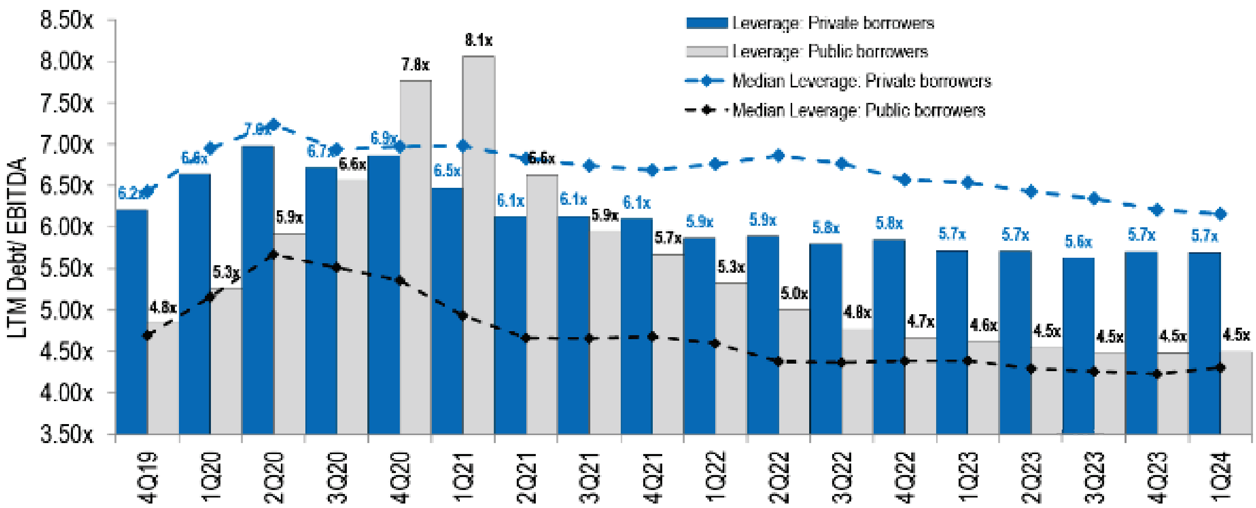
BOTTOM LINE: The ability of a company to manage through the entire cycle is paramount. Internally, we refer to this as resilience—an essential attribute we seek in our investments, directly influencing portfolio construction. Investment decisions require consideration of multiple variables. Understanding potential returns and the idiosyncratic risks associated with individual borrowers, as well as the trends and risk factors impacting the leveraged loan market as a whole, remains core to our bottom-up process. We remain diligent on underwriting, monitoring for a material rate of change in fundamentals, and positioning opportunistically to take advantage of dislocations that may arise.

Yield vs. spread valuations have made the carry trade a focal point for credit investors in 2024. The elevated anticipation of Fed rate cuts has positioned loans as a favorable contrarian bet for investors in the 'higher for longer' camp. We have maintained that the Fed does not need to cut rates in 2024; however, we now recognize that the window may open to cut rates this year. Thus far, we have utilized loans to enhance carry across portfolios. Understanding the underlying fundamental cross currents in leveraged loans is crucial to our ability to identify favorable risk-adjusted return opportunities in the current market environment.

- **Leveraged Loan Market:** 1Q24 metrics suggest stabilization amidst a potentially more challenging fundamental landscape. Revenue and EBITDA expanded year-over-year at the third slowest and slowest rates over the last three years, respectively. Despite this, leverage metrics have settled around a post-pandemic low of 4.92x, remaining below 5x throughout four consecutive quarters and decreasing for the 11th time in twelve quarters.

- **Public vs. Private Borrowers:** While the loan cohort exhibits stable metrics overall, there is a notable divergence between public and private borrowers. Public borrowers maintain a leverage ratio of 4.5x, significantly lower than the 5.7x ratio for private companies—the widest gap since 1Q20. On a last-twelve-month (LTM) basis, EBITDA margins for public companies stood at 17.1% in 1Q, compared to 13.8% for private companies. This gap has averaged 3.7% over the past five quarters. Interest coverage for public companies, at 4.15x, exceeds that of private companies at 2.04x. On average, public loan borrowers screen as much higher quality on these fundamental data points.

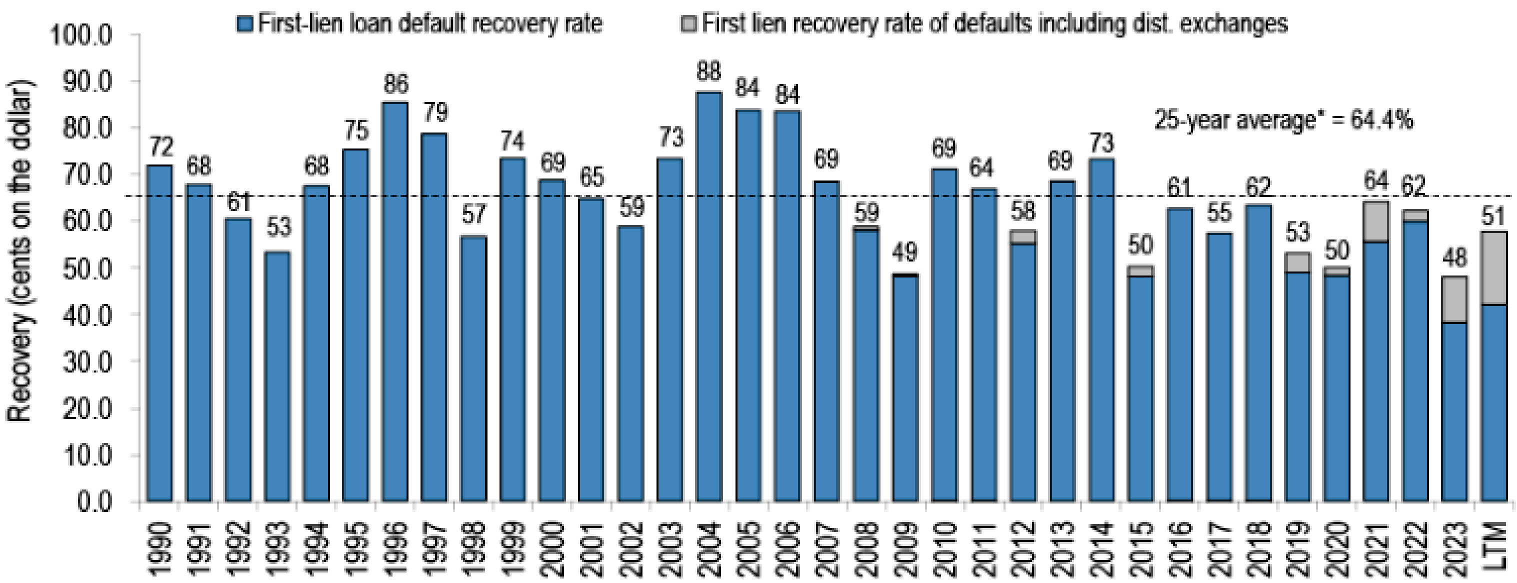
Leverage For Private Loan Borrowers Is More Than a Full Turn Higher Than For Public Companies



Source: J.P. Morgan; Capital IQ; Bixby Research and Analytics Inc (6/18/2024)

- **Ratings Action:** Loan ratings action has remained topical for over two years now. In June, there were 20 upgrades compared to 23 downgrades, marking the 26th consecutive month where downgrades have outnumbered upgrades. Over this period, there have been more than twice as many downgrades as upgrades, with 845 downgrades vs. 408 upgrades. The total dollar volume affected is $844 billion downgraded vs. $456 billion upgraded. Loans have experienced a significant downgrade cycle, which could lead to market dislocation and create investment opportunities where security selection will be essential.
- **Defaults and Recoveries:** Year-to-date, there have been $37.1 billion in defaults and distressed exchanges, tracking 14% below last year's pace. In June, leveraged loan recovery rates increased for the fifth time in the last six months. First lien loan recovery rates rose by 12bps in June to 42.1%, compared to 38.3% in 2023. That said, recovery rates remain well below the 25-year annual average of 63.5%.

First-lien Loan Recoveries Continued To Rise But Remain Below Long-Term Averages



Source: J.P. Morgan; PitchBook Data, Inc; Bloomberg Finance L.P.; S&P/IHS Markit; Moody's Investor Services.

5 Numbers Are Never Wrong, But Strategists Often Are - MBS vs IG

Written by Eric Bernum

BOTTOM LINE: With agency MBS option-adjusted spreads near long term averages, a higher sensitivity to directional movements in interest rates, and continued Fed reduction in MBS holdings, we were more cautious than most coming into 2024. Consequently, we have been happy to let our exposure to agency MBS passively roll off with prepayments. This marks a dramatic shift from our stance throughout 2022 and into Q3 of 2023, where we significantly increased our agency MBS exposure. We would point to the massive rally in spreads and change in both valuations as well as fundamental drivers of MBS that occurred in Q4 of 2023 as the reason for our sentiment shift, but we remain closely focused on this market segment for potential opportunities going forward. We remain highly convicted that the MBS market is much more of a bond-picker's market compared to historic periods, given the very diverse characteristics of individual securities compared to aggregate index exposure, which means that there is significant alpha available to those willing to do the time-intensive work of evaluating individual securities one by one.

Coming into 2024, agency MBS (MBS) was the top fixed income asset class pick for many strategists, given wide nominal spreads and the potential for declining interest rate volatility. However, through the first half of the year, MBS has been the worst-performing asset class in the Bloomberg US Aggregate Index (Agg). Given the impact of the Federal Reserves' intervention in the MBS market and the speed of the increase in interest rates over the last two years, we are dealing with a very different mortgage market than just extrapolating history would have led us to believe.

- From an outright return perspective, the Bloomberg US MBS Index (MBS Index) has the worst outright and excess returns of all major classes in the Agg. Year-to-date, the MBS Index has posted nominal returns of -0.98% and excess returns of -23bps, underperforming the broader Agg Index by 20-30bps on both measures.

- Worse still, the MBS Index has underperformed the Bloomberg US Investment Grade Corporate Index by ~50bps in nominal returns and ~110bps in excess returns. This drastic underperformance vs. IG Corporates stands out to us, as many of the same strategists calling for MBS outperformance this year also called for underperformance in IG Corporates.

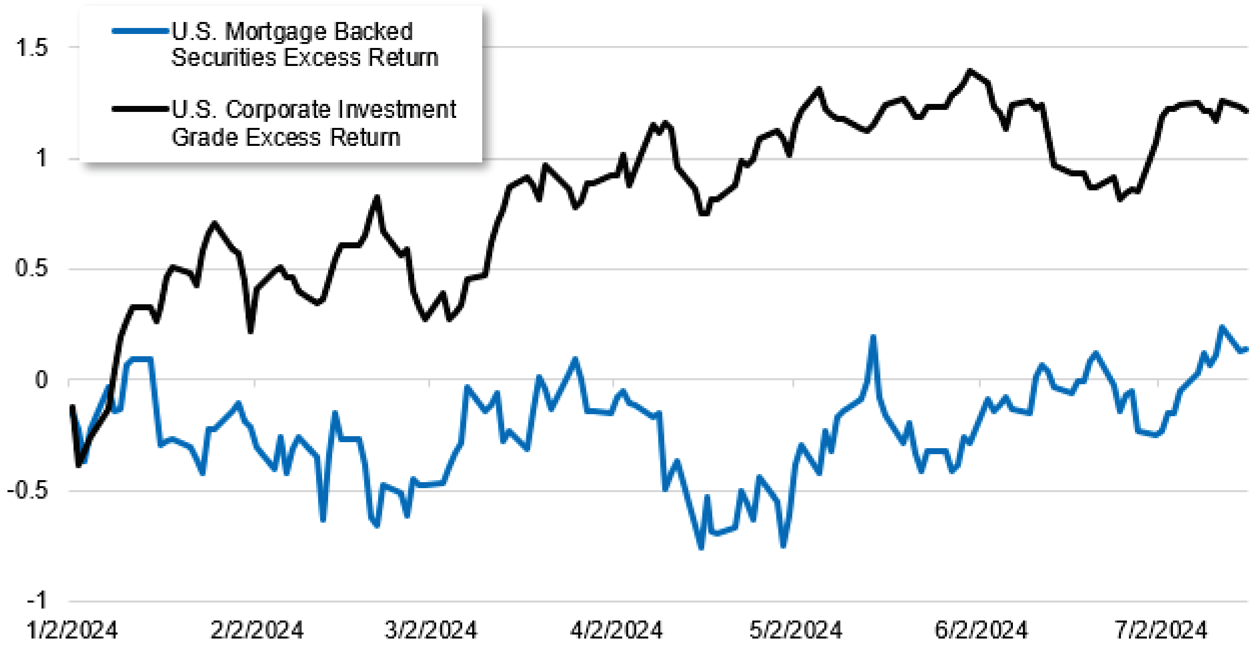
- There are many reasons for these drastic differentials in performance, but at a high level, US investment grade credit has benefited from a resilient domestic economy, both in corporate and consumer sectors. This has led to solid corporate fundamentals continuing despite being two years into a tightening cycle. Additionally, there has been significant demand for longer duration credit as all in yield investors look to lock in these new higher yields for longer.

- Conversely, given the composition of outstanding mortgage stock in the US and the impact of the Federal Reserve's MBS ownership, MBS performance is much more tied to decreases in interest rates than any other factor. This is a dramatic difference from normal markets, where the volatility of interest rates is a larger driver of returns than the outright direction of yield moves.

- Without getting too in the weeds, the vast majority of the MBS Index is still composed of mortgages with very low interest rates (1.5% - 3.5%). With the move higher from interest rates over the last two years, these bonds now trade at significant discounts to par. This dynamic means the return profiles of these securities are extremely sensitive to the direction of interest rates (and the associated impact of prepayment assumptions). Any tick up in prepayments assumptions (which occur at par) is very material considering we are talking about bonds trading as low as 75 cents on the dollar.

- Thus, the poor performance of MBS in 1H24 is largely attributable to the increase in yields we saw over the time frame. US Treasury yields rose by ~40bps during this period. Consequently, nominal MBS spreads widened by 15bps, and MBS OAS remained relatively flat compared to the decline in Corporate Credit spreads. Additionally, the continued roll off of MBS from the Fed's balance sheet during its QT program has weighed on the asset class as the largest buyer of the last 5 years has continued its passive reduction of MBS holdings.

MBS Index Excess Returns YTD vs. US IG Corp Index



Source: Smith Capital Investors, Bloomberg (7/16/2024).
**U.S. Mortgage Backed Securities Excess Return = LUMSTRUU Index excess return*
**U.S. Corporate Investment Grade Excess Return = LUMSTRUU Index excess return*

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