SMITH
CAPITAL INVESTORS

October 2024

Market Update – Riding Into Year-End

Introduction – Gibson Smith

Dear Friends,

As we enter the final months of 2024, we would like to take this opportunity to share our perspective on the evolving economic and geopolitical landscape, along with our insights on various market segments. We continue to navigate a period of heightened uncertainty as the economy undergoes the post-COVID normalization process. Policymakers and politicians are encountering new challenges during this transition. While it may indeed be different this time—a phrase that has historically caused difficulties for many portfolio managers—we find that maintaining discipline and flexibility is critically important in this environment.

Our strategies are currently positioned defensively, with an emphasis on heightened liquidity. This positioning reflects current market valuations and the uncertainty that lies ahead. Our preference for high liquidity stems from our expectations of increased volatility as we approach year-end and into early 2025. We aim to capitalize on opportunities as they arise. In our pursuit of risk-adjusted returns and capital preservation, we lean toward protecting capital rather than seeking aggressive returns. We hope the commentary below elucidates the rationale behind this positioning.

Continued →

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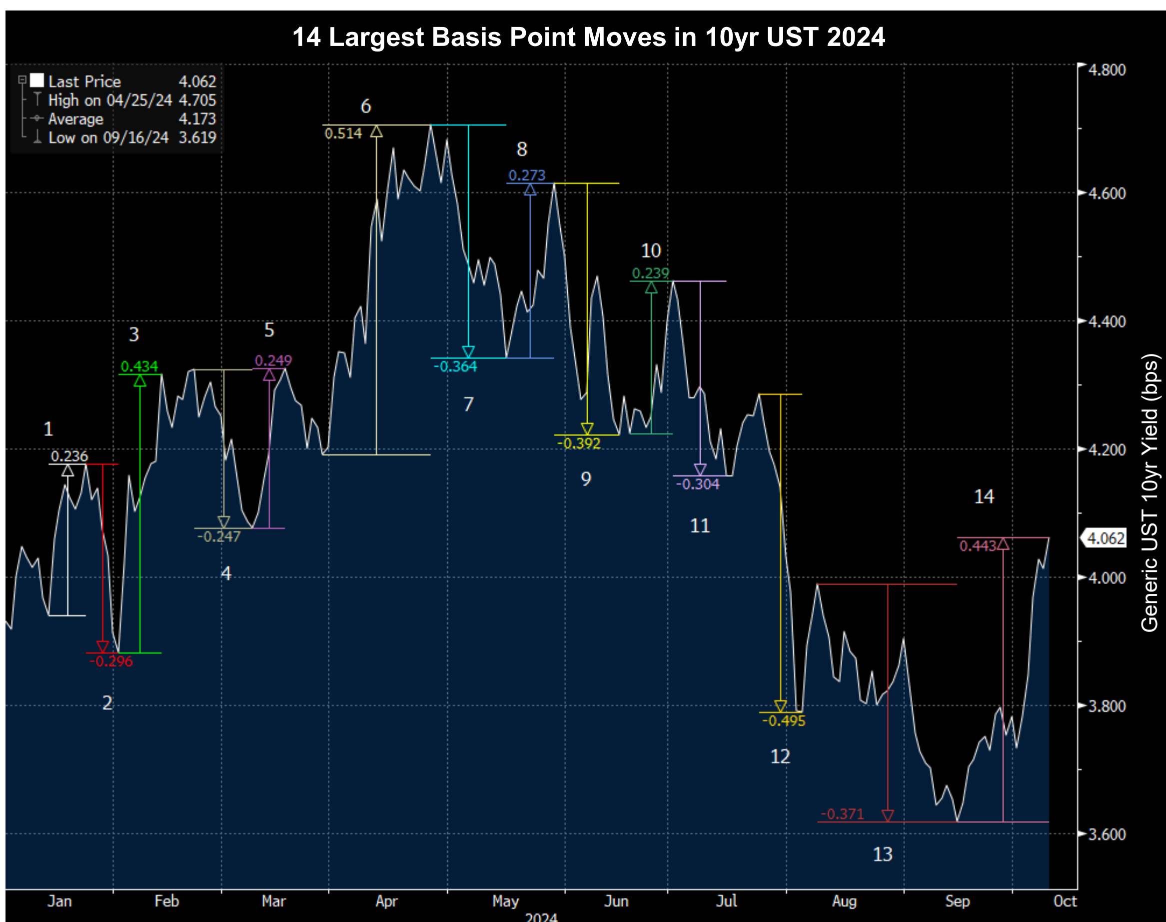
Economic Outlook: Inflation, Growth, and Market Dynamics:

US Treasuries (as of October 9th, 2024):

Changes	1 Month	6 Month	Year-to-Date
2 Year	+30 bps	-77 bps	-28 bps
5 Year	+38 bps	-51 bps	+2 bps
10 Year	+34 bps	-32 bps	+16 bps
30 Year	+33 bps	-17 bps	+30 bps
Curve			
10yr – 2 yr	+2 bps	+45 bps	+43 bps



Source: Smith Capital Investors, Bloomberg (10/9/2024).

The data above encapsulates the story of fixed income markets year-to-date, characterized by 14 fluctuations of approximately 25 basis points (both up and down) in the 10-year Treasury. This illustrates the ongoing search for direction in the post-COVID normalization phase.

This year has presented both challenges and opportunities across the global economy. Inflation, a major concern for much of the past two years, is showing signs of moderation in certain areas, particularly consumer goods and select services. However, persistent inflation in sectors such as energy, food, and housing continues to exert pressure on global central banks, including the Federal Reserve.

Expectations surrounding the Fed's monetary policy decisions have been pivotal for the bond market. The volatility in interest rates, as the Fed has focused on controlling inflation, has conflicted with emerging concerns about slowing growth.

INTRODUCTION (CONTINUED)

While interest rate hikes and tighter monetary policy by central banks have generally succeeded in reversing upward inflation trends, many remain skeptical about whether the inflation battle has truly been won. Both the Consumer Price Index (CPI) and Producer Price Index (PPI) exhibit stickiness, while the Fed's primary inflation measure, core Personal Consumption Expenditures (PCE), shows progress. Despite the positive trends, new concerns regarding economic cooling have emerged, igniting debate about the potential nature of the economic landing ahead. These discussions have led to significant volatility in both equity and fixed income markets. Consequently, we are closely monitoring these dynamics and positioning our portfolios to endure potential future volatility, while ensuring exposure to segments, sectors, and individual credits that demonstrate greater resilience and less drawdown risk.

Our focus remains on identifying companies undergoing fundamental changes in their capital structures, favoring those that generate free cash flow and allocate liquidity towards reducing leverage. Recently, we have observed marked differences among companies, with some prioritizing balance sheet and debt reduction, while others focus on returning capital to shareholders. Generally, the robust fundamentals established during the post-COVID monetary and fiscal stimulus era have broadened management teams' options, promising an exciting landscape for credit research moving forward.

Geopolitical Tensions in the Middle East: Energy and Global Stability: The recent escalation of conflict in the Middle East adds another layer of complexity to an already fragile global landscape. Historically, instability in this region has significantly impacted global energy prices, particularly oil. The ripple effects of rising oil prices are often felt in inflation, supply chains, and consumer sentiment, influencing overall market performance.

However, the global energy landscape has evolved considerably in recent years. The United States has increased its energy independence, and alternative energy sources are becoming more integrated into the global economy, which helps cushion the potential impact of instability in the Middle East. Nonetheless, the escalating conflict raises concerns regarding its influence on investor sentiment. We remain vigilant in assessing how prolonged conflict could affect energy prices, investor sentiment, and geopolitical stability, recognizing that periods of heightened fear can lead to significant flight-to-quality sentiment.

The 2024 U.S. Election: Policy Uncertainty and Market Implications: As we approach the 2024 presidential election, political uncertainty is expected to play an increasingly prominent role in market dynamics. Historically, election years are marked by heightened volatility as investors evaluate potential outcomes and associated policy shifts. This year is no exception, with critical debates surrounding tax policy, government spending, healthcare reform, and energy policy.

While the spotlight is on the Trump vs. Harris matchup, we are particularly focused on potential shifts in the State elections for Congress, as these outcomes are equally significant. A sweep by either party could lead to substantial policy changes and increasing volatility. The divergent policy positions of the two parties could result in meaningful adjustments to tax and regulatory frameworks across various sectors, impacting earnings and profitability for many industries.

Although political uncertainty often leads to short-term market disruptions, we remain committed to a long-term perspective, seeking to leverage short-term opportunities created by volatility. It is important to remember that markets have historically rebounded from election-related volatility as the policy landscape becomes clearer. Our approach in this election period is emphasizing flexibility and adaptability, ensuring that our portfolios are positioned to capitalize on opportunities while minimizing exposure to potential risks.

INTRODUCTION (CONTINUED)

The Path Forward: Managing Through Uncertainty: We remain committed to our guiding principles of Investment Excellence, Relationships/People, and Intentional Culture. Navigating through cycles can be challenging, particularly in an environment characterized by high volatility. However, we believe our philosophy and processes will guide us through this period.

Looking ahead, our focus remains on managing risk while identifying opportunities aligned with our defensive risk/reward criteria. We find ourselves somewhat surprised by the strength of risk markets, with broad-based domestic equity indices up over 20% year-to-date (and significantly more over the past 12 months), alongside credit spreads at or near historical tights. It is difficult to ignore that a lot of good news may be priced into the markets at this time. Additionally, with yields rising above 4% and real yields approaching 150 basis points (assuming a 2.5% terminal inflation rate), the bond market is reflecting some concerns regarding future inflation expectation volatility.

While I see many risks on the horizon, I think the ongoing interest rate and yield curve normalization process presents the greatest risk to absolute performance over the next 12 months. The wild swings in sentiment in 2023 and 2024 are residuals of the aggressive monetary and fiscal paradigms we have experienced. I also find the stretched valuations in the credit and securitized markets to be reflective of great optimism about the future. When investor's expectations are not met, heightened volatility and drawdown risk can follow.

My partners follow with their thoughts on current markets and what they anticipate heading into year-end. I hope you find this of great value in helping you and your clients work through the challenges ahead.

A quick note on the business: We have been fortunate to experience growth in our business and have welcomed new talent to our team. This year, we have added Cassie Kneen to our Business Development team, alongside Nate Palmer (internal technology development and data science), Charlie Smith (business operations), and Carys Murphy (business strategy and leadership) to our Business Excellence team. These individuals bring a strong commitment to our vision, mission, and core values.

We continually discuss our core values of discipline, integrity, character, empathy, and service, and how these individuals are excellent representations of them. They also relate to the current environment and are central to how we engage with you and manage your assets.

I conclude with sincere appreciation and gratitude for your role in helping us turn our vision into reality. Without you—our clients and partners—we have little reason to exist. Thank you!

We hope you find our insights on the market valuable. If you wish to discuss further or delve deeper into any aspect, we are always here to engage.

Let's talk!

Best regards,
Gibson

1 Macro & Rates

Markus Manly

Macro

BOTTOM LINE: Economic activity remains resilient, and the Fed will adopt a data-dependent approach to policy actions and future outlooks. There is consensus that monetary policy is currently restrictive, and normalizing rates is prudent; however, future policy decisions will ultimately be guided by incoming data. We will remain proactive in our portfolio positioning and leverage anticipated volatility as a means of generating risk-adjusted returns.

In a year characterized by the Federal Reserve's prominent role in market dynamics, each economic data release is carefully analyzed for its potential impact on the trajectory of the Federal Funds (FF) rate. Market pricing surrounding these expectations has been volatile, and we anticipate ongoing fluctuations as sentiment shifts in response to incoming data.

Recent economic indicators have suggested that inflation is making progress towards the Fed's 2% target, while the labor market is normalizing to pre-COVID conditions after a prolonged period of tightness. The Fed's preferred inflation measure, core PCE, has returned to a 3-month annualized rate of 2%, providing the Fed with the confidence to initiate an easing cycle in September. In light of softer payroll data preceding the September meeting, the committee opted for a more substantial 50 basis point cut, reinforcing their commitment to sustaining economic expansion and a healthy labor market. Attention had shifted from upside inflation risks to potential downside risks stemming from a weakening labor market, with the committee indicating a readiness to act decisively if job market conditions further deteriorate. The strong payroll report for September, released in October, defied the trend of slowing job gains, underscoring that labor markets are normalizing rather than exhibiting outright weakness.

Rates

BOTTOM LINE: We anticipate that rate volatility will remain elevated in the near term as expectations for Fed cuts continue to adjust with incoming data. However, the underlying economic environment is likely to remain resilient, keeping Treasury yields within a range as markets gauge the neutral rate for Fed Funds. We view this as an opportunity within our active management strategy to capitalize on market dislocations and enhance returns.

Given the critical role of economic data in shaping the Fed's policy decisions and the rapid pace at which markets adjust, numerous narrative shifts have occurred throughout the year, resulting in swift repricing of expectations.

A series of softer payroll reports and inflation figures over the summer triggered a significant rally in rates, with market sentiment suggesting that the Fed would need to implement more aggressive rate cuts by year-end to support a faltering labor market. Yields on 2-year Treasuries declined by 143 basis points from their May peak to the September trough prior to the Fed meeting. Following the Fed's 50 basis point rate cut to initiate the easing cycle, concerns about the Fed lagging behind in response to the labor market's weakening abated. The yield curve reacted with a bear steepening bias, as the 2s/10s spread widened to a high of 22 basis points after previously inverting. Yields on 30-year Treasuries increased by 14 basis points post-meeting, followed by an additional 27 basis points after the strong September payrolls report. Improved economic data has challenged the previous narrative that swift Fed cuts were necessary to address labor market weaknesses, with current swap probabilities now indicating only an 83% chance of a 25 basis point cut in November, as market views have readjusted.

2 Investment Grade Overview

Jonathan Aal

BOTTOM LINE: In a rangebound sideways spread environment where risk is tight and compressed, taking measures to create durability, defensiveness, optionality, and nimbleness across credit sleeves should be of priority. As such, from the last series of spread volatility we know that being pre-positioned for such is more ideal than not given the swiftness of moves wider and ultimately the value it can create for investors in terms of optionality.

Despite being built on what has been a more resilient than expected foundation, we do not expect a major portion of forward return profiles to come from tightening spreads. Currently, U.S. Investment Grade (IG) spreads are perched at year-to-date tights of 81bps, which is 18bps tighter from the start of this year. At these levels, inside of the 1st percentile on a 20-year basis, it is not an exaggeration to say spreads have been wider than current levels almost 100% of the time over this period.

Considering corporate fundamentals, valuation potential, the bent in monetary policy, and known sources of uncertainty, we see the most likely path forward for spreads as range-bound and sideways. Importantly, however, sideways in fixed income is not without return potential. Within the operating environment of this view, we presume yield (carry), curve positioning, and downside protection (because it is comparatively cheap given the lack of dispersion in IG markets) should be prioritized elements for the foreseeable future.

- **Yield (Carry)**: Despite spreads trading at the 1st percentile on a 20-year basis (spreads are historically tight), and hence our view on limited further tightening, yields are trading at the 68th percentile over the same time horizon. Leveraging our bottom-up investment approach, we have noticed a trend across corporate treasury teams prioritizing the paydown of high-cost, high-coupon debt. This suggests to us that these high current yield, high coupon opportunities minted over the past several years will be of increasing scarcity value.
- **Curve Positioning**: Curve opportunities are always a consideration for total-return-minded investors and are particularly amplified during periods of monetary policy shifts. IG Long Duration Credit at 99bps is at the 0th percentile on a 20-year basis and at 20-year tights. When considered together, a period of shifting and dynamic monetary policy and 20-year tights on long duration IG credit, investors must have extremely high conviction in long duration credit investments and are likely better suited for a wider range of outcomes in investments across other parts of the curve.
- **Downside Protection**: Given the lack of risk dispersion within IG markets, downside protection is naturally "inexpensive"; or as executed, the cost to move from lower quality, less stable credits into higher quality, more resilient issuers is historically minimal in terms of spread compensation. One example to highlight this risk compression is the comparison between bank senior and bank subordinated bonds. Currently the average spread difference between these two parts of banks' capital structure is 35bps, which is at the 2nd percentile on a 20-year basis.

Source: Smith Capital Investors, Bloomberg 10/10/2024

3 High Yield Market Overview

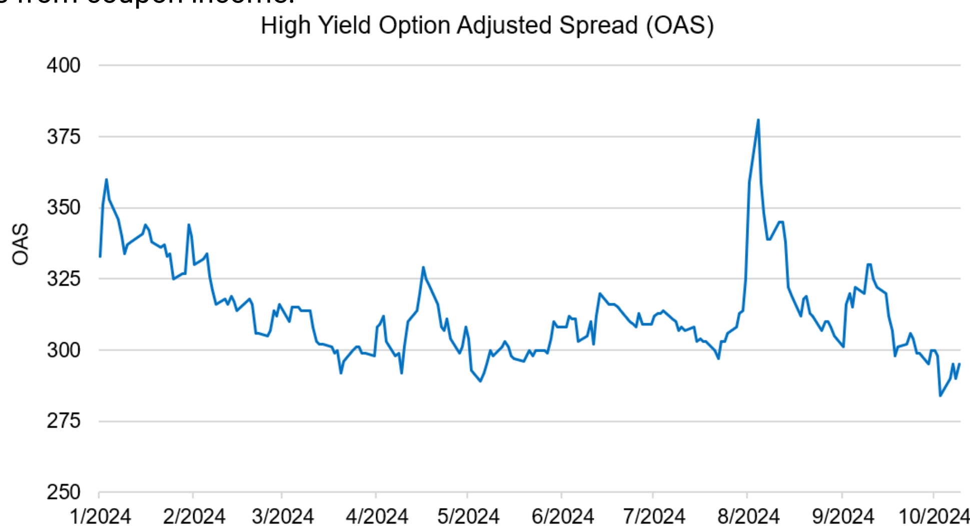
Garrett Olson

BOTTOM LINE: We expect both fundamental and technical factors to remain supportive in the near term, and while valuations may not appear exceedingly cheap, they should contribute to resilient forward return profiles. In a low-growth or sideways economic environment, we see a high probability that high yield credit exposure will yield favorable outcomes for investors. At the same time, we acknowledge that significant changes in sentiment around the growth outlook will flow directly into greater spread volatility.

The high yield market has delivered strong performance in 2024, with a year-to-date return of 7.50% (as of October 8), driven by option-adjusted spread compression from 333 basis points to 295 basis points. Performance has varied significantly across rating categories, with BB and B-rated credits returning 6.16% and 6.60%, respectively, while CCC-rated credits outperformed with a 12.37% return year-to-date, largely attributed to gains over the past two months. The high yield credit market continues to see a positive ratings upgrade cycle, with a year-to-date ratio of 1.6 upgrades to downgrades, reflecting solid underlying fundamentals, a trend that has persisted since 2021. Additionally, last twelve months (LTM) default rates have declined, currently standing at 1.64% as of September's end. With $17 billion of year-to-date inflows into retail funds and 78% of new issuance proceeds allocated to refinancing rather than new supply, technical factors remain supportive.

Key Considerations for Future Returns:

- **Fundamental Factors:** We anticipate that fundamental conditions will remain resilient. While leverage and interest coverage may experience slight deterioration, they remain healthy relative to historical averages. Default rates are expected to remain low, particularly as lower-quality credits continue to access new capital with relative ease.
- **Technical Factors:** From a technical standpoint, high yield is likely to be well supported. Following the latest NFP report, expectations for rate cuts have moderated, while optimism surrounding economic growth and resilience of the economy has increased. High yield, being economically sensitive and possessing a relatively short duration, aligns well with this environment. Investor interest in locking in attractive yields and strong LTM returns could further stimulate demand for high yield credit.
- **Valuation:** High yield spreads are historically low, currently at the 4th percentile on a trailing 15-year basis (spreads are tight). However, the likelihood of further spread tightening driving returns appears limited. Despite a decrease over the past year, the yield opportunity remains reasonable, with the index yield-to-worst (YTW) above the 15-year average. An analysis of the market indicates that the combination of above-average yields and an average index price of 96.08, alongside an option-adjusted duration (OAD) of 3.0, creates a resilient forward return profile, as bonds can generally withstand significant spread widening before price declines offset the benefits from coupon income.



Source: Smith Capital Investors, Bloomberg (10/11/24)

4 Leveraged Loans Analysis

Garrett Olson

BOTTOM LINE: Given the low fundamental resilience, potential waning interest in floating rate credit in a declining rate environment, and historically average valuations, we do not see leveraged loans as particularly well-positioned in the current investment landscape. However, we believe that selective, fundamentally-focused investors may still find idiosyncratic opportunities within this $1.5 trillion market.

Leveraged loan performance has exhibited two distinct phases in 2024. Initially, leveraged loans were among the best-performing credit asset classes, benefiting from elevated starting yields and a significant resetting of rate cut expectations. However, since May, leveraged loan returns have lagged behind high yield bonds due to increased repricing activity and the anticipation, followed by the realization, of a Fed cutting cycle.

Key Considerations for Future Returns:

- **Fundamental Factors:** In contrast to the high yield market, the leveraged loan sector has experienced a general decline in fundamental quality. This is evident in rating downgrades surpassing upgrades since 2022, leading to an expansion of B3 or lower-rated loans. Leveraged loan default rates have reflected this decline, currently at 3.70%, significantly higher than the high yield bond market's default rate of 1.64%, marking the widest gap since 2000. Private loan borrowers face more substantial fundamental challenges compared to public borrowers, with higher leverage and lower interest coverage.
- **Technical Factors:** Robust CLO issuance has thus far created a positive supply-demand dynamic in the leveraged loan market. However, if the Fed continues easing and reference rates decline, demand for floating rate credit may diminish, leading to potential outflows and selling pressure.
- **Valuation:** Leveraged loan valuations are close to long-term averages, with spreads slightly below and yields slightly above average. Many individual loans yield comparably to pari passu bonds, suggesting a broad level of market efficiency.

5 MBS Outlook

Eric Bernum

BOTTOM LINE: Looking forward we are cognizant of the risks facing the mortgage market. Technically, the Fed continues to reduce its mortgage holdings, mutual fund managers continue to be overweight the sector, and bank demand is very sensitive to the shape of the interest rate curve. From a more fundamental perspective, for now, the index performance continues to be sensitive to the direction of overall interest rates, but with the growing negative convexity being added to the market, mortgages generically should begin to demonstrate a more traditional correlation with interest rate volatility. Finally, mortgage spreads have been positively influenced by the continued rally in credit spreads. Any reversal in credit spreads will probably weigh on the mortgage market as well as macro investors consider differing valuation opportunities across macro fixed income sectors.

The outlook for agency mortgages is less clear than in recent years. Current valuations are positioned at the tighter end of historical ranges, which appears justified given the ongoing compression of risk premia across asset classes. MBS durations are longer than historical averages, and negative convexity is re-emerging in the market as more mortgages are originated at elevated rates. Additionally, the Fed is actively unwinding its mortgage holdings through its monthly balance sheet runoff. While interest rate volatility had been declining throughout the year, recent fluctuations—driven by changing projections regarding the timing and magnitude of Fed cuts—have become an essential factor to monitor. **We maintain a neutral view on MBS for the remainder of the year.**

Throughout the year, we have reduced our new MBS investments compared to the previous two years, as current valuations and risk-adjusted return profiles no longer appear as attractive. However, we do not view the market as misaligned as it was during the peak of the Fed's MBS interventions in the post-COVID quantitative easing environment. Consequently, while we have not abandoned this asset class, our new purchases this year have been slower than the principal repayments received, leading to a gradual decline in our MBS weighting. Despite low absolute valuations, the compression of credit spreads has justified some of the tightening observed. **We believe that the most significant uncertainty for mortgages approaching year-end will stem from continued interest rate volatility as the market seeks clarity on future Fed cuts, U.S. election outcomes, and domestic economic forecasts for 2025.**

6 Trading Environment

Zach Tucker

BOTTOM LINE: Record corporate bond issuance and heightened interest rate volatility have historically not been friendly to credit spreads. Nevertheless, we sit at year-to-date tights and demand still feels strong. Capital markets are, and can continue to be, wide open.

Following record-breaking September issuance in the U.S. High Grade bond market, concerns about oversupply relative to investor demand were prevalent. However, the $170.6 billion in U.S. IG and $37 billion in HY issuance did not negatively impact spreads; in fact, the market remained resilient. The outlook for year-end 2024 and 2025 appears constructive, given how well participants managed volatility and re-entered riskier credit segments.

Since the end of July, the ICE BofA MOVE Index has exhibited significant volatility, surging 22% by August 5th, decreasing by 26% by September 26th, and then rising 38% to October 8th. Typically, increased interest rate volatility negatively affects corporate spreads; however, the OAS spread for the U.S. Aggregate Baa Index narrowed from +116 on July 31st to +106 by October 8th, despite realized rate volatility. Meanwhile, CCC-rated spreads tightened significantly, indicating a shift towards lower quality credit and a pursuit of yield in a lower rate environment.

Overall demand for credit has opened avenues for issuers in capital markets. Year-to-date IG issuance stands at $1,290 billion, reflecting a 29% increase compared to last year, while HY issuance has reached $239 billion, a remarkable 177% ahead of 2023 supply. While underwriters anticipate a potential slowdown as we approach year-end, the refinancing needs and a more active M&A environment suggest that 2025 may either match or exceed this year's issuance levels.

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