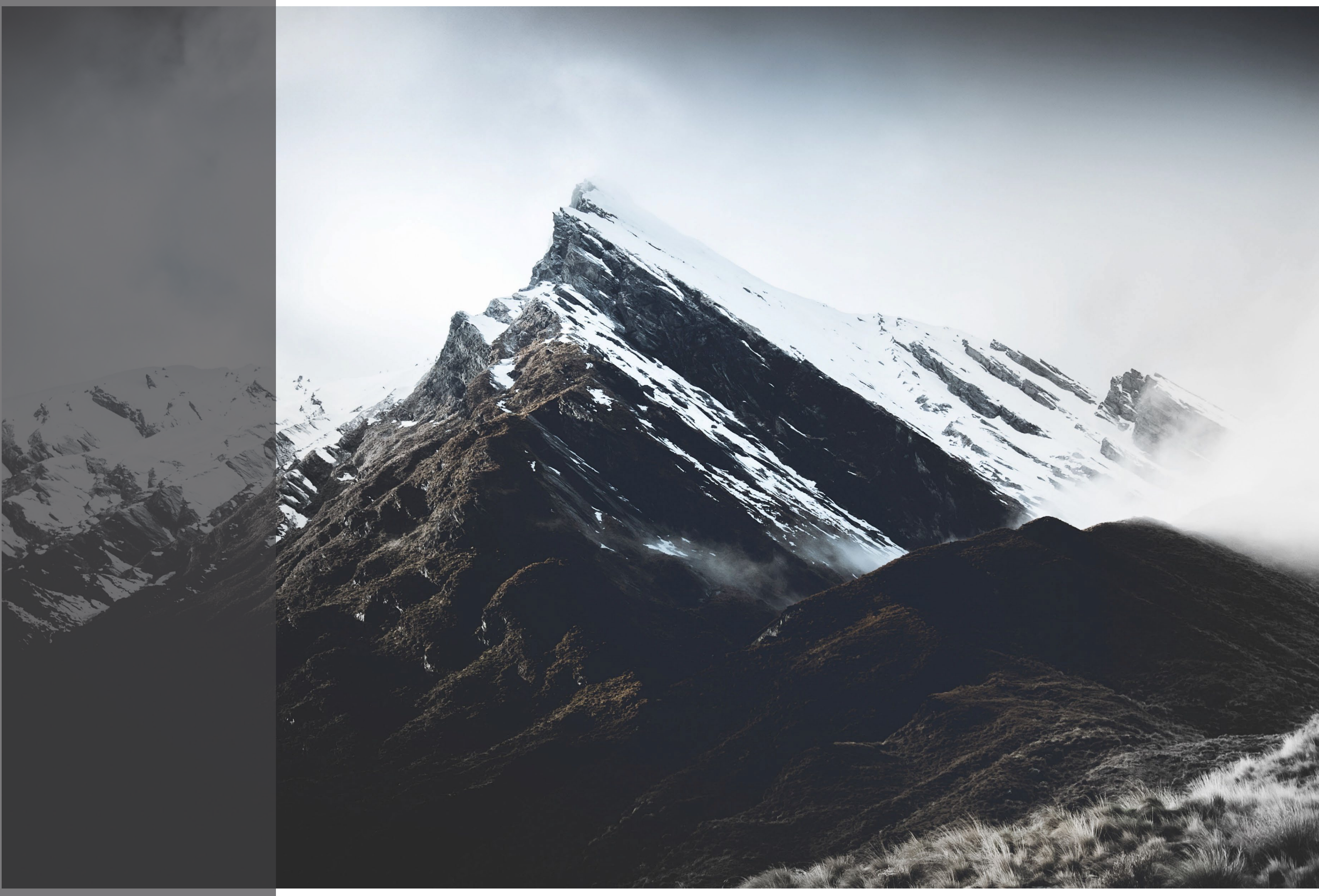
November 2024

Post-Election Fixed Income Sector Views



Dear Friends,

The election has passed, and markets are now assessing the implications of the red wave political shift. A pro-growth agenda (spearheaded by tax cuts), a pro-business agenda, and pro-growth policies, comes at a time when corporate profitability is strong and the consumer is very resilient. Despite the expected natural slowing effects of higher interest rates, this agenda is expected to support economic momentum as well as trigger adjustments in inflation expectations. We should not forget that headwinds such as geopolitical tensions in Ukraine and the Middle East, ongoing social polarization and dysfunction, and the potential for policy missteps could bring increased market volatility.

The consensus outlook for core inflation has already shifted slightly upward to a terminal range of 2.5–3.5% versus 2.0–2.5%. We are reminded that disinflationary pressures remain embedded in the economy due to advancements in technology, demographic trends, and the growing debt burden. However, a new focus on deglobalization could add a potential new structural inflationary layer to the mix. The overwhelmingly bearish tone on rates post the recent Federal Reserve meeting and the election requires careful navigation, as significant risks persist. Credit markets, while supported by strong fundamentals and a deep bid for yield, offer little excitement at current tight spreads. With very low break-evens and limited disruption among individual credits and sectors, we are surprised that the market continues to put money to work near 20-year tights on spreads. The idea of picking up nickels and dimes in front of a steamroller resonates with us.

This market dynamic underscores the importance of active management and staying vigilant against unforeseen events. In this environment, we remain defensively positioned, prioritizing heightened liquidity in portfolios. Going into year-end, our greatest focus is on events that could trigger a flight to quality or a significant shift lower in growth expectations.

Below, we outline our views across fixed-income sectors as we prepare for the opportunities and challenges ahead.

Macro, Interest Rates & Yield Curve

Macro – *Lindsay Bernum*

After a Trump victory and a red sweep of Congress, markets are now expecting a slower path for rate cuts into 2025. Trump's pro-growth, U.S.-centric policies are anticipated to create additional pricing pressures, which could force the Fed to extend its pause on rate cuts. Market consensus going into 2025 suggests the economy will grow at a slightly slower pace than in 2024, inflation is expected to remain sticky, and we may find the new normal is closer to 3% inflation, rather than the Fed's desired 2% target. We expect job creation to continue and wages to remain at a healthy pace, with improvement likely coming from the manufacturing sector.

Overall, expectations for the economy are range-bound and productive: companies are in good shape, and the consumer remains healthy. However, we anticipate continued market volatility as a new administration ushers in a new political landscape. Additionally, Powell noted that the Fed's dual mandate is currently balanced, which we interpret as a sign the Fed will continue to be data-dependent going forward. This could result in a potential pause and possibly a higher terminal Fed Funds rate.

Interest Rates & Yield Curve – *Markus Manly*

Post-election our highest confidence and conviction center around expectations of higher interest rate and yield curve volatility. With the Fed still in play on its rate normalization campaign, we anticipate that the front end of the yield curve will be reactive to expectations around future changes in the Federal Funds rate, while the long end will reflect evolving views around anticipated growth and possible persistent inflation pressures.

After two years of inversion, we expect the yield curve to continue its normalization process, steepening over the short to intermediate term. We believe that front-end rates will be a more powerful component in the steepening, but we also think that long-end Treasuries could, once again, serve as an insurance policy against risk asset volatility and uncertainty related to non-market-based risk factors (with geopolitical risk at the top of the list).

Our views on interest rates remain anchored in our focus on real rates. The return of positive real rates makes the bond market more compelling from a return standpoint, while also offering some protection against changes in inflation expectations. The return of term premium will become a greater focus for all investors, as the new 'red wave' administration will have the ability to alter policy positions of the prior administration.

Once again, the highest conviction today is that we will experience higher levels of volatility in rates and the shape of the yield curve. Lastly, we would be remiss to not mention the growing concerns around deficits and the debt burden. The complete disregard for any level of fiscal discipline by either party is a growing risk factor that could sneak up on the rates markets, and therefore, have a bigger impact on all markets.

Investment Grade & High Yield

Investment Grade – *Jonathan Aal*

Less than a week after the recent elections, U.S. Investment Grade (IG) Corporate Credit achieved a milestone not seen in nearly two decades. The last instance of IG credit spreads reaching 76 OAS occurred on March 11, 2005—a level few could have predicted would take 19 years to revisit. Remarkably, on November 7th, just two days post-election, spreads fell to 75 OAS. This milestone, alongside the underlying "math behind the market," highlights a noteworthy moment in credit markets.

That said, it's important to acknowledge that we are here for a reason. As we look ahead, we see both fundamental and technical strengths trending favorably into the foreseeable future. While we are cautious about how much this may translate into further spread compression, our focus now shifts to identifying ways to create future optionality within our Investment Grade credit allocations. This brings with it a heightened focus on the "math behind the market'.

High Yield – *Garrett Olson*

A "Red Sweep" scenario could be viewed as creating a favorable "Goldilocks" environment for risk assets, driven by expectations of lower taxes, improved margins, deregulation, and increased M&A and capital expenditure activity. These factors are underpinned by a fundamentally healthy corporate backdrop and a technical landscape supportive of risk assets.

However, the current spread environment reflects these positives. High Yield OAS, now at 15-year lows and in the 2nd percentile over the past 30 years, leaves investors with minimal compensation for potential adverse developments. While historically attractive yields and relatively short durations provide some support for forward returns, we remain biased toward a defensive positioning. Our focus is on moving up in quality and toward fundamentally improving credits, particularly given the lack of meaningful dispersion in the market, which limits opportunities for differentiation.

Leveraged Loans & Mortgage-Backed Securities

Leveraged Loans -- *Garrett Olson*

Heading into the election, consensus sentiment toward the leveraged loan asset class was broadly negative, driven by deteriorating credit fundamentals. Factors such as higher leverage, lower interest coverage relative to High Yield borrowers, and a pronounced imbalance of ratings downgrades outpacing upgrades contributed to this view.

Post-election, market sentiment shifted, with renewed enthusiasm for floating-rate assets amid expectations of a slower and less substantial trajectory for rate cuts. This optimism for leveraged loans has resulted in significant retail inflows into the asset class. This, along with 62% of the market now trading above par, has led to elevated repricing activity, compressing discount margins and coupons, which has diminished the relative value of the asset class.

While we remain broadly cautious on leveraged loans, we continue to identify select opportunities to invest in secured credits with strong and improving fundamentals. These targeted investments have the potential to deliver attractive risk-adjusted returns despite the broader challenges facing the asset class.

Mortgage-Backed Securities -- *Eric Bernum*

Mortgages initially performed strongly post-election, alongside other risk assets, due to the expectation that deregulation could increase bank demand and the steepening of the yield curve, which is also good for MBS. As the market has further digested the implications of the election, MBS performance has become more mixed. While expectations of lower interest rate volatility are another positive theme for MBS valuations, this has been offset by questions around what absolute level interest rates will settle at. Mortgage OAS initially responded very positively, approaching YTD lows at 37 bps immediately post-election. However, since then, we have seen spreads widen to the mid-40s as the levels of initial optimism have been questioned.

Since the initial Fed cuts in September, MBS durations have been extending due to the move higher in interest rates flowing through to mortgage rates. At current levels, durations appear close to fully extended, making the risk factor of the asset class more manageable. We are monitoring the market for continued near-term rate volatility, combined with uncertainties surrounding the Trump administration's policies and their impact on the inflation narrative, which could create opportunities to add to the asset class. However, that decision is highly nuanced, as the spike higher in mortgage rates has had very divergent performance and valuation impacts across the MBS coupon stack.

Preferred Securities

Preferred Securities – *Eric Bernum*

Preferred securities have seen recent underperformance since the Fed's first Fed Funds rate cut back in September, given the move higher in US Treasury yields. With performance down about 200 bps over this time, preferred valuations have come down from very high levels. However, with the strong fundamental backdrop and the massive technical of investors searching for yield, preferreds are still one of the best-performing asset classes in the fixed-income market, with ~10% year-to-date performance. Election impacts on the preferred space are arguably more generic and market-related, as the overall level of interest rates and the tone for risk assets will be larger drivers of performance going forward than any election-specific impact to the sector. The only tangible outcome of the election on preferreds is the idea of less regulatory pressure on banks, which could reduce future preferred issuance, creating a supportive supply-demand technical for the asset class.

With valuations for preferreds ranging from the mid-5% to mid-6% yield range and spreads in the 150-250 range, we think valuations are still pricing in benign, if not optimistic outlooks. These valuations don't leave a large cushion or margin of safety for unexpected outcomes in the market. Given these relatively compressed current valuations, we remain incrementally more cautious around the asset class outlook, as future returns for this part of the market are extremely sensitive to both credit spreads and overall interest rate levels.

Closing Comments – Gibson Smith

As fixed-income investors, we inherently lean toward cautious optimism while always considering outcomes related to downside scenarios. Heightened rate volatility appears likely as we extend into the new year, and the consensus view seems very complacent regarding risk. This is not a time to chase yield blindly or fall into the carry trap; instead, it's a moment to focus on fundamentals, liquidity, and disciplined security selection.

We are concentrating our decreased exposure in our credit weighting toward credits with improving fundamentals and strong free cash flow generation, as we believe these are best positioned to withstand potential volatility. While spread tightening has driven valuations to extremes, we remain watchful for opportunities to reposition portfolios when markets overreact, taking advantage of spread widening opportunities.

If one thing is certain, the post-election market environment will be dynamic. Success in this environment demands agility, foresight, and a focus on investments with greater resiliency. We find our post-election views to be largely aligned with the consensus, giving us some discomfort, but also knowing that the current administration will bring significant change and likely elevated volatility. Active management will remain critical—we're committed to navigating this landscape with discipline and adaptability.

We look forward to providing more thoughts around 2025 as we head into the end of the year.

As always, we want to thank you for your partnership and trust.

Wishing you a Happy Thanksgiving.

- Gibson and Team

Important Notices and Disclosures

The opinions and views expressed are as of the date published and are subject to change without notice. Information presented herein is for discussion and illustrative purposes only and should not be used or construed as financial, legal, or tax advice. It is not a recommendation or an offer or solicitation to buy, sell, or hold any security, investment strategy, or market sector. No forecasts can be guaranteed.

Any investment or management recommendation in this document is not meant to be impartial investment advice or advice in a fiduciary capacity, and it is not tailored to the investment needs of any specific individual or category of individuals. Opinions and examples are meant as illustrations of broader themes, are not indicative of trading intent, and are subject to change at any time due to shifts in market or economic conditions. There is no guarantee that the information supplied is accurate, complete, or timely, nor are there any warranties concerning the results obtained from its use. It is not intended to imply that any illustration or example mentioned is now or was ever held in any portfolio.

Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation, default, and liquidity risk. The bond market is volatile, and the value of most bonds and bond strategies is affected by changes in interest rates. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or if its credit strength weakens. High-yield or "junk" bonds involve a greater risk of default and price volatility and can experience sudden and sharp price swings.

The information included in this report may contain statements related to future events or developments that may constitute forward-looking statements. These statements may be in the form of financial projections or may be identified by words such as "expectation," "anticipate," "intend," "believe," "could," "estimate," "will," "should," or similar expressions. Such statements are based on the current expectations and certain assumptions of the author and are, therefore, subject to certain risks and uncertainties.

All indices are unmanaged. You cannot invest directly in an index. Index or benchmark performance presented in this document does not reflect the deduction of advisory fees, transaction charges, and other expenses, which would reduce performance.

Please consider the charges, risks, expenses, and investment objectives carefully before investing. Review a prospectus, or, if available, a summary prospectus containing this and other information. Read it carefully before you invest or send money. Investing involves risk, including the possible loss of principal and fluctuation of value.

This material may not be reproduced in whole or in part in any form or referred to in any other publication without express written permission from Smith Capital Investors.

Smith Capital Investors, LLC is an SEC-registered investment adviser. Registration with the SEC does not imply any specific qualifications.

SCI0555