IR+M
INCOME RESEARCH + MANAGEMENT

PLAYING WITH THE WIND AT OUR BACKS IN 2024

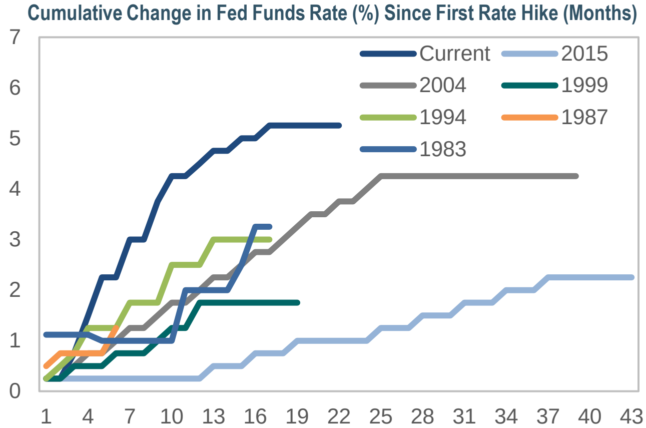
January 9, 2024

For market participants and spectators, 2023 seemingly had a little bit of something for everyone: a nail-biter of an acute banking crisis; near-miss on a US government shutdown; a downgrade of the home team's credit rating. These events, coupled with ongoing geopolitical conflicts and rate volatility, made 2023 a challenging, but memorable year. With a US presidential election, possible government shutdown, and rate cuts on the horizon, 2024 may be another year awash with momentum shifts and unexpected winners and losers. As investors grapple with persistently high yields and volatility, we believe that there will be opportunities for skilled active managers to shine.

2023 HIGHLIGHT REEL

FASTEST RATE HIKING CYCLE EVER

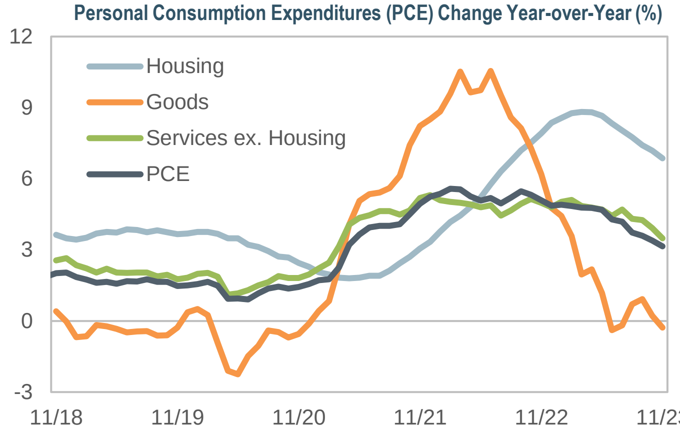
Cumulative Change in Fed Funds Rate (%) Since First Rate Hike (Months)



The Federal Reserve (Fed) continued its fight against inflation, hiking rates four times in 2023. The fed funds target range ended the year at 5.25-5.50%, slightly above 2022's dot plot projection of 5.00-5.25%.

STUBBORN INFLATION PERSISTS

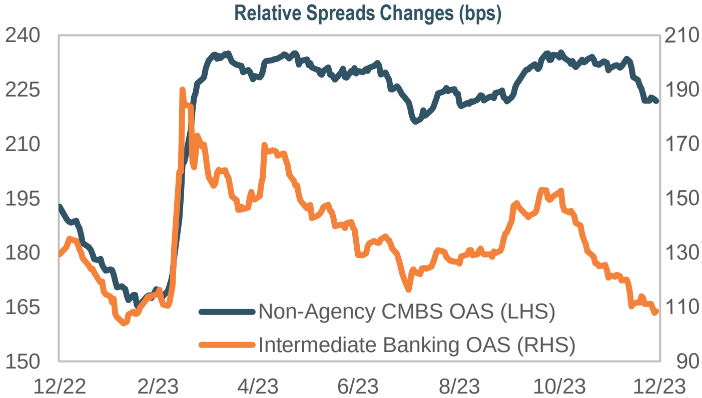
Personal Consumption Expenditures (PCE) Change Year-over-Year (%)



Tight monetary policy helped curb inflationary pressures – PCE fell to 3.2% in November – but it remained above the Fed's long-term 2% target. While goods inflation fell, monetary policy alone has not been enough to significantly reduce housing and services inflation.

COMMERCIAL REAL ESTATE AND REGIONAL BANKS SHOWED CRACKS

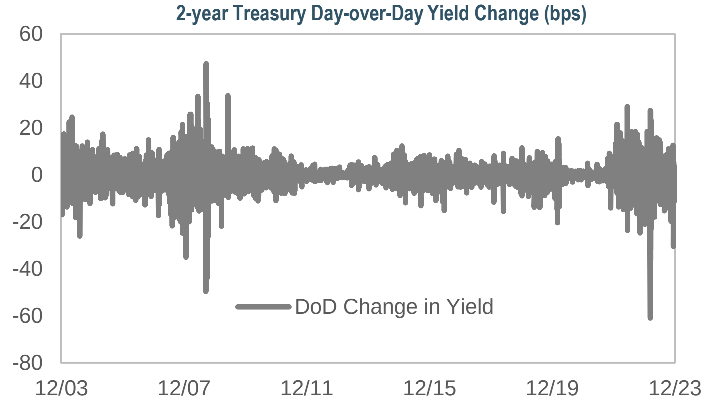
Relative Spreads Changes (bps)



While the collapse of Silicon Valley Bank forced investors to reassess the stability of financial institutions, central banks quickly stepped in to alleviate widespread contagion. Conversely, the Commercial Real Estate sector, stressed by higher rates and lower occupancy levels, ended the year weaker.

RECORD RATES MARKET VOLATILITY

2-year Treasury Day-over-Day Yield Change (bps)



The rates market grappled with a variety of macro, fundamental, and geopolitical events. In March, the 2-year Treasury fell over 60bps day-over-day, the largest single-day change in over two decades.

Source: Bloomberg as of 12/31/23 unless stated otherwise. Top left chart: Shows the change in Fed Funds Rate (%) during the respective hiking cycles using the Fed Funds Target Range Upper Bound. Top right chart: shows the different components of the Personal Consumption Expenditures (PCE) as of 11/30/23. Bottom left chart: Non-Agency CMBS is based on the Bloomberg Non-Agency Investment Grade CMBS Index. Intermediate Banking is based on the Bloomberg US Intermediate Corp Banking Index. The views contained in this report are those of Income Research & Management ("IR+M") and are based on information obtained by IR+M from sources that are believed to be reliable but IR+M makes no guarantee as to the accuracy or completeness of the underlying third-party data used to form IR+M's views and opinions.

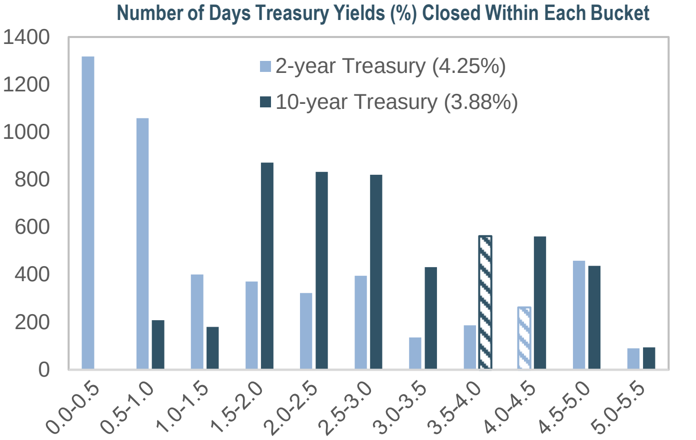
PLAYING WITH THE WIND AT OUR BACKS IN 2024

January 9, 2024

TODAY'S STANDINGS

YIELDS REMAIN ATTRACTIVE…

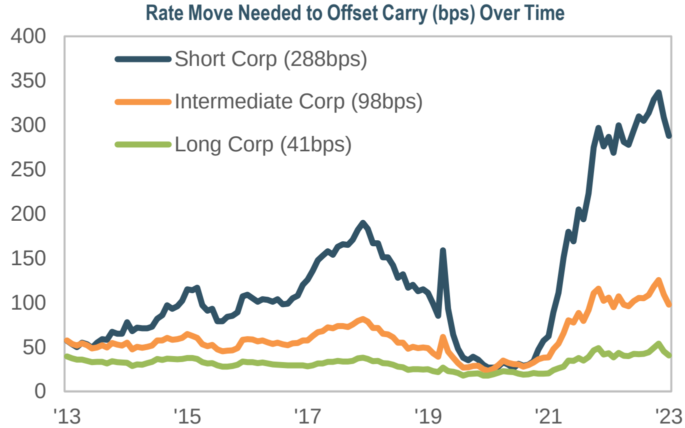
Number of Days Treasury Yields (%) Closed Within Each Bucket



Yields, the primary driver of long-term returns, remain elevated and at levels not seen since 2006-07. Today's investors benefit from the high carry and may see additional price appreciation if rates converge towards historical averages.

…AND PROVIDE AMPLE CARRY SHOULD RATES RISE

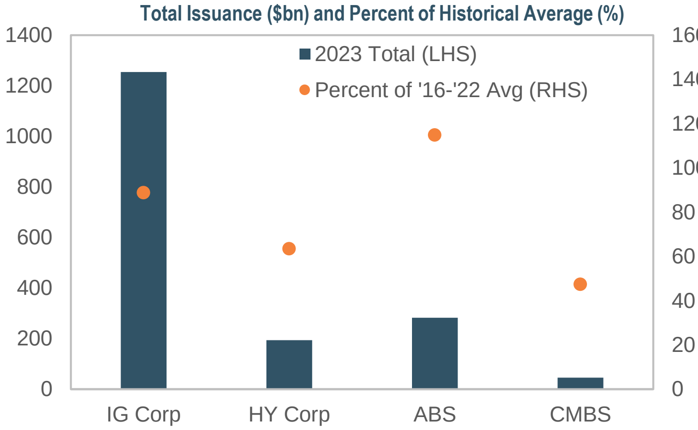
Rate Move Needed to Offset Carry (bps) Over Time



A large rate increase, while unexpected, is now needed to result in a negative total return. Short corporate rates would need to increase by almost 300bps for the negative price return to offset the carry.

FEWER BONDS TO GO AROUND

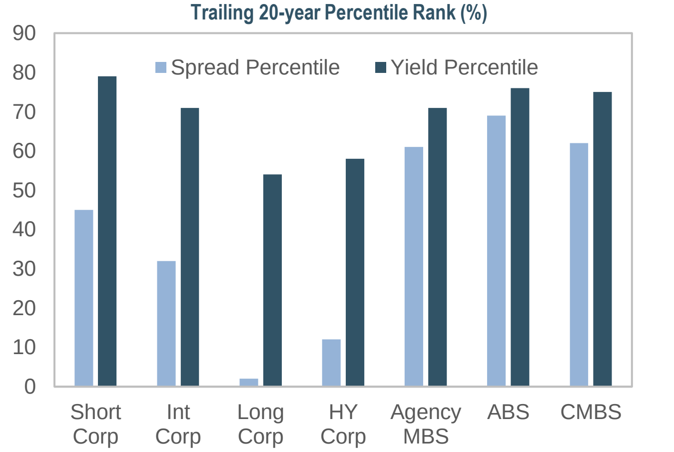
Total Issuance ($bn) and Percent of Historical Average (%)



Many issuers remain on the sidelines in the hopes that rates settle lower and volatility decreases. High yield corporate and CMBS issuers will likely be opportunistic and avoid issuing new debt in the short-term.

CONFLICTING VALUATION METRICS

Trailing 20-year Percentile Rank (%)



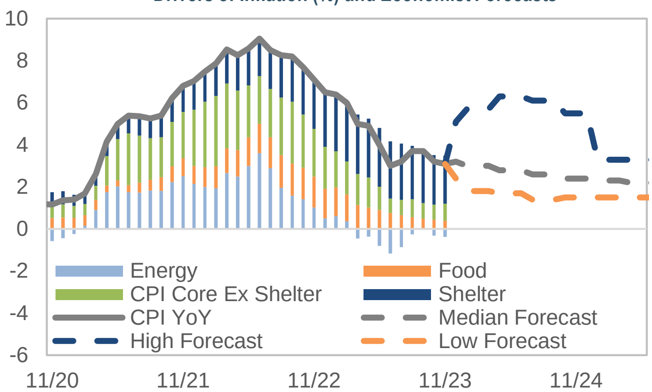
While yields across sectors ended the year near recent highs, limited supply, solid fundamentals, and strong flows into fixed income funds kept spreads tight relative to recent history.

Sources: Bloomberg as of 12/31/23 unless stated otherwise. Top left chart: patterned bars represent which bucket the most recent month-end yield falls into. Top right chart: each category based on Bloomberg Indices (Short = Bloomberg 1-3yr Corporate Index, Intermediate = Bloomberg 3-10yr Corporate Index, Long = Bloomberg Long Corporate Index). Rate move needed to offset carry is calculated by dividing the yield to worst by the duration as of each month-end. Bottom left chart: sourced from Bloomberg as of 12/31/23 and are based on Bloomberg estimates of supply across those sectors. Bottom right chart: each category based on Bloomberg Indices (Short = Bloomberg 1-3yr Corporate Index, Intermediate = Bloomberg 3-10yr Corporate Index, Long = Bloomberg Long Corporate Index, Bloomberg US High Yield Index, Bloomberg US MBS Index, Bloomberg ABS Index, and Bloomberg CMBS Index, respectively). Percentile calculated using monthly spread and yields back 20 years. The views contained in this report are those of Income Research & Management ("IR+M") and are based on information obtained by IR+M from sources that are believed to be reliable but IR+M makes no guarantee as to the accuracy or completeness of the underlying third-party data used to form IR+M's views and opinions.

PREVIEWING THE 2024 SEASON

INFLATION REMAINS CENTER STAGE

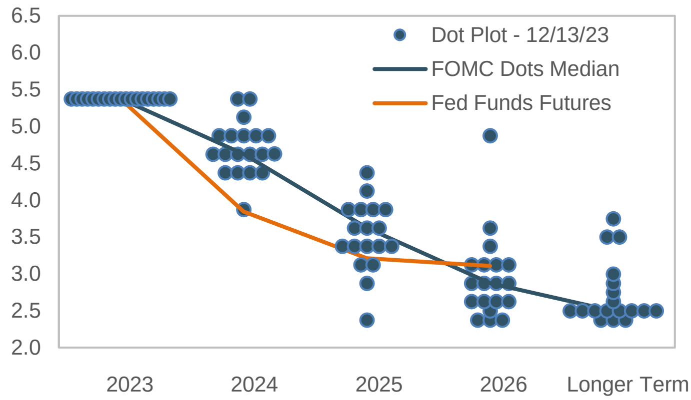
Drivers of Inflation (%) and Economist Forecasts



Inflationary pressures are expected to wane in 2024, but crossing the Fed's 2% threshold would signal a recession. While not consensus, the risk of rising inflation remains, especially if energy prices rebound.

IS THE FED BEHIND THE CURVE?

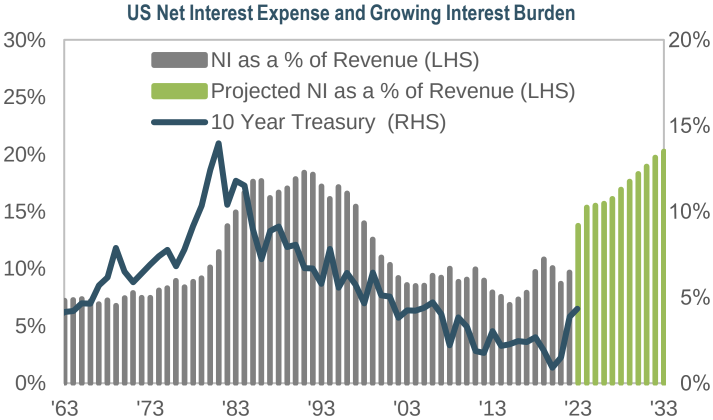
December Fed DOT Plot and Fed Futures (%)



The December dot plot signaled a dovish pivot that resulted in rates immediately falling. FOMC members have since reiterated that cuts are not guaranteed, but the market still predicts 6 cuts of 25bps each in 2024.

INTEREST EXPENSE IS BECOMING A BIGGER BURDEN

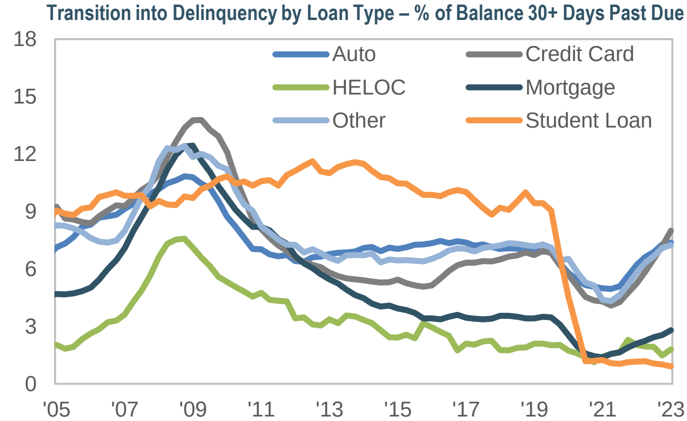
US Net Interest Expense and Growing Interest Burden



Almost a third of all Treasuries mature in 2024 and the higher interest expense will put further strain on the already stressed fiscal situation.

TIGHTER MONETARY POLICY IMPACTING CONSUMERS

Transition into Delinquency by Loan Type – % of Balance 30+ Days Past Due



While still below past peaks, delinquencies are trending higher amid rising interest and student loan payments. Despite the headwinds, consumers remain confident with prospects of increased wages, improved economic conditions, and healthy job prospects.

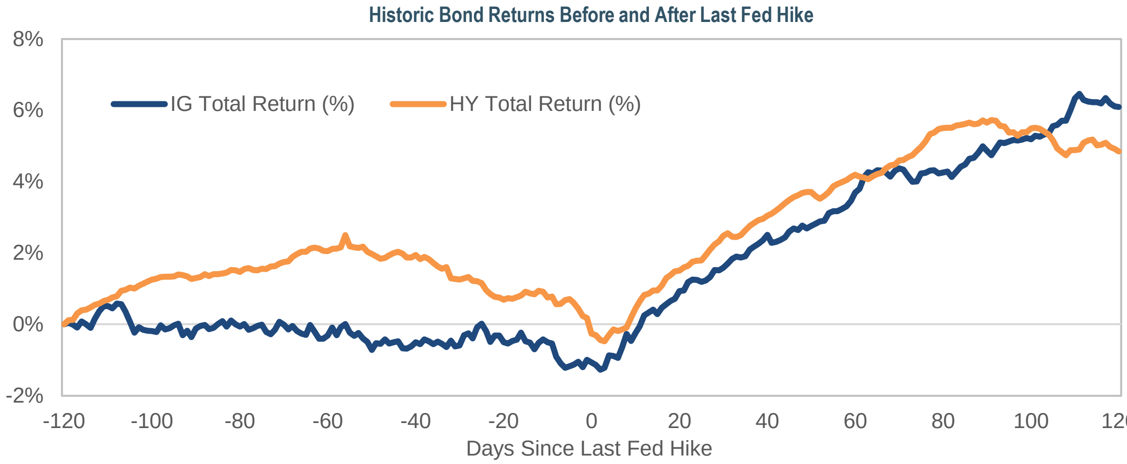
Source: Bloomberg as of 12/31/23 unless otherwise stated. Top left chart: As of 11/30/23 but retrieved on 12/12/23; dashed grey line represents estimated median year-over-year change in CPI and the navy and orange dashed lines represent the high and low forecasted year-over-year change in CPI. Top right chart: Fed dot plot as of 12/13/23 FOMC meeting. Fed funds futures as of 12/31/23. Bottom left chart: Source: Congressional Budget Office data retrieved on 9/26/2023 and the 10 Year Treasury from Bloomberg as of 11/30/2023. Bottom right chart: sourced from Bloomberg as of 9/30/23. Other includes retail cards and other consumer loans. The views contained in this report are those of Income Research & Management ("IR+M") and are based on information obtained by IR+M from sources that are believed to be reliable but IR+M makes no guarantee as to the accuracy or completeness of the underlying third-party data used to form IR+M's views and opinions.

INCOME RESEARCH + MANAGEMENT

PLAYING WITH THE WIND AT OUR BACKS IN 2024

January 9, 2024

COULD THE DOVISH PIVOT SIGNAL A RESURGENCE FOR FIXED INCOME RETURNS?



THE IR+M 2024 PLAYBOOK

PREPARE FOR ANY CONDITIONS

- Trim credits more susceptible to underperformance during market stress and reduce lower-conviction positions.

BUILD A STRONG BENCH

- Build liquidity to opportunistically capitalize on any spread moves – either wider or tighter.

PLAY TO YOUR STRENGTHS

- Opportunistically search the markets for mispriced, misunderstood, and overlooked bonds, capitalizing on security selection expertise.

KNOW WHEN TO CALL IN REINFORCEMENTS

- Monetize outperformers that have little upside and rotate into higher-quality alternatives with attractive risk-reward profiles.

2024 SCHEDULE

- Fed Meeting Dates – January, March, April, June, July, September, November, December
- Market's First Expected Rate Decrease – March
- Debt Ceiling Dates – Jan 19th /Feb 2nd
- First US Primary (NH) – Jan 23rd
- US Election Date – November 5th

WHAT TO WATCH

- Inflation Trend
- Consumer Health/Delinquencies
- Labor Markets/Wage Growth
- Housing Market
- Geopolitical Risks
- Commercial Real Estate

At IR+M, we believe 2024 could be just as eventful as the last year with several potential destabilizers on the horizon. We embrace market environments that have historically led to greater volatility, dispersion, and opportunities. Through active risk management and careful fundamental analysis, we believe fixed income investors should benefit from today's higher interest rates, which can further buoy long-term returns and provide some protection amidst volatility.

Source: Bloomberg as of 12/31/23 unless otherwise stated. The above IR+M 2024 Playbook shows themes we feel are most prevalent across IR+M's Broad Strategies in 2024 as of 12/31/23. Market conditions and opportunities could potentially change these themes. Top Chart: IG and HY total returns are based on the respective Bloomberg indices. Chart shows the average IG and HY total returns for the last three hiking cycles +/- 120 business days since last Fed hike. The views contained in this report are those of Income Research & Management ("IR+M") and are based on information obtained by IR+M from sources that are believed to be reliable but IR+M makes no guarantee as to the accuracy or completeness of the underlying third-party data used to form IR+M's views and opinions.