PERSPECTIVES – FEBRUARY 2024

2024 Outlook

Economic growth will likely slow, but remain positive, in 2024. The labor market is expected to soften, and inflation should moderate. The U.S consumer remains resilient, though the effects of growing debt burdens may dampen their ability to spend at elevated levels. The FOMC has reacted to this trend by signaling multiple rate cuts in 2024.

Economic Outlook

Many of the post-pandemic tailwinds that led to a surprisingly strong 2023 continue to fade as we enter 2024. Combined with the lagged effects of restrictive monetary policy, this will likely lead to slowing (but still positive) GDP growth in 2024. While the unemployment rate remained extremely low this year, job openings have declined as companies pull back hiring, and employee quit rates fell throughout the year. The labor market is expected to soften further due to slower growth and improved production efficiencies. In this more balanced labor market, wage inflation is also expected to moderate. A softening labor market and slower growth rate should put further downward pressure on inflation. Throughout 2023, U.S. consumers continued to spend despite depleting excess savings built up during the pandemic and the resumption of student loan payments. As companies scale back hiring and wage inflation moderates, the effects of growing debt burdens may dampen consumers' ability to continue to spend at elevated levels. Slowing growth, declining inflation, and a softening labor market are many of the key data points the FOMC is monitoring to definitively close the book on further rate hikes and move toward neutral policy.

Corporate Sector

The corporate bond market is expected to remain a key sector for the generation of investment income in 2024 due to the comparative yield advantage it provides versus other sectors of the investment grade universe and the ability to achieve good diversification by industry mix and issuer. Fundamental credit quality is expected to benefit from slow but positive growth, moderating inflation and declining rates. Corporate earnings should return to positive growth, following three consecutive quarters of contraction. Although spreads have contracted considerably and below long-term averages, absolute yields remain attractive and are expected to remain sufficiently high. Considering the full effects of tighter monetary policy, higher interest rates, tighter bank lending, and inflation, a downside scenario could emerge. If so, companies will benefit from the fiscal discipline they have exercised in recent quarters.

Credit Fundamentals: Per Wall Street consensus, investment-grade credit metrics are expected to be resilient in 2024, even with key leverage and interest coverage ratios having recently weakened. This is both because most of the deterioration in credit metrics is coming from the commodity sectors, and because companies have cut back aggressively on shareholder payouts and are slowing capex. Both trends show a conservative balance sheet focus which is good for creditors. Although credit metrics have weakened due to slower EBITDA growth, tighter margins, higher interest expense, and rising debt levels, it has so far not been enough to impair ratings as evidenced by the YTD U.S. investment-grade corporate rating upgrade/downgrade ratios of approximately 1.2x. Companies have exercised financial discipline in recent quarters, with many expressing a willingness to continue doing so to absorb some of the downside of inflationary pressures, recessionary concerns, and the impact of higher rates. The outlook for corporate earnings shows improvement in 2024. Lower oil prices are likely to continue to lead to weakness in commodity sector results, but these companies generally have strong credit metrics. The increase in earnings ex-commodities expected in coming quarters should help stabilize and perhaps improve credit metrics going forward, modestly offset by steadily rising interest expense.

Earnings Outlook: Based on consensus estimates, earnings should remain positive through 2024. All 11 sectors in the S&P 500 are expected to report positive full-year results. Key drivers of the upswing include low-single digit top-line growth driven by economic growth and consumer spending. According to FactSet consensus, net profit margin for the S&P 500 for CY 2024 will be 12.3%, which is above the estimated net profit margin of 11.7% for CY 2023. Nine of the eleven sectors are projected to report higher net profit margins in CY 2024. Drivers of margin expansion should include operating leverage, moderating of wage and labor expense pressures, cost inflation,

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and lower interest rates. However, substantial margin expansion is unlikely given interest rate forecasts, limited pricing power of consumers, resilient wage growth, and ongoing technology spending initiatives for some companies. Sources of downside to earnings include the ultimate impact that higher rates, inflation and tighter bank lending have on economic growth and consumer spending, the resumption of U.S. federal student loan payments, and concern about the health of lower-income consumers. There is also uncertainty about companies' more limited pricing power amid an environment of an increasingly pressured consumer as Americans deal with high prices for most goods, energy and services, coupled with higher borrowing costs.

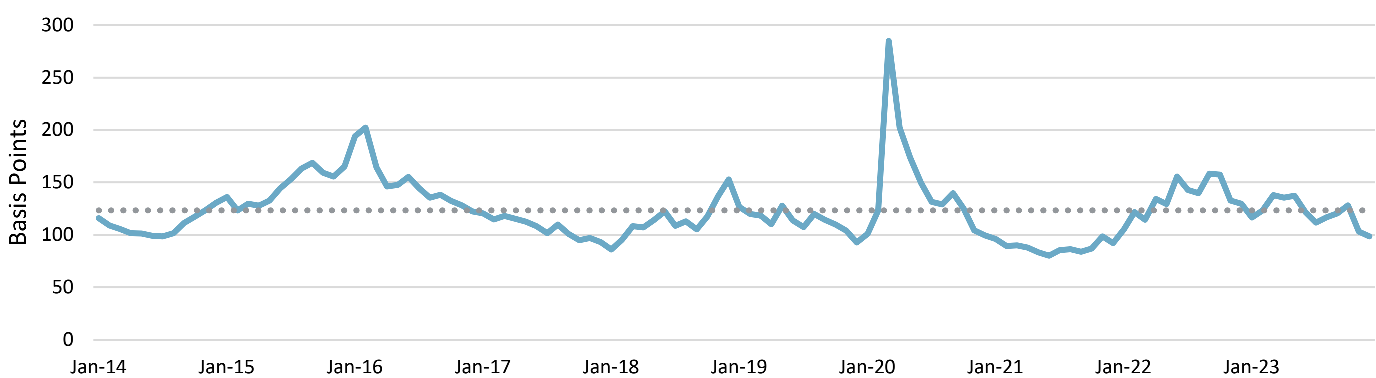
Municipal Sector

State and local issuers were diligent in boosting reserves during the past few fiscal years, aided by extraordinary federal support during the pandemic period and above-forecast tax revenue growth. The latter was attributable to continued wage growth, particularly among high-income individuals, and home price appreciation having lifted property tax collections. More recently, we have seen a reversal in this revenue trend, with income and sales tax revenues forecast to decline into the next fiscal year as economic growth slows. States and municipalities have been proactive in keeping expenditure growth in check, despite inflation pressures (including on wages); combined with strong reserves, these entities should manage through the near-term growth headwinds. Ratings movement, as measured by upgrades/downgrades, has been very strong in 2023. Unlike in other sectors, key challenges in the municipal sector are long-term in nature and require long-term solutions.

Our focus will continue to be on the taxable municipal market, given current tax-exempt/taxable ratios, the prevailing corporate tax rate, and the effect of proration. However, we continue to monitor these trends over time, and will consider adding tax-exempts opportunistically based on relative value. The fact that the value of the tax exemption is significantly higher for high-income individual investors, because of their meaningfully higher marginal tax rate, means that tax-exempts normally only look attractive to us in times of significant market volatility.

Taxable supply is expected to remain subdued in 2024, as in this past year, following significant issuance in 2020 – 2022 largely driven by taxable advance refundings. In our view, the current and projected rate environment simply does not support a continuation of strong refunding issuance. Therefore, absent a significant rally in rates, taxable supply will be minimal and driven by new money issuance.

Exhibit 1: Corporate spreads (the added yield for taking risk above the risk-free rate) are trading inside the long-term average reflecting growing confidence that a recession will be avoided and that the FOMC will begin reducing rates in 2024.



Source: Bloomberg U.S. Corporate Bond Index, Opus

Residential Mortgage-Backed Securities (RMBS)

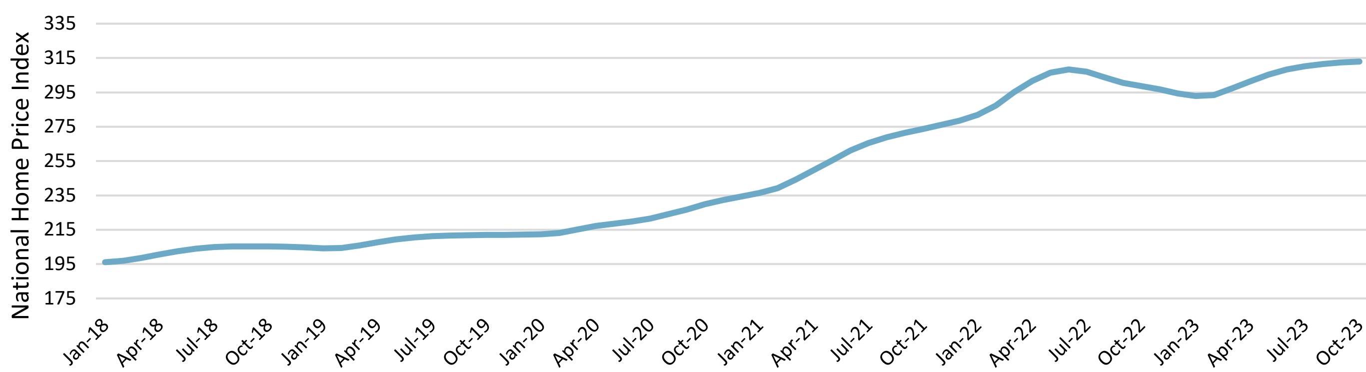
RMBS began 2023 outperforming U.S. Treasuries until the second week of March, following several large bank failures and a spike in interest rate volatility in the aftermath. RMBS recovered rather quickly as the Fed implemented new funding facilities for depository institutions, and the FDIC hired Blackrock to facilitate the liquidation of the failed bank securities portfolios. Inflows into bond funds played a pivotal role in soaking up the FDIC supply, especially the demand from passively managed funds, as they track indices composed of primarily lower coupon RMBS pools. In the autumn months, markets began to price the end of the current rate hiking cycle and a higher likelihood of a soft landing, which led to a swift tightening in RMBS into the end of the year.

Mortgage rates remained elevated during the year, reaching 8% for a 30-year fixed-rate mortgage for the first time since June 2000. Home prices continued to increase despite historically high mortgage rates, rising 6.08% YTD through September 30, according to the S&P CoreLogic Case-Shiller U.S. National Home Price Index. With prices and rates at such high levels, affordability continues to be challenged, with a median household income being unable to afford a median-priced home. Other key contributors to the housing market's current state include the limited supply of new and existing homes. As a result, many forecast that home price appreciation will continue in 2024, albeit at a more moderate pace than 2023, and prepayment risk will remain muted.

The limited supply picture for 2024 may contribute to more stability for RMBS performance and perhaps lead to outperformance next year. However, the demand for RMBS may remain challenged following a very difficult year for the largest buyer base of RMBS, domestic banks. This investor cohort has been largely absent for all of 2023, although many do anticipate they will come back into the market during the second half of 2024 as the FOMC maintains its pause or begins rate cuts, and there is more clarity regarding Basel III endgame and the changes to risk weights and capital requirements.

Despite more recent tightening in the sector, current valuations are historically cheap, and several factors could be an impetus for spread tightening, including significantly lower net supply, the re-emergence of bank demand, declining rate volatility, and the current cross-sector relative value that favors both Agency and Non-Agency RMBS. Given the technical backdrop, it is probable that nominal spreads could be tighter by the end of 2024; however, the path will undoubtedly present opportunities for substantial new money investment into the RMBS sector, further bolstering the liquidity and credit quality of the overall portfolio.

Exhibit 2: Home prices continued to increase throughout 2023 despite higher mortgage rates challenging affordability



Source: S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index, Opus

Commercial Mortgage-Backed Securities (CMBS)

2023 was a very challenging year for commercial real estate. Rising interest rates pressured properties that face refinancing needs and pushed cap rates higher placing downward pressure on valuations. Following the bank turmoil in late Q1, regional banks also pulled back from lending. GDP and employment were generally strong throughout the year which helped property cash flows. Delinquencies increased, largely driven by the office sector, where vacancies are at multi-year highs in some metropolitan areas. As we look forward, the commercial real estate market has not fully adjusted to current interest rates and could face further valuation declines. Cap rates have gone higher but there has been a limited number of transactions to truly determine the market clearing prices for challenged sectors (e.g., office). Estimates of property price declines range from 10% to 25% with some more bearish expectations assigning as much as a 40% decline in office property valuations. 2023 saw average refinance and extension trends; however, the volume of debt needing to refinance increases in 2024. With a solid economy, the risk continues to skew more towards a maturity default (where the loan is current but cannot be refinanced) given the significant increases in rates. Office will remain in the spotlight with the dispersion between well-located, high amenity Class A buildings and more commodity buildings expected to widen further. Focusing on quality, location, and diversification has always been a hallmark of our CMBS investing strategy which will continue. Commercial real estate is often a laggard and there are risks ahead as we enter 2024 - valuations sit at multi-year wides relative to the corporate sector and therefore reflect this risk.

Asset-Backed Securities (ABS)

2023 saw prime borrower pools perform within pre-pandemic expectations whereas subprime pools saw more pronounced credit deterioration and faster increases in delinquencies that set new records. Subprime consumers suffered disproportionately when higher inflation worked its way through the economy. Tighter underwriting standards were implemented over the past few years, with banks' willingness to lend contracting. This should help performance on higher quality ABS pools that come to market as we approach 2024 funding.

While student loan payment resumption is expected to affect consumers, economists estimate the drag on economic growth to be minimal. There may be marginal impacts to performance from consumers with an outstanding student loan, but the guardrails in place for resumption should minimize the flow through impact. These guardrails do expire in the second half of 2024; however, if Biden were to win re-election, student loan relief may be back on the agenda.

Idiosyncratic sponsor risks remain elevated as recession probabilities have not diminished. In 2023, two small subprime ABS issuers exited the market, American Car Center and U.S. Auto. While there was no disruption to the overall industry, it did create headline risk. Certain bonds of these entities were downgraded, reflecting shutdowns, servicing transfer, and lagging performance of the receivables.

We are also likely to see a continued pickup in issuance from new auto lending platforms as new capital requirements make it more efficient for larger financial institutions to securitize loans. Captives, credit unions and regional banks were in the spotlight in 2023 as old issuers returned and inaugural issuances expanded the market size. There were also three new credit union transactions, doubling the list to six credit union issuers in total. Total 2024 ABS supply is expected to be around $267 billion, higher than the $255 billion issued in 2023.

Equity Sector

In 2023, market volatility rose and relative value in investment grade fixed income became increasingly attractive. Sell-side strategists' median index estimates for 2024 year-end forecast the following modest return expectations

Exhibit 3: Sell-side strategists' median index estimates for 2024 year-end forecast.

S&P 500 Index	1.4%
Euro Stoxx 600 Index	2.1%
FTSE 100 Index	6.4%

Source: Bloomberg

These return forecasts show equity returns may not have an impressive year in 2024. We expect earnings, economic data, and Fed actions to drive equity market sentiment to start 2024. Specifically, we will be closely monitoring corporate earnings and stated guidance, any recessionary signs (such as negative GDP growth), and the Fed's monetary policy. We will also maintain focus on whether high growth technology companies that dominate market indices can continue to outperform considering the top five companies (Apple, Microsoft, Amazon, NVIDIA, and Alphabet) make up more than 22% of the S&P 500 Index.