Active Management.
Independent Perspectives.
Serving Fixed Income Investors Since 1970.

2025 OUTLOOK: A YEAR OF OPPORTUNITY

Our 2025 fixed income outlook is driven by three themes

> **Fixed Income is attractive in our view, both on an absolute and relative basis**. We remain defensive regarding credit risk.

> **We expect easing monetary policy to be supportive of fixed income in 2025**. Historically, fixed income has performed well during rate cutting cycles.

> **Although we are defensive with regards to credit positioning, we think there are a couple pockets of opportunity.** Treasury securities' defensive nature is attractive, and Asset Backed Securities (ABS) offer value relative to other credit asset classes.

What's Inside

20241216-4101751

Executive Summary

Fixed income investors may benefit from higher yields, as historically, fixed income returns have been highly correlated to starting yields. In our view, the potential for increased inflationary pressures and tighter-than-historical average credit spreads supports defensive credit positioning.

	Defensive	Neutral	Aggressive
Credit Positioning	☑	☐	☐
Investment Grade	Underperform	Neutral	Outperform
Treasury	☐	☐	☑
Agency MBS	☐	☐	☑
Agency CMBS	☐	☑	☐
Corporate	☑	☐	☐
Loans	☑	☐	☐
Asset Backed Securities	☐	☐	☑
Commercial Mortgage Backed Securities	☐	☑	☐
Taxable Municipal Bonds	☐	☑	☐
Tax Exempt Municipal Bonds	☐	☑	☐
Below Investment Grade	Underperform	Neutral	Outperform
High Yield Bonds	☑	☐	☐
Loans	☑	☐	☐

For illustrative purposes only--not to be construed as investment advice or a recommendation to buy, sell or hold any security

As of October 31, 2024. The above views reflect the relative value of sectors shown based on the forward-looking return expectations over the next 12 months relative to the Bloomberg U.S. Aggregate Index. A defensive stance in fixed income investing involves making choices that prioritize safety and stability, even if it means sacrificing some potential returns in exchange for reduced risk. It's a strategy often favored by investors seeking to protect their portfolios during periods of uncertainty or economic downturns.

Investment Grade Bonds

Investment Grade Corporate bonds are offering lower compensation (or spread), relative to history, for taking credit risk.

High Yield Corporate Bonds

High Yield Corporate bond spreads are near historic lows and we anticipate increased volatility in 2025, as post-election optimism might give way to the practicalities of governing and potential inflationary pressures.

Taxable Municipal Bonds

We expect credit quality for taxable municipal bonds to remain strong. Although spreads are tighter than historical averages, taxable municipal bonds are fairly valued relative to other spread products.

Tax-Exempt Municipal Bonds

Tax-exempt municipal bonds continue to be an attractive opportunity for tax-sensitive investors, as credit quality remains strong and tax equivalent yields are compelling.

Securitized Debt

Residential Mortgage-Backed Securities (MBS), Asset Backed Securities (ABS), and Commercial Mortgage-Backed Securities (CMBS) may offer compelling relative value opportunities.

Money Markets

Cash currently offers compelling yields, but we think reinvestment risk is rising and intermediate duration bonds might offer better return opportunities.

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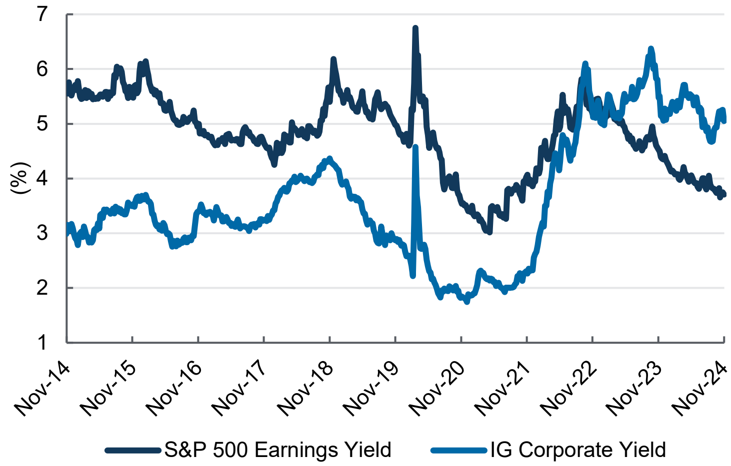
Fixed Income is Positioned for Success in 2025

Current valuations show fixed income attractive on an absolute and real basis. Real yields are currently positive, reaching pre-GFC levels. This indicates to us that investors are being better compensated for inflation risk, as real yields are adjusted for inflation **(Chart 1)**. Nominal yields are historically elevated as well, offering fixed income investors an attractive opportunity to benefit from price appreciation in a falling rate environment **(Chart 3)**.

Chart 1: 10 Year Inflation Indexed Treasury Real Yield

Source: Bloomberg.

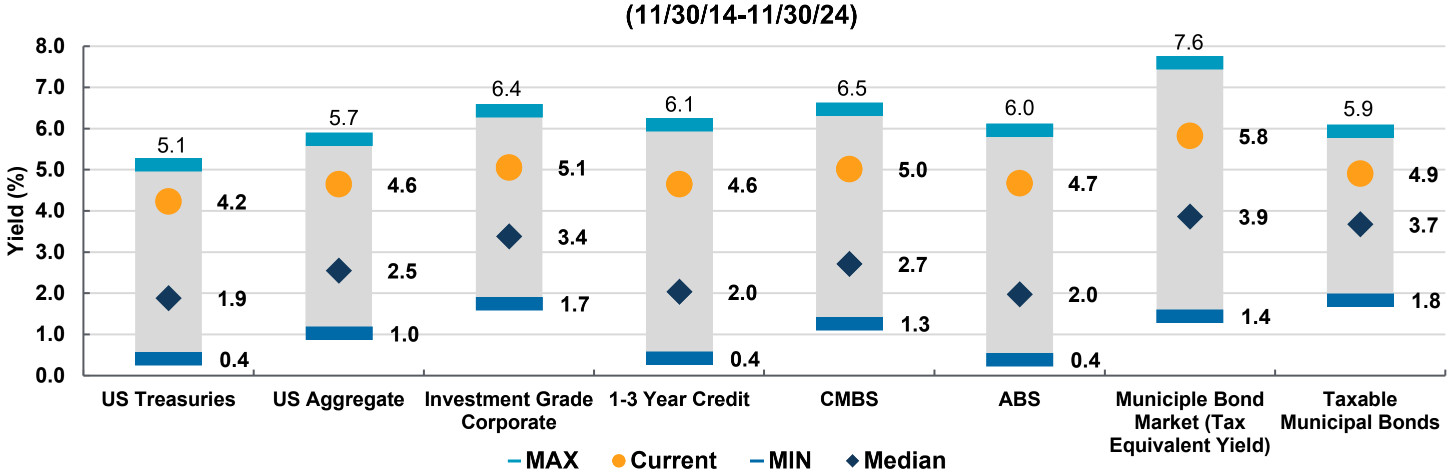
Chart 2: Investment Grade Corporate Yields Exceed Equity Earnings Yield



Source: Bloomberg.

On a relative basis, the yield on investment grade corporates has surpassed the earnings yield on the S&P 500 **(Chart 2)**. This highlights to us that fixed income is well positioned as both a shock absorber and a relatively attractive income generator due to elevated yields. Corporate credit spreads are still very tight, however, indicating that compensation for taking on additional credit risk is low. This has informed our defensive positioning across the platform – but overall fixed income looks attractive.

Chart 3: Ten-year Historical Yield Ranges (11/30/14-11/30/24)



Source: Bloomberg; Indices represented are Bloomberg US Treasury Index, Bloomberg US Aggregate Index, Bloomberg US Corporate Index, Bloomberg 1-3 yr Credit Index, Bloomberg US CMBS: Erisa Eligible Index, Bloomberg US Aggregate ABS Index, Bloomberg Municipal Bond Index, and Bloomberg Taxable Municipal Bond Index. Yield-to-worst is the lowest possible yield received on a bond, absent default. Tax Equivalent yield for Municipals assumes the highest tax bracket.

Past performance is no guarantee of future results.

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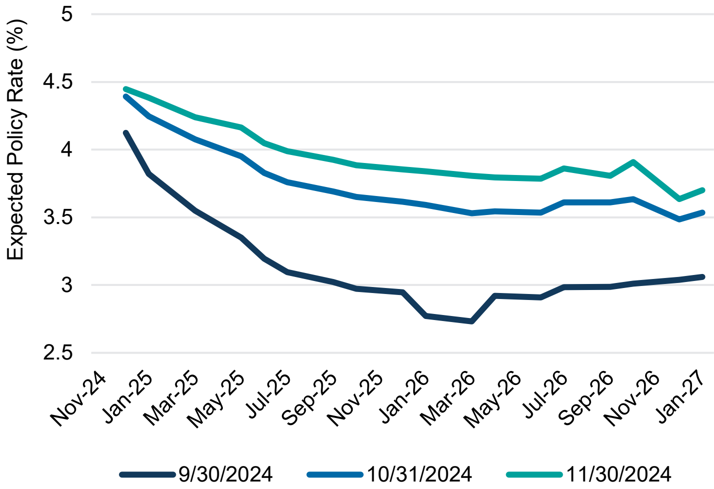
Rate Cuts and Post Election Investing

With the Fed cutting rates in September of this year – kicking off a long-awaited easing cycle – it seems possible that we are entering a rare non-recessionary rate-cutting cycle that should be supportive of fixed income performance. The range of potential outcomes is wide heading into 2025, nonetheless, we believe that the easing cycle will provide a favorable environment for fixed income, particularly high-quality bonds.

Additional rate cuts will be dependent on the strength of the labor market and further softening of inflation **(Chart 6)**, and we expect the Fed will be closely reviewing data to balance appropriate support for the labor market and inflationary pressures. Following shifts in political power and stronger than expected economic reports, markets have priced in a slower pace of rate cuts in 2025 **(Chart 4)**. Regardless of the pace or magnitude, we find it valuable to point out that the current environment differs from when President Trump took office the first time. While markets have already priced in some of the inflationary risks of potential policies including additional tariffs, reduced taxes, and large-scale immigration reform, **(Chart 5)** outlines that stronger growth, and higher inflationary pressures might make using Trump 1.0 an inappropriate model for Trump 2.0.

Chart 4: Markets Reduce Forecasts for Future Rate Cuts



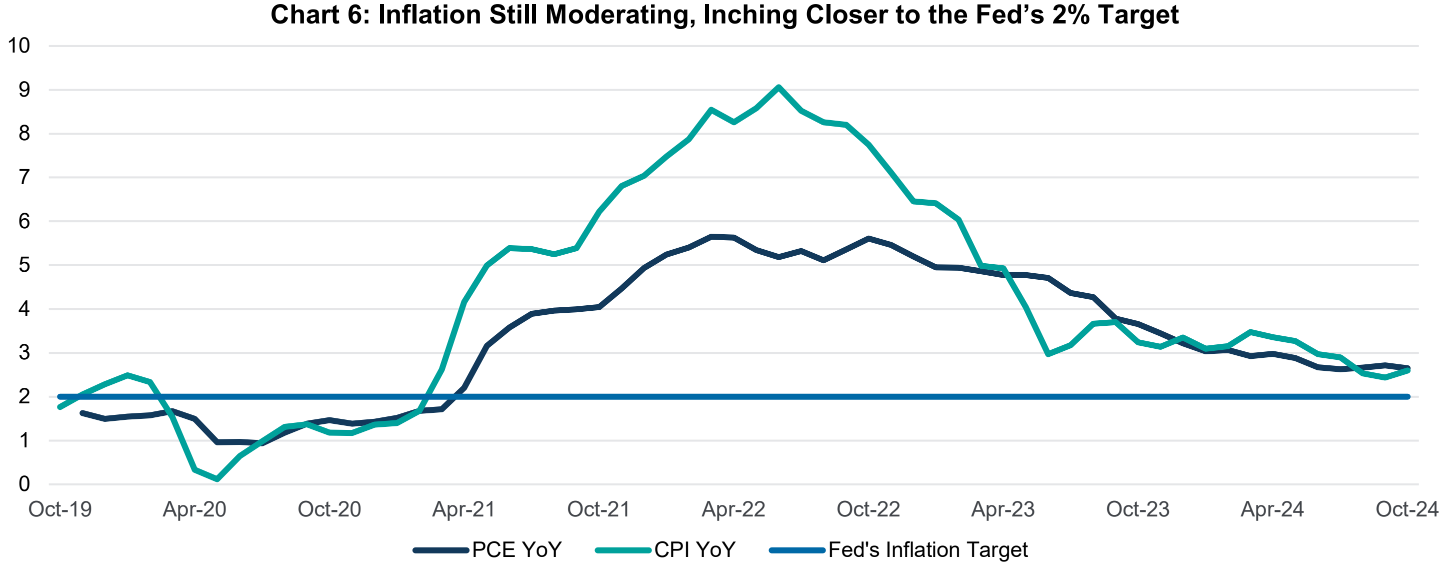
Source: Bloomberg.

Chart 5: Strong Growth and Tighter Spreads for Trump 2.0

	October 2016	October 2024
CPI (% YoY)	1.6	2.6
GDP (% QoQ SAAR)	2.9	2.8
Unemployment (%)	4.9	4.1
US High Yield spreads (%)	4.8	2.8
US Investment Grade spreads (%)	1.3	0.8

Source: Bloomberg.

Chart 6: Inflation Still Moderating, Inching Closer to the Fed's 2% Target



Source: Bloomberg.

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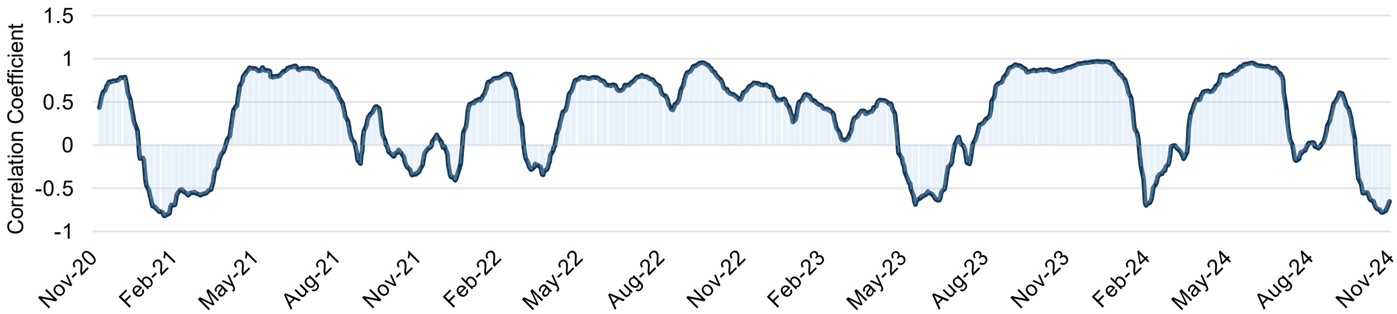
Bonds are Back as Ballast

Fixed income's relationship with equities is once again negatively correlated **(Chart 7)**. Fixed income investors that were nervous about this relationship following 2022 might find comfort knowing that the positive correlation we observed is not the 'new normal'. As inflation and GDP growth moderate, as we've seen in the U.S., the equities/bond correlation tends to decrease and then turn negative.

Chart 7: 1 Yr Correlation Between the S&P 500 Total Return Index and US Bloomberg Aggregate Index



The most valuable part of this relationship for investors is not that bonds and equities are always negatively correlated, but instead negatively correlated at the right time as we saw in the brief stock market meltdown in August 2024 **(Chart 8)**. As we turn to the new year, we believe that the reemergence of this relationship adds credence to the value of active fixed income in a well-diversified portfolio.

Chart 8: Market Shocks Since 2010

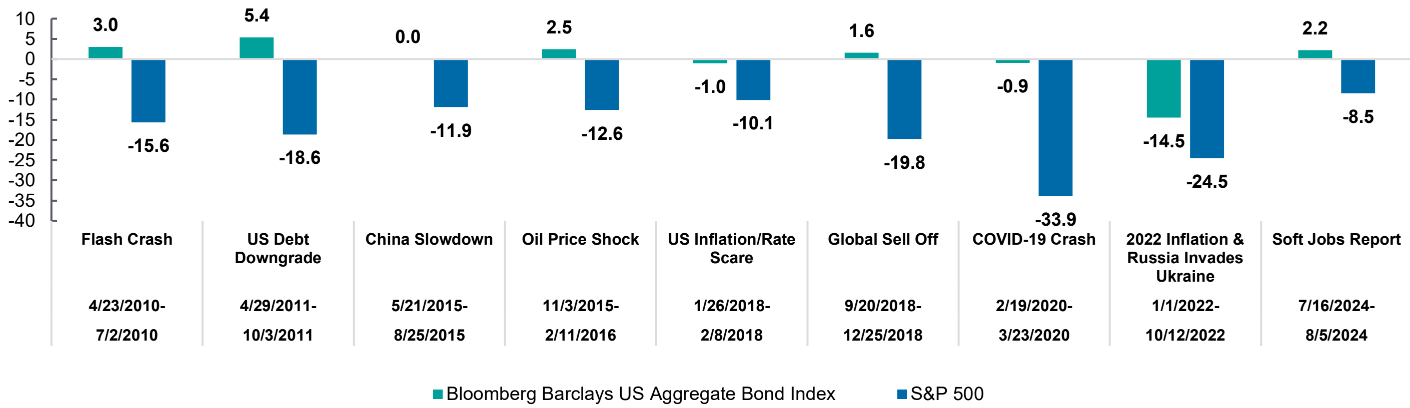
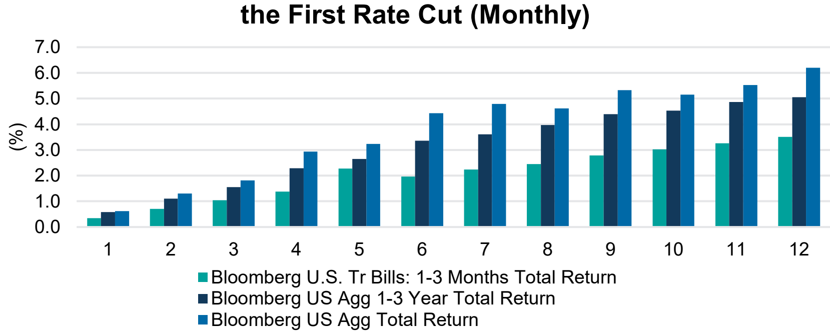


Chart 9: Average Index Performance Following the First Rate Cut (Monthly)



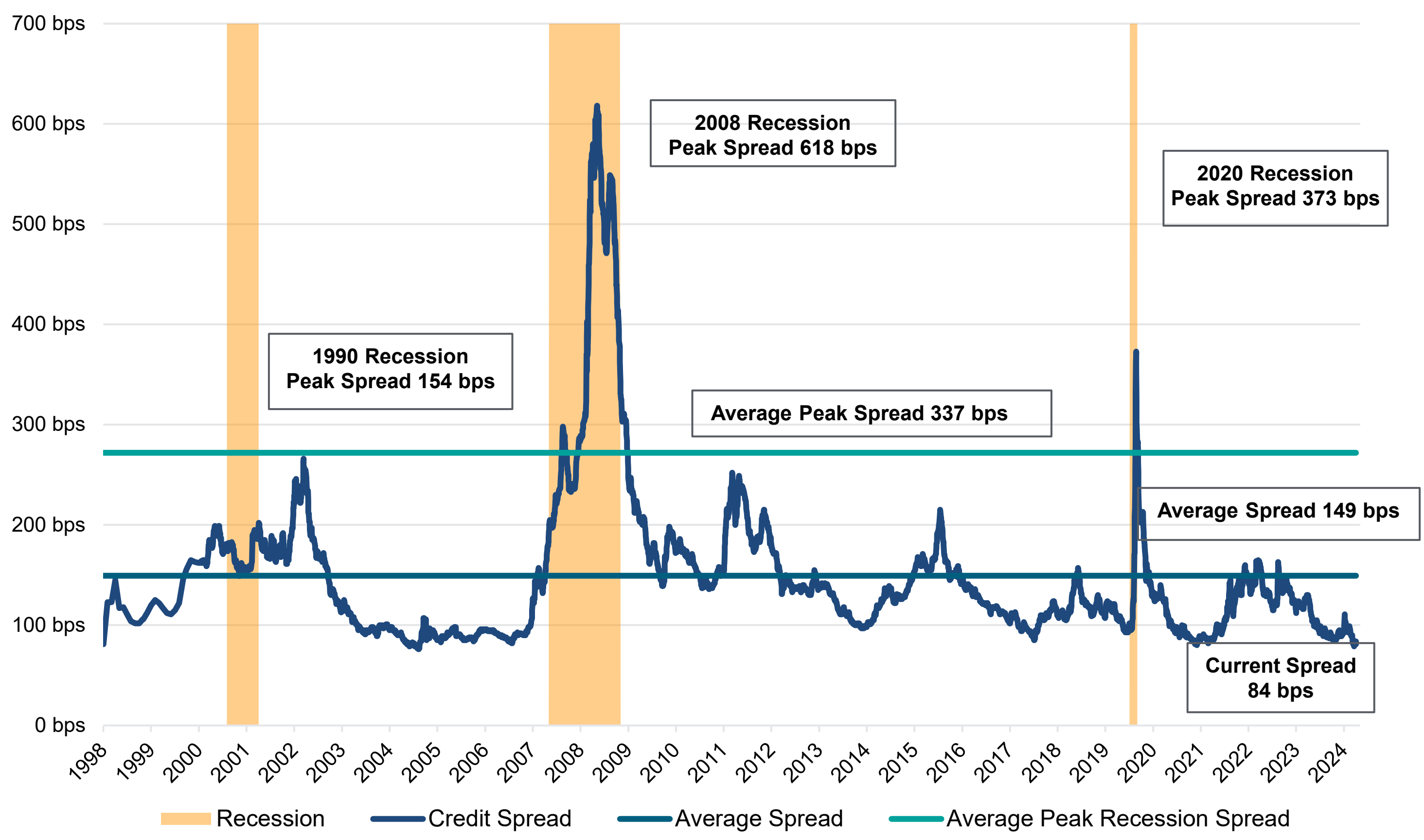
Additionally, fixed income has historically performed well in falling rate environments. Diving deeper into that, intermediate term fixed income has historically outperformed short-term debt and Treasury bills in past cutting cycles from the 1980s to today **(Chart 9)**.

Source: Bloomberg.
Past performance is no guarantee of future results.
Indexes are unmanaged and do not reflect fees and expenses; One cannot invest directly in an index.

Investment Grade Corporate Bonds

- **Uncertain Economic Outlook:** While the recent underlying tone for the economic outlook and corporate profitability has been mostly positive there are several factors that add to uncertainty. A new political administration will likely impact the regulatory and geopolitical landscape, and we are still seeing mixed signals on the inflation front. An easing regulatory environment could facilitate more corporate M&A and increased corporate leverage metrics.
- **Corporate Spreads Remain Tight:** Investment Grade Corporate spreads recently touched multi-decade lows **(Chart 10)**. Spreads remain compressed across rating categories and industry classifications. The spread environment suggests investors should adopt a defensive and patient posture and be selective in taking on credit risk.
- **Overall Corporate Yields Look More Attractive:** While corporate spreads remain tight relative to historical levels, the yield to maturity looks more attractive. After a decade plus era of very low overall interest rates corporate investment grade yields have hovered in the 5% to 6% range over the past couple of years.

Chart 10: Corporate Credit Spreads During Last US Recessions



Credit spread is the difference in yield between a U.S. Treasury bond and another debt security of the same maturity but different credit quality. Credit spreads are the additional compensation that investors require to hold securities that are not as safe and liquid as those issued by the US Treasury. Basis point “bps” is 1/100th of a percentage point.

Source: Bloomberg Corporate Index, U.S. Recession Indicator (National Bureau of Economic Research).

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High Yield Corporate Bonds

- **Year-to-date, both the high yield and leveraged loan markets have delivered positive returns,** driven by moderating inflation, the Federal Reserve's shift towards rate cuts, and optimism surrounding a business-friendly Republican sweep in the elections. While these factors have supported strong performance, high yield spreads are now approaching historic lows. As a result, we anticipate increased volatility in 2025, as post-election optimism gives way to the practicalities of governing and the potential for a resurgence in inflation.
- **Single-B credit spreads have continued to tighten throughout the year,** beginning at 317 basis points and reaching a low of 236 in November **(Chart 12**). When viewed in a broader context, this represents a notable outlier, highlighting how quickly spreads can change. In light of these conditions, we believe it remains prudent to maintain a disciplined, patient, and opportunistic approach in selecting our investment opportunities.

Chart 12: High Yield Spreads

Source: Bloomberg.

High Yield bonds, aka junk bonds, are bonds that pay higher interest rates because they have lower credit ratings (below BBB) than investment-grade bonds. As such, High Yield credit spreads correlate inversely with credit rating, lower credit ratings generally have higher average credit spreads.

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Municipal Bonds

- **Municipal bonds performed well in 2024:** returns remained positive for the year, and yields (which we view as a strong predictor of future long-term returns) remained high **(Chart 13)**. Looking ahead to 2025, we expect yields to likely decline modestly but remain relatively elevated. This should continue to provide a very attractive potential entry point for investors, particularly on a tax-equivalent basis.
- **Credit spreads have tightened considerably over the last year,** nearing historically tight levels. It is possible that these could widen out a bit in 2025, but if flows remain strong and deals remain oversubscribed, we do not expect them to go far **(Chart 14).**
- **Heading into 2025, we expect muni credit quality to remain very strong.** Revenues have performed quite well across the sector, and this coupled with solid reserve balances and a strong economy, bode well for continued credit stability.

Chart 13: Municipal vs US Aggregate vs Tax Equivalent Index

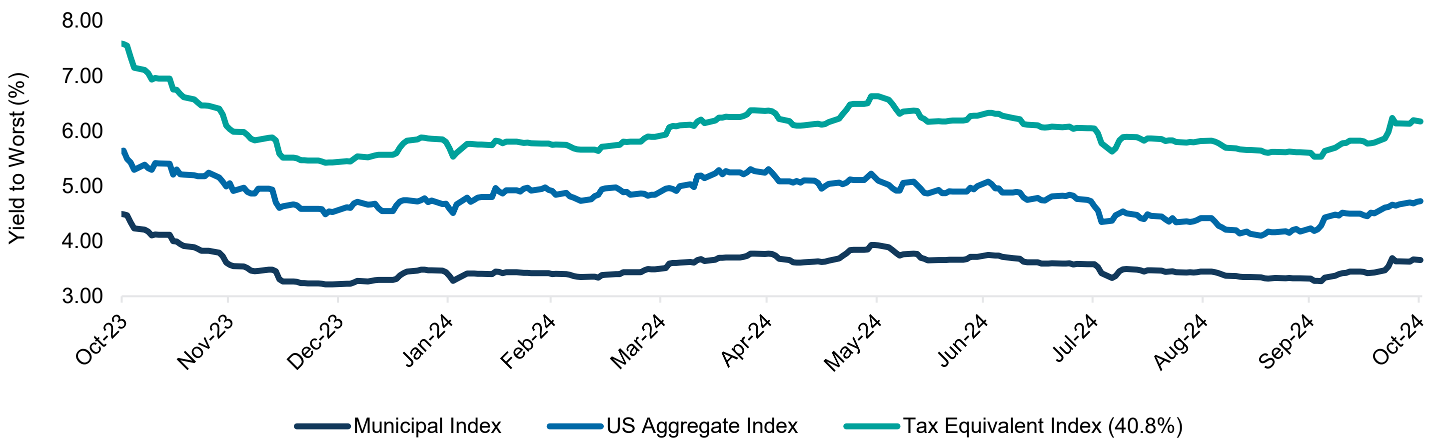
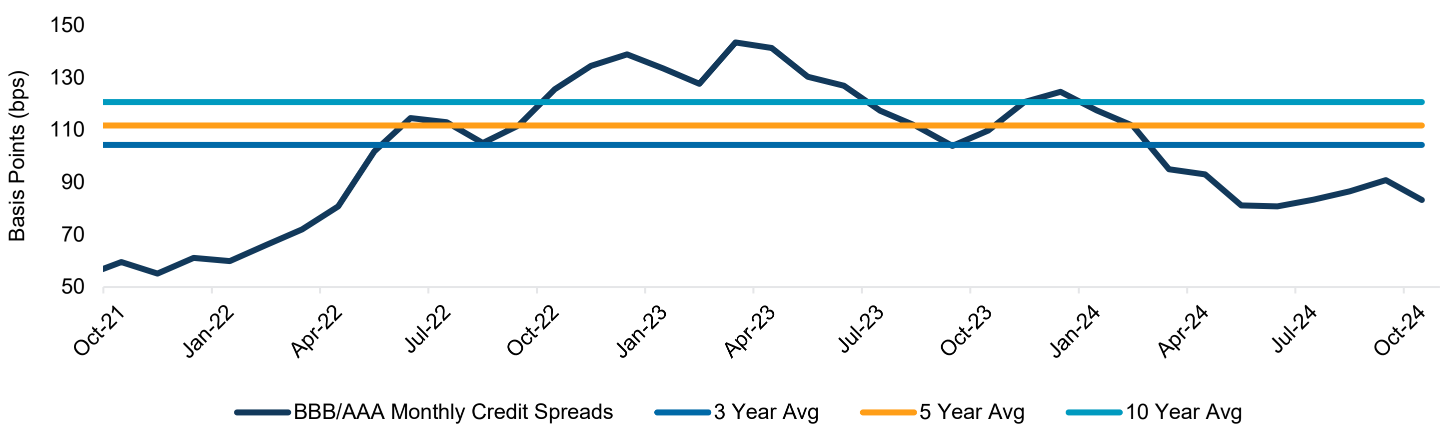


Chart 14: BBB/AAA Muni Credit Spreads since 2021



Source: Bloomberg. Indices represented are the Bloomberg Municipal Index, the Bloomberg US Aggregate Index, Bloomberg Municipal BBB Index, and Bloomberg Municipal AAA Index.

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Residential Mortgage-Backed Securities (MBS)

- **We project MBS to outperform in 2025.** MBS spreads have been volatile in 2024 but are currently wide (both nominal and option-adjusted) vs. how they historically trade vs. corporate bonds **(Chart 15 & 16).**
- **The supply/demand picture for 2025 favors MBS spread tightening.** We expect Bank demand to pick up, which should offset the risk of money managers unwinding their large MBS overweight as spreads tighten.
- **Fed rate cuts, interest rate volatility, and finalization of bank capital rules will all be factors to watch in 2025.**

Chart 15: MBS Current Coupon Zero-Volatility Spreads vs. A-Rated Corporate Bonds

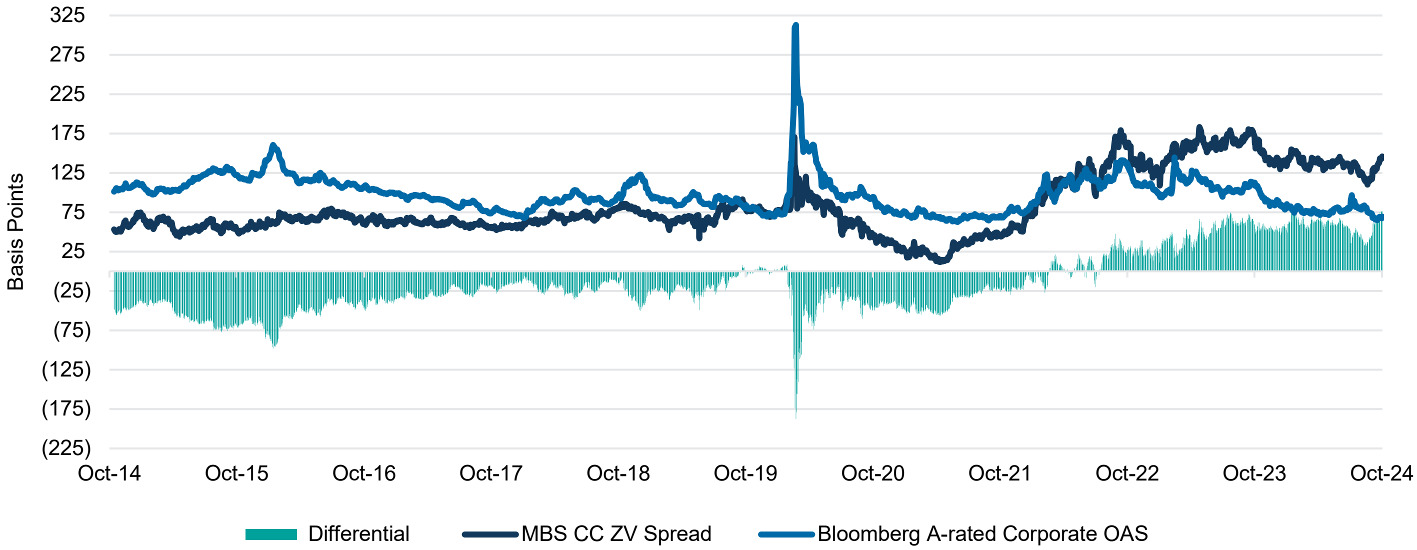
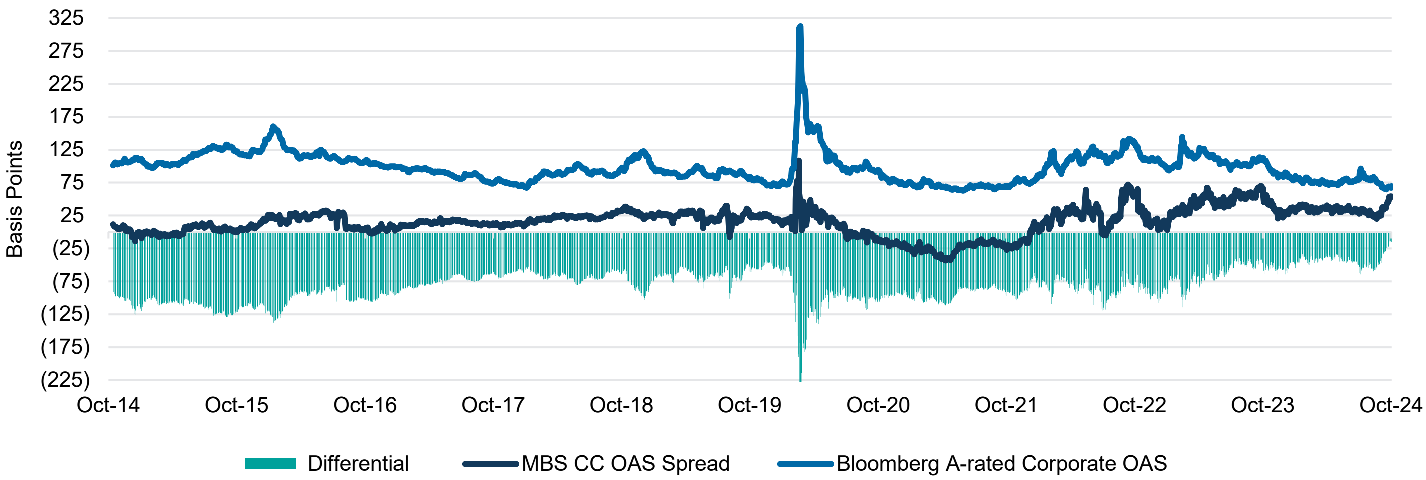


Chart 16: MBS Current Coupon OAS vs. A-Rated Corporate Bonds



Source: Bloomberg. The A-rated corporate OAS represented is the OAS of the Bloomberg A-rated Corporate Index. The Morgan Stanley 30Y Conventional Current Coupon Zero Volatility Indicator represents the ZV (zero volatility spread) for the hypothetical $100-priced 30yr conventional mortgage over time. The aforementioned Indicators are for tracking data and are the property of Morgan Stanley & Co. LLC and its affiliates ("MS Group"). The Indicators should not be used as or treated as an Index or benchmark. Any use requires the consent of MS Group.

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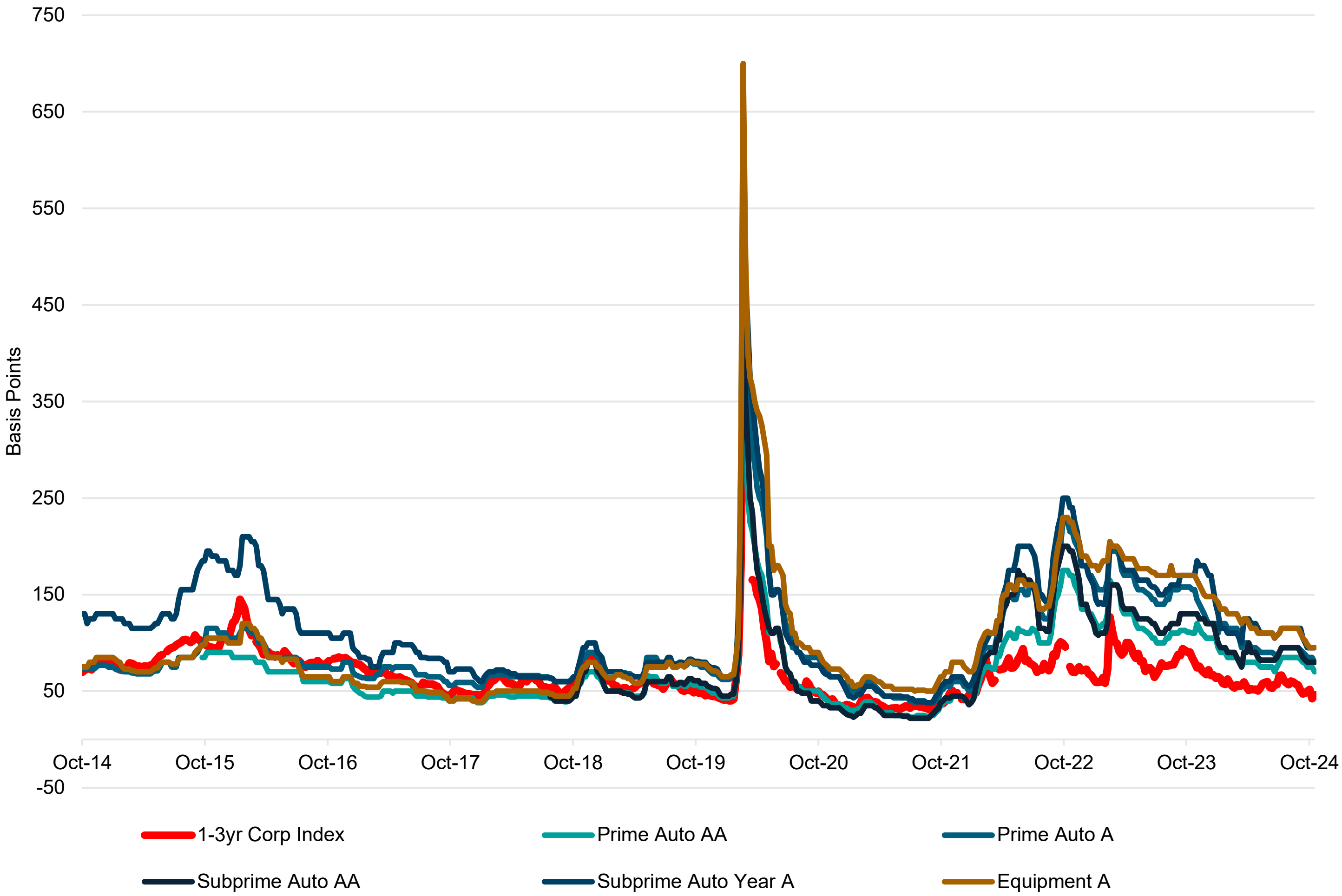
Asset-Backed Securities (ABS)

> **We expect ABS to outperform in 2025.** The gap between ABS and corporate bond spreads narrowed over 2024 but remains wide relative to history **(Chart 17**).

> **We focus on the parts of the ABS market with robust structures and substantial credit enhancement** that have been able to withstand severe recessions like the Global Financial Crisis (GFC) and Covid.

> **ABS structures have the added benefit of de-leveraging over time** which makes ABS a good defensive play and can result in predictable upgrades as deals season.

Chart 17: Various ABS Sectors vs. 1-3yr Corporate OAS



Source: S&P.

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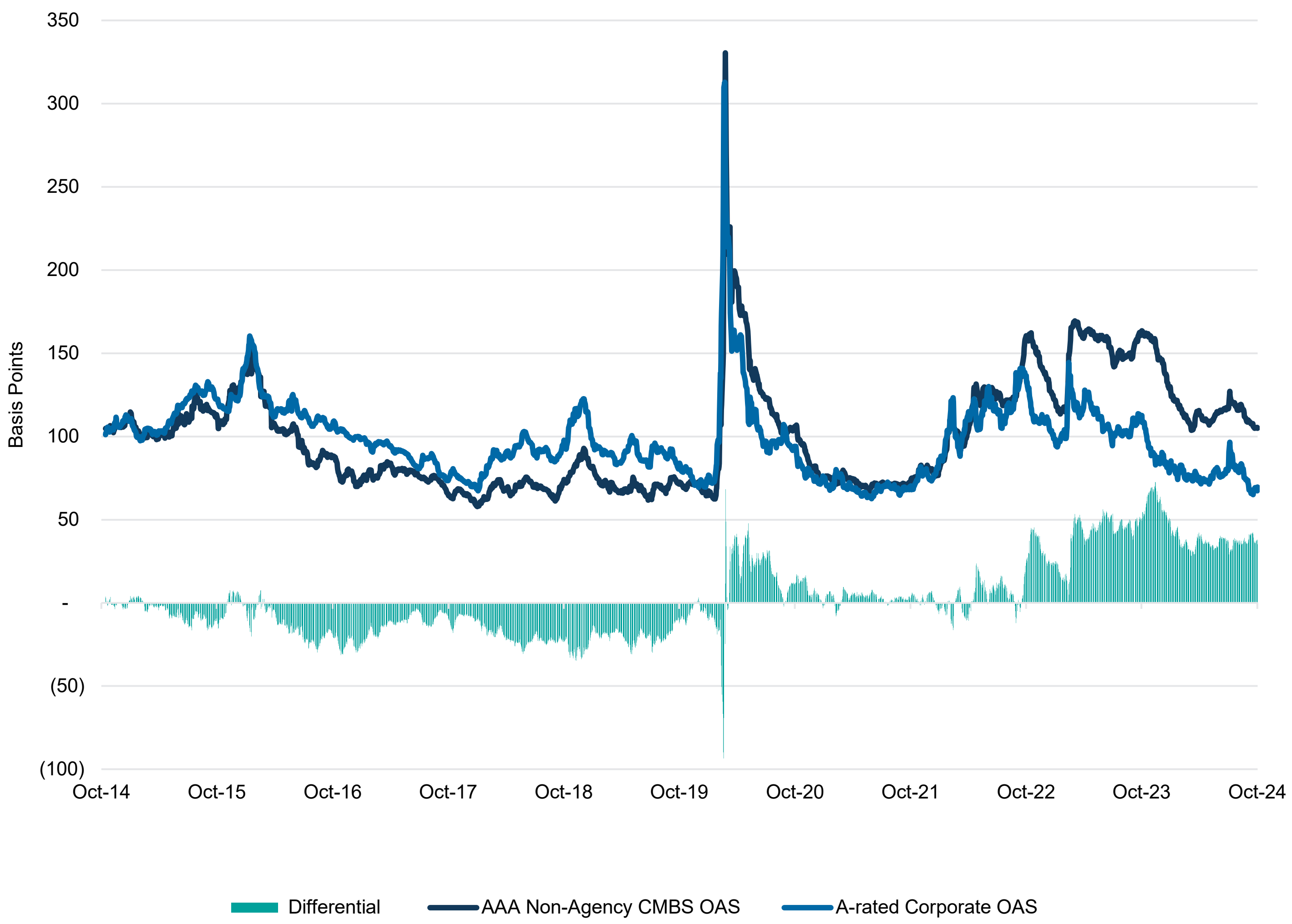
Commercial Mortgage-Backed Securities (CMBS)

- **We project CMBS to marketperform in 2025**. Even though the gap between CMBS and corporate bond spreads narrowed in 2024, the relationship of CMBS spreads relative to corporate bond spreads remains wide relative to history **(Chart 18)**.
- We temper our outlook to neutral due to the tendency for CMBS to trade with a high beta to corporate spreads, which are near 20-year tights.
- Lending market conditions, CRE transaction volume, and secular demand issues within the office sector remain the primary indicators to watch.

Chart 18: AAA-Rated CMBS vs. A-Rated Corporate Bonds



Source: Bloomberg.

Indices represented are the Bloomberg Non-Agency Investment Grade CMBS: AAA Total Return Index (I31070US) and the Bloomberg A-rated Corporate Index.

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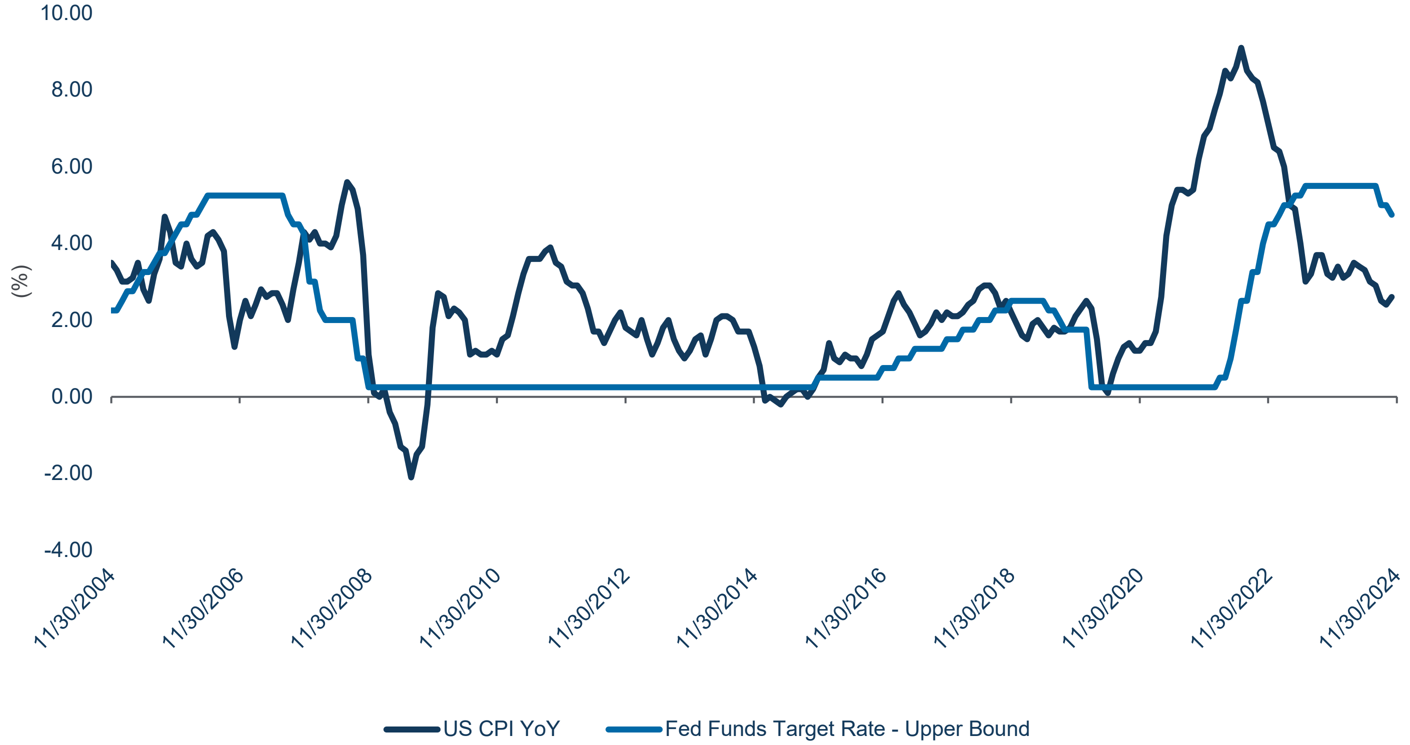
Money Markets

> **We expect money market rates to fall in 2025.** The FOMC recognizes that inflation has begun to moderate toward its 2% target and has already lowered rates twice **(Chart 19).**

> **Despite the expected decrease in yield, we think money market funds will remain a popular investment choice in 2025** due to their history of stability, security and very short duration. These three factors persist and have been a feature of money market funds for decades regardless of the direction of interest rate movements.

Chart 19: Fed Funds vs. CPI



Source: Bloomberg.

U.S. CPI: The Consumer Price Index measures the monthly changes in prices paid by U.S. consumers. The Bureau of Labor Statistics calculates the CPI as a weighted average of prices for a basket of goods and services representative of aggregate U.S. consumer spending.

Fed Funds Target Rate – Upper Bound: Shows the upper limit of the federal funds target range established by the Federal Open Market Committee.

> **History tells us that longer-duration fixed income outperforms money markets as rates decline,** so we would caution against an excessive overweight in money market funds. Money markets require continuous repurchase of securities since they mature within days or weeks of issuance in most cases. This requirement to reinvest proceeds is called “reinvestment risk” and is an inherent risk in all short-term instruments. Longer term bonds, in contrast, do not face immediate reinvestment risk because they mature over the course of years and their prices can appreciate with falling rates.

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Disclosures

All investing involves risk, including the potential loss of principal.

Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. Bonds and bond funds will decrease in value as interest rates rise and vice versa. Credit risk refers to the possibility that debt issuers may not be able to make principal and interest payments or may have their debt downgraded by ratings agencies. High yield securities may be more volatile, be subject to greater levels of credit or default risk, and may be less liquid and more difficult to sell at an advantageous time or price than higher-rated securities of similar maturity.

Mortgage-backed securities (“MBS”) and asset-backed securities (“ABS”) are subject to credit, prepayment and extension risk and may react differently to changes in interest rates than other bonds. Small movements in interest rates may quickly and significantly reduce the value of certain MBS and ABS.

The value of your investment is also subject to geopolitical risks such as wars, terrorism, environmental disasters, and public health crises; the risk of technology malfunctions or disruptions; and the responses to such events by governments and/or individual companies.

R-squared is a statistical measure that represents the percentage of a fund’s or security’s movements that can be explained by movements in a benchmark index.

Credit spread is the difference in yield between a U.S. Treasury bond and another debt security of the same maturity but different credit quality. Credit spreads are the additional compensation that investors require to hold securities that are not as safe and liquid as those issued by the US Treasury.

Yield to Worst (YTW) is the lowest possible yield received on a bond, absent default.

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