

Dynamic Core Bond Strategy

Strategy overview

Total return approach, investing across full spectrum of the fixed income market including up to 20% in below investment-grade securities.

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Key takeaways

- Yields rallied and credit outperformed as continued disinflation allowed the U.S. Federal Reserve to shift their focus to labor market conditions and begin an easing cycle.
- The Fund outperformed its benchmark, the Bloomberg U.S. Aggregate Bond Index (the Index) on a net asset value (NAV) basis. Outperformance was driven by sector allocation, while duration and yield curve positioning detracted modestly and security selection was mixed.
- While a soft landing appears likely, we favor assets with higher credit quality or shorter spread durations, as we believe spreads are too tight relative to the underlying risks.

Portfolio review

The labor market continued its path of normalization in the third quarter of 2024, with the number of job openings continuing to decline along with the quit rate reverting to pre-pandemic levels. This cooling was further evidenced by the Non-Farm Payroll (NFP) report, which missed expectations for both July and August. The substantial miss for July, reported in August, coincided with a controversial rate hike by the Bank of Japan (BoJ), unsettling markets and leading to a sharp widening of credit spreads. However, as investors digested the data, spreads eventually retraced, reflecting a more measured perspective on the total economy.

This moderation in the labor market did not significantly hinder consumer spending, which continued to advance at a decent rate. With elevated home prices and strong equity performance, the wealth effect remained in play however the moderation in the labor market may have been responsible for more measured spending growth, relative to more recent quarters. More broadly, the economy continued to advance at a reasonable pace, as evidenced by 2Q24 gross domestic product (GDP) growth, which exceeded expectations at 2.80% and was later revised to 3.00%.

Inflation continued its downward trend, with core Consumer Price Index (CPI) approaching 3.00% year over year, despite the shelter component remaining stubbornly elevated. Core goods prices remained in deflation, while core services inflation decelerated significantly, partially attributable to moderating wage gains. The Fed's preferred measure, Core Personal Consumption Expenditure (PCE), displayed an even more favorable environment, reading at 2.70% YoY in August. This disinflationary environment provided the Fed with the flexibility to shift its focus from inflation concerns to labor market conditions.

A pivotal moment came in late August with Jerome Powell's speech at Jackson Hole, signaling a shift towards an easing cycle. The Fed, acknowledging the softening labor market, opted for a 50 basis points (bp) cut at their September meeting, larger than the previously anticipated 25 bp reduction. Powell's influence was evident, with only one Federal Open Market Committee member dissenting. This decision underscored the Fed's proactive approach to preserving a healthy labor market and broader economic stability.

Credit spreads began the quarter at tight levels, reflecting a macro environment that balanced disinflation with stable growth. Despite the early August volatility, driven by labor market data and the BoJ's actions, spreads finished the quarter at similarly tight levels as the disinflationary trend allowed the Fed to begin an easing cycle.

Yields rallied in response to continued disinflation, with front-end rates falling more significantly than long-end rates. This bull steepening of the yield curve was driven by expectations of the Fed's easing, which prompted front-end rates to aggressively rally, while a stable growth outlook translated to a more measured decline in the long end.

In conclusion, the third quarter of 2024 was characterized by a gradual moderation in the labor market, further easing of inflation and a proactive shift in monetary policy by the Fed. These factors positively influenced market dynamics, resulting in a period of strong returns for fixed income investors.

For the quarter, the Fund outperformed the Index. Our overweight to credit and underweight in Treasuries broadly contributed. High yield (HY) was the largest individual contributor, driven by both our strategic position, as well as tactical trades executed during August's volatility. Selections within commercial mortgage-backed securities (CMBS) also contributed, as improved financial conditions continued to help spreads tighten from crisis like levels. Meanwhile, selections in agency mortgage-backed securities (MBS) detracted, particularly our collateralized mortgage obligations (CMO) positions which lagged the rally in MBS pools. Duration and yield curve decisions modestly detracted from relative performance due to a tactical short position implemented intra-quarter.

Current strategy and outlook

As we look ahead to the fourth quarter of 2024, we expect the theme of "normalization" to continue shaping the economic landscape. We anticipate growth will stabilize close to trend levels, remaining positive but likely decelerating from the robust pace seen in recent quarters. This dynamic will be driven largely by consumer spending, which, while expected to slow, will continue to be supported by a relatively strong (albeit moderating) labor market and a favorable wealth effect stemming from elevated asset prices.

We project inflation will continue its decline, but at a slow pace and ultimately settling above the Fed's target. Goods inflation is expected to remain at 0% or lower, as consumption growth moderates from historically high levels. Services inflation is likely to continue decelerating as the labor market continues to rebalance and wage growth eases further. Additionally, we anticipate that the shelter component of inflation will eventually align more closely with real-time indicators from sources like Zillow, Apartment List and Yardi, further contributing to the easing of inflationary pressures.

While all this points to a soft landing, markets appear to have priced in this scenario with a high degree of certainty. Investment-grade corporate spreads are currently below 100 bp, while HY spreads hover around 300 bp. These levels suggests that markets are highly optimistic that disinflation can continue without a recession materializing. While we tend to agree this is a likely outcome, there remains a risk of more rapid deterioration in the labor market, particularly if corporate margins face further pressures.

Given these tight valuations, we favor assets with higher credit quality or shorter spread durations, as we believe spreads are too tight relative to the underlying risks. However, we remain confident in the fundamental factors that support the economy and are prepared to add risk where appropriate, especially in the face of market volatility stemming from data releases, Fed actions, elections and geopolitical developments. In keeping with the theme of higher quality and shorter spread duration, during the quarter we continued to reduce exposure to long end corporates and increasing our allocation to AAA rated CMBS.

On the interest rate front, following the substantial rally in 3Q24—particularly at the front end of the curve—the market is now pointing to the Fed reaching its terminal rate roughly one year ahead of the most recent dot plot projections. We believe this reflects a skew of potential outcomes related to monetary policy. Specifically, we believe that the likelihood of reacceleration of inflation that prompts the Fed to reverse course is significantly lower than the probability of a faster cutting cycle if the labor market deteriorates more rapidly. Because of this, our duration profile remains roughly in line with the benchmark.

In summary, as we enter the final quarter of 2024, our economic outlook is characterized by a continued normalization process, with stable growth supported by consumer spending and a moderating labor market backdrop. While we maintain a cautious optimism, we remain vigilant, ready to adjust our positioning in response to an evolving landscape.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is a widely recognized, unmanaged index of publicly issued investment grade U.S. Government, mortgage-backed, asset-backed and corporate debt securities. The Index does not reflect fees, brokerage commissions, taxes or other expenses of investing. **Investors cannot invest directly in an index.**

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