

Economy and Rates:

- We believe the Federal Reserve (Fed) will cut rates three times in 2025, with their target rate ending around 3.50-3.75%, which is somewhat more dovish than the approximately 1.75 cuts indicated by the Fed Funds futures market at year end. While our strategy doesn't depend on market-timing interest rates, we have had a good track record recently, correctly predicting the Fed's year-end 2024 target rate back in our 2024 Outlook.
- Uncertainty surrounding the new administration's tariff policies, budget cuts proposed by the Department of Government Efficiency (DOGE), and potential declines in energy prices resulting from the new administration's pro-fossil fuel stance could lead to the Fed showing more accommodation and easing rates more than expected – mirroring the 75bps of easing that occurred in late 2019 after a series of tariff proposals by the previous Trump Administration.
- Led by a softening housing market and a predicted rent disinflation to a 2.5 -3% range, we expect to see inflation continue to decelerate toward the Fed's 2% target rate. We also expect declining energy prices to provide some relief. At the same time, inflation should remain sticky across various service categories and potential tariffs could be inflationary. All things considered, we expect the Consumer Price Index (CPI) to continue its slow, steady decline to the 2.4-2.6% range by the end of 2025. Based on the recent employment reports, we believe the unemployment rate can rise to 4.5% while the overall economy could continue to show decent growth, with a 2-2.5% increase in GDP in 2025 following the 3.1% real growth in Q3 of 2024.¹
- We saw yield curve steepening in 2024 by 70bps between twos and 10s while dis-inverting to a positive slope of 33bp by yearend. We could see additional curve steepening in 2025, with the short end of the curve declining to be more aligned with our predicted Fed target range of 3.50-3.75%. Meanwhile, we believe the long end of the curve will likely trade somewhere between the 4.25-4.75% range as a persistent supply of Treasury debt, necessary to fund budget deficits, could weigh heavily on the long end of the curve until Congress has a chance to meaningfully implement spending cuts as they have promised.
- Recall that many investors entered 2023 with a bullish outlook on the 10-year Treasury, as the Fed seemed to be nearing the end of the tightening cycle. Frustrating those expectations, the 10-year finished 2023 exactly where it started the year at a 3.88% yield (although it ranged from 3.31% to 4.99% throughout 2023). Going into 2024, many investors were bullish again on the long end of the curve, because the Fed appeared to be finished hiking rates. For the second year in a row, the 10-year Treasury not only did not rally, but ended the year about 70bp *higher* in yield. In fact, the 10-year yield spent 86% of the time higher than the 3.88% starting point– averaging 4.21% for 2024 in spite of 75bps of rate cuts. This illustrates the perils of relying on market timing or rate predictions, which our strategy avoids by maintaining a low duration (i.e. low sensitivity to interest rates).

Table 1 – Behavior of 10-year Treasury yields over the past 2 years

10-Year Treasury	2023	2024
starting yield	3.88	3.88
ending yield	3.88	4.57
%days > start yield	49%	86%
average yield	3.96	4.21
max yield	4.99	4.71
min yield	3.31	3.62

¹ “Gross Domestic Product (Third Estimate), Corporate Profits (Revised Estimate), and GDP by Industry, Third Quarter 2024.” BEA, 19 Dec. 2024, www.bea.gov/news/2024/gross-domestic-product-third-estimate-corporate-profits-revised-estimate-and-gdp-1.



Credit Spreads:

Structured Credit:

- Based on trailing 10-year spread percentile ranks, all structured credit sectors are trading cheaper (i.e. wider credit spread) on a historical basis than traditional fixed income sectors. That is, per Table 2 and Chart 1 below, the credit spreads of the listed Structured Credit sectors are at higher percentiles within their respective distributions over the last 10 years than the listed traditional fixed income sectors. Structured credit is not only cheap relative to its historical credit spread distribution, but offers more yield for a given credit rating than traditional fixed income sectors such as Corporates. For example, the credit spread differentials between BBB-rated CMBS and the Corporate High Yield Index (which has an average rating of B+/B) are close to historical highs (see Chart 2 below). Similar observations can be made about A-rated CMBS offering 90 bp credit spread pickup over BBB-rated Corporates, AAA-rated Non-QM front-pay RMBS offering over 86 bp of spread advantage relative to AAA Corporates, and short duration BBB Prime Auto ABS tranches providing 18 bp of spread advantage versus BBB Corporate bonds (source: JP Morgan, Wells Fargo, Bank of America, Bloomberg).

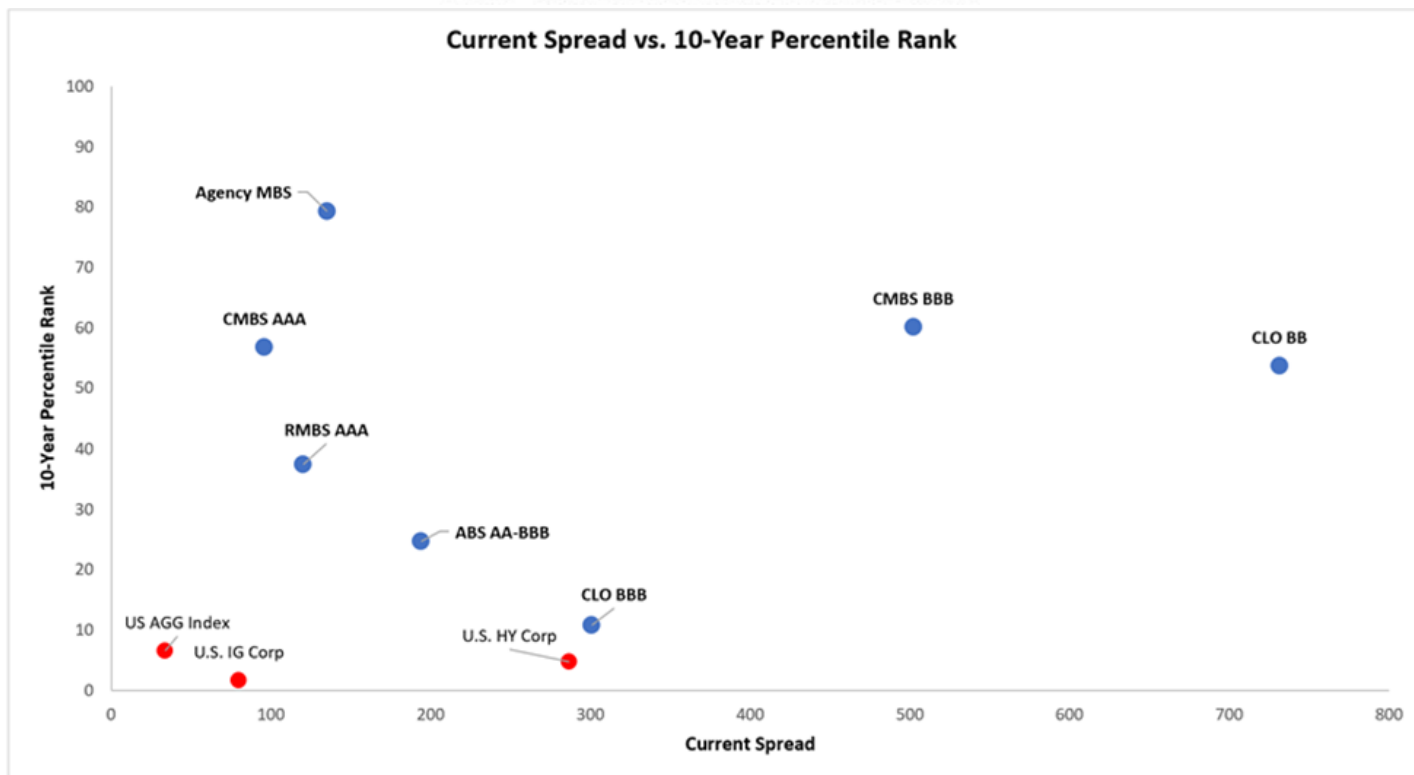
Table 2 – Credit spread percentile rankings for the trailing 10-year period for various fixed income sectors

Spreads	Structured Credit Sector							Fixed Income Sectors		
	Agency MBS	CMBS BBB	CMBS AAA	CLO BB	RMBS AAA	ABS AA-BBB	CLO BBB	US AGG Index	U.S. HY Corp	U.S. IG Corp
Current	135	502	96	731	120	194	301	34	287	80
10-Year Average	107	511	102	769	137	256	407	46	484	135
YTD Change	-4	-387	-40	-104	-30	-87	-110	-8	-36	-19
10-Year Percentile Rank	79%	60%	57%	54%	37%	25%	11%	7%	5%	2%

Source: Orange Investment Advisors, Bloomberg, J.P. Morgan, BofA, Wells Fargo. As of 12/31/2024.

US AGG Index: Bloomberg US Aggregate Bond Index; Agency MBS: 30-Year FNCL Par Coupon Index; U.S. IG Corp: Bloomberg US Corporate Index; U.S. HY Corp: Bloomberg US Corporate High Yield Index; CMBS AAA: J.P. Morgan; CMBS BBB: J.P. Morgan (Mar 2019-Present); BofA (Dec 2013-Mar 2019); RMBS Non-QM AAA: Wells Fargo; start date: 12/23/2016; ABS – AA-BBB: ICE BofA AA-BBB US Fixed Rate Miscellaneous ABS Index; CLO: J.P. Morgan Indices.

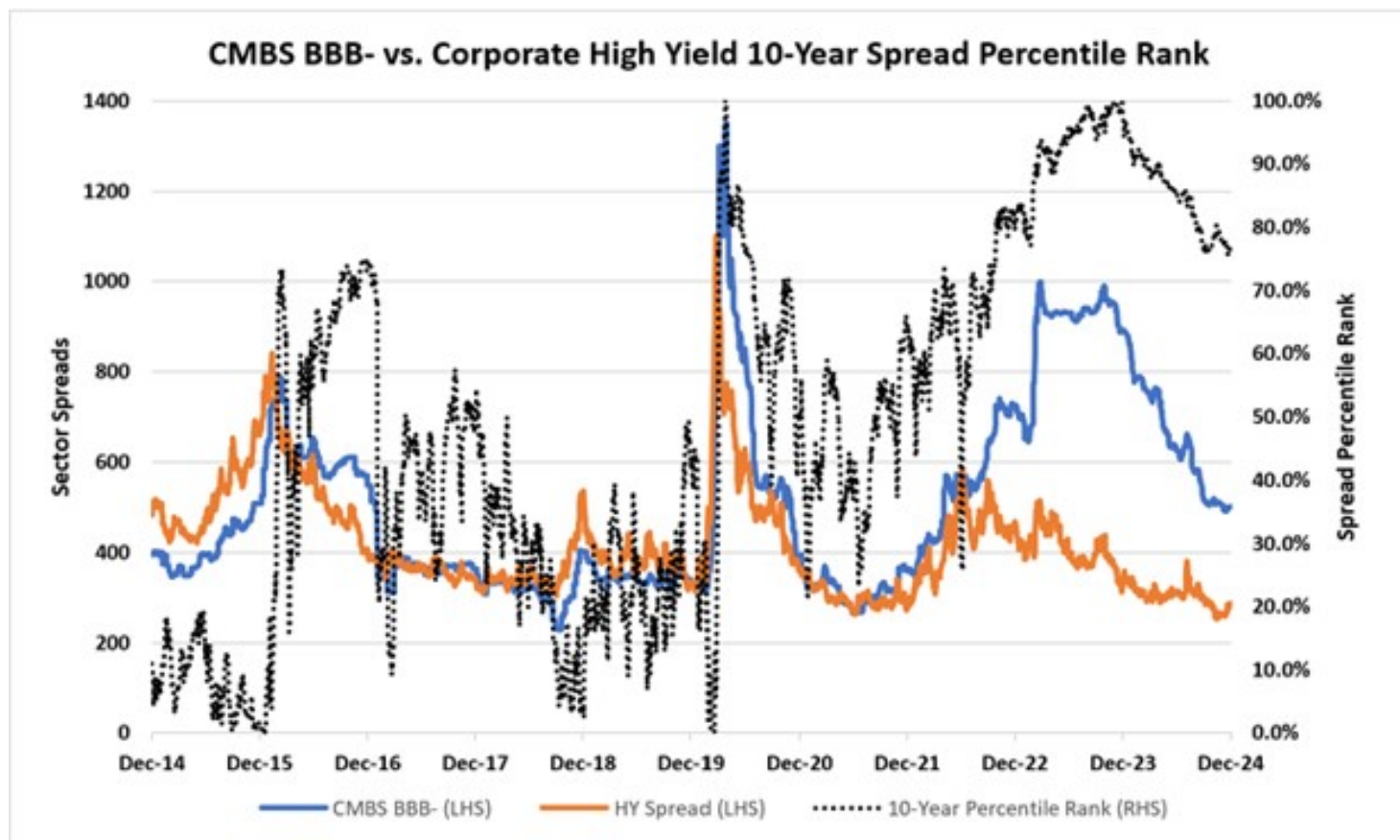
Chart 1 – Credit spread vs. 10-year percentile rank



Source: Orange Investment Advisors, Bloomberg, J.P. Morgan, BofA, Wells Fargo. As of 12/31/2024.



Chart 2 – Credit spread differentials between BBB-rated CMBS and the Corporate High Yield Index (average rating of B+/B)



Source: Orange Investment Advisors, Bloomberg, J.P. Morgan. As of 12/31/2024.

Corporates:

- The option-adjusted spread of the Bloomberg Corporate High Yield (HY) Index was 287 bp as of year end, while the Corporate Investment Grade (IG) Index was at 80 bp. Adjusted for potential credit losses, the High Yield Index spreads would be 112 bp (assuming defaults of 3.5% and 50% loss severity, which would reduce returns by 175 bp). Given how tight spreads currently are relative to the trailing 10 years, both HY and IG Corporates could easily underperform Treasuries in 2025. For example, given its spread duration of about 3 years, the Corporate HY Index spread would only need to widen 37 bp to wipe out the entire return advantage over Treasuries. With Corporate HY spreads in the 5th percentile (see Table 2 above), that seems like a plausible scenario. Similarly, with the Corporate IG Index spread duration of 6.8 years, only 11 bp of spread widening would wipe out their 80 bp of return advantage over Treasuries. Again, this seems very possible with spreads starting the year at the 2nd percentile. Given their starting percentile ranks, there appears to be limited room for additional spread tightening in Corporates, even assuming a benign credit environment and low corporate default rates through 2025. However, uncertainty surrounding the new administration’s potential tariff and fiscal policies could lead to credit spread volatility. Additionally, given historically high equity valuations, any significant correction in the U.S. equity market could leave its imprint on Corporate HY spreads, similar to the brief spike of credit spreads that occurred in early Aug. 2024, after the unwind of JPY carry trade.

**Structured Credit Markets:*****Agency MBS:***

- While Agency MBS posted positive returns versus Treasuries in 2024, they underperformed compared to other structured credit sectors. At 138 bp, the current 30-year Agency MBS Zero Volatility spread is wide on a historical basis and gives better upside potential relative to IG Corporates.
- We expect Agency MBS to post decent excess returns in 2025 assuming a decline in rate volatility, improved sponsorship from banks, and favorable technicals with the likely end of quantitative tightening (QT). In particular, bank deposit growth could be bolstered by low short-term rates, robust economic growth, and an end to QT. Within Agency MBS, we prefer FNCL 2.5s and 6.5s – given that they lie on opposite ends of the pricing spectrum.

Non-Agency MBS:

- Non-Agency RMBS sectors had a very strong 2024, with spreads tightening from 30 bp on AAA-rated Non-QM front-pays to 175 bp on non-rated CRT B2 tranches. The sector benefited from strong demand for yield spread, as most Non-Agency RMBS sectors offer higher spreads relative to Corporates. Non-QM credit curve flattened with BBBs tightening by 75 bp, while BB-rated subordinate tranches tightened more (105 bp). Regarding the housing market, we expect HPA to decelerate to 2% with some markets in the Sun Belt states to experience slightly negative prices due to extremely low affordability and increasing supply.
- That said, we like 2023 vintage AAA-A rated high coupon Non-QM front-pays at slight premiums, as they offer the highest spreads with limited negative convexity. We find the CRT sector quite expensive, and believe it has limited further upside. Instead, we continue to focus our search on Legacy RMBS senior and subordinate tranches with loss-adjusted yields above 7%. We continue to like Private Reverse RMBS senior and subordinate tranches where spreads are wider relative to the Non-QM sector by at least 50bps for each rating category.

CMBS:

- CMBS was the best performing sector among securitized products in 2024, as the Goldilocks economy – showcasing robust growth and declining inflation – helped offset repricing due to higher cap rates, rising delinquency rates, and secular problems affecting the office sector. Despite a rise in delinquencies in the Conduit CMBS universe by 1.8% to 6.2% in 2024, CMBS spreads tightened across the capital structure and the credit curve flattened in 2024. AAA Conduit CMBS tightened by 40 bp to 100 bp, while BBB-Conduit CMBS tightened by 385 bp to 505 bp. Despite their dramatic tightening in 2024, however, CMBS spreads remain attractive relative to historical levels because they came from such wide levels at the end of 2023.
- Fundamentally, CMBS sectors are facing two major issues: Cap rate expansions and structural problems in office and retail. Despite widening over the last three years, spreads of CRE cap rates over risk-free yields are well below historical norms per Goldman Sachs, and sticky long-term rates continue to present a binding constraint. Barring an unexpected surge in rent growth, if long-term rates remain elevated due to expectations for higher growth, continued inflation, and the growing national debt, it's likely that cap rates will increase in 2025.
- While we expect the number of delinquencies on office loans to increase in 2025, we believe that payments for non-office loans (retail in particular) will remain stable or even improve. Also, despite elevated delinquencies, certain office deals offer attractive risk-adjusted returns. For example, rent growth for recently constructed LEED-certified offices remains very strong. Also, if the new Work-From-Office policy for government bureaucrats proposed by DOGE takes hold across corporations, we could see higher occupancy rates for the office sector.



- We believe that current distressed, seasoned CMBS Conduit and SASB valuations already reflect worst-case scenarios, and we expect many problematic loans to be resolved via maturity extensions, forbearance plans, and other types of modifications rather than liquidated in a fire sale. Within the CMBS market, we favor more seasoned, beaten-down, investment-grade Conduit and SASB deals that will benefit from lower policy rates and improving fundamentals. For example, seasoned IG CMBS Conduit mezzanine tranches from 2012-2015 vintages priced in 80s and 90s offer loss-adjusted yields between 7.5-9% under extension/principal forbearance scenarios. Finally, we expect valuations could be supported if private capital raised for distressed credit situations flows into the CMBS market and outpaces any increased supply expected in 2025.

ABS:

- ABS had a strong year in 2024 driven by investors' seemingly insatiable demand for yield spread over Treasuries. Despite the record issuance in 2024 (with \$330 billion of new issues through November), demand for ABS caused spreads to tighten with the Bloomberg ABS Index outperforming Treasuries by 1.46%. The ABS credit curve flattened, which also occurred in all securitized products (AAAs tightening by 60bps, BBBs by 95bps, and BBs by 175bps). Credit performance was mixed in 2024, with signs of broad deterioration in subprime auto ABS as annualized loss rates approach the 10% mark due to poor performance of 2022 vintage. There was a bit of a better outcome for the unsecured consumer/market-placed lending (MPL) sector, where both defaults and delinquencies declined throughout 2024 after reaching their peak in January 2024.
- Unless there's an unexpected spike in unemployment, we believe credit performance should stabilize at current elevated delinquency levels. With \$7 trillion of AUM sitting in money market funds, the demand for incremental spread in the short duration space should absorb a significant amount of supply in 2025. The path of least resistance is for ABS spreads to continue their marginal tightening trend, as ABS still remains at a lower cost relative to IG Corporates. Also, the ABS market looks more attractive on an all-in yield basis compared to pre-COVID levels when ABS spreads were tighter relative to current spreads. We prefer to stick with more recognized sponsors across the ABS market, as any extra spread picked up in lesser known and less experienced sponsors doesn't compensate investors for periods of potential spread volatility and diminished liquidity.

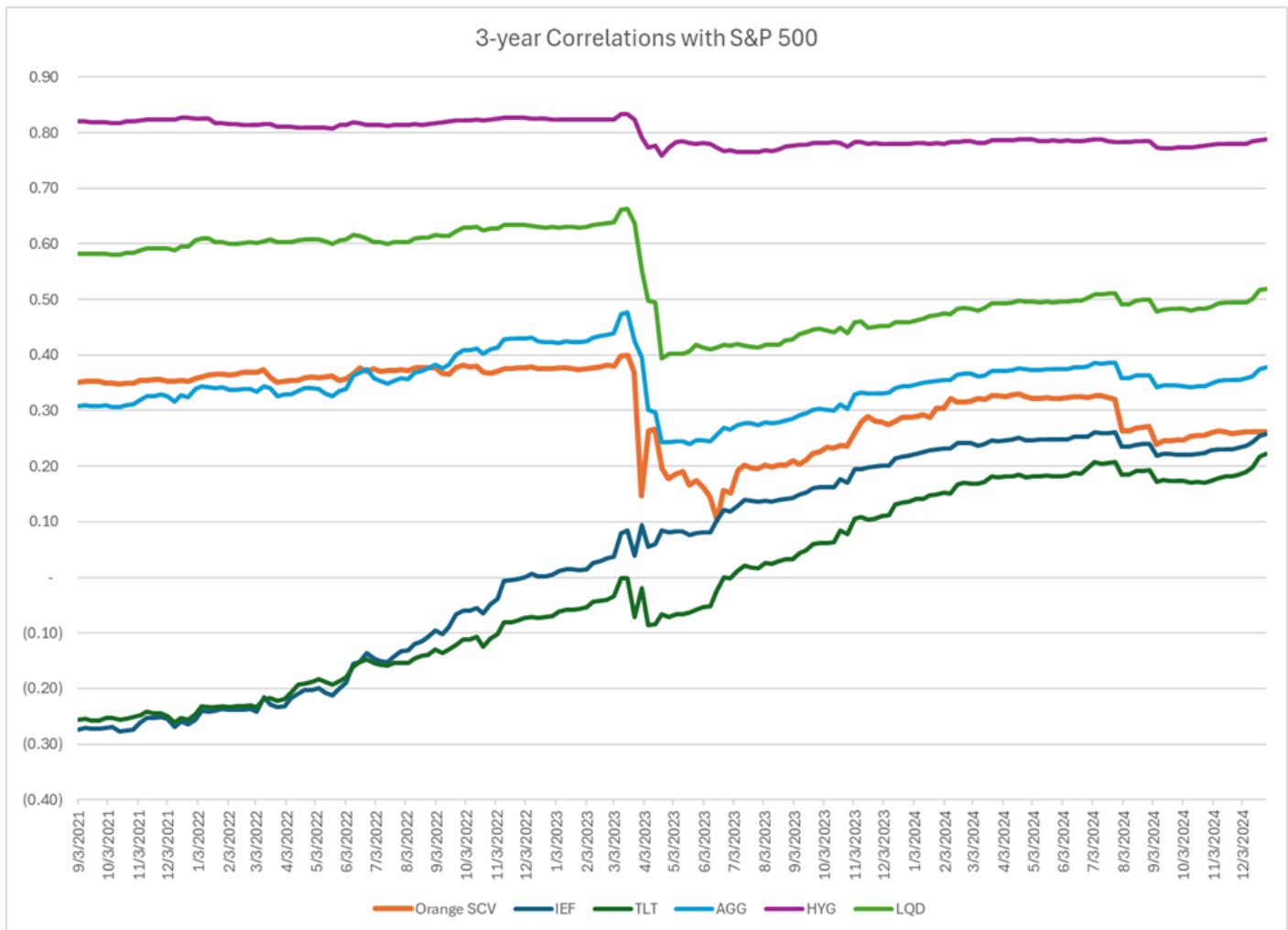
Corporate Structured Notes (CSN):

- CSN issued by banks with coupons that reset based on the difference between long- and short-end constant maturity swap rates (CMS) had a great 2024. Their prices increased by 8-12% due to strong demand for IG Corporates and a steepening of the yield curve (36 bp of steepening between 2 and 30-year SOFR rates). While still inverted between the 2-year and 30-year point, this steepening of the SOFR curve increased the probability of these longer duration bonds receiving coupon payments. Since there are many CSNs that have less than 10-year maturities and yields above 4% even with 0% coupons, we expect strong demand to continue for CMS floaters in 2025. At the end of November 2024, CMS floaters picked up 200-250 bp of option-adjusted spread relative to fixed coupon corporate bonds issued by the same banks. Since we expect further curve steepening in 2025, we believe these CMS floaters can deliver strong price returns and coupon income in 2025.



Orange Structured Credit Value (SCV) Strategy in a 60/40 Portfolio:

- The chart below shows trailing 3-year correlations between S&P 500 (represented by the SPY ETF) and the following: Orange SCV Strategy, IEF (7-10 year Treasury ETF), TLT (20+ Tsy ETF), AGG (Bloomberg Aggregate ETF), LQD (Investment Grade Corporate ETF), and HYG (High Yield Corporate ETF). The major discontinuity in the chart appears 3 years post-Covid when the correlations before and during Covid drop off the 3-year trailing period. Notice that post-Covid, the correlations of the 2 Treasury funds increase significantly and actually go positive while the 3 bond funds (AGG, LQD, HYG) decrease but remain elevated. Orange SCV has correlation with the SPX significantly lower than the other bond funds and has converged with that of Treasuries. Given its significant yield advantage over the treasury funds, we believe this makes Orange SCV an attractive strategy choice in combination with equities in a traditional 60/40 portfolio setting.



Conclusion:

- Orange Structured Credit Value Strategy provides the best of both worlds: providing Treasury-like correlation with equities and significantly higher yield and Sharpe Ratio than the Bloomberg Aggregate, Investment Grade Corporates and High Yield Corporate bonds. Orange SCV can offer great diversification from equities with much higher Sharpe/Sortino ratios than traditional fixed income indices.