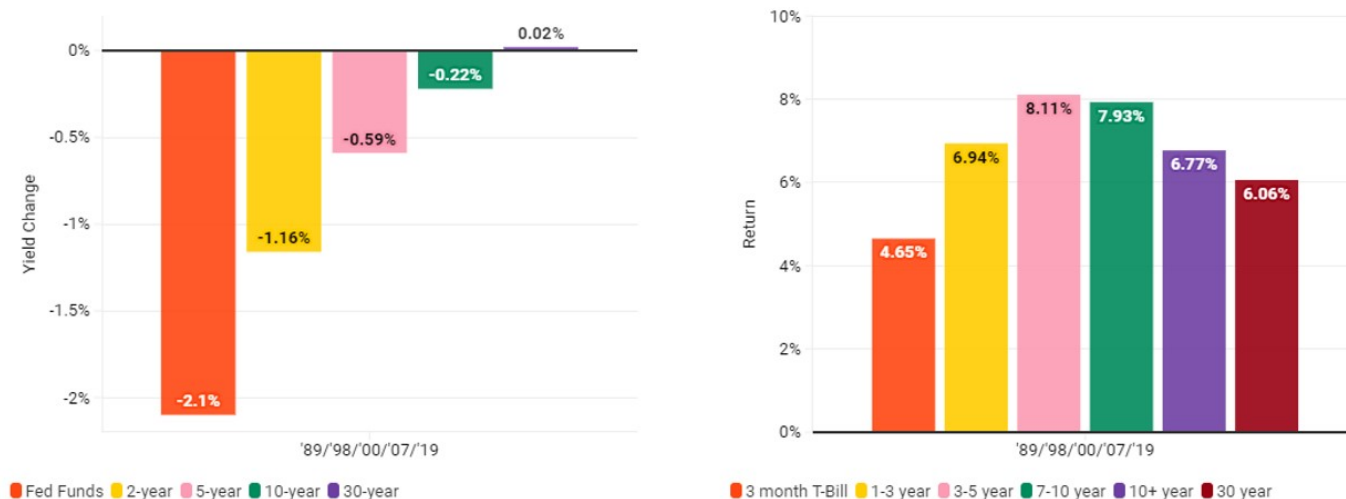


Summary:

- Fixed-rate structured credit securities’ valuations and technicals look compelling relative to both floating-rate leveraged loans (bank loans) and floating-rate MBS sectors such as GSE CRT. Below, we outline the case for fixed vs floating rate securities.
- In 2023 Money Market Funds (MMF) saw \$1.2 trillion of inflows, the largest on record, and by August 2024, MMF assets reached a record \$6.2 trillion. The primary reasons behind such inflows were attractive short-term yields and investors’ concerns about the safety of their deposits at regional banks. With the Fed poised to embark on a rate cutting cycle, MMFs will experience reduced yields which will likely cause significant outflows, and much of that cash should find its way into fixed income mutual funds and ETFs. The reallocation from MMFs into Fixed-Income is already well underway with \$280bn of net inflows into fixed income mutual funds and ETFs through July 2024, marking a “Golden Age” of Bond Funds. Based on the historical returns data available for major asset classes going back to 1929, both government bonds and corporate bonds outperformed cash by 3% and 4% on average in the 12 months following the first Fed rate cut of an easing cycle. Thus, we believe this trajectory will continue as investors facing reinvestment risks will rush to lock in the high all-in yields available in fixed income, and particularly so in the structured credit market.
- According to Bloomberg and Blackrock, as shown in the left chart below, during Fed normalization, the yield curve steepens as shorter maturity rates most closely follow Fed policy rates while longer dated rates lag. The chart on the right highlights the impact of this steepening dimension on bond market total returns. After considering the impact on total return of both yield change and duration, the highest returns are found in the 3–5-year part of the curve. This segment combines enough duration exposure to segments of the curve with more significant yield declines. This data further supports the case for moving from floating rate securities to fixed-rate bonds at durations in the short to intermediate part of the curve.
- This is a desirable consequence for fixed income investors as less duration exposure always results in lower volatility, and if expected returns are the same or higher for lower duration strategies, risk-adjusted returns (e.g. Sharpe and Sortino Ratios) will be even higher.

Average 12-month yield change (left) and average 12-month return (return) following curve normalization and rate cuts:



Source: BlackRock, with data from Bloomberg as of 2/29/2024. Periods represent occurrences of an inverted yield curve since 1989, represented by a negative spread between the 2y and 10y US Treasury yields. Yield change and return calculations begin the month in which the yield curve normalized and did not reinvert before a rate cut by the Federal Reserve. Yields represented by generic US Treasuries. Returns represented by the respective ICE BofA US Treasury indices for each maturity bucket.

- From a credit perspective, according to JPM, the valuation of floating rate leveraged loans is not attractive with leveraged loan spreads in the 4th percentile based on a 10-year historical lookback period (1st richest, 99th cheapest). Following significant price appreciation, a sizeable amount of leveraged loans are currently trading above par and are susceptible to a call risk. Hence, leveraged loans are facing reduced forward carry from upcoming Fed rate cuts and increased convexity risks from corporate borrowers refinancing their loans.

- Within the structured credit space, fixed-rate securities are currently more attractive relative to their floating rate counterparts. For example, on-the-run GSE CRT STACR M2/B1 and CAS B2 floaters (BB and unrated respectively) are currently priced in the 1st and 6th percentiles based on a 3-year lookback period or close to the tightest levels in 3 years. At the same time, Non-QM B1 and B2 fixed-rate tranches (rated BB and B respectively) are priced in the 28th and 33rd percentile over the same lookback period, according to Wells Fargo. Not only is the carry on CRT floaters going to decline due to a lower Fed Funds rate, but given their high dollar prices, faster prepayment speeds will shorten their average life profiles and further reduce the available yields.
- In conclusion, we believe during the upcoming Fed easing cycle fixed-rate bonds are poised to outperform their floating-rate counterparts, including leverage loans (bank loans) and MBS sectors such as GSE CRT, that performed so well during Fed tightening and the high Fed Funds rate environment of 2022-2024. While we believe fixed-rate securities in general will fare better than floating rate during the impending Fed easing cycle, amongst fixed-rate bonds, we expect structured credit sectors to outperform Corporate and other Aggregate sectors because it currently offers the most relative value based on 10-year historical spread percentiles.

Structured Credit offers better risk-adjusted returns than Corporate Credit:

Spreads	Structured Credit Sector							Fixed Income Sectors		
Period	ABS AA-BBB	Agency MBS	CMBS BBB	CMBS AAA	CLO BB	RMBS AAA	CLO BBB	US AGG Index	U.S. IG Corp	U.S. HY Corp
Current	274	140	626	118	790	135	370	39	95	312
10-Year Average	235	106	505	102	764	137	409	47	123	421
YTD Change	16	1	-263	-18	-46	-15	-41	-3	-3	-12
10-Year Percentile Rank	100%	83%	77%	75%	68%	59%	39%	18%	15%	10%

Source: Orange Investment Advisors, Bloomberg, J.P. Morgan, BofA, Wells Fargo. As of 8/19/2024.

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.

