FIXED INCOME | SEPTEMBER 30, 2024

Investment Grade Corporate

Market Review and Outlook

		OAS TSY	QTD OAS Δ	YTD OAS Δ	QTD Total Return	YTD Total Return	QTD Excess Return*	YTD Excess Return*
	US Aggregate Index	36	-3	-6	5.20%	4.45%	0.40%	0.61%
	US Credit Index	84	-4	-9	5.71%	5.23%	0.70%	1.53%
	US Corporate Index	89	-5	-10	5.84%	5.32%	0.77%	1.65%
	Industrials	87	-3	-3	5.90%	4.73%	0.60%	1.19%
	Financials	89	-7	-22	5.38%	6.27%	0.84%	2.29%
	Utilities	92	-11	-13	7.08%	5.62%	1.50%	2.29%
	Non-Corporate Credit	47	0	0	4.63%	4.56%	0.22%	0.66%
Quality	A	73	-7	-11	5.86%	5.11%	0.79%	1.44%
	Baa	110	-3	-11	5.76%	5.70%	0.74%	1.98%
Maturity	Intermediate	79	-4	-11	4.66%	5.71%	0.52%	1.49%
	Long	107	-7	-9	8.21%	4.53%	1.26%	1.94%

** Bloomberg. As of September 30, 2024.*

MetLife Investment Management

Fixed income performance in the third quarter was strong underpinned by lower interest rates. Excess returns were more subdued, but still bolstered performance. Despite credit experiencing intermittent volatility and periods of weakness, credit spreads ultimately rebounded and concluded the quarter narrower than their initial levels on the index. Sector-wise, higher beta (Office REITS, Tobacco) and longer duration segments (Aerospace/Defense, Utilities) were larger contributors, whereas energy/commodity-sensitive sectors underperformed (Home Construction, Independent Energy, Airlines) while Automotives and Home Construction also lagged. Across segments of credit quality, excess returns were just basis points apart between single-A's and BBBs (0.79%, 0.74%, respectively).[1] Separately from quality, longer duration option adjusted spreads (OAS) nearly doubled the compression of the intermediate (0.52% excess return) segment resulting in material performance differentiation (1.26% excess return).[1] The 10-year Treasury yield rallied from a peak of 4.46% to as low as 3.62% before closing the quarter at 3.78%. Concurrently, the 2-year Treasury declined from 4.76% to 3.64%, reflecting market adjustments to a potentially decelerating economy and the prospect of more lenient monetary policies.[1] Another notable development during this period was the dis-inversion of the yield curve with the 2s/10s Treasury curve now as steep as 14 basis points—a 50 basis point move between the two key rates.

A rather significant change for markets this quarter occurred on September 18, 2024, when Jerome Powell and the Federal Reserve Open Market Committee (FOMC) defied the prevailing consensus among economists by implementing a 50 basis point reduction in the Federal Funds Rate. This marked the initiation of a monetary policy "re-calibration." While market pricing had anticipated a more substantial initial cut, many investors were nonetheless taken by surprise, given the mixed signals from FOMC communications over the summer. In his press conference, Chairman Powell articulated that the convergence of inflation towards the 2% target, coupled with heightened risks to broad employment, justified the shift towards a more neutral monetary stance. July's moderation in the U.S. Consumer Price Index (CPI) was well-received, though concurrent weakness in labor market indicators had already suggested potential growth concerns. The subdued July payroll report, released in August, further exacerbated recession fears, both amplifying equity market volatility and prompting a significant re-pricing of Federal Reserve expectations. The reaction was a bull steepening of the Treasury yield curve.

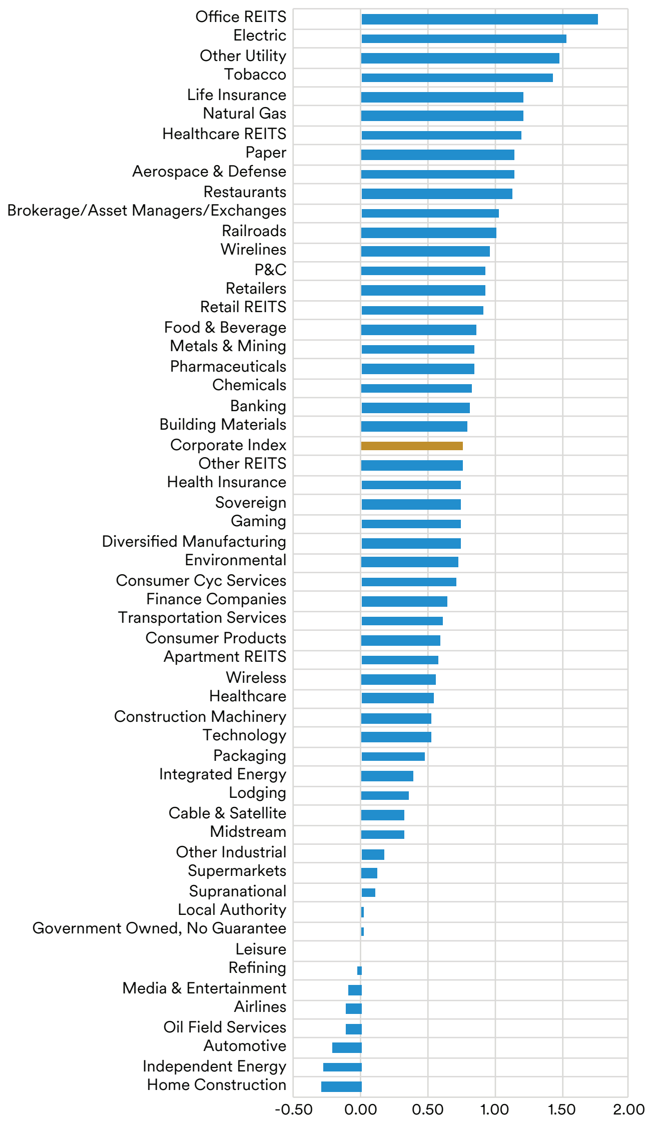
These dynamics also played a part in the observed volatility of credit spreads over the period. Specifically in the first week of August, Investment-grade corporate spreads widened by 18 basis points to 111 basis points. Following this risk-off episode, spreads snapped back by 14 basis points by the end of August. To start September, spreads were again influenced wider by robust new issuance only to rally 10 basis points tighter into the close of the quarter. Periodically spreads on a ticker basis were modestly widened on weaker earnings and management commentary from select corporates, but overall remained well supported given the demand from buyers of fixed income whether that be mutual funds, ETFs or other institutional flows. In our view, credit remains nearly priced to perfection and the potential for outperformance relative to Treasuries is still quite limited.

Despite data highlighting a rise in auto-loan delinquencies among lower credit cohorts and increased credit card utilization indicating a weakening consumer base, credit fundamentals remained broadly stable. Spreads, while tight relative to historical norms, saw both the 5s10s and 10s30s credit curves flatten from periods of steepness. Notably, the 5s10s credit curve reached its flattest level in nearly two years, and the 10s30s Non-Financials curve also flattened by quarter-end, driven by limited back-end supply and robust demand for duration. Beyond technical factors, the prevailing interest rate environment continued to influence curve dynamics.

The financials-industrials spread basis experienced further compression through Q3, contributing to the year-to-date narrowing. We adjusted our positioning to capitalize on this trend, which we attribute to increased sector confidence post-regional banking concerns and select bank failures in 2023. Another area in the portfolios we sought exposure this quarter was Utilities. Similar to the financial-industrials basis, the Utilities-Industrials basis saw notable compression following a strong third-quarter rally, driven by a general quest for longer-duration spread assets. At the same time, there is still some potential opportunities for compression in choice Utilities. Within Industrials, the BBB/A spread pickup widened by 4 basis points to 44bps over the quarter, with single A's tightening relative to BBBs.

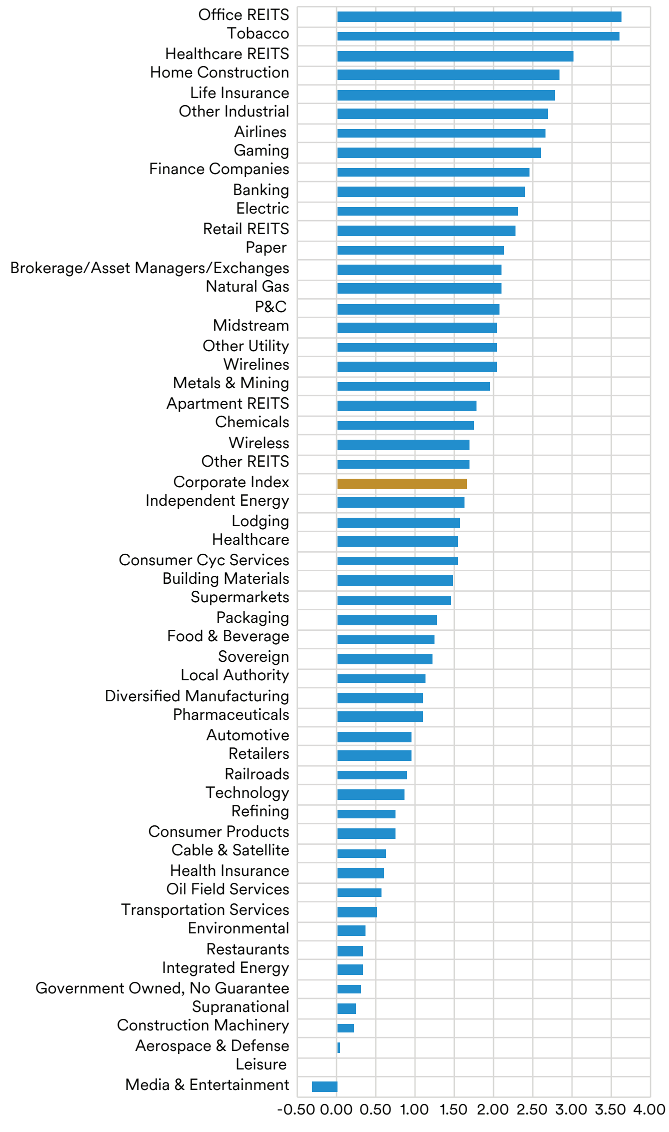
Further compression in the Industrial BBB cohort appears limited, despite selective opportunities throughout the period. Intel's challenges, for instance, resulted in their 10-year on-the-run spreads widening by nearly 63 basis points during the quarter. However, positive news of strategic partnerships in mid-September led to a tightening of spreads by up to 36 basis points from the wides. Smaller sectors like Supermarkets faced pressures from larger M&A new-issue concessions from Kroger Co. Overall, performance was favorable on an excess basis across both high-quality and lower-quality credit indices and maturity profiles. With a substantial decline in interest rates, higher beta sectors and issuers led in excess returns, although some sectors lagged. This quarter mirrored much of what was observed earlier in the year, with strong technical demand for fixed income holding spreads near historical tight levels.

Chart 1 | 3Q 2024 Credit Excess Return (%)



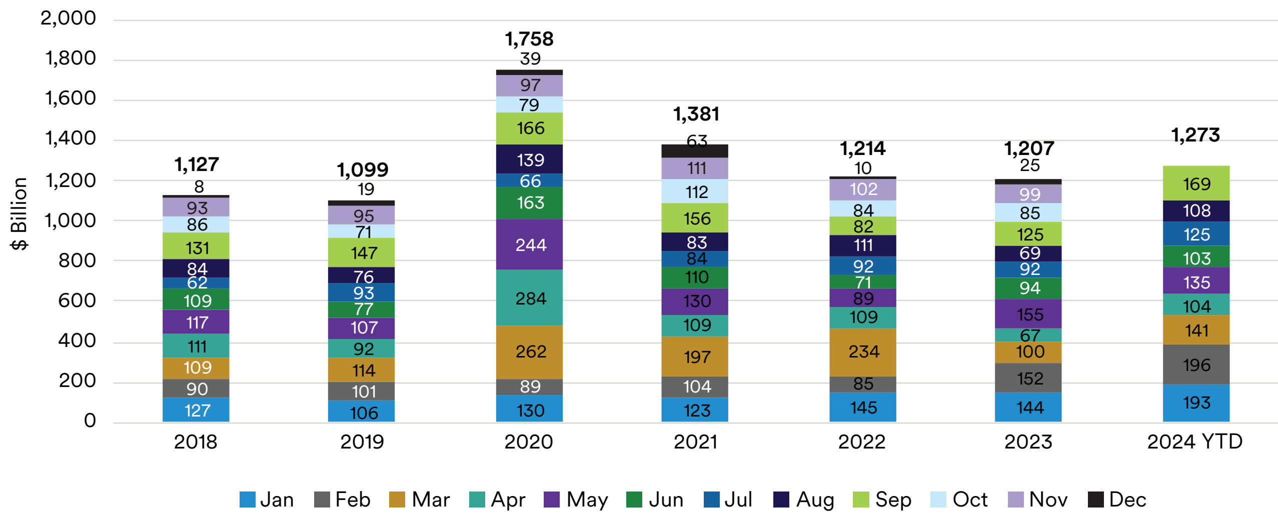
Source: MIM, Bloomberg L.P. As of September 30, 2024.

Chart 2 | 2024 Credit Excess Return (%)



Source: MIM, Bloomberg L.P. As of September 30, 2024.

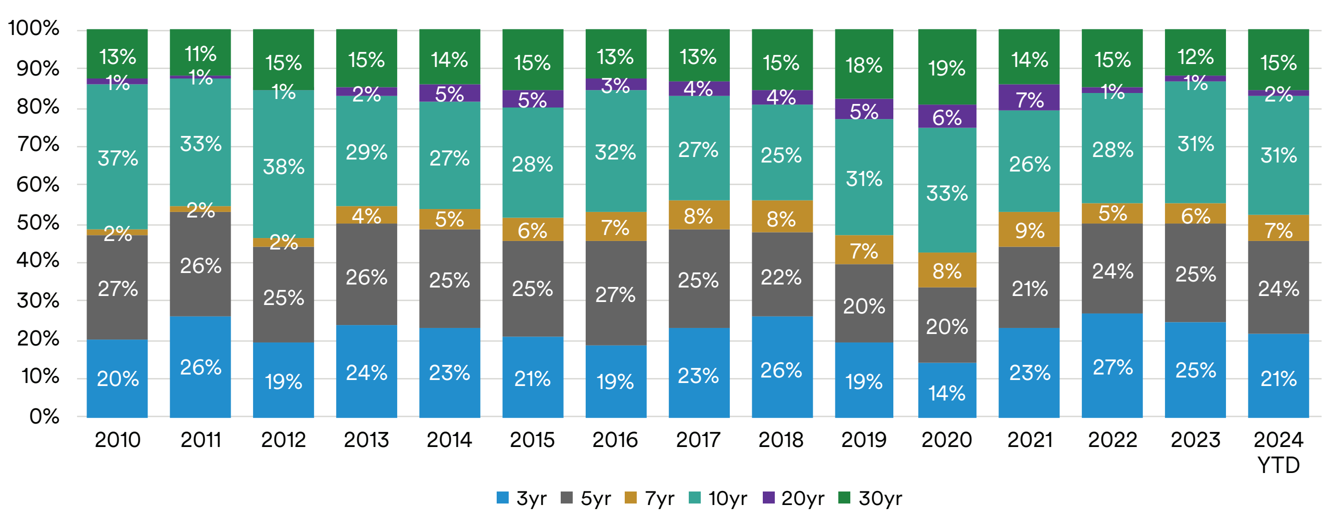
Chart 3 | YTD High Grade Issuance is Running at a Record Pace



Source: JP Morgan. As of September 30, 2024.

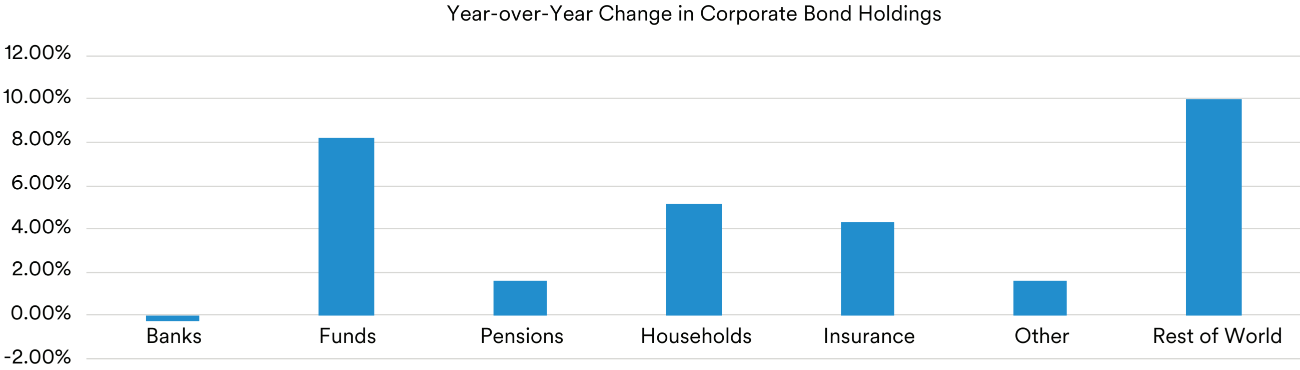
U.S. corporate issuance remained strong in the third quarter, with September setting a new record, 34% higher than the prior four-year average. Quarterly supply totaled $404 billion, up 30% from the previous average. The year-to-date high-grade issuance of $1,275 billion reflects issuers' strategy to advance issuance ahead of potential election-related volatility and to capitalize on favorable funding conditions, marked by strong demand and narrow credit spreads due to lower interest rates. Long-end issuance rebounded, increasing the average tenor of new issues to 10.5 years. In 3Q24, the average maturity of high-grade new issuance was 10.9 years, up from 8.3 years in 3Q23 and 9.9 years in 3Q22, the highest since 3Q21 (11 years). Year-to-date, the average tenor is 10.5 years, surpassing the 2023 and 2022 averages of 9.6 and 10.1 years, respectively.M&A-related funding was active, with nine deals totaling $27 billion. Financials accounted for one-third, and non-financials for two-thirds of primary market activity. Notable transactions included Kroger Co.'s $10.5 billion issuance for its Albertsons Cos Inc. acquisition, Occidental Petroleum Corp.'s $5 billion issuance for CrownRock LP, and $5 billion issuances by both Eli Lilly and Broadcom Inc.[1]

Chart 4 | High Grade Gross Issuance by Maturity



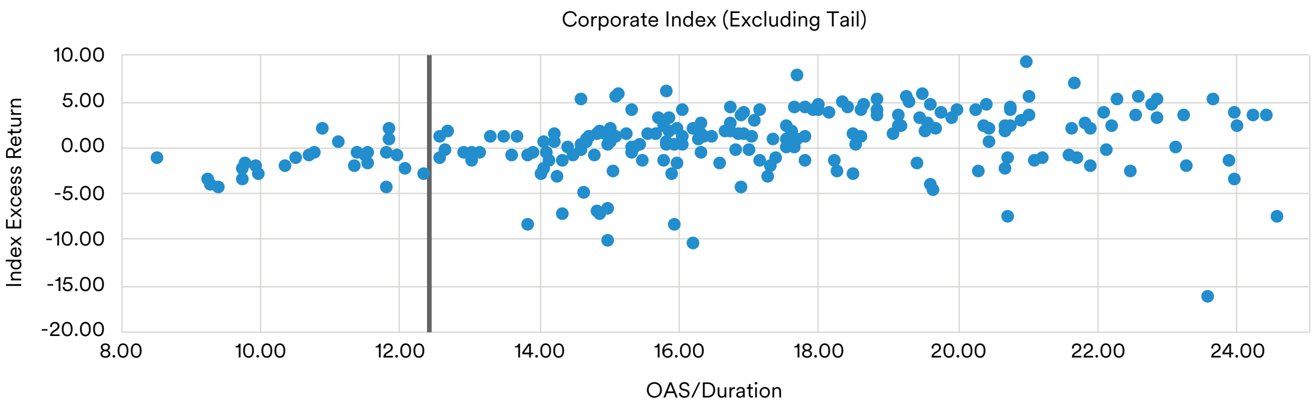
Source: JP Morgan. As of September 30, 2024.

Chart 5 | Meeting robust supply has been healthy demand for investment grade fixed income from a variety of investor types.



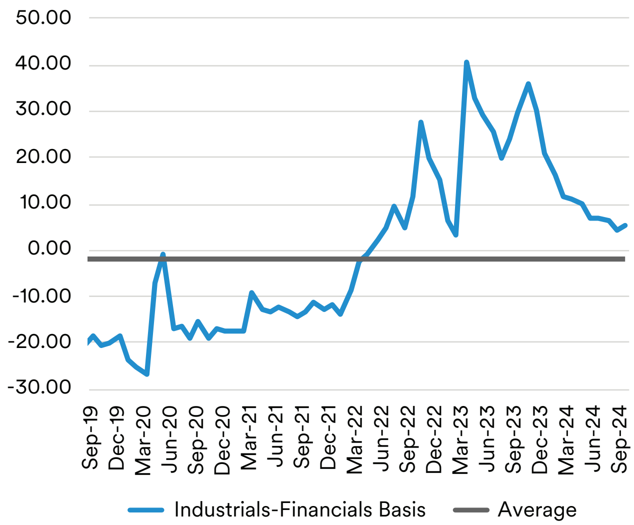
Source: JP Morgan. As of September 30, 2024.

Chart 6 | From a Technical Perspective, the Upside Remains Limited From These Starting Levels of Spread (OAS)

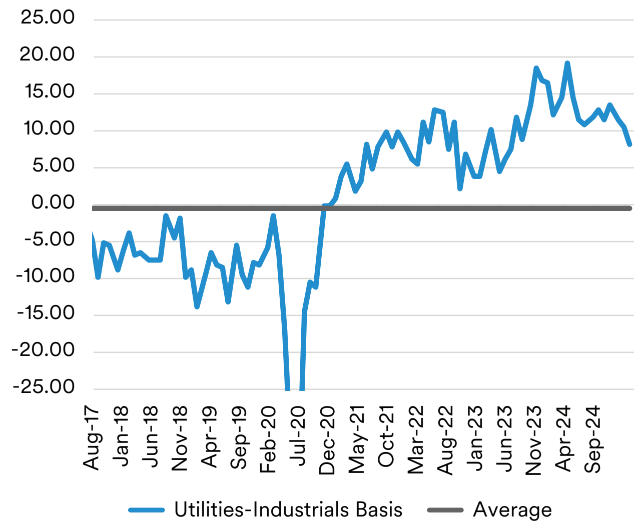


Source: MIM, Bloomberg, LP. As of September 30, 2024.

Chart 7 | The Financials-Industrials basis has rallied as has the Utilities-Industrials basis. Both relationships still appear to have some upside relative to history.

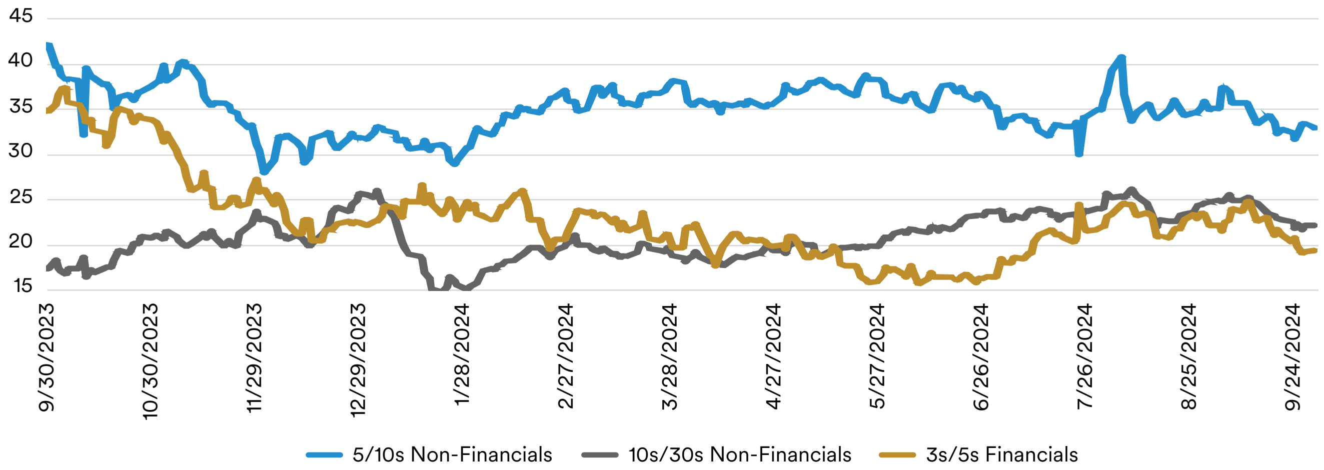


Source: MIM, Bloomberg, L.P. As of September 30, 2024.



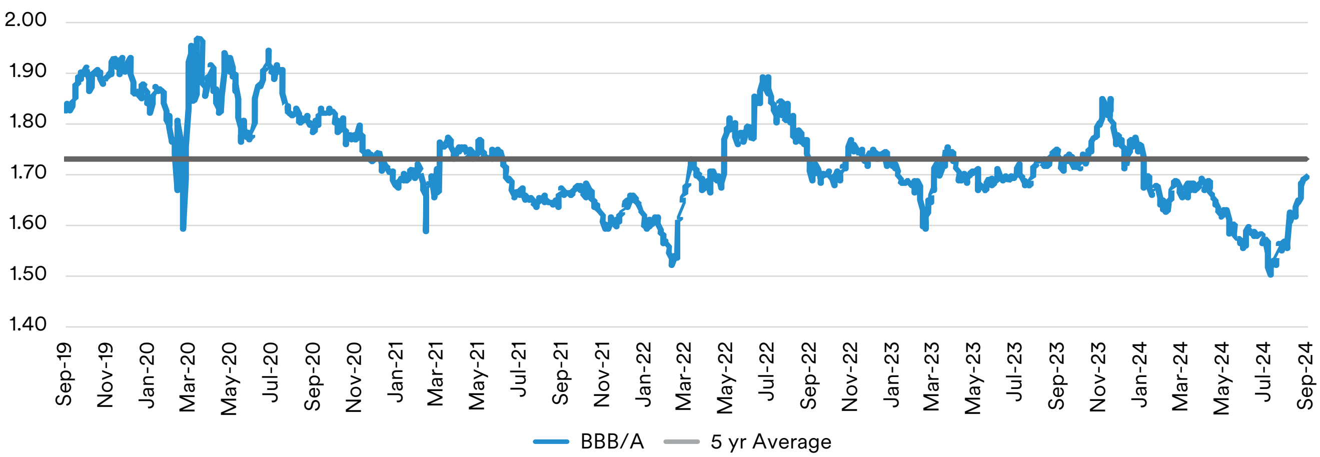
Source: MIM, Bloomberg, L.P. As of September 30, 2024.

Chart 8 | Credit Curves (Bloomberg Indices)



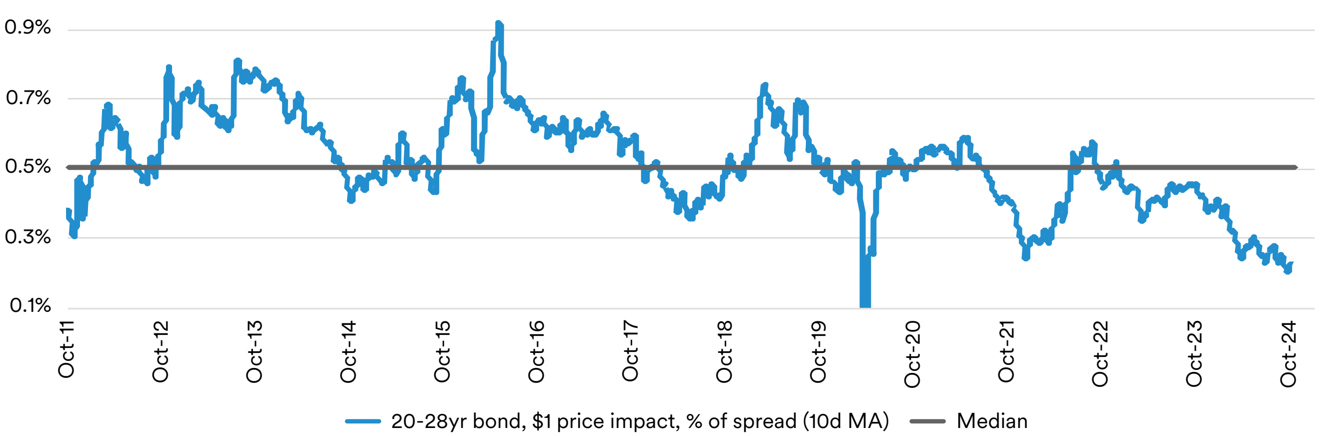
Source: MIM, Bloomberg, LP. As of September 30, 2024.

Chart 9 | IG Industrial BBB s Have Cheapened Relative to Single A's



Source: Barclays, Bloomberg. As of September 30, 2024.

Chart 10 | The Small Low $ Premium Offers a Relatively Attractive Opportunity to Position More Defensively



Source: BofA Global Research, MIM. As of September 30, 2024.

Anticipating a widening of spreads at times feels like Waiting for Godot. We have cautioned in previous outlooks that valuations fail to discount a myriad of risks in the market, and in early August we caught a glimpse of the volatility that can ensue when the Goldilocks environment for credit is disrupted. All it took was one weak labor report that called into question the durability of growth and the efficacy of monetary policy to cause spread widening of a magnitude not seen since last year's regional banking crisis. Subsequent data suggested more benign trends and restored calm to the markets, but the brief bout of weakness served as a stern reminder of the asymmetry in valuations.

Valuations remain amongst the clearest negatives in the market. The third quarter ends with spreads just 9 basis points off of post-GFC tights (80bp in 2021), with those tights being established during a far more supportive environment for credit. Spreads have been tighter before, but rarely so at this level of yields (or lower). Fundamentals have been steady though they fail to inspire a powerful bull case for credit. A more compelling argument can be underpinned by persistently solid technicals. The primary market is on pace to record the 2nd highest annual tally (behind 2020), but this supply has been easily absorbed by varied sources of demand. Traditional yield buyers such as insurance companies and pensions remain a steady presence, but the incremental demand this year has been driven by foreign investors and mutual funds. The outlook remains promising for the latter two buyer bases, with constructive outlooks for both the trajectory of hedging costs and total returns. We recognize the ability for powerful technicals to overwhelm a macro backdrop that we believe should auger for wider spreads, but also caution that valuations simply do not allow any cushion for a misstep.

So how do we position portfolios when there is limited room for spread compression, ample room for spread widening, but a potentially prolonged period of rangebound spreads until a negative catalyst develops? We discussed last quarter our preference for decompression trades, and this will remain the predominant theme. Compression was the main tool we used to generate alpha in the first half of the year, but those opportunities are increasingly less attractive. A traditional playbook of compression trades would feature areas of the market such as BBBs, cyclicals, and emerging market debt. These were all areas of underperformance in the third quarter, and so upgrading the quality of the portfolio proved timely in client portfolios. Offsetting this tactical shift was a healthy allocation to Treasuries, which has been and will be a drag if spreads grind tighter, but which we still believe offers tremendous utility as a liquidity source to be deployed back into credit during periods of volatility. While most of the market can be characterized by a lack of dispersion (and opportunity), there are a number of high beta idiosyncratic credit stories where getting the credit call right will be impactful to returns. Similarly, 2024 has been a year where avoiding certain high quality credits trading at non-economic valuations can be equally valuable. Security selection has been, and will remain, a key driver of alpha in the near term.

Away from our hyperfocus on security selection, we believe being positioned in the right part of the curve can be additive to returns. After a gradual re-steepening of 10s/30s curves throughout the year allowed us to slowly reduce our long end underweight, the recent grab for duration is flattening curves once again—eaving us less enthralled with adding spread duration out the curve with the Long Corporate Index within spitting distance of 25-year tights. On the intermediate part of the curve, a similar dynamic has pushed 5s/10s spread curves to a level of flatness not seen in almost a year, leaving us biased towards allocating our marginal dollar to the front end of the curve, where attractive breakevens can provide a buffer against a spread widening event.

Investing in the credit markets today requires great patience. Low spread dispersion in a market so compressed that high quality credit screens more attractive than lower quality can really constrain the opportunity set to generate outsized alpha. We believe it prudent however to take what the market is giving us, and today that is an opportunity to re-position into credits that are going to be more durable into an economic slowdown, with the cost to rotate into such credits at historically compressed levels. It remains to be seen whether the Fed's commencement of rate cuts is timely and significant enough to stem potential labor market weakness, but every economic data point will be heavily scrutinized and has the potential to be a catalyst for volatility. It is equally difficult to project the impact that the US elections may have on market sentiment, or how exogenous shocks like a US port strike or Middle East conflicts may impact an inflation trajectory that has taken a backseat in the minds of many investors (and seemingly The Fed). The technicals are admittedly quite strong, but valuations are rich and there are too many potential sources of volatility to take comfort in anything other than a higher quality risk posture in portfolios that will afford us the flexibility to take advantage of pockets of weakness. The sell-off in August may have just been a precursor to a more durable spread widening event, and we stand ready to take advantage of such an opportunity. Even if that opportunity fails to present, we still believe our security selection driven approach will provide enough ammunition to generate relative outperformance—just as it has throughout 2024.

Endnote

[1] Bank of America Merrill Lynch. As of September 30, 2024.

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