FIXED INCOME PERSPECTIVES

A Monthly Strategy Review of Bond Market Trends and Economic Developments

September 2024

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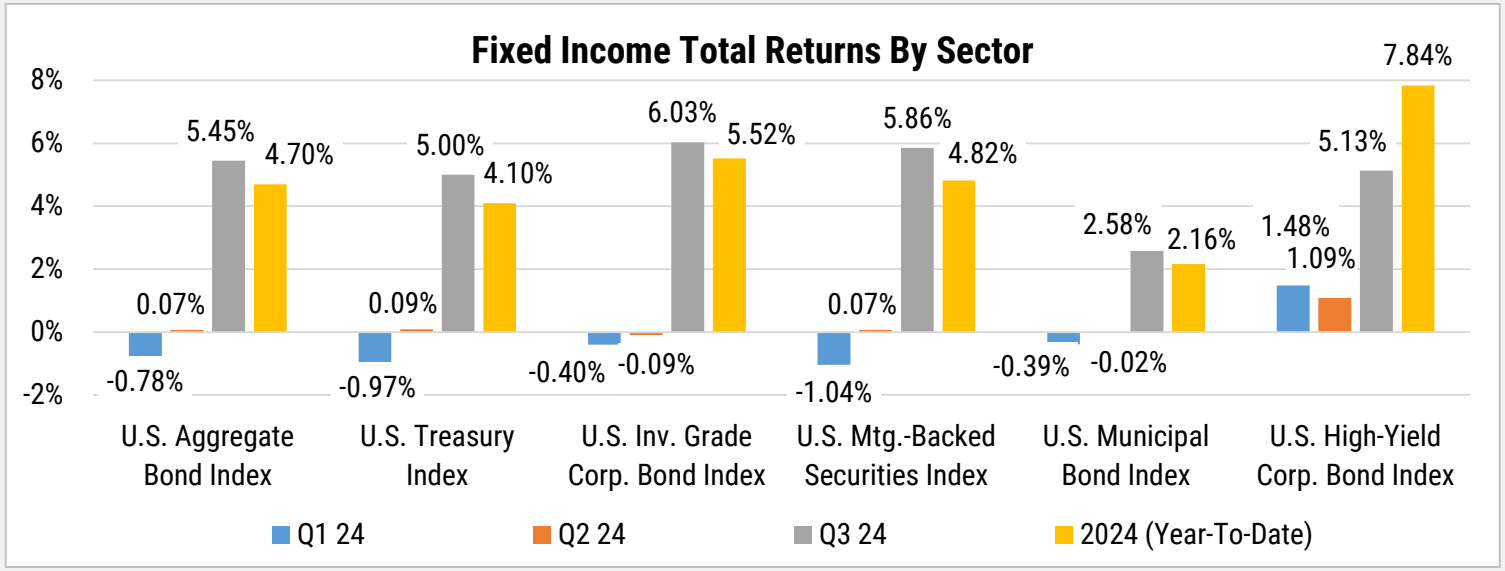
Senior Portfolio Manager

The Road to Normalization

EquityCompass

Fixed Income Sector Performance

Following two lackluster quarters, the Bloomberg U.S. Aggregate Bond Index (AGG) has rebounded sharply since the end of June. **After posting a modest decline over the first six months of the year, the AGG has generated an impressive total return of 5.5% in the third quarter through September 20.** The Federal Reserve's (Fed) first rate cut in over four years, along with expectations for further sizable rate reductions through the end of 2025, have boosted all sectors of the fixed income market. On a year-to-date basis, returns across the taxable investment-grade sectors have been tightly clustered in the 4% to 6% range. Municipals have lagged Treasuries, while high-yield bonds have substantially outperformed all other major sectors.



Returns through 9/20/2024; Fixed income indices provided by Bloomberg; Source: Bloomberg Finance, LP

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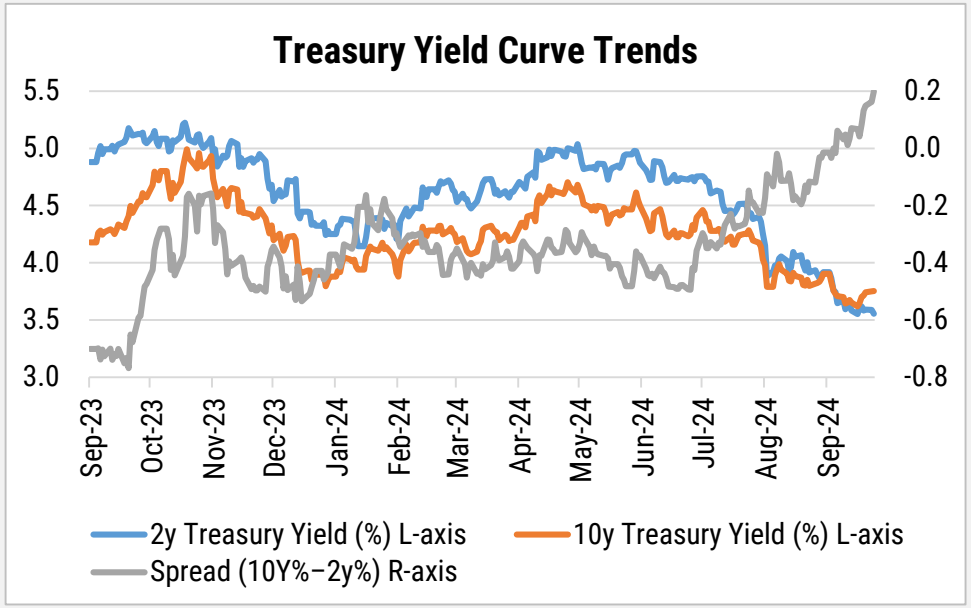
Indices are unmanaged, do not reflect fees and expenses, and are not available for direct investment.
Past performance cannot and should not be viewed as an indicator of future performance.

Treasury Yield Curve

The combination of a cooler labor market and softer inflation has spurred the Fed into action, setting a new course for short-term rates on the road to normalization. Since the end of the second quarter, Treasury yields have moved decisively downward, led by a 110 basis point (bps) decline in the two-year yield to 3.5%.

With multiple rate cuts now fully priced into the front-end of the curve, the 2s to 10s yield spread is no longer inverted. As of September 24, the 2s to 10s spread was a positive 20 bps, marking the highest level for this key yield curve measure since June 2022. Further curve steepening should be expected over the coming months, as the Fed continues to drive down short-term interest rates.



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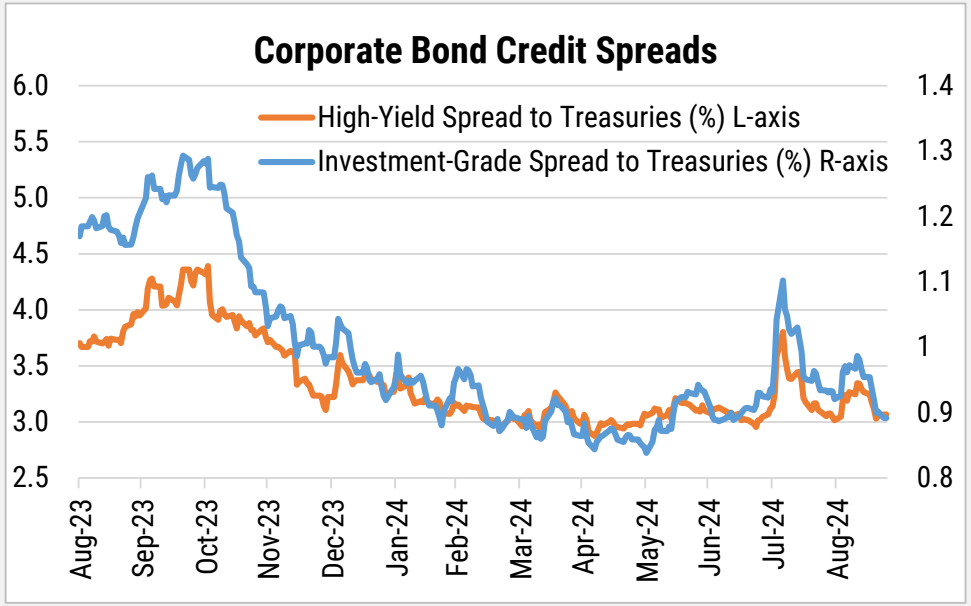
Credit Spreads

After two brief bouts of significant volatility in August and early September, credit spreads have returned to the lower end of their 12-month trading ranges. Since reaching a 12-month high of 110 bps on August 5, investment-grade spreads have subsequently dropped 19%. Corporate bonds have clearly benefited from the broad-based improvement in financial conditions since the Fed pivoted toward lower rates. At these relatively tight levels, corporate spreads appear to be pricing in a soft landing and could widen significantly if the economy fails to meet the credit market's optimistic expectations.



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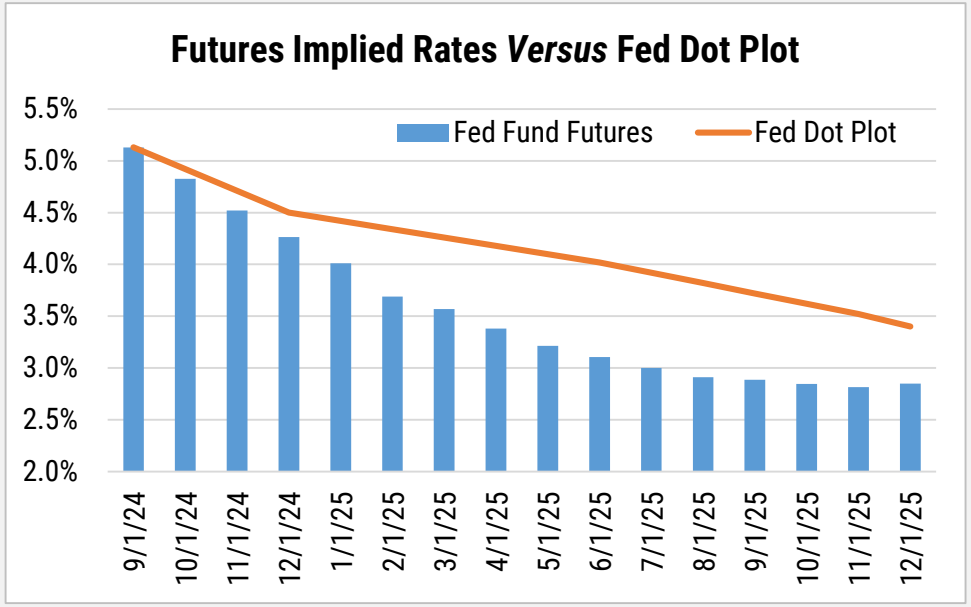
Federal Reserve Monetary Policy

After hinting at lower rates for several months, the Federal Open Market Committee (FOMC) made a decisive initial move toward less restrictive monetary policy with a 50 bps rate cut on September 18. **Interest rate futures are anticipating an aggressive easing cycle, with the overnight funds rate projected to fall by another 200 bps to 3% by the end of next year.** While the September "dot plot" moved closer to the rate path implied by futures, traders continue to expect a faster pace of rate cuts than envisioned by the Fed's forward guidance as the economy slows and inflation moderates. The revised "dot plot" reflects a fed funds rate of 4.5% by the end of this year and 3.5% by the conclusion of 2025. Bond market conditions will likely remain volatile until this remaining gap between futures and the "dot plot" is resolved.



As of 9/24/2024; Source: Bloomberg Finance, LP

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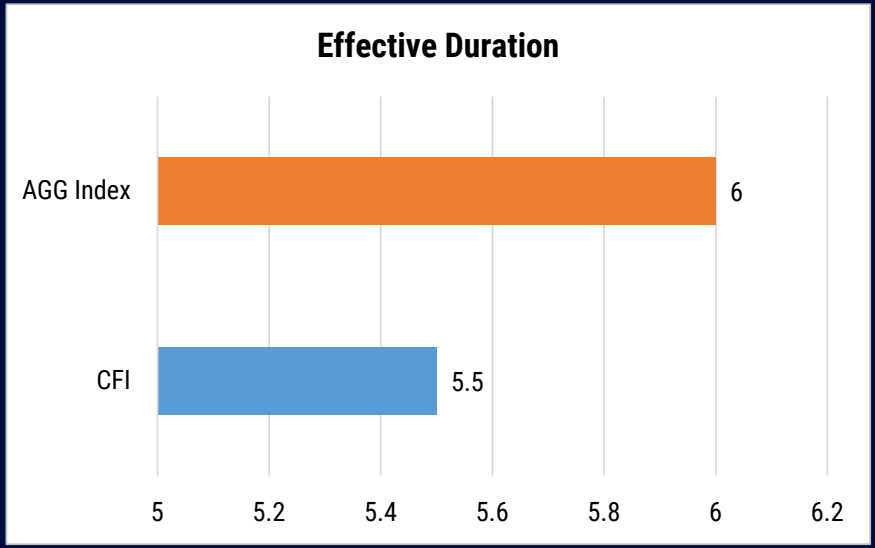
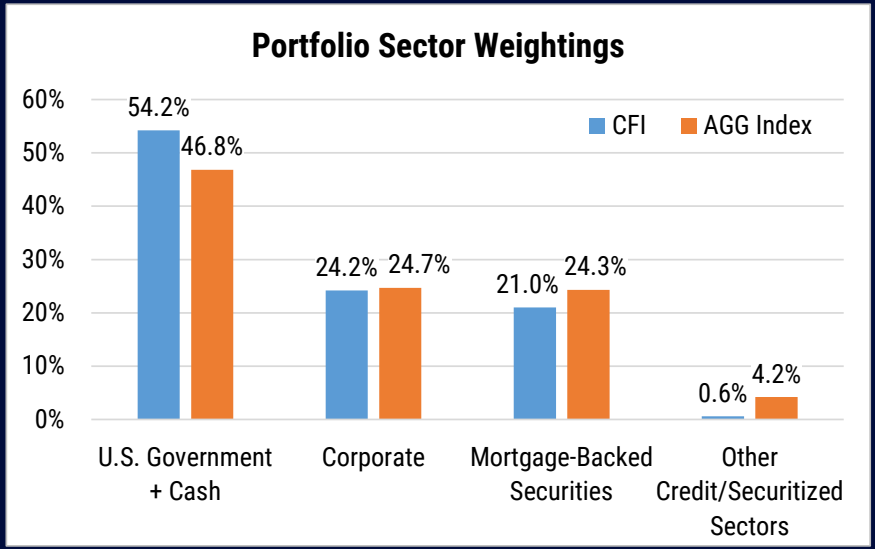
Core Fixed Income Portfolio (CFI) Statistics



As of 9/24/2024; Source: FactSet Data Systems, Inc. and Bloomberg Finance, LP



As of 9/24/2024; Source: FactSet Data Systems, Inc. and Bloomberg Finance, LP

In preparation for a steeper curve (lower short-term yields coupled with flat to higher long-term yields) driven by additional Fed rate cuts, we are targeting the portfolio's duration at 5.5 years, which is approximately 92% of the AGG's duration. Concentrating principal cash flows in the intermediate-term segment of the curve should assist performance and address risks in several ways, including potentially maximizing roll down benefits, reducing front-end reinvestment risk, and lowering the inflation risk associated with longer duration instruments.

In an effort to protect against wider corporate bond spreads, CFI maintains significantly higher credit quality relative to the AGG. Compared to the benchmark, CFI holds an overweight to Treasuries (including cash) of 740 bps, with a commensurate and combined underweight to MBS, corporate bonds, and other credit-sensitive sectors.

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Fixed Income Market Review

- After a sluggish start to the year, bonds have rebounded sharply in the third quarter, fueled by the beginning of the Fed's easing cycle.
- The trends toward lower short-term rates and a steeper Treasury yield curve have gained momentum, with monetary policy now on the road to normalization.
- Corporate credit spreads have largely recovered from two brief bouts of volatility earlier this quarter, amid a Fed-inspired, broad-based improvement in overall financial conditions.
- Interest rate futures project another 200 bps of rate cuts by the end of next year, as traders price in a more aggressive easing cycle than reflected in the September "dot plot."
- Compared to its benchmark, the Core Fixed Income Portfolio offers a similar yield with higher credit quality and a shorter duration.

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High-Frequency Economic Data Monitor

Over the past four weeks, the U.S. economy has rebounded from a lethargic summer, with positive momentum heading into the fourth quarter. While the monthly data for August was generally tepid, the weekly high-frequency metrics for September have shown clear improvement. Despite this encouraging stabilization, key leading indicators continue to send a cautionary signal. **The Conference Board's Leading Index declined in August, dropping for the 30th time in the past 32 months, with one unchanged reading over that time span.** On a month-over-month basis, the Leading Index fell by 0.2% (consensus -0.3%). On a six-month annualized basis, the Leading Index sank by 4.6%—its worst showing since February.

High-Frequency Indicators	Current Reading	-1 Week	-2 Weeks	-3 Weeks	1 Week Pct	2 Week Pct	3 Week Pct
U.S. Crude Rotary Rig Count	488	483	483	483	1.0%	1.0%	1.0%
Raw Steel Production	1,749	1,772	1,760	1,782	-1.3%	-0.6%	-1.9%
MBA U.S. Purchase Index	146.1	138.6	136.1	131.8	5.4%	7.3%	10.8%
JRI Same Store Sales Monthly (YoY)	5.6%	6.5%	5.2%	4.9%	-0.9%	0.4%	0.7%
Department Store YOY % Change (MTD)	-0.1%	0.0%	-0.5%	-0.4%	-0.1%	0.4%	0.3%
Initial Jobless Claims	219	231	228	232	-5.2%	-3.9%	-5.6%
Continuing Jobless Claims	1,829	1,843	1,845	1,860	-0.8%	-0.9%	-1.7%
N.Y. Fed Weekly Economic Index (WEI)	2.3	1.8	2.2	1.8	29.3%	6.4%	30.7%
U.S. TSA Checkpoint Numbers	2,751,315	2,634,933	2,218,818	2,702,301	4.4%	24.0%	1.8%
Chicago Board Options Exchange (VIX)	16.0	16.6	22.4	15.0	-3.5%	-28.6%	6.5%
IG Corp. Credit Default Spread (CDX)	52.6	49.8	54.0	49.3	5.6%	-2.6%	6.8%

Data as of 9/20/2024. Green denotes positive trend; red denotes negative trend.
Source: Bloomberg Finance, LP

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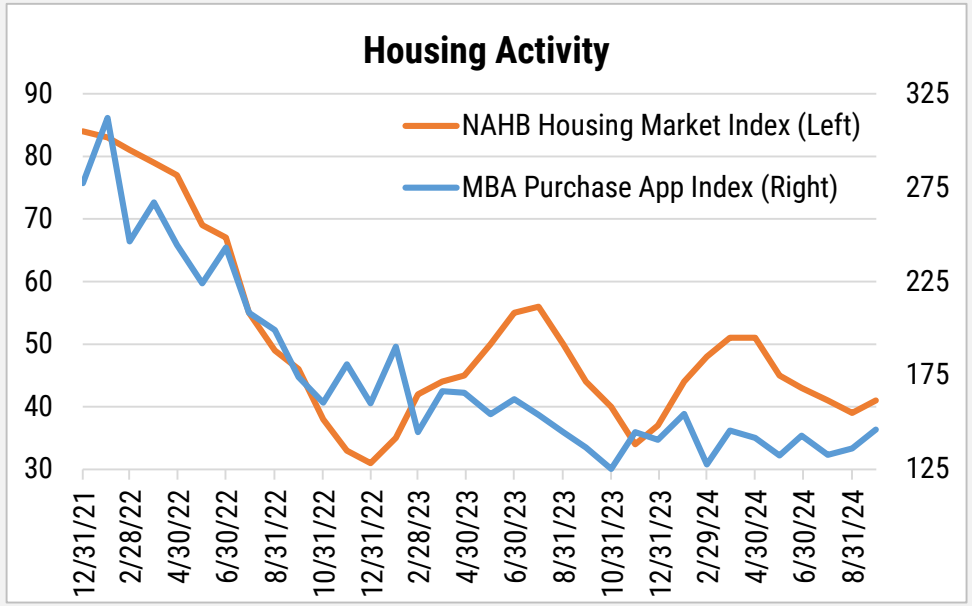
Mortgage Applications

Housing has been the most negatively impacted sector from higher interest rates and stands to benefit significantly from less restrictive monetary policy. The latest round of housing data confirmed the ongoing stress in turnover rates for residential real estate.

- Existing home sales have fared poorly this year, falling by another 2.5% in August to a 10-month low of 3.9 million on an annualized basis.
- The National Association of Home Builders' Market Index has languished around the 40 level for the past four months, coming in at a lackluster 41 in August.
- Mortgage purchase applications have shown only modest improvement despite the recent decline in mortgage rates below 7%. The Mortgage Bankers Association's Mortgage Purchase Index for the week of September 20 rose by 1% week-over-week but remained 15% below its year-to-date peak set in January.



Source: Bloomberg Finance, LP

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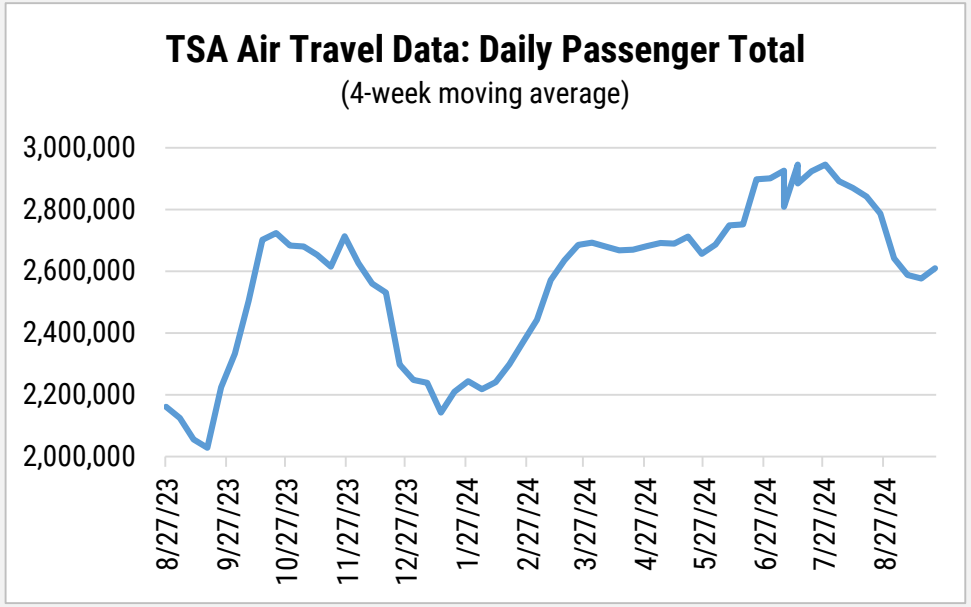
Air Travel By Total Passengers

The daily passenger count for air travelers has averaged 2.6 million in 2024—a 6% increase compared to the same period in 2023 and the strongest nine-month stretch since 2019. Lingering pent-up demand, coupled with low unemployment, have created a tailwind for air travel despite reduced savings reserves and significant economic uncertainty. **Over the past two years, the travel and leisure sector has provided a helpful boost to the economy and helped to mitigate some of the weakness in the housing and manufacturing sectors.**



Source: Bloomberg Finance, LP

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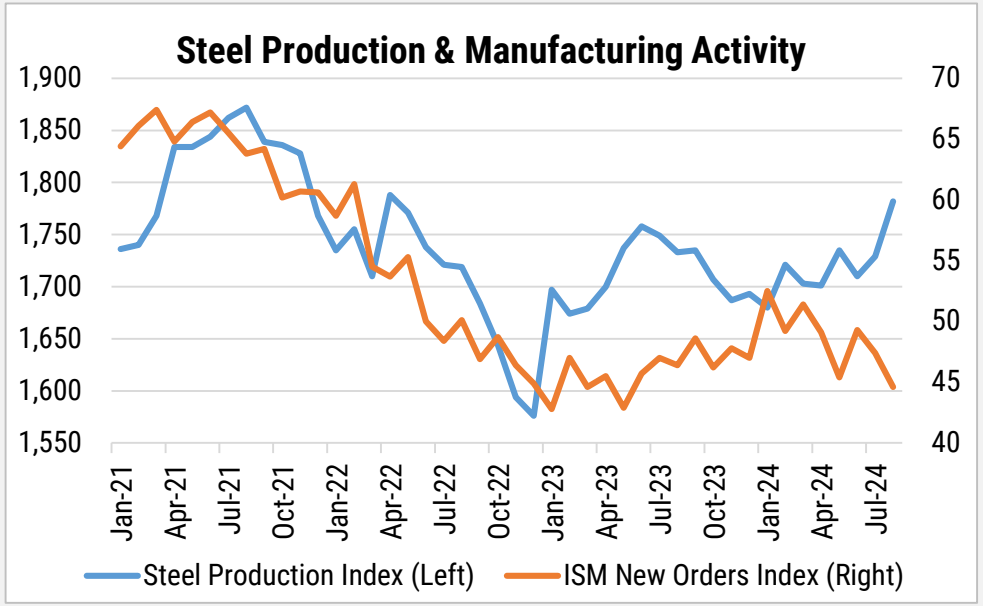
Steel Production

Through the first three quarters of 2024, the production side of the economy has lagged the services sector by a wide margin, primarily due to elevated borrowing costs and a shift in consumer spending preferences. **The ISM New Orders Index, a key leading indicator of manufacturing activity, has held below 50 for the past five months, with an August reading of 44.6.** Steel production has increased recently despite weak manufacturing output but may be poised to shift lower without a near-term rebound in end-user demand.



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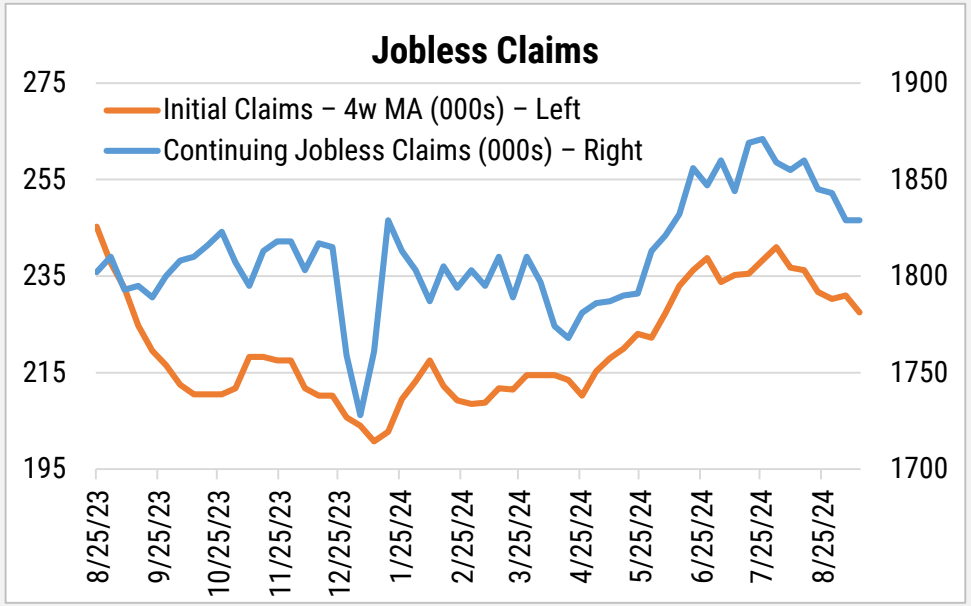
Jobless Claims

The labor market continued to soften in August, with net job growth (including downward revisions to prior months) slowing to 56,000. The unemployment rate ticked down by 0.1% to 4.2%, due to slower growth in the size of the labor force, but it has risen by 0.5% since the beginning of the year.

Initial jobless claims (four-week moving average) have jumped by 11% this year but have shown some modest signs of improvement over the past six weeks. Continuing jobless claims have followed a similar pattern, coming in at 1.8 million for the week of September 6.



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Economic Data Review

- High-frequency economic indicators have improved in September after a lethargic summer.
- Housing turnover rates remain depressed, given record prices, locked-in mortgage rates, and limited supply.
- In a sign of persistent strength in consumer services, air passenger volume continues to run well ahead of last year's pace.
- The production side of the economy has underperformed the services sector by a wide margin, due to elevated borrowing costs, limited economic visibility, and a shift in consumer spending preferences.
- Higher jobless claims, fewer open positions, and slower job creation have spurred the Fed into action.

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About the Author

James J. DeMasi, CFA
Senior Portfolio Manager

Jim joined EquityCompass in July 2019. He is a Senior Portfolio Manager for the Core Fixed Income Portfolio, Municipal Income Enhanced Portfolio, and co-manager of the High-Dividend Portfolio. Prior to joining the portfolio management team, Jim served as the Chief Fixed Income Strategist at Stifel, Nicolaus & Company, Incorporated for 12 years. At Stifel, Jim created investment portfolio and risk management strategies for the firm's institutional fixed income clients. He also managed a $3 billion bond portfolio for Stifel Bank. Previously, he spent five years at Legg Mason as a fixed income strategist and 13 years at the Federal Deposit Insurance Corporation (FDIC) in bank supervision. His FDIC career focused on the credit analysis of bank balance sheets and the risk profile of innovative credit market instruments, including corporate bonds, mortgage-backed securities, and derivatives.

Jim has a B.S.B.A. in Finance from West Virginia University. He is also a CFA charter holder and member of the CFA Society Baltimore.

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About EquityCompass

EquityCompass Investment Management, LLC ("EquityCompass") is a Baltimore-based equity investment management team that provides portfolio strategies with respect to assets of approximately $5.2 billion.[1]

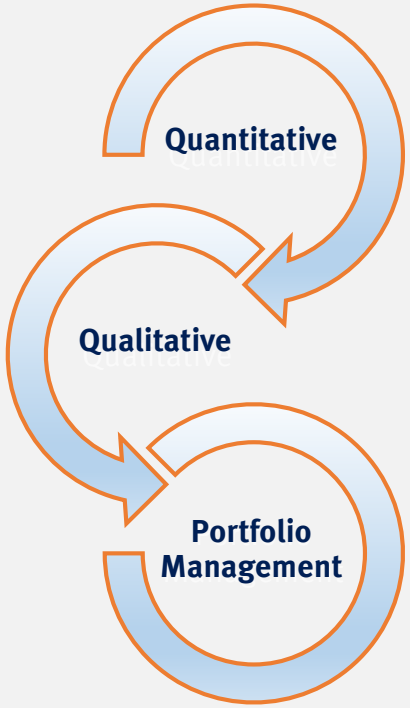
At EquityCompass, our mission as an asset management company is to provide investment solutions that address the needs of clients accumulating, mitigating risk to, and decumulating wealth. We aim to accomplish these goals with an organization culture that prizes intellectual honesty, open dialogue among colleagues, and a commitment to continually improve ourselves and the investment process.

Extensive Investment Experience

- Investment team led by Richard Cripps, CFA – former Managing Director of Portfolio Strategy at Stifel and former Chief Market Strategist and Co-Chairman of the investment committee at Legg Mason Wood Walker
- Senior members include Robert Hagstrom, CFA, as Chief Investment Officer and Chris Mutascio as Senior Managing Director – both with 20+ years of investment experience
- Publishing investment research since 2001
- Offering investment portfolios on the Stifel platform since 2006

Research-Driven, Risk-Managed Portfolio Strategies

- Incorporates fundamental, technical, and behavioral insights evolving from original research by EquityCompass professionals
- Portfolios are designed to maximize expected returns by focusing on stock selection while incorporating rigorous risk management strategies
- The investment team collaborates to leverage ideas, research, and expertise in making investment decisions on all strategies



Rigorous empirical testing to identify favorable risk-adjusted investment insights

Experienced qualitative analysis for final investment selection

Focused and disciplined portfolio decision-making

(1) Total assets combines both Assets Under Management and Assets Under Advisement as of September 30, 2024. Assets Under Management represents the aggregate fair value of all discretionary and non-discretionary assets, including fee paying and non-fee paying portfolios. Assets Under Advisement represent advisory-only assets where the firm provides a model portfolio and does not have trading authority over the assets.

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Description of Benchmark(s): **The MBA (Mortgage Bankers Association) Purchase Index** is a weekly report of mortgage loan applications based on a sample of 75% of U.S. mortgage activity. Analysts consider the report to be a leading indicator of housing market activity. The **Bloomberg U.S. Aggregate Bond Index** is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency). The **Bloomberg U.S. Treasury Index** measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting. The **Bloomberg U.S. Mortgage Backed Securities (MBS) Index** tracks fixed-rate agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage. The **Bloomberg U.S. Corporate Bond Index** measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers. The **Bloomberg U.S. Corporate High Yield Bond Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on EM country definition are excluded. The **Bloomberg U.S. Municipal Bond Index** is considered representative of the broad market for investment grade, tax-exempt bonds with a maturity of at least one year.

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The **Chicago Board Options Exchange (CBOE)** created the VIX (**CBOE Volatility Index**) to measure the 30-day expected volatility of the U.S. stock market, sometimes called the "fear index." The VIX is based on the prices of options on the S&P 500 Index and is calculated by aggregating weighted prices of the index's call and put options over a wide range of strike prices. **The Institute of Supply Management (ISM) Manufacturing Purchasing Managers Index (PMI)** is based on data compiled from monthly replies to questions asked of purchasing and supply executives in over 400 industrial companies. For each of the indicators measured, this report shows the percentage reporting each response, the net difference between the number of responses in the positive economic direction and the negative economic direction and the diffusion index. **The Raw Steel Production Index** measures the real output of all relevant establishments located in the United States, regardless of their ownership, but not those located in U.S. territories. The **Weekly Economic Index (WEI)** provides a signal of the state of the U.S. economy based on data available at a daily or weekly frequency. The WEI is an index of ten indicators of real economic activity, scaled to align with the four-quarter GDP growth rate. It represents the common component of series covering consumer behavior, the labor market, and production. The **Manufacturing ISM Report** is based on data compiled from monthly replies to questions asked of purchasing and supply executives in over 400 industrial companies for each of the indicators measured: New Orders, Backlog of Orders, New Export Orders, Imports, Production, Supplier Deliveries, Inventories, Customers Inventories, Employment, and Prices. The **Conference Board Leading Economic Index** is an American economic leading indicator intended to forecast future economic activity. It is calculated by The Conference Board, a non-governmental organization, which determines the value of the index from the values of ten key variables. The **NAHB/Wells Fargo Housing Market Index (HMI)** is based on a monthly survey of NAHB members designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months as well as the traffic of prospective buyers of new homes. The **credit default swap index (CDX)** is a benchmark financial instrument made up of credit default swaps that have been issued by North American or emerging market companies. A credit default swap is an over-the-counter derivative contract that offers one counterparty protection against a credit event, such as the default or bankruptcy of an issuer. It can be thought of as insurance in the financial world. The credit default swap index tracks and measures total returns for the various segments of the bond issuer market so that the overall return of the index can be benchmarked against funds that invest in similar products. **Gross domestic product (GDP)** is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period. As a broad measure of overall domestic production, it functions as a comprehensive scorecard of a given country's economic health. All benchmark returns are shown on a total return basis and assume that all cash distributions, such as dividends, are reinvested. The volatility of the indices identified in this report may be materially different from the volatility of the model portfolios presented by EquityCompass. Indices are unmanaged, do not reflect fees and expenses, and are not available for direct investment.

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