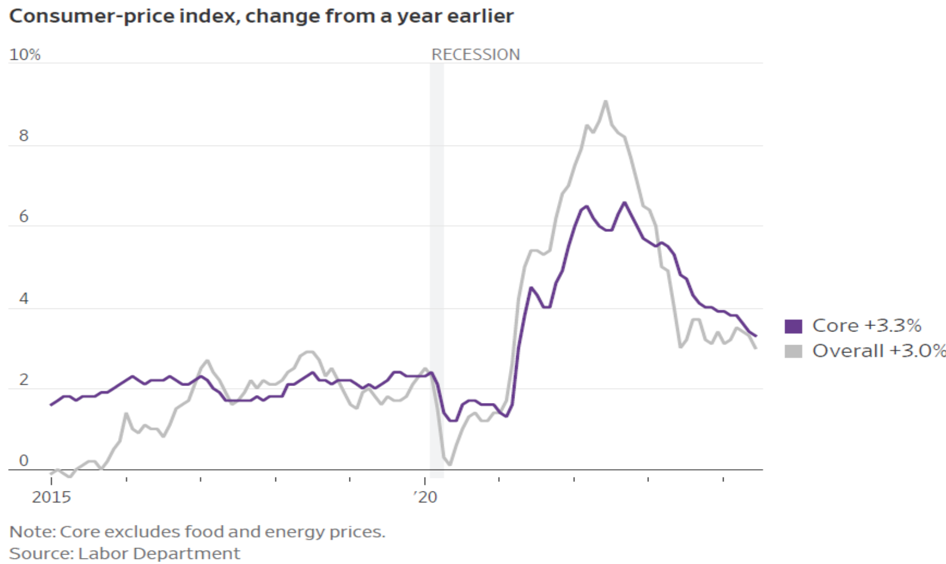
Second Quarter 2024 Bond Market Review and Outlook

"Monetary policy operates with long and variable lags." (Milton Freidman as quoted in *Bloomberg* 10/16/23)



What a difference a few months makes. As noted in previous letters many at the Federal Reserve and private sector economists believed the trend to lower inflation to the FED's 2% target would be bumpy. That has certainly been the case of late.

The consensus among economists for easing by the Federal Reserve of overnight rates is now projected at two cuts in 2024 and an additional three in 2025 (Source: *Bloomberg economic Forecasts* 7/18/24). A reversal of the consensus just a month ago, when many feared elevated inflation over a much longer term.

Federal Reserve Chairman, Jerome Powell noted on July 15 that "second-quarter economic data has provided policymakers greater confidence that inflation is heading down to the central bank's 2% goal, possibly paving the way for near term interest-rate cuts" (source: *Bloomberg* 7/15/24).

Powell also shifted the Federal Reserve's focus to now include labor market and employment risks in addition to their quest to lower inflation. He stated, "Now that inflation has come down and the labor market has indeed cooled off, we're going to be looking at both mandates". He then added, "an unexpected weakening" in the labor market could also be a reason for the federal Reserve to react (source: ibid).

The following day unemployment claims data increased along with a rise in continuing claims, evidencing a slowing labor market. Initial claims rose to the highest level since January and the unemployment rate rose to 4.1%, the highest since 2021 (source: *Bloomberg* 7/18/24).

While the labor department's payroll survey shows job growth has risen by a healthy monthly average of 200,000 in 2024, their separate survey of households shows poor growth (source: *Wall Street Journal* 7/18/24). Furthermore, those sectors showing the largest increases are those closely tied to government spending, namely government jobs, healthcare and social assistance, while most other sectors show no growth (manufacturing since last November) and even losses (IT

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Yields* on 06/30/2024	Yield*
CAM Broad Market (corporate core plus) Strategy (6.0 year maturity; 4.9 duration)	**5.65%**
CAM Investment Grade (100% corporate bonds) Strategy (6.4 year maturity; 5.3 duration)	**5.24%**
CAM High-Yield Strategy (only BA & B rated purchased) (4.9 year maturity; 3.9 duration)	**6.47%**
CAM Short Duration Strategy (2.7 year maturity; 2.2 duration; 50% IG & 50% HY)	**5.71%**
CAM Short Duration Investment Grade Strategy (2.3 year maturity; 2.0 duration)	**5.27%**
U.S. Treasury** (10 year maturity)	**4.40%**
U.S. Treasury** (5 year maturity)	**4.38%**
U.S. Treasury** (2 year maturity)	**4.76%**

* The lower of yield to maturity or yield to worst call date ** Source: Bloomberg

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CAM's Key Strategic Elements

- Bottom-up credit analysis determines value and risk.
- Primary objective is preservation of capital.
- Larger, more liquid issues preferred.
- Target is always intermediate maturity.
- No interest rate forecasting.
- <u>All</u> clients benefit from institutional trading platform and multi-firm competitive bids and offers.

CAM returns are after CAM's average management fee & all transaction costs but before any broker, custody or consulting fees. **The indices are unmanaged and do not take into account fees, expenses, and transaction costs.**	**Total Return (%)**	**Annualized Returns (%)**				
	2Q '24	YTD	1-YEAR	3-YEARS	5-YEARS	10-YEARS
CAM Broad Market Strategy—Net 1/3 high yield, 2/3 investment grade	0.57	0.81	6.06	-1.60	1.32	2.16
CAM High Yield "Upper Tier" Strategy—Net only purchase BB and B; no purchases of CCC & lower	1.05	2.54	9.57	0.34	2.99	2.38
Bloomberg US Corporate High Yield Index	1.09	2.58	10.43	1.64	3.92	4.31
CAM Investment Grade Strategy—Net 100% corporate bonds	0.36	0.00	4.43	-2.51	0.54	2.06
Bloomberg US Corporate Index	-0.09	-0.49	4.64	-3.03	0.62	2.34
CAM Short Duration Strategy—Net 1/2 investment grade, 1/2 high yield	0.98	2.27	7.00	0.69	2.55	1.85
CAM Short Duration Investment Grade Strategy—Net 100% corporate bonds	0.90	1.46	5.07	-0.49	1.12	1.69

Relative Performance Review 06/30/2024

CAM's **Investment Grade Strategy ("IG")** produced a gross total return of 0.42% in the quarter ended June 30, 2024, compared to -0.09% for the Bloomberg U.S. Corporate Index. Notably, CAM always positions a majority of the portfolio within intermediate maturities. Longer dated securities (10+ years) returned -2.07% for the period, underperforming the broader index. CAM's zero weighting in this duration bucket produced a +53 basis point contribution to excess return. The YTD return for the CAM IG strategy was 0.12% compared to the Index return of -0.49%. CAM's positioning within the Electric Utility and Airline industries were the largest positive impact to performance, with +11 and +9 basis point contributions to excess return, respectfully. Our positioning within the Banking industry was the largest negative contribution of -8 basis points.

The **High Yield Strategy ("HY")** delivered a gross total return of 1.12% in Q2 while the Bloomberg US Corporate High Yield Index returned 1.09%. CAM's overweight and security selection within the Cable & Satellite industry group had the biggest positive impact on performance relative to the index with a 22 basis point contribution to excess return during the quarter. The HY YTD return was 2.69% while the Index returned 2.58%. The Cable & Satellite and Banking industry groups provided the largest positive impact on excess return over this time period at 39 and 34 basis points, respectively.

Our **Broad Market Strategy ("BM")** – a 67%/33% blend of the IG and HY strategies above – produced a gross total return of 0.64% for the quarter compared to 0.31% for the Index, a similar blend of Bloomberg IG and HY corporates. Our BM strategy is structurally underweight the 10+ year maturity bucket relative to the Index, which underperformed the Index as a whole. The result of our underweight was a 43 basis point contribution to excess return. The YTD return for the CAM Broad Market strategy was 0.94% compared to a blended Index return of 0.53%. The biggest contributors were the Banking and Cable & Satellite industry groups, with 11 and 9 basis point contributions to excess return, respectively. The largest detractors were REIT's and Oil Field Services, each posting a -4 basis point contribution to excess return.

The CAM **Short Duration Strategy ("SD")** blends equal weights of IG and HY bonds with a target duration of 3 years. The strategy's gross total return for the quarter was 1.05% while the Index, a similar blend of intermediate IG and HY corporates, returned 1.07%. CAM's positioning within the Cable & Satellite and Wirelines industry groups posted the largest positive impact to performance, generating +9 and +7 basis point contributions to excess return, respectively. CAM's exposure to the Midstream industry group was the largest negative contributor, with a -7 basis point contribution to excess return. The strategy's YTD gross total return was 2.40% compared to the blended Index return of 2.11%. The top and bottom contributions to excess return for this period were the Wirelines and Cable & Satellite industries with +30 and +26 basis point contributions to excess return and Retailers and Midstream with -9 and -8 basis points, respectively.

The **Short Duration Investment Grade Strategy ("SD-IG")** delivered a gross total return of 0.96% for Q2, equivalent to the Bloomberg U.S. Corporate 1-5 Index return of 0.96%, as well. CAM's duration profile differs from that of the index, with an overweight in the front end of the curve (0-1yrs) and an underweight of the 3-to-5 year bucket. Overall, the duration allocation effect was +10 basis points given the outperformance of the 0-to-1yr portion of the curve. Over the YTD period, SD-IG approximated the Index, delivering 1.58% gross total return versus an Index return of 1.56%. Exposure to the Banking and Metals & Mining industries generated the largest positive contributions to return of +4 and +3 basis points, respectively. Exposure to the Electric Utility and Oil Field Services industries each generated -3 basis point contributions to excess return.

Bloomberg Bond Indices Returns vs. CAM Gross (annualized %)

Periods ended 06/30/2024	**10-yrs**	**20-yrs**
U.S. Aggregate	**1.35**	**3.12**
U.S. Corporate	**2.34**	**4.12**
CAM Investment Grade Strategy (gross)	**2.30**	**4.19**
CAM Investment Grade Strategy (net)	**2.06**	**3.95**

Better Asset Allocation Might Result from More Exacting Analysis

CAM looks to minimize the overall volatility of our High Yield strategy by focusing on the upper tier of High Yield credit (BA-B), as well as the conservative portion of a firm's capital structure. The chart to the right indicates that lower tier securities (CAA-rated cohorts and below) underperformed BA-rated bonds for all periods shown. B-rated bonds also outperformed over the 5-year and 10-year periods. Not shown in the table is the pronounced volatility that has characterized the CAA-rated and lower subsectors. For example, the standard deviation of the CAA credit tier has been approximately 45% greater than the broader Bloomberg US Corporate HY Index over the 10-year period (12.26% versus 8.48%). This shows investors may not be rewarded for the additional risk of the CAA-rated and lower subsectors.

Upper tier High Yield credit (BA-B) has also outperformed the Bloomberg US Aggregate Index (the "Agg") for all periods shown. This connotes BA and B rated credit quality stripes have also kept better pace with inflation than the Agg.

The above points suggest that upper tier High Yield bonds deserve consideration as a core holding over a complete market cycle.

Total Return of High-Yield Bonds by Credit Quality

(periods ended 06/30/2024) Source: Bloomberg US Corporate Indices **(annualized %)**

High-Yield Bond Sectors	**5-years**	**10-years**	**20-years**
BA-rated bonds	**4.20**	**4.68**	**6.77**
B-rated bonds	**3.64**	**3.96**	**5.93**
CAA-rated bonds	**3.00**	**3.63**	**6.29**
CA & D-rated bonds	**4.29**	**-2.07**	**3.42**

Performance of Other Asset Classes

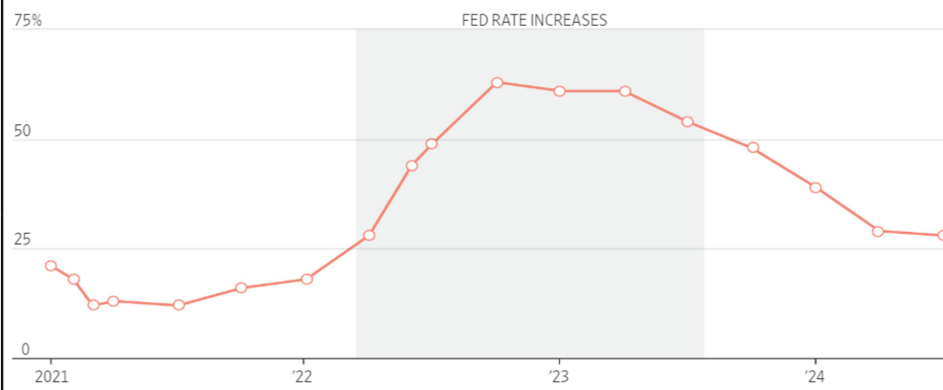
(periods ended 06/30/2024) Source: Bloomberg & Lipper

	5-years	10-years	20-years
S & P 500 Stocks	**15.05**	**12.86**	**10.28**
Bloomberg U.S. Aggregate	**-0.23**	**1.35**	**3.12**

The June 30 spread levels (shown at the right) enhance the value of corporate bonds versus U.S. Treasuries. As of 6/30/2024 all spread cohorts but CAA have tightened modestly on a YTD basis, while the 10-year U.S. Treasury ended Q2 2024 at 4.40%, 52 basis points higher than 12/31/2023 (3.88%).

Credit spreads remained in a tight range during the second quarter and stubbornly higher Treasury yields continued to be a thorn in the side of total returns. We continue to believe that the current environment is opportunistic for bond investors but it may require patience.

Credit Rating	20-Year Average Spread (as of 12/31/23)	06/30/24	12/31/23	12/31/22	12/31/21	12/31/20	Tightest This Decade (as of 12/31/23)
A	1.26%	0.81%	0.85%	1.09%	0.74%	0.73%	0.63%
BAA	1.87%	1.14%	1.21%	1.59%	1.13%	1.21%	1.00%
BA	3.51%	1.77%	2.01%	2.95%	1.94%	2.64%	1.82%
B	4.88%	2.79%	3.10%	4.89%	3.13%	3.79%	2.94%
CAA	8.84%	9.18%	8.09%	11.54%	5.96%	7.15%	4.91%



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over the past two years). (source: *Wall Street Journal* 7/5/24).

The Federal Reserve's inflation fight through higher overnight rates may well have been muted to some degree by the low interest rates many homeowners locked in on their mortgages and businesses on longer term debt. But now, in addition to the questionable job market, we have credit card delinquencies and auto loan delinquencies above prepandemic levels (source: *Wall Street Journal* 7/18/24).

The graph on the first page shows the historical and now favorable trends in inflation.

Contributing to this downward trend is decelerating consumer spending.

Of all major consumer debt categories, credit card debt is growing the fastest. Total credit card debt topped $1 trillion for the first time in 2023 and continues to grow, increasing 12.1% for the 12-months ending March 31,2024 (source: U.S. Bank *Financial Perspectives* 7/12/24), while auto loans and home mortgages increased 3.8% and 3.6% respectively.

However, debt service as a percent of disposable income remains manageable at about 10%. But the increase in debt servicing costs to consumers has increased significantly as shown on the graph on page 4.

We expect this trend to continue and will consume more of the consumers' budgets since growth of real disposable incomes continues to decelerate (see chart on page 4). Additionally, many consumers have exhausted the savings built up during the pandemic (source: *Bloomberg* 6/2/24). Reports show consumers increasingly favoring purchases of staples over large ticket discretionary purchases.

Sensing a weakening consumer, lenders are increasingly cautious, restricting access to credit. At Synchrony Financial, a very large credit card lender, an executive stated during their 2nd quarter earnings call that their recent credit tightening actions had helped to slow new account growth and purchase volumes, as well as lower delinquency rates (source: *Wall Street Journal* 7/17/24).

Recently, at Ally Financial, one of the largest auto lenders, executives advised analysts that it had "taken a microscope" to auto originations and

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Footnotes and Disclosure

Advisory services are offered through Cincinnati Asset Management, Inc., ("CAM") an investment adviser registered with the U. S. Securities and Exchange Commission. The CAM High Yield, Investment Grade, Broad Market, Short Duration, and Short Duration-Investment Grade composites consist of all discretionary portfolios under management, including all securities and cash held in the portfolios, and have been appropriately weighted for the size of the account. All accounts are included after they are substantially invested.

Returns are calculated monthly in U.S. dollars and include reinvestment of dividends and interest. Figures for periods of less than one year are cumulative returns. All other figures represent annualized returns. Past performance is no guarantee of future results.

When compared to indices' performance, CAM results are after deduction of all transaction costs and CAM advisory fees. CAM advisory fees used are the actual composite averages. Accounts managed through brokerage firm programs usually will include additional fees. "Net of fees" herein refers only to CAM's management fee. The indices and information shown for comparative purposes are based on or derived from information generally available to the public from sources believed to be reliable. No representation is made to its accuracy or completeness. The Indices are referred to for informational purposes only and the composition of the Index is different from the composition of the accounts included in the performance shown above. Index returns do not reflect the deduction of fees, trading costs or other expenses.

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High yield bonds may not be suitable investments for all individuals. Before investing a thorough reading of all materials and consultation with an independent third party financial consultant may be appropriate. Fixed Income securities may be sensitive to changes in prevailing interest rates. When rates rise the value generally declines. For a depository institution, there is also risk that spread income will suffer because of a change in interest rates. Additional disclosures on the material risks and potential benefits of investing in corporate bonds are available on our website: https://www.cambonds.com/disclosure-statements/

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recently tightened underwriting standards (source: ibid).

In a similar vein, the latest Senior Loan Officer Opinion Survey reported tighter standards and weaker demand for credit card, auto, home equity lines, and some categories of residential real estate loans in the first quarter of 2024 (source: Federal Reserve of St. Louis 5/6/24).

More concerning is the tightening standards to businesses. The same survey reported tighter lending standards and weaker demand for commercial and industrial loans to firms of all sizes in the first quarter of 2024 (source: ibid).

Another significant signal of a slowdown is the first quarter 2024 GDP growth of 1.4% versus 3.4% in the 4th quarter of 2023 (source: Bureau of Economic Analysis 6/27/24), 4.9% in the 3rd quarter and 2.1% and 2,2% in the 2nd and 1st quarter of 2023 (source: ibid).

So there are many signs of a slowing economy sustaining deceleration of inflation. The Federal Reserve will be willing to lower rates, impacting all shorter maturity yields.

For investors in cash and shorter maturites, the problem now is higher reinvestment risk.

The outlook by economists in Bloomberg's July 19 survey looks promising with the Personal Consumption Expenditure Index falling to 2.2% by year end 2025 (source: *Bloomberg* 7/19/24). If the pace of the slowdown accelerates, rates may move down more quickly.

Sharpe Ratios (risk & reward relative value) Inception-Q2 2024

CAM Investment Grade Strategy 0.32
Bloomberg U.S. Corp Bonds 0.29

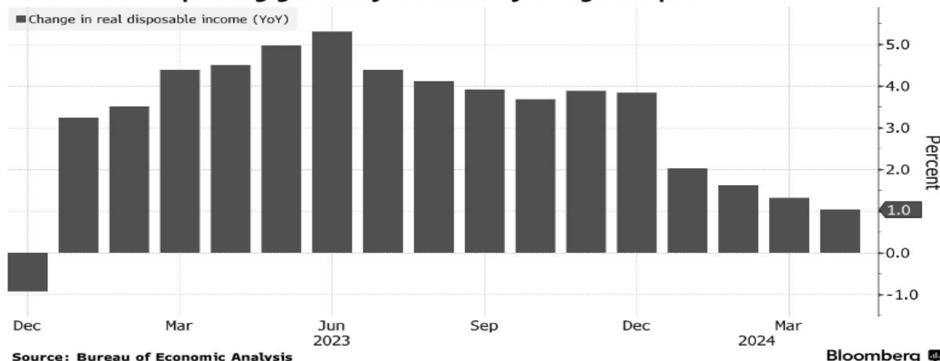
CAM High Yield Strategy 0.47
Bloomberg High Yield Corp Bonds 0.46

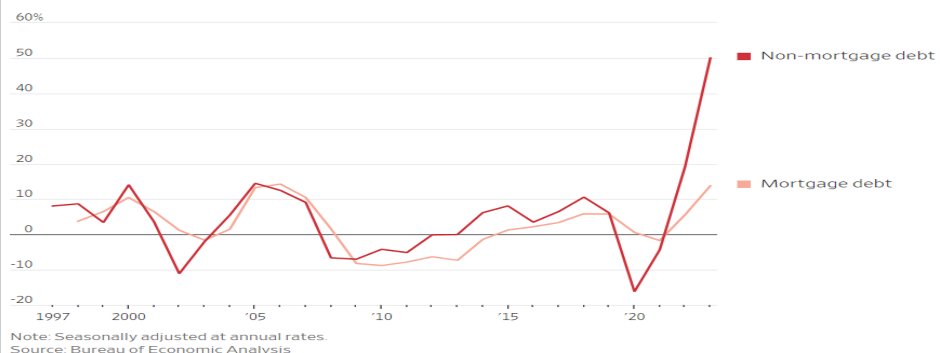
CAM Short Duration 0.42
Bloomberg Weighted Benchmark
(1/2 Interm. HY & 1/2 U.S. Corporate 1-5) 0.51

CAM Short Duration IG Strategy 0.75
Bloomberg U.S. Corporate 1-5 Yr 0.77

CAM Broad Market Strategy 0.53
Bloomberg Weighted Benchmark
(2/3 Corporate and 1/3 High Yield) 0.54

An important objective for all Cincinnati Asset Management investment strategies is to deliver superior risk-weighted returns. A quantitative indication of our success is the Sharpe Ratio that calculates total return per unit of risk. The data on the left indicates we have largely been successful. The Sharpe Ratio of the Investment Grade Strategy exceeded its respective benchmark by approximately 10%. The High Yield, Short Duration Investment Grade, and Broad Market strategies approximated their benchmarks. The Short Duration Strategy's Sharpe Ratio trailed the benchmark primarily due to total return underperformance in the 10-year and older periods.





Rating	BA	B	CAA
Avg Spread	354	511	948
Std. Dev.	164	220	409
06/30/2024	**177**	**279**	**918**
Lowest Spread	151	228	378

Spreads to Treasuries by Credit Rating show significantly lower risk of BA and B rated bonds. Source: Bloomberg, Barclays Research (12/31/99 to 06/30/2024)