April 2024

Q2 2024 Economic & Fixed Income Outlook

Economic Outlook

Economic growth in 2023 was far more resilient than expected. Heading into last year, many economists were forecasting a recession, instead, the U.S. grew by 2.5%.

The 'above potential' growth momentum carried over into the first quarter and as a result, many economists have increased their forecasts for economic activity in 2024.

Economic activity has been driven by strong consumer spending, business investment, and government stimulus. While excess savings have largely waned, the consumer continues to be supported by a strong labor market and rising real wages.

Recent inflation readings have seen a stalling in the process back down to the Federal Reserve's 2% target. Core inflation, which is the Fed's preferred measure, actually reaccelerated during the first quarter, suggesting that the inflation problem may not yet be resolved. Despite stronger inflation, the Fed still seems to have a bias to cut rates.

Globally, most developed economies (Europe, U.K., and Japan) are running around stall speed, leaving the potential for them to tip into a recession. Growth in China looks set to remain below trend as the country continues to work through a deleveraging of the property sector. Outside of China, growth is forecast to be relatively strong in India, some of the commodity-exporting countries as well as parts of emerging markets that will benefit from global re-, near-, and friend-shoring, such as Mexico.

Region	2024 Median Economic Growth Forecast
U.S.	2.2%
Europe	0.5%
U.K.	0.2%
Japan	0.7%
China	4.6%
Emerging Markets	4.1%
Global	2.8%

Source: Bloomberg, 04/03/2024

As always, we remain cognizant of the risks to our outlook and are vigilant to the potential impacts the changing macro environment may have on financial markets and investment allocations. The US election, the delayed effects of higher policy rates, and increased geopolitical conflict are the most obvious risks that could threaten US economic growth.

Fixed Income Outlook

As widely expected, the Federal Open Market Committee (FOMC) left the Federal funds policy rate unchanged at a target rate of 5.25%-5.50% - where it has been since last summer – at its March meeting.

While there was no change to the level of the policy rate, the refreshed Summary of Economic Projections (SEP) provided an update on the Fed's economic and policy

Craig Sullivan, CFA, CAIA®
Director of Fixed Income, External Managers, and Alternative Investments

Tia Simser
Fixed Income Portfolio Manager and Trader

Christopher Eckert
Fixed Income Portfolio Manager

Matthew Inman, CFA, CFP®
Senior Client Portfolio Strategist and Alternative Investment Analyst

outlook. The update showed an increase in the median forecasts for economic growth and core inflation. Despite the upward revisions to growth and inflation, the Fed is still forecasting 3 rate cuts during 2024.

The changes within the SEP seem to reflect a recalibration in the Fed's willingness to tolerate slightly above-target inflation, at least in the near term. This is implied by their forecast for the same number of rate cuts as their previous forecast in December, despite increasing its inflation forecast for this year.

The combination of above-trend growth and a reacceleration in inflation during the first quarter led investors to reprice expectations for the timing (later) and magnitude (from 6 cuts to 3 cuts) of rate cuts. The result was a rise in interest rates. Heading into the year, we felt that market pricing for rate cuts had become too exuberate and this led us to add more floating rate exposure within core fixed income and less cyclical industries. Conversely, we have a more cautious view on many parts of the energy, food and beverage, and technology sectors. We seek to avoid companies that are overly focused on shareholder-friendly activities, in very cyclical industries, or trading at expensive valuations.

Our base case is that the transition to a higher cost of capital environment will involve a further uptick in financial distress and defaults among issuers with over-leveraged and rate-sensitive balance sheets. While all-in yield levels are attractive, the risk premium (credit spread) offered by generic high-yield does not discount in the potential for a recession.

Economic data releases, rhetoric from the Federal Reserve, and market pricing around the timing of rate cuts will continue to produce volatility. But investors must not allow the noise to distract them from the signal: that the outlook for bonds is attractive over time given the level of yields available.

This view is important not only for investors with a current bond portfolio but also for investors with a large allocation to money market funds or similar investments (T-bills, CDs, savings accounts, etc). While the timing of rate cuts remains uncertain when they do occur, yields on products tied to short-maturity bonds will reprice very rapidly. Investors in such products will miss out on potential price gains experienced by intermediate-maturity bonds and will be forced to reinvest at a lower interest rate.

We continue to see the most value in the intermediate (3-7 years to maturity) portion of the yield curve. This is a sweet spot between money market yields which will drop when the Fed begins cutting interest rates, and long-maturity bonds which may see yields remain elevated as investors demand a 'term premium' for the uncertainty over inflation and the fiscal deficit.

The intermediate portion of the curve offers an attractive combination of potential price appreciation if rates decline, lower reinvestment risk, and a hedge against equity volatility.

Fixed Income Sector Outlook:

We continue to find attractive opportunities within investment grade (IG) corporate bonds, particularly in short-dated maturities. However, investors must be vigilant about the sectors and issuers where the impact of higher interest rates has resulted in a deterioration of balance sheets. Individual security selection (and security avoidance) will be paramount, as refinancing at

	2024	2025	2026	Longer Run
Change in real GDP, Q4 to Q4	**2.1**	**2.0**	**2.0**	**1.8**
December Forecast	1.4	1.8	1.9	1.8
Unemployment Rate, Q4	**4.0**	**4.1**	**4.0**	**4.1**
December Forecast	4.1	4.1	4.0	4.1
Headline PCE Inflation, Q4 to Q4	**2.4**	**2.2**	**2.0**	**2.0**
December Forecast	2.4	2.1	2.0	2.0
Core PCE Inflation	**2.6**	**2.2**	**2.0**	
December Forecast	2.4	2.2	2.0	
Federal Funds Rate, end of year	**4.6**	**3.9**	**3.1**	**2.6**
December Forecast	4.6	3.6	2.9	2.5

Source: Bloomberg, 04/03/2024

higher coupon rates will create problems for some issuers, resulting in a larger dispersion in performance.

From a technical perspective, it was a record quarter for supply. However, strong demand meant there was little supply indigestion. We expect demand for the sector to remain strong as IG corporates could see inflows from the over $6 trillion in money market funds.

Following a very dormant mergers and acquisitions (M&A) environment in 2023, transaction volumes are picking up. Bond investors, including ourselves, are traditionally not enamored by M&A activity, which can often result in additional debt on the company's balance sheet. However, many of the recent transactions have been financed in large part by equity, meaning they have not added significant amounts of debt to the company's balance sheet. In these situations, there can be attractive opportunities if the merger creates a combined business that is more profitable and capable of generating positive free-cash-flow.

From a sector perspective within investment grade corporate bonds, we have a favorable view of regulated and less cyclical industries. Conversely, we are seeking to avoid companies that are overly focused on shareholder-friendly activities, in very cyclical industries, or trading at expensive valuations.

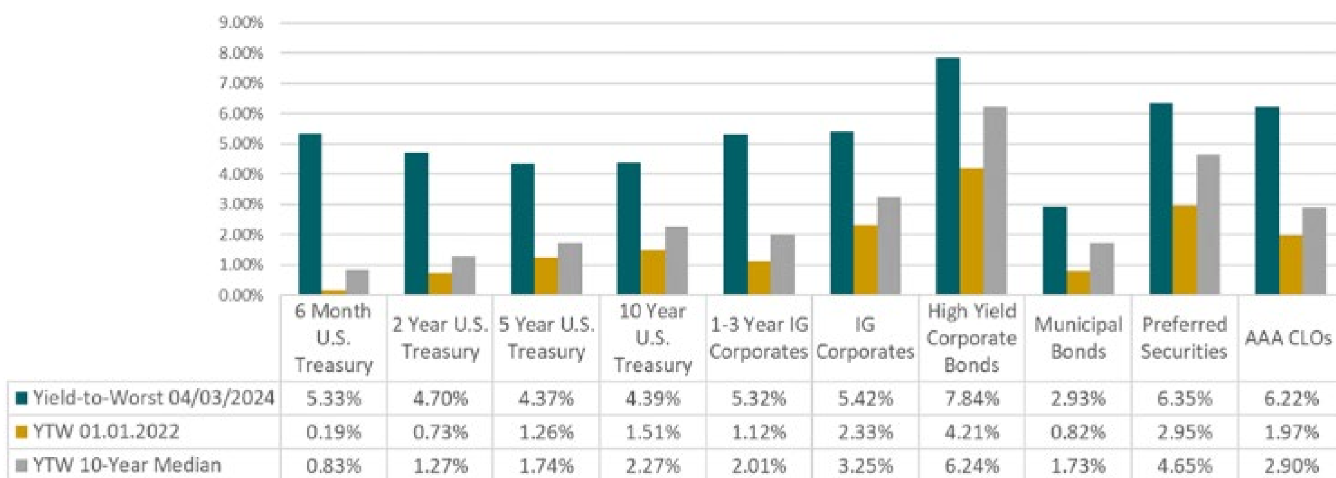
From a rating perspective, we still find BBB-rated bonds, particularly short-maturity (3 years or less) attractive. Many companies in this ratings bucket have successfully de-levered their balance sheets and now have better credit metrics than higher-rated parts of the market.

Given the availability of attractive yields within investment grade corporate bonds, we continue to urge caution on below investment grade rated segments of the market. Credit spreads in high-yield are well below their long-run median, while this is partly due to the 'higher' credit quality of the market (i.e. more BBs than CCCs compared to the historical composition), we still believe investors are not receiving enough compensation for investing in the complex.

Within the muni market, fundamentals remain healthy and demand remains strong while supply continues to be limited. But from a valuation perspective, tax-exempt municipal bonds – at an aggregate level – are expensive relative to taxable bonds. A common metric to compare the relative attractiveness is the muni-to-Treasury ratio, which compares the yield on AAA-rated tax-exempt munis to Treasury bonds (before factoring in the effect of taxes). The ratio has steadily declined from over 100% in 2015 to around 60% currently. In some cases, investors can obtain a better *after-tax* return by purchasing a taxable bond and paying the tax.

Security selection within the municipal market will remain critical. Our focus remains on high-quality general obligation and essential-service revenue bonds. We continue to avoid bonds tied to entities such as airports, health care, toll roads, and stadiums.

Preferred securities have been one of the best-performing fixed-income sectors over the past six months aided by a combination of lower long-term U.S. Treasury yields, a general 'risk-on' theme in financial



	6 Month U.S. Treasury	2 Year U.S. Treasury	5 Year U.S. Treasury	10 Year U.S. Treasury	1-3 Year IG Corporates	IG Corporates	High Yield Corporate Bonds	Municipal Bonds	Preferred Securities	AAA CLOs
Yield-to-Worst 04/03/2024	5.33%	4.70%	4.37%	4.39%	5.32%	5.42%	7.84%	2.93%	6.35%	6.22%
YTW 01.01.2022	0.19%	0.73%	1.26%	1.51%	1.12%	2.33%	4.21%	0.82%	2.95%	1.97%
YTW 10-Year Median	0.83%	1.27%	1.74%	2.27%	2.01%	3.25%	6.24%	1.73%	4.65%	2.90%

Source: Bloomberg, 04/03/2024

markets, and receding fears about the stress in the banking system.

While value remains in the preferred sector over time, returns in the near term are going to be driven more by coupon income rather than by further price appreciation. Furthermore, given the recent strong performance, the yield pick-up offered by preferred securities has compressed relative to other areas of the bond market. For example, the yield-to-worst on the preferred index is roughly 6.3%, which is around 80 bps higher than the yield on the Bloomberg BBB-rated corporate bond index. During the 2010 through 2019 period, the yield pick-up offered by preferred index relative to the BBB-index averaged around 200 bps.

However, comparing yields at an index level masks the potential value that can exist *within* the preferred sector. Preferred securities are complex and very idiosyncratic, in terms of issuers, coupon structures, call/reset features, and regulation. This provides unique opportunities for active management focused on individual security selection to generate excess returns over the benchmark.

We also see value in the senior positions (or tranches) of certain securities within securitized credit. Senior AAA-rated collateralized loan obligations (CLO) offer strong structural protections, and higher spreads relative to sectors with similar credit quality and typically have floating-rate coupons making them particularly attractive if the policy rate remains higher for longer.

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