Portfolio Management Outlook

2025 Looks Bright for Prudent, Active Fixed-Income Management

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Entering 2025, we expect moderate U.S. economic growth supported by mild real wage growth, healthy consumer and business balance sheets, and increased optimism over potential deregulation and tax cuts. Disinflation has stalled, though fundamentals point to further progress. At the same time, potential policy shifts from the incoming administration add a significant layer of uncertainty that will likely contribute to ongoing heightened interest rate volatility.

With this backdrop, our investment approach is informed by several important market dynamics: Yields remain elevated with spreads near historic tights. Investor demand is brisk, with primary credit markets oversubscribed. Credit fundamentals are generally strong, but they mask a range of idiosyncratic risks in widely dispersed credits, many of which continue to suffer under the weight of elevated interest rates.

This is broadly a constructive environment for credit, and we maintain a diversified allocation across asset classes that prioritizes carry. We prefer higher quality credit, particularly within structured products, which typically offer a less competitive market, opportunity for excess yield over similarly rated corporates, and wide spreads relative to fundamental risk. We are prioritizing high carry, shorter duration instruments, particularly non-Agency residential mortgage-backed securities (RMBS), senior collateralized loan obligation (CLO) tranches, and commercial asset-backed securities (ABS). We also favor select higher quality high yield corporate bonds with relatively strong fundamentals and attractive yields. With interest rate volatility elevated, we are maintaining healthy cash positions and targeting an average level of credit beta to position our portfolios for further spread compression.

From a duration perspective, we expect the 10-year Treasury yield to stay range bound over the next few months, with yields currently near the range's upper end. Longer term, we expect the yield curve to steepen, led by Fed rate cuts on the front end and potentially heavier Treasury issuance to fund growing fiscal deficits. Tactically this means adjusting duration targets as yields move from one end of the range to the other. We prefer to express duration in this environment using Agency RMBS, which offer the potential for yield pickup, and Treasury inflation-protected securities (TIPS).

Attractive 5 percent-plus yields for high quality fixed income could bode well for investors, as starting yields have been highly correlated with forward returns. Elevated policy uncertainty, interest-rate volatility, and widely dispersed credit risks make security selection critical—which we believe makes it an ideal environment for active fixed-income management.

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Investing involves risk, including the possible loss of principal. In general, the value of a fixed-income security falls when interest rates rise and rises when interest rates fall. Longer term bonds are more sensitive to interest rate changes and subject to greater volatility than those with shorter maturities. During periods of declining rates, the interest rates on floating rate securities generally reset downward and their value is unlikely to rise to the same extent as comparable fixed rate securities. High yield and unrated debt securities are at a greater risk of default than investment grade bonds and may be less liquid, which may increase volatility. Investors in asset-backed securities, including mortgage-backed securities and collateralized loan obligations ("CLOs"), generally receive payments that are part interest and part return of principal. These payments may vary based on the rate loans are repaid. Some asset-backed securities may have structures that make their reaction to interest rates and other factors difficult to predict, making their prices volatile and they are subject to liquidity and valuation risk. CLOs bear similar risks to investing in loans directly, such as credit, interest rate, counterparty, prepayment, liquidity, and valuation risks. Loans are often below investment grade, may be unrated, and typically offer a fixed or floating interest rate.

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GPIM 63635