

# Focus on short-duration, US investment grade credit

## Strategy overview

The Short Duration High Quality strategy seeks to outperform over a full market cycle via a broadly diversified portfolio, with a focus on risk-adjusted returns, emphasizing opportunities across the full range of US investment grade corporate bonds while maintaining a short duration profile.

## Key takeaways

- Rates ended lower and credit spreads tightened due to encouraging economic data and renewed hopes for rate cuts.
- The Portfolio outperformed its benchmark, the Bloomberg U.S. Government/Credit 1-3 year Index (the Index) on a gross- and net-of-fees basis. Sector allocation drove outperformance, while duration and yield curve decisions contributed modestly and security selection decisions had minimal impact.
- Many corners of the market appear to be priced for a soft landing and therefore the Portfolio is more focused on higher quality credits.

## Portfolio review

**Rates continued to sell-off into October as strong economic data faded hopes for a U.S. Federal Reserve “pivot”.** In particular, the labor market showed significant strength, with September’s payroll data reporting an impressive pace of job gains. This was followed by the initial reading for third-quarter gross domestic product growth which exceeded already elevated expectations, coming in well above trend. By the end of October, the 10-year Treasury yield had breached 5%, a level not seen since 2007. As rates moved higher, credit spreads widened reflecting the increased risk that comes with a prolonged period of restrictive policy.

**Then came November and with it, a notable turn in sentiment.** Inflation data, which had already been declining for several months, continued to decline resulting in more balanced market expectations. One Fed governor even suggested the possibility of rate cuts ahead of reaching the 2% inflation target. Additionally, while payroll gains remained strong, they were more measured over the next couple of months, and September’s blockbuster gain was revised downward by a meaningful amount. As a result, rates rallied and credit spreads tightened.

**In the final month of the quarter, the Fed appeared to confirm renewed market expectations that a less restrictive stance was in the near future.** The updated dot plot showed that every single participant believed the hiking cycle had concluded, and the median participant projected 75 basis points worth of cuts in 2024. This affirmation from the Fed further contributed to the tightening of credit spreads, and a fall in rates.

**The experience of November and December stood out from the first 10 months of the year. Rates experienced a significant decline, and the Bloomberg US Aggregate Index rallied, resulting in a 6.82% return for the quarter, with more than 4% coming from November alone.** One thing that was consistent throughout the year was that lower credit sectors produced strong excess returns however even higher quality sectors posted respectable outperformance.

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**Sector allocation drove outperformance, while duration and yield curve decisions contributed modestly and security selection decisions had minimal impact.** Our allocation to commercial mortgage-backed securities (CMBS) was the largest contributor due to the sectors higher carry. The allocation to asset-backed securities and overweight to investment grade (IG) corporate were also notable contributors. For much of the quarter, we held a slightly longer duration profile and this contributed to performance as rates fell.

## Current strategy and outlook

**Looking forward, the outlook has improved marginally, however we still expect growth to slow below trend.** The increased cost of capital will likely curb consumption and investment, however ongoing government support measures at a global level are expected to partially offset these effects. In particular, China's growth focused investment and advanced economies efforts to enhance supply chain security are anticipated to bolster growth in the short term.

**As the market focus shifts from inflation to growth concerns, duration will become an effective offset to risky asset drawdowns.** Rate volatility, though receding from recent peaks, will remain above pre-pandemic levels due to uncertainty

about the timing of rate cuts and concerns about government debt levels. Elevated real rates will incent investors to increase allocations to fixed income, creating opportunities during bouts of volatility.

**That said, many corners of the market appear to be priced for a soft landing.** While this has become a more likely outcome, we believe the risks to this outcome materializing are being ignored. Labor markets are coming into better balance which, while good news for inflation, could cause concern among workers that a turn in the cycle is approaching. This in turn could compel workers to boost savings rates which would limit consumption and act as a challenge to growth.

**With this dynamic in place, portfolios have a moderate level of risk with focus on higher quality credit, and allocations are skewed towards sectors with better relative value.** For example, securitized credit markets are currently trading with wider spreads relative to comparably rated corporates bonds. Meanwhile, the dark clouds facing the sector due to concerns over CMBS appear to be fading as lower rates make refinancing existing loans less challenging. Within corporate credit, we remain overweight to IG, however this is primarily expressed in names rated A or above. Outside of credit, collateralized mortgage obligation floaters remain an attractive alternative to Treasuries due to better yields.

The **Bloomberg US Government/Credit 1-3 Year index** covers US Treasury securities, agencies, publicly issued US corporate and foreign debentures and secured notes that meet specified maturity, liquidity and quality requirements. The index is fully invested, which includes the reinvestment of income. Indexes are unmanaged and index returns do not include fees or expenses. **An individual cannot invest directly in an index.**

The **Bloomberg US Aggregate index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes US Treasury securities, government-related and corporate securities, fixed-rate agency mortgage-backed securities, asset-backed securities and commercial mortgage-backed securities, both agency and non-agency issues. Indexes are unmanaged and index returns do not include fees or expenses. **An individual cannot invest directly in an index.**

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