MACRO OUTLOOK

ORANGE INVESTMENT ADVISORS

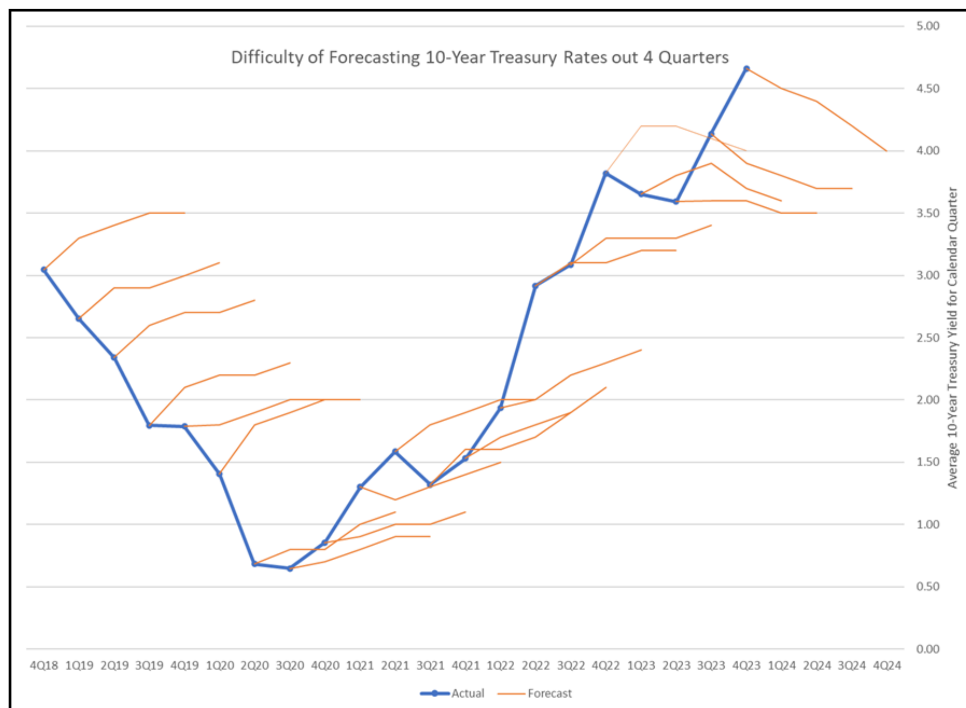
JSVIX 2024 Outlook

December 22, 2023

Economy and Rates:

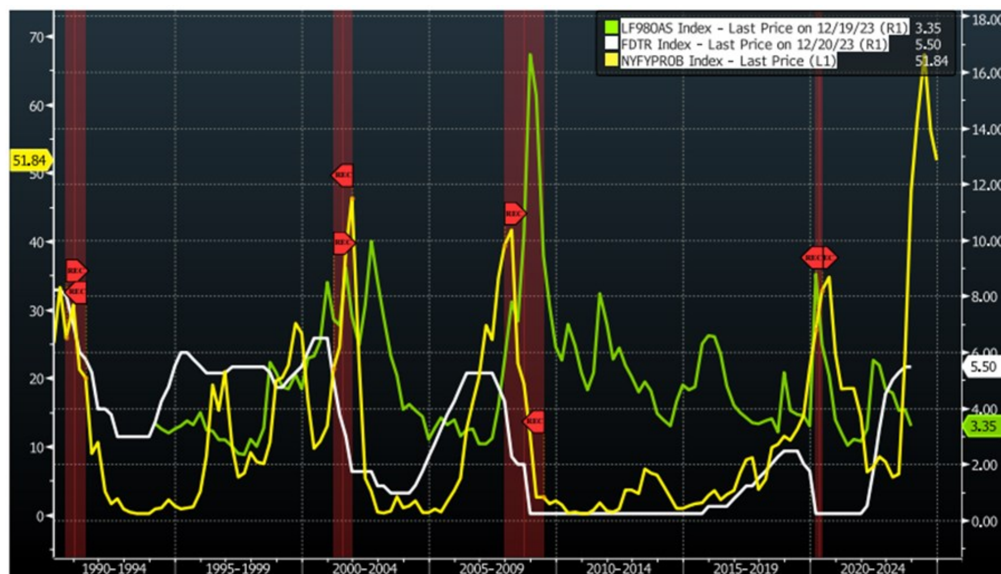
- While the market is currently pricing a no landing/soft landing scenario, we expect 2024 to be a rocky year in terms of economic growth and market volatility. Historically it takes about 10 quarters from the start of Fed tightening to push the US economy into recession. We are currently in quarter #7. Furthermore, bank loan officer surveys (SLOOS lending surveys) are now at levels signaling an upcoming recession. A prolonged curve inversion is another indicator consistent with a future recessionary environment. Consumer spending has been resilient throughout 2023 and has made a significant contribution to the strong growth. However, the excess savings accumulated through the pandemic has been depleted for all but the top decile of income earners which should trigger an increase in the savings rate that has plunged all the way to 3.8% from the 30-year average of 6.1%. Higher savings rates may tip the economy into a negative real growth rate.
- 2024 is going to be a tug of war between deflationary and inflationary forces. On the one hand, the expected decline in consumer demand will continue to put pressure on the prices of durable goods, while the slowdown in housing activity and residential investment will likely accelerate and add to deflationary forces. At the other end, steady wage increases and a rise in unit labor costs will add to service inflation and force companies to pass on labor costs to final goods prices or face falling profit margins. Given the elevated share of nominal GDP contributed by corporate profits, 7.6%, we do not think that it would be feasible for companies to continue to raise prices, forcing them to cut back on labor at some point in 2024.
- We expect the Fed to initiate its rate cutting program by the end of Q2 and implement 4 rate cuts by the end of 2024, resulting in a Fed Fund's rate in the 4.25-4.5 range. While it has been a fool's errand to make any predictions regarding the direction of long term Treasury rates given the number of factors that influence interest rate volatility, we believe that the 10-year will trade in the 3.25 – 4.25 range next year as the demand for Treasuries—reinforced by fund flows out of money market funds and into fixed income funds—will counteract the supply coming from the need to fund sizeable fiscal deficits and the Fed's ongoing QT program. The US Treasury will need to refinance around $11 trillion in bills and notes over the next 2 years while the Fed is shedding $90 billion of Treasuries and MBS from its balance sheet.
- We generally avoid interest rate risk in the portfolio, maintaining an effective duration around 2 years, but always between 1 and 3 years. As rates rose to 4%, we added a long 10-year treasury position of about 10% to the portfolio at an average yield of about 4.2% to act as a tail risk hedge in the event of a flight to quality rally.

- It is interesting to observe the futility of professional forecasters in predicting 10-year Treasury rates out 4 quarters. The Philly Fed publishes forecasts of 34 professional economic forecasters every quarter. The chart below illustrates the difficulty of forecasting 10-year Treasury rates out only 4 quarters. Over the past 25 quarters, the 10-year forecast has been off, on average, by 40bp out 1 quarter, 70 bp out 2 quarters, 80 bp out 3 quarters, and 110 bp out 4 quarters. Directionally, the forecast has overstated the actual 10-year rate as often as understating it. Bottom line: it's very difficult to forecast 10-year Treasury rates.



Credit Spreads:

- **Corporates** - We believe that the current HY spread of 334bp (12/20/23) doesn't compensate investors for the recession risks in 2024 and the corresponding spread volatility. US Corporate HY option adjusted spreads are now in the 15th percentile based on the last 10-years, and we expect HY spreads to widen about 100bp in 2024. Similarly, IG Corporate spreads are trading at 103bp and are in the 22nd percentile based on the last 10-years. We think that IG credit has a lot less downside in a recessionary scenario given the overall health of corporate balance sheets and think the spread widening will be limited to 20-30bp.
- Over the course of 4Q23, we have accumulated a short CDX HY position on in the portfolio sized approximately to our CMBS Conduit/ SASB position (about 16%) at an average spread of 417bp. The current spread is 365bp, which has caused it to weigh on recent performance due to continued tightening. In a recessionary scenario accompanied by significant HY Corporate spread widening, this position will serve as a valuable hedge enhancing portfolio returns.
- The chart below shows High Yield Corporate spreads (green line) versus easing cycles (white line) and the New York Fed Recession Probability Model (yellow line) with actual recessions shaded in red. The current probability of recession per the New York Fed Model (51.8%) is higher than its level during the last 4 actual recessions. It is also obvious that each of the last 4 Fed easing cycles was accompanied by a recession. Finally, it is apparent that High Yield Corporate spreads widen significantly during recessions, while they have been tightening steadily since mid-2022.



- **Structured Credit** – Every major Structured Credit sector is trading at spreads wider than the median over the last 10 years. CMBS, both AAA and BBB credits, have been trading at spreads above the 90th percentile over the last 10 years.

Spreads	Structured Credit Sector							Fixed Income Sectors		
Period	CMBS BBB	CMBS AAA	Agency MBS	ABS AA-BBB	CLO BB	RMBS AAA	CLO BBB	US AGG Index	U.S. HY Corp	U.S. IG Corp
Current	934	153	148	253	882	155	439	45	363	104
10-Year Average	479	100	104	231	750	137	408	47	425	124
YTD Change	210	19	5	17	-110	-25	-83	-6	-106	-26
10-Year Percentile Rank	95%	92%	89%	87%	73%	71%	67%	50%	31%	22%

Source: Orange Investment Advisors, Bloomberg, J.P. Morgan, BofA, Wells Fargo. As of 12/12/2023.

US AGG Index: Bloomberg US Aggregate Bond Index; Agency MBS: 30-Year FNCL Par Coupon Index; U.S. IG Corp: Bloomberg US Corporate Index; U.S. HY Corp: Bloomberg US Corporate High Yield Index

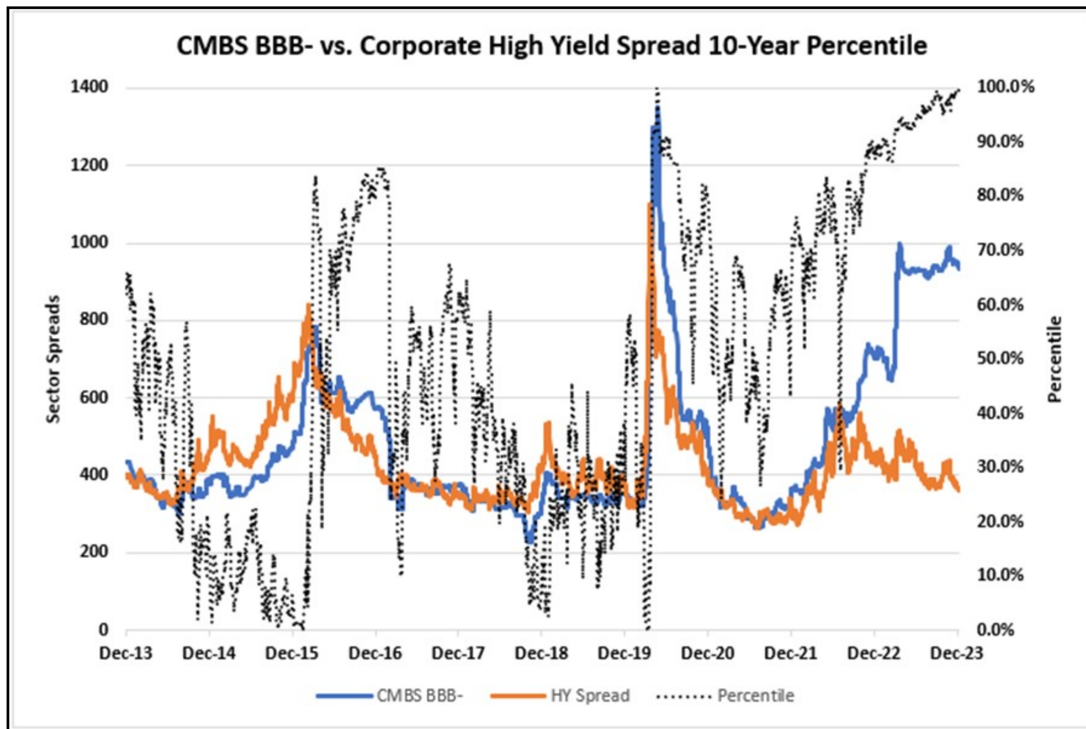
Leveraged Loans: Credit Suisse Liquid Leveraged Loan Index; CMBS AAA: JP Morgan; CMBS BBB: JP Morgan (Mar 2019-Present); BofA (Dec 2013-Mar 2019).

RMBS Non-QM AAA: Wells Fargo; start date: 12/23/2016; ABS – AA-BBB; ICE BofA AA-BBB US Fixed Rate Miscellaneous ABS Index; CLO: JP Morgan Indexes

- Structured Credit continues to offer the most relative value amongst traditional fixed income sectors. For instance, the differential between new issue CMBS BBB- spreads and high yield corporates is currently in the 99.9 percentile over the last 10-years (see chart below).

Credit Spreads (Con't):

- Structured Credit continues to offer the most relative value amongst traditional fixed income sectors. For instance, the differential between new issue CMBS BBB- spreads and high yield corporates is currently in the 99.9 percentile over the last 10-years (see chart below).



Structured Credit Markets:

- **Agency MBS** are trading wide relative to historical spread levels. At a nominal spread of 150 bp, the current coupon Agency MBS is close to the 90th percentile based on the last 10-years. As of mid-December, Agency MBS underperformed other credit sectors with 0.67% of excess returns versus Treasuries YTD. The main drag on Agency MBS has been the Fed's QT, lack of interest from the banking sector given the flight of deposits, an inverted yield curve, and high interest rate volatility. We expect the Fed's pace of QT to slow down toward the end of 2024 and MBS net supply could decline further given a slowdown in the housing market. These factors should push spreads tighter from the supply side but in the end, it will depend on money managers' demand for AGY MBS in their Bloomberg Aggregate-benchmarked portfolios which are already heavily overweight AGY MBS. Marginal flows from money market funds into fixed income funds should help bolster demand for Agency MBS and we expect spreads to tighten from these wide levels.
- **Non-Agency RMBS** had a very strong year in 2023 with spreads tightening by 65bp for AAAs to as much as 200bp for select BBBs. The sector continued to be supported by a robust housing market with nationwide home prices climbing by 3.9% YoY despite 7% mortgage rates. Mortgage delinquencies continue to be minimal as skyrocketing home prices helped homeowners reach nearly $30 trillion in home equity. We see flat to slightly lower home prices in 2024 due to a 40-year low in affordability and a large supply of multifamily buildings coming online that should help alleviate the shortage of housing options for potential first time homebuyers. CRT M1 through B1 bonds are trading at the tightest level over the last 12 months. Non-QM senior and subordinate tranches have tightened YTD but still sit at the 70th percentile when compared to the last 10 years. We see minimal potential for spread compression at current levels for most RMBS sectors but see potential for price upside in the more esoteric segments of RMBS like Private Reverse RMBS deals that have not participated in the latest spread rally and can be purchased at double digit yields. We also continue to like Legacy RMBS which has been slow to react to the spread rally due to poor sponsorship and persistent fund outflows from mutual funds that typically participate in that diminishing sector.

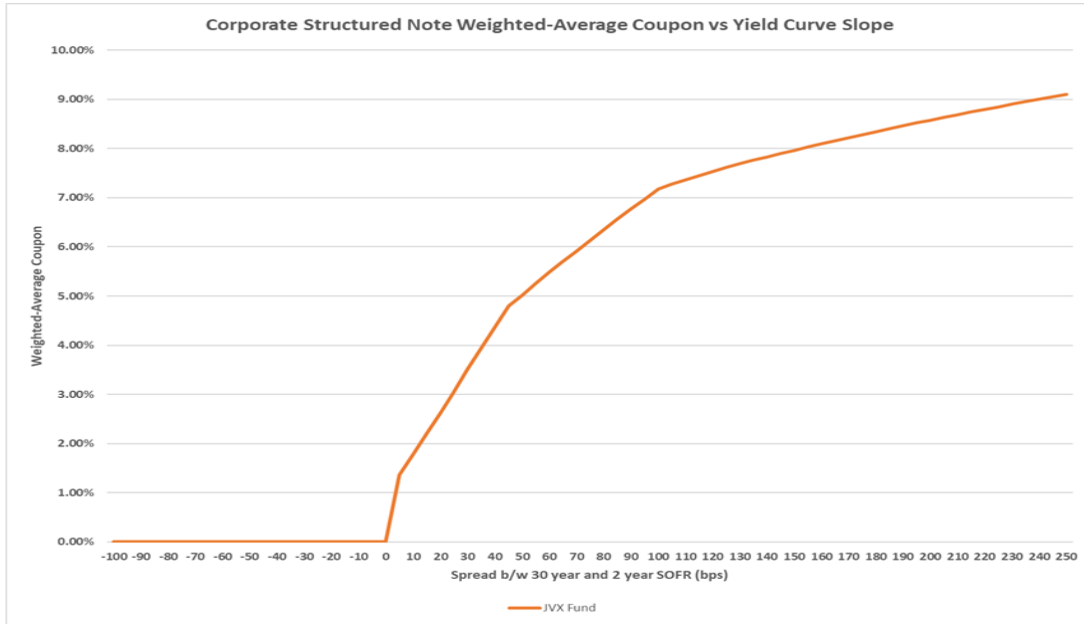
Structured Credit Markets (Con't):

- **CMBS** has been the redheaded stepchild for all of fixed income in 2024 with spreads wider across the capital structure. AAA Conduit LCFs (last cashflows) widened by nearly 20bp while on-the-run Conduit BBB- tranches saw over 200bp of spread widening. AAA through BBB- CMBS spreads are currently in 92-95th percentile based on the last 10-years with only a brief period of Covid-19 related widening in March and April of 2020 offering better value. CMBS sectors are facing a couple of major issues: a) cap rate expansions from higher interest rates that trigger declines in property values and require sponsors to contribute equity to refinance CRE loans at term maturities, and b) structural problems in office and retail sectors. We believe that current CMBS Conduit and SASB (Single Asset Single Borrower) valuations for the most part already reflect the worst-case scenarios for property values and borrowers' inability or unwillingness to refinance loans at maturity. We expect many problematic loans to be resolved via maturity extensions, forbearance plans, and other types of modifications rather than be liquidated at a fire sale level. We are deploying maturity extensions for many loan resolutions as a base case scenario when running cashflows to value bonds. We expect the current CMBS conduit delinquency rate of 4.7% to rise to close to 10% over the next 12-24 months. Even based on these conservative assumptions, we still see yields between 9-12% for many investment-grade conduit tranches. Similarly, in the SASB space, we have observed many senior AAA through A-rated tranches trading at double digit yields even when running them to extension and/or liquidation scenarios. We have a significant allocation to Small Balance Commercial (SBC) tranches, which tend to trade at similar yields to similarly rated conduit/SASB tranches (9-12%), but typically have better performing collateral and more credit support. SBC collateral more closely resembles that of RMBS than CMBS yet they trade wider than similarly rated RMBS. We believe that in 2024 we are going to see more private capital, raised for distressed situations, flow into the CMBS space and, given limited issuance (57% decline YoY in private label issuance in 2023), we expect CMBS spreads to firm up as money pours into the higher echelons of CMBS credit market.
- Over the course of 2023, we have added 7% to the CMBS allocation, primarily in Conduit bonds rated AAA-A, with incremental additions to our SASB and SBC holdings.

CMBS Type	12/31/2022	11/30/2023	YTD Change
Conduit	5.90%	10.51%	4.61%
SASB	4.15%	5.41%	1.26%
SBC	8.12%	9.34%	1.22%
Agency CMBS	2.80%	2.77%	-0.03%
Total	**20.97%**	**28.03%**	**7.07%**

- **ABS** experienced marginal spread tightening in 2023 with the BofA AA-BBB Asset Backed Securities index posting a 6.1% return through the end of November. Despite some spread tightening in 2023, ABS sectors remain cheap from a relative basis against similar duration IG Corporates with current ABS spreads in the 89th percentile over the last 10-years. There has been a definitive bifurcation in the performance of ABS prime and subprime collateral, with ABS backed by subprime collateral seeing a deterioration in the credit performance as subprime borrowers have struggled to keep up consumption against the backdrop of declining savings and high inflation. Delinquencies on subprime auto ABS and subprime unsecured lending (marketplace lending) have been rising. According to Fitch, subprime auto 60+ delinquencies have reached 6.1%, the highest level since 1994. While ABS sectors benefit from structural credit protections offered in securitizations such as excess spread, overcollateralization, and reserve accounts, we plan on staying higher in the credit stack as we expect a decent amount of spread volatility in 2024 with the economy likely to head into a recession. In lower credit tranches it is crucial to select strong sponsors with a long track record as we have seen a significant collateral deterioration in deals brought in by new sponsors with limited credit performance history. We also think that 2023 issued deals will benefit from stronger underwriting in a rising rate environment, and we will prefer these recent deals to 2021-2022 pre rate hike collateral.
- **Corporate Structured Notes** are very attractively priced relative to IG corporate bullets issued by banks and financial institutions. CSNs like CMS spread floaters currently offer 200-250bp of spread pick up to bullets as they are priced in high 50s and low 60s with 4.5% plus yields as zero-coupon bonds. They provide great exposure to yield curve steepening and will start paying interest as soon as the yield curve re-inverts and normalizes to its long-term steady state. The chart below shows the weighted average coupon of the CSN position as a function of the steepness of the SOFR curve from the 2-year to the 30-year point.

Structured Credit Markets (Con't):



- We think there is a high probability of significant yield curve steepening in 2024 as the Fed might overreact to bad economic data and cut rates significantly as it often does during a recession. At the same time the long end of the curve will likely be rangebound or might even rise as the market starts to price in an eventual recovery from a recession. We think that these CMS spread floaters could gain 10-15% next year from a combination of curve steepening and spread compression to catch up with the rally across IG corporates.
- The chart below shows the spread between the 30-year Treasury and the 2-year Treasury (green line) versus easing cycles (white line) and the New York Fed Recession Probability Model (yellow line) with actual recessions shaded in red. The spread is currently negative (inverted) but has increased (steepened) significantly during the last 4 recessions and easing cycles.