Q2 2024 Market Review:

Despite failing to produce the hoped for Fed rate cuts, Q2 2024 left investors in a relatively good mood as most risk assets generated positive returns. The US economy continued to be in a "goldilocks" phase—as the disinflationary trend continued with the headline Consumer Price Index (CPI) dropping to 3.0% YoY and the Fed's preferred inflation gauge, Core Personal Consumption Expenses (PCE), posting 2.6% YoY in May, down from a peak of 5.6% in early 2022—albeit at a more subdued pace, with Q1 US real GDP growth coming in at 1.4% QoQ and Q2 on track for 1.5% QoQ growth.

At the latest Federal Open Market Committee (FOMC, the Fed) meeting Fed Chairman Powell continued to emphasize the need for sustained progress toward the Fed's inflation target of 2% while acknowledging that labor market conditions are not as tight as they have been in the recent past and that risks to the economy have become more balanced. Despite the US economy adding 1.4 million jobs through June, the unemployment rate rose to 4.1% in June from a low of 3.4% in Q1 2023 as the pool of available workers has expanded due to illegal immigration. In the latest June Statement of Economic Projections (SEP) the Fed members expected just one rate cut by the end of 2024 based on the median dot plot, down from three rate cuts in the Fed's March 2024 SEP. At the end of Q2, the market seems to be in an agreement with the Fed's rate cut projections as it is pricing in a 57% probability for a rate cut in September and a 100% probability for a rate cut by November while assigning an equal weight for a second rate cut in either December 2024 or January 2025.

The 10-year Treasury rate jumped to 4.7% in April on the back of stronger than anticipated inflation, robust employment gains, and a bulging US fiscal deficit that will likely increase the supply of longer dated Treasuries. However, following some moderation in inflationary pressures primarily due to disinflation in durable and non-durable goods, weak retail sales and manufacturing data, the 10-year declined to 4.40% by the end of Q2 to finish the quarter higher by 20bp. Meanwhile, the 2-year Treasury yield pushed up by 13bp with the 2-10-year spread finishing the quarter with -35bp of inversion. The US yield curve has been inverted for over 24 months, the longest inversion in US history. However, unlike previous inversion episodes there is no sign yet of recession.

"Bifurcation" has been the theme of equity indices so far in 2024, with "haves" and "have nots" emerging as the "Magnificent 7" (Microsoft, Amazon, Meta, Apple, Google, Nvidia and Tesla) outperformed the S&P ex Mag 7 by a staggering 29% YTD (37% vs 8%). The Nasdaq 100 finished the 2nd quarter on top of all equity indices at +7.82% despite a pullback in April, the S&P 500 index was +4.49%, and the Russell 2000 index was negative -2.28% for the quarter. Turning to fixed income, the Bloomberg US Aggregate Bond (AGG), Bloomberg US Investment Grade Corporate (IG Corp), and Bloomberg US High Yield Corporate (HY Corp) Indices returned 0.83%, 0.75%, and 1.33% respectively for the quarter.

One of the key components behind the current bull market remains the liquidity injection by global central banks. In particular, the US Federal Reserve announced the tapering of the Quantitative Tightening (QT) program starting in June when only $25bn of Treasuries per month will not be reinvested, down from the previous $60bn. The QT tapering announcement on May 1st (consensus was $30bn cap) reinvigorated risk markets. One of the primary beneficiaries of flows into risk assets have been High Yield ETFs and mutual funds; YTD there have been $218bn of inflows into taxable bond mutual funds and ETFs with a large portion into the high yield sector. These flows into HY funds outweighed fundamental negatives such as higher for longer interest rates, a slowdown in consumption, a spike in bankruptcies to a 13-year high, and a decline in manufacturing and capital expenditures.

Fund Performance:

The Easterly Structured Credit Value strategy returned 1.59% net for the quarter ending June 30, 2024. The strategy outperformed its benchmark by 1.52%, as the Bloomberg U.S. Aggregate Bond Index returned 0.07% for the quarter. The outperformance relative to the benchmark was primarily attributed to lower duration of the strategy relative to Bloomberg Aggregate (3.0 yrs vs 6.2 yrs) as interest rates sold off by 20bp. The strategy's net yield advantage versus the index of over 300bp also played a role in the strategy's outperformance in Q2.

Sector Performance:

The main contributors to the outperformance in Q2 were our allocations to RMBS (39%) and CMBS (28%), contributing returns of 72bp and 83bp, respectively, from a combination of carry plus realized and unrealized gains. The ABS and CLO/CDO sectors, which collectively make up 11% of the portfolio, contributed 44bp of return for the quarter. The main detractors were the Corporate Structured Note position (12%) due to their longer duration and relatively low carry, our Treasury and bond futures positions, whose purpose is to bring up the portfolio duration to three years, and our Credit Default Index (CDX) High Yield hedge, which is designed to reduce overall portfolio spread duration. While the CDX HY spread widened by 13bp, the negative carry of this position outweighed the spread widening in Q2 for a slight loss. Finally advisory fees and other expenses amounted to 16bp for the quarter. The table below shows capital allocation and net portfolio return for the quarter broken down by sector. Sector-level commentary is given in the following sections.

Sector	%Port	%Attrib
RMBS	39.0%	0.73%
CMBS	28.3%	0.83%
ABS	6.9%	0.27%
CLO/CDO	4.6%	0.17%
CORP	11.9%	-0.13%
GOVT	3.6%	-0.07%
Cash	6.8%	0.06%
Hedge	-1.1%	-0.12%
Expenses	0.0%	-0.16%
Total	**100.0%**	**1.59%**

Residential Mortgage Backed Securities (RMBS):

Non-Agency RMBS made up approximately 38% of the portfolio over Q2 and produced a total return of 1.84%, contributing 72bp to portfolio return for the quarter. In terms of fundamentals, home prices have increased by 3.5% YTD according to the Core Logic National Home Price Index, despite an increased supply of homes for sale and record low affordability. At the regional level there has been an emergence of higher existing home inventories in the sunbelt states like TX and FL which have experienced the most price appreciation since the Covid pandemic. In some MSAs the inventory supply is beginning to approach pre-pandemic levels which will likely pressure home prices in the near term. Existing home

sales continue to flounder close to all-time lows while new home sales are trending up as home builders are using discounts in the form of lower interest rates to attract home buyers.

2024 Non-Agency RMBS gross issuance through Q2 surpassed 2023 through Q2 Issuance by 56% ($64bn vs. $41bn) with Non-Qualified Mortgage (Non-QM) being the largest component in 2024 with over $20bn in issuance. Non-QM spreads have been tightening throughout the year and have settled into the 130bp – 210bp range for AAA through BBB rated tranches while BBs are often issued at 310-320bp. Despite 30-40bp of tightening for AAA Non-QM they still look attractive relative to IG Corporates with Non-QM AAAs in the 63rd percentile over the last 10-years while IG Corporate spreads are in the 9th percentile. Insurance companies have been regular buyers of Non-QM securities and Non-QM whole loans. Delinquency rates have been subdued across Non-QM deals due to a robust housing market and healthy employment conditions.

The over $9bn in issuance of Re-performing Loan (RPL) and Non-Performing Loan (NPL) deals has increased in 2024 due to securitization of recently redeemed deals. On-the-run AAA RPL tranches tightened to a 110bp spread in May before widening to 130bp by the end of the quarter while AA subordinate RPL tranches ended the quarter at a spread of 220bp. The Government-Sponsored Entities (GSE) Credit Risk Transfer(CRT) market absorbed $5bn in issuance YTD, less than 2023 YTD due to reduced issuance by GSEs and the net issuance is negative in 2024 due to increased tender activity by GSEs. CRT spreads continued to grind tighter in Q2, with M2 tranches tightening by 5bp to 160bp, B1s by 15bp to 210bp, and B2 spreads by 15bp to 385bp. There has also been increased issuance in Closed-End Seconds and Home Equity deals with issuance reaching $6bn through the end of Q2. The market has absorbed this product very well. The spread on AAA and BBB tranches has ranged from 135bp to 175bp and 215bp to 250bp respectively depending on the issuer. Reverse RMBS spreads tightened in Q2 as investors became more comfortable with the product and its valuation/performance. New issue Private Jumbo Reverse AAAs were placed at 250bp while BBBs were issued at 650bp. Legacy RMBS yields were mostly unchanged in Q2 with below IG loss-taking subprime floaters and Prime/Alt-A Senior tranches trading between 7.5% and 8.25% yields.

Commercial Mortgage Backed Securities (CMBS):

CMBS accounted for about 28% of portfolio capital over the 2nd quarter. The CMBS position posted a return of 2.92% in the 2nd quarter, contributing 83bp to overall portfolio total return. The CMBS market continued to straddle between favorable technicals and challenging fundamentals in Q2. The Fed's higher for longer stance on interest rates compounded by longer term secular issues in the office and retail sector presents a challenging backdrop for CRE valuations. The Real Capital Analytics Commercial Property Price Index (RCA CPPI) National All Property Index is down 12.4% from its Q3 2022 peak while its subindices are struggling a lot more with the Office Central Business District (CBD) index plunging 51% from its peak in 2022. The blended transaction cap rate across major property types has not changed much from its 6.5% value in 2023 as transaction volumes remain muted. The gulf between buyers and sellers across CRE sectors often remains too high and many sponsors are exercising their optional extension options or are working with special servicers to extend loan maturities and/or obtain a forbearance agreement at term maturities. The challenging CRE fundamentals are reflected in a low maturity repayment rate in Q2 with only 63% of Conduit cut-off loan balances repaid by maturity in Q2 compared to 82% in Q1. The vast majority of Single-Asset, Single-Borrower (SASB) borrowers are exercising all their extension options as high interest rates make it difficult for sponsors to find refinancing options unless a sponsor is willing to contribute considerable equity.

Both Conduit and SASB CMBS credit performance has been deteriorating with 30+ delinquencies rising to 5.3% for Conduit deals and 4.2% for SASB deals at the end of Q2. The office collateral has been at the forefront of this deteriorating credit performance with 7.8% of the balance in Conduit deals being 30+ delinquent. What has been even more concerning for CMBS investors are large appraisal reductions for office loans entering special servicing or defaulting. These large appraisal reductions are coming on the heels of the SASB BWAY 2015-1740 property disposition at 69% severity which wiped out all mezzanine tranches and 25% of the senior (originally-rated AAA) class in what became known as the first AAA CMBS deal to take a write-down (though it had been downgraded to junk 7 months prior to liquidation). There may be more originally-rated AAA SASB CMBS bonds that will follow in its footsteps.

2024 new issuance volume across private label CMBS sectors has almost tripled the volume from 2023 through Q2, at $45bn vs $16.9bn with $30bn coming from the SASB space. CMBS SASB spreads softened a bit in Q2, with AAAs widening by 30bp to the 160-190bp range across most collateral types while BBB spreads were wider by 20bp to 30bp and settled in the high 200s to low 400bp with office being on the wider end. The conduit credit curve flattened in Q2 as on-the-run AAA LCF 10-year bonds saw 10bp of spread widening to 100bp while the mezzanine tranches tightened between 10bps for AAs to 90bp for BBB-s to settle in the 160bp to 475bp range.

Asset Backed Securities (ABS):

During the 2nd quarter, ABS accounted for around 7% of portfolio capital. The ABS holdings returned 3.86%, contributing 27bp to portfolio total return. The ABS market is on pace to have record issuance in 2024 with $178bn issued through Q2, more than half of which came from the Auto sector, with Prime Auto at $43.7bn and Subprime Auto at $24.5bn. Credit performance has been mixed but in general delinquencies and losses fared much better than receivables from aggregate US households in areas like credit cards and auto loans due to tighter underwriting criteria and better borrower selection. A robust economic backdrop with low unemployment has been helping the performance of prime credit borrowers while the performance of non-prime borrowers in the auto space has stabilized after a significant post pandemic deterioration. Improved credit performance across ABS sectors caused excess spreads to be at record high levels which should help ABS structures protect bond holders against future collateral losses. Despite the record issuance amount, investors readily absorbed new ABS supply as ABS bonds continue to offer attractive relative value to unsecured corporates in the short duration space.

Structured Notes:

The Corporate Structured Note position made up about 12% of the portfolio in Q2, posting a total return of -1.12%, contributing -13bp to the portfolio. The yield curve steepened by 8bp between 2s and 30s while the differential between 2-year SOFR spreads and 30-year SOFR spreads remained at -65bp in Q2. CMS spread floater prices declined in April when rates spiked up on the high CPI print and robust employment data. CMS spread floaters rallied in June as rates stabilized and yield curve steepened but the rally was not enough to pull their performance into positive territory. Morgan Stanley 10X multiple CMS spread floaters maturing in 2030 ended Q2 priced in the 70/71 area with their zero-coupon yield still reaching more than 5% from accretion. Prices of MS 15-20X CMS spread floaters maturing in 2036-2037 have settled in the low 60s area and offer a great convexity play on the curve steepening. Other issuers like DB and Citi with 4 & 4.5X multiples maturing in 2033-2034 were trading at 62-63 area at the end of Q2.

Other Sectors:

Collateralized Loan Obligations/Collateralized Debt Obligations (CLO/CDO) accounted for just under 5% of portfolio capital during the 2nd quarter, posting a total return of 3.65% which contributed 17bp to the overall portfolio. Treasury bonds made up 3.6% of portfolio capital, returning -1.98%, costing the portfolio 7bp of total return. Hedges, including Treasury futures for duration and HY CDX to reduce portfolio spread duration, cost the portfolio 12bp of total return for the quarter. Cash accounted for just under 7% of portfolio assets in Q2 and contributed 5bp of return. Fund expenses reduced portfolio gross return by 16bp.

Portfolio Outlook:

We expect interest rates to be rangebound in H2 2024 with concerns surrounding bulging deficits counterbalancing a potential weakening in the economy. At the current pace of Federal deficits as a percentage of GDP (5 - 6%), and current interest rates, the interest payments on Federal debt already exceed annual defense spending. It is plausible that the Federal Reserve will attempt to inflate its way out of this debt and deficit problems by lowering short-term interest rates and engaging in quasi-QE as they have done in the past. These inflationary measures will cause long term rates to push higher, and the yield curve to steepen significantly. At the same time Structured Credit spreads should fare well relative to corporate spreads as Non-Agency RMBS, CMBS and ABS spreads look very attractive compared to IG and HY Corporates. Unlike Corporate spreads which are in the bottom decile over the last 10 years, Structured Credit spreads are above the 50th percentile over the same period and while spreads of Structured Credit sectors have tightened in 2024, they still look attractive relative to the 2018-2019 pre-pandemic period.