MacKay Shields Fixed Income Quarterly Outlooks

January 2025

Investments

Table of Contents

Macroeconomic Outlook **3-4**

High Yield Outlook **5**

Convertibles Outlook **6-7**

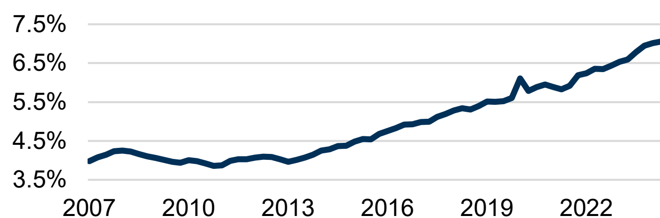
Macroeconomic 1Q2025

A Tale of Two Outlooks

- We expect another year of solid growth for the U.S. economy. A healthy labor market and high levels of household net worth will support consumer spending. The AI boom, along with ongoing fiscal incentives for public and private investment, will also serve as tailwinds.
- The economic policies of the incoming administration inject a high level of uncertainty into the outlook. In our base case, changes to trade, immigration and fiscal policies will be much more limited than former President Trump's campaign promises. However, if policies turn out to be closer to those discussed during the campaign, the outcome would be stagflationary – lower growth and higher inflation.

The U.S. economy continues to display remarkable resilience, emerging from the period of peak monetary policy rates with considerable growth momentum. This trend is set to continue, as some additional monetary policy easing should leave financial conditions supportive of growth. In addition, with the labor market showing signs of stabilizing, real wage growth and gains in overall household net worth should support robust household spending. The AI investment boom, along with investment incentives from landmark legislation such as the CHIPS Act and Inflation Reduction Act, continue to catalyze innovation and private-sector investment, reinforcing a robust growth outlook.

Figure 1: Real Investment Spending in Categories Related to CHIPS ACT, IIJA , IRA and AI as Percent of GDP



Includes private investment in computing and peripheral equipment, communications equipment, electrical transmission equipment, construction equipment, alternative electrical energy structures, manufacturing structures and office structures, software; and state and local government investment in structures and equipment. Data centers included in office structures.

CHIPS: 2022 Creating Helpful Incentives to Produce Semiconductors Act; IIJA: 2021 Infrastructure Investment and Jobs Act; IRA: 2022 Inflation Reduction Act

The economic policies of the incoming administration inject a high degree of uncertainty into this outlook. Assessing the impact of former President Trump's policies is challenging because (1) they will be implemented at different points in time over the next few years; (2) some policies have an immediate impact following implementation while others impact the economy more gradually; and (3) there could be substantial differences between the scale of implementation and what Trump promised or proposed during the presidential campaign.

In practice, we anticipate a more measured implementation of Trump's campaign pledges, with tariff rhetoric primarily serving as leverage for trade negotiations or aimed at winning other concessions from major trade partners. The more recent threat of immediate 25% tariffs against Canadian and Mexican imports fits into this category, in our view, with Trump seeking to pressure both countries into stricter border enforcement. We would expect this issue to be resolved within the first few months of Trump's term. Similarly, mass deportations are very unlikely given how disruptive they would be to the economy, and the potential difficulties in securing the necessary funding from a fractious Republican-controlled Congress that commands only a slight House majority. Finally, although Trump promised a host of new tax breaks during the presidential campaign, in reality, simply extending the expiring provisions of the 2017 tax cuts will add significantly to deficits. Pushback from Republican Senators and from the bond market will ultimately constrain the amount of fiscal loosening. Trump's December failure to secure a two-year debt ceiling suspension from Congress during passage of a Continuing Resolution portends the challenges he will face in seeking additional tax cuts.

A scaled-down version of economic policy implementation may look more like the following:

- Higher tariff rates against many Chinese goods, but no sustained tariffs against other trading partners.
- Some restrictions on legal immigration, heightened border security and expedited removal procedures for new asylum seekers. Some long-standing programs that allow for asylum on humanitarian grounds could be phased out.
- Little fiscal easing beyond extension of expiring provisions of the 2017 Tax Cuts and Jobs Act and increases in defense spending.

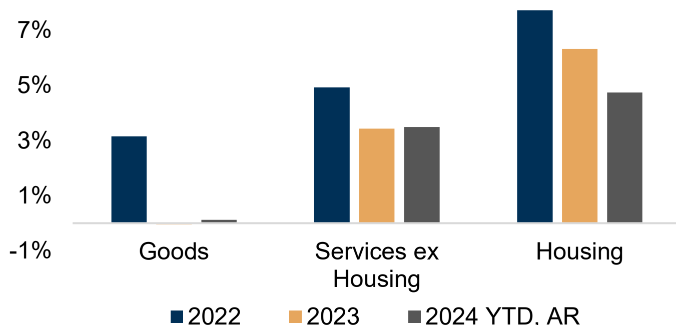
Macroeconomic 1Q2025 (cont'd)

A Tale of Two Outlooks

The net impact of these policies would be a slight drag on the economy in 2025; as such, we see real GDP growth in the year ahead moderating to a 2.25% pace, which is modestly above our estimate of the economy's potential.

Meanwhile, the inflation outlook is somewhat less encouraging. After moderating significantly in 2023, core inflation has turned somewhat sticky lately. In fact, with one more month of price data to go in 2024, core PCE inflation looks set to finish this year just a few tenths below where it ended 2023, and notably above the Committee's 2% objective.

Figure 2: In 2023, Services Inflation Excluding Housing Proved Sticky

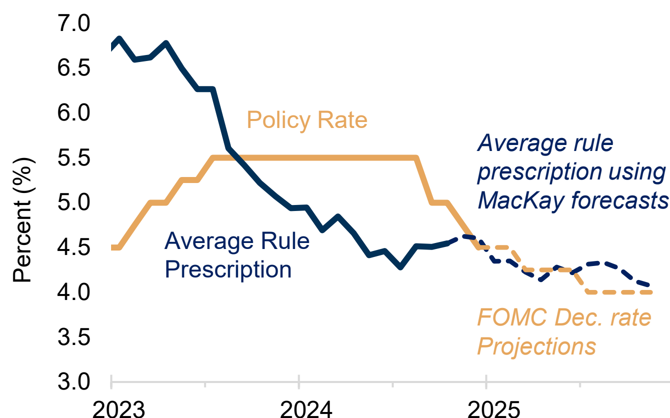


Source: Bureau of Economic Analysis, MacKay Shields.
2024 inflation is through November and annualized.

The rebalancing that has occurred in the labor market suggests that inflation should continue to moderate. But the journey back to the Fed's 2% inflation objective will continue to be bumpy, in our view; above-trend growth, strong real income gains and high levels of household net worth, and the economic policies of the incoming administration suggest that core inflation will end 2025 around 2.5%.

With solid economic activity and somewhat sticky inflation, we believe that the FOMC will feel less urgency to cut the policy rate over coming quarters. As a result, we expect just 50 basis points of easing between now and the end of 2025. The risks to this policy outlook are generally balanced, though fiscal policy bears close monitoring. If Congress moves forward with meaningful fiscal expansion in 2025, any additional rate cuts could be entirely off the table.

Figure 3: Monetary Policy Rules Indicate Limited Scope for Further Easing



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Board of Governors of the Federal Reserve System, MacKay Shields. MacKay end-2025 forecasts: core PCE inflation - 2.4 percent; unemployment rate – 3.9 percent; median longer-run federal funds rate from the FOMC's *Summary of Economic Projections* – 3.25%.

Economic Policy Risks

Despite our constructive outlook, we are highly attuned to the risk that the policies of the incoming administration may be closer to Trump's campaign promises and proposals than we currently envision. Such an outcome would be stagflationary: growth and employment would suffer, and inflation and interest rate volatility would increase. Most importantly, broad-based and high tariff barriers and retaliation, along with immigration restrictions and significant deportations, would serve as a drag on growth that would only be partially offset by additional fiscal easing and deregulation. Meanwhile, all four policy thrusts – tariffs, immigration restrictions and deportations, deregulation and fiscal expansion—would boost inflation. All told, we estimate that these policies would lower the level of GDP by approximately one percentage point relative to our baseline, with that growth drag peaking in early 2026. Inflation would be close to a full percentage point higher by Q4 2025, mainly due to tariffs, though the inflationary impact would fade over the course of 2026. And most importantly for investors, this stagflationary outcome would likely dent risk-taking in financial markets, especially against the backdrop of tight credit spreads and exceptionally strong equity gains over the past two years.

High Yield 1Q2025

Andrew Susser, Executive Managing Director,
Head of High Yield

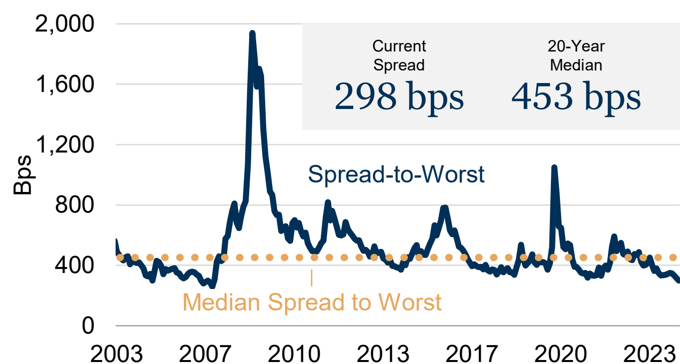
Joseph Maietta, CFA, Client Portfolio Manager

Outlook

Technicals continue to be very supportive of U.S. high yield market performance. While new issue activity has increased to approximately $280 billion of high yield bonds in 2024 as of November 30, 2024, compared to $106.5 billion and $176.1 billion in 2022 and 2023, respectively – 78% of the proceeds have been used to refinance existing high yield bonds.[1] Moreover, new supply this year is still approximately 38% below the average volumes between 2019 and 2021.[2] Net new supply remains constrained due to a sluggish rebound in corporate M&A activity, a lack of "fallen angels" from the investment-grade sector, and muted LBO activity from private equity sponsors. Private credit has also played a role, as it competes to lend to companies that would normally borrow from the leveraged loan and, to a lesser extent, the high yield markets.

Valuations reflect near-perfect conditions. As of November 30, the ICE BofA US High Yield Index spread-to-worst of 298 basis points is lower than the 20-year median of 452 basis points and sits at the lower end of the post-GFC "non-panic" range of 325-525 basis points, as illustrated below:

Figure 1: Spread-to-Worst



Index: ICE BofA US High Yield Index
As of November 30, 2024
Source: ICE Data

While the valuation of high yield appears unattractive from a spread perspective, it compares favorably to equities. The difference between the yield on the ICE BofA US High Yield Index and the earnings yield of the S&P 500 Index – the inverse of the P/E - has historically shown positive correlation to relative performance of high yield. Over the past 20 years, when this "earnings spread" is over 3.5%, the high yield market has outperformed equities 83% of the time over the following one-year period.[3] It currently stands at 4.0%.

Yields are also attractive relative to historical levels given the higher interest rate environment. Starting yields have generally been good indicators for strong subsequent five-year performance for the market.[4] It stands at 7.1% at the end of November.

There are many risks in financial markets today. However, we maintain that stable fundamentals and reasonable valuations suggest that U.S. high yield continues to represent a reasonable, lower-duration fixed income investment option.

1. ICE Data
2. ICE Data
3. Based on historical data from the S&P 500 and ICE Data. Past performance is not indicative of future results.
4. Based on historical ICE Data. Past performance is not indicative of future results.

Convertibles 1Q2025

Edward Silverstein, CFA, Senior Managing Director, Head of Convertibles

Performance

The first two months of the fourth quarter saw stocks and equity-linked convertible bonds soar in the wake of the U.S. elections. Smaller caps continued their outperformance that began in late summer, propelling the U.S. convertible market, which has few mega-cap companies among its constituents. During the first two months of the fourth quarter, the U.S. Convertible Index[1] rose 7.67%, which bested the 4.90% return of the S&P 500 and the 5.77% return of the NASDAQ Composite over the same period. Much of the convertible market's strong performance is a result of the performance of small-cap stocks as evidenced by the 9.37% return of the Russell 2000 Index in October and November. In addition, the U.S Convertible Index benefited from the tremendous advance of its largest constituent, MicroStrategy. The common shares and convertible bonds of MicroStrategy, a company with a small software business, whose main asset is its holding of Bitcoin, surged following the election on the expectation that the new administration would impose fewer regulations on cryptocurrencies.

The convertible market's advance in the fourth quarter puts the year-to-date upside capture of the equity markets closer in line to historical norms of 60-80%. Through the end November, the U.S Convertible market has participated in approximately 56%, 54%, and 73% of the upside moves in the S&P 500, NASDAQ, and Russell 200 Indices, respectively (*Source: Bloomberg*).

1. The ICE BofA All U.S. Convertibles (VXA0) Index. See index descriptions below.

Issuance

Issuance of convertible securities for the eleven months of 2024 has been strong, with $71.8 billion of new issuance coming to the market (source: Bank of America). Higher interest rates and a coming wave of maturing debt has companies searching for less costly avenues to refinance that debt. In addition, with stocks at record levels, many managements are comfortable issuing a security linked to their share price. Higher rates, however, have been the main motivating factor for companies seeking financing in our asset class, as they can usually issue a convertible bond with a meaningfully lower coupon than they would be required to pay in the straight high yield or investment grade market. Lastly, several large offerings from a few companies have helped to increase year-to-date issuance. In October, Boeing issued $5 billion of convertible shares in an attempt to improve its balance sheet profile. In November, the aforementioned MicroStrategy issued $3 billion of zero-coupon convertible notes, using the proceeds to purchase additional Bitcoin.

Our expectation is that issuance will reach $90 billion this year, as December has seen at least ten new issues come to market as companies rush to raise capital before year-end. This compares to $53.4 billion of new issuance in 2023 and $28.7 billion of new issuance in 2022. New issuance is generally a positive for the convertible market, as most new securities are priced at a discount to their theoretical fair value and generally trade above the issue price on their first days of trading, providing a small boost to index returns. In addition, new bonds priced at par are balanced securities that usually offer an asymmetric return profile, whereby the bond will capture a greater percentage of the underlying equity's upside than downside. Lastly, with higher prevailing interest rates, most new issues are coming to market with higher coupons and lower conversion premiums—the amount that the common stock price needs to go up before it becomes advantageous to convert – than what was prevalent in the post-financial crisis environment of ultra-low interest rates.

Convertibles 1Q2025 (cont'd)

Edward Silverstein, CFA, Senior Managing Director, Head of Convertibles

Positioning and Outlook

While the economy seems reasonably healthy, we are not incorporating any macroeconomic views into our investment decisions, as our investment process is focused on company-specific fundamentals. We do have concerns about the valuations accorded to many listed equities. Stocks were trading at relatively high multiples of earnings and cash flow before the November election, and their subsequent advance is hard to justify even taking into account the possibility of lower corporate tax rates and a generally more business-friendly climate. Given the current rate of core inflation and the yield on risk-free Treasuries, it is difficult to rationalize equity valuations. Our positioning has us overweighted sectors such as Healthcare and to a lesser extent, Energy, where we find decent fundamentals and attractive valuations based on free-cash-flow generation. These sectors have been a drag on relative performance in the fourth quarter as investors have bid up securities that are expected to benefit most from a Trump presidency. Our experience has shown that positioning based on who occupies the White House has a way of not turning out as expected. While our current positioning and its impact on performance has been frustrating, we have been through periods such as this before, most notably in the late 1990s and 2020, and we believe that our process, which emphasizes strong company fundamentals and reasonable valuation, will outperform over a complete market or economic cycle.

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Convertible securities are subject to a risk of loss. Convertible securities may be subordinate to other securities. The total return for a convertible security depends, in part, upon the performance of the underlying stock into which it can be converted. Additionally, an issuer may encounter financial difficulties which could affect its ability to make interest and principal payments. If an issuer stops making interest and/or principal payments, an investor could lose its entire investment.

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The following indices may be referred to in this document:

The ICE BofA US High Yield Index tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. The ICE BofA US High Yield Index tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody’s, S&P and Fitch) and an investment grade rated country of risk (based on an average of Moody’s, S&P and Fitch foreign currency long term sovereign debt ratings). In addition, qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of $100 million. Original issue zero coupon bonds, "global" securities (debt issued simultaneously in the Eurobond and U. S. domestic bond markets), 144a securities and pay-in-kind securities, including toggle notes, qualify for inclusion in the Index. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. DRD-eligible and defaulted securities are excluded from the Index.

The ICE BofA All U.S. Convertibles (VXA0) Index is an unmanaged index that consists of convertible bonds traded in the U.S. dollar denominated investment grade and non-investment grade convertible securities sold into the U.S. market and publicly traded in the United States. The Index constituents are market value weighted based on the convertible securities prices and outstanding shares, and the underlying index is rebalanced daily.

The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

The NASDAQ Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market.

The Russell 2000 Index is an unmanaged and market capitalization weighted equity index maintained by the Russell Investment Group that seeks to be a benchmark of the entire US stock market. More specifically, this index encompasses the 2,000 largest US-traded stocks, in which the underlying companies are all incorporated in the US

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