MacKay Shields Fixed Income Quarterly Outlooks

October 2024

New York Life Investments

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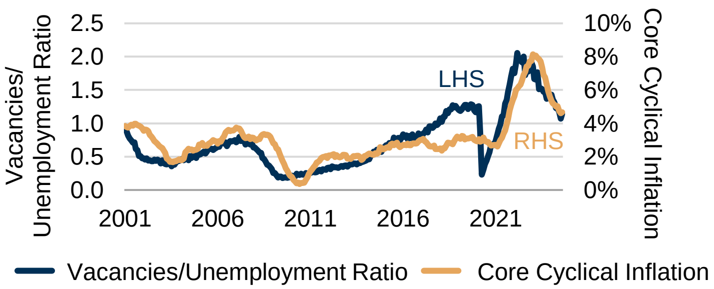
Macro & Multi-Sector 4Q2024

Focus on Carry and Selection Opportunities

The U.S. economy continues to display remarkable resilience, emerging from the period of peak policy rates with strong growth momentum. We expect this trend to continue, as gradual monetary policy easing should leave financial conditions supportive of growth. In addition, with the labor market stabilizing, real wage growth should support robust household spending, especially given gains in overall household net worth. Importantly, recent revisions to national output and employment figures suggest that productivity growth has been stronger than previously thought. In this event, firms may have greater flexibility to manage higher labor costs while preserving margins.

The economy's sustained momentum has recently brought about a shift in investor perceptions of the balance of risks to the outlook, with previous concerns over recession giving way to higher risks of reflation. While we have been at odds with the market's focus on recession risks, a sustained pickup in growth and inflation also strikes us as unlikely. Importantly, we attribute some of the strength in the economy to higher potential growth, given increases in labor supply as well as the aforementioned evidence of higher productivity growth. These developments have allowed for solid economic performance without renewed tightening in the labor market or a resumption of inflationary pressure. In addition, the ratio of job vacancies to the unemployed is at a level that historically has been associated with low and stable inflation. Without a renewed surge in job openings, the better balance evident in this, and other labor market indicators, suggests that inflation should continue to moderate.

Figure 1: Labor Market Balance and Cyclical Inflation



Source: Bureau of Labor Statistics, Federal Reserve Bank of San Francisco, MacKay Shields. Core cyclical inflation includes those core PCE categories that have historically responded to the level of slack in the economy.

As we analyze the current fixed income landscape, we anticipate that markets will remain sensitive to upside risks to the outlook and the Federal Reserve's reaction. Therefore, several key themes emerge as we position portfolios into the fourth quarter:

Ride the Carry

The Federal Reserve's decision to lower interest rates signals a proactive approach to stimulate economic growth amid evolving economic conditions. Lower rates typically lead to reduced borrowing costs, encouraging consumer spending and investment. This environment can enhance demand for fixed income securities, particularly as investors seek to lock in yield.

Moderating Inflation Is a Boon to Fixed Income

With inflationary pressures easing, the fixed income market has seen a shift in investor sentiment, with risk appetites reinvigorated by loosening monetary policy. Investors may favor longer-duration bonds, anticipating that lower rates will persist, which could lead to price appreciation in those segments. However, it remains crucial to monitor inflation trends closely, as any resurgence could prompt the Fed to reconsider its stance.

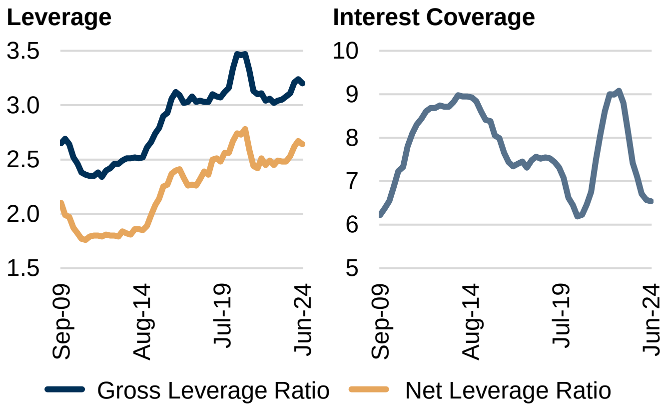
A Healthy Labor Market Supports Credit Fundamentals

A robust labor market supports consumer confidence and spending, underpinning economic stability. This dynamic typically bodes well for fixed income securities, as steady employment can lead to improved credit conditions and lower default risks. One caveat is that if wage growth accelerates significantly, it could reignite inflation concerns, impacting bond yields.

Macro & Multi-Sector 4Q2024 (cont'd)

Focus on Carry and Selection Opportunities

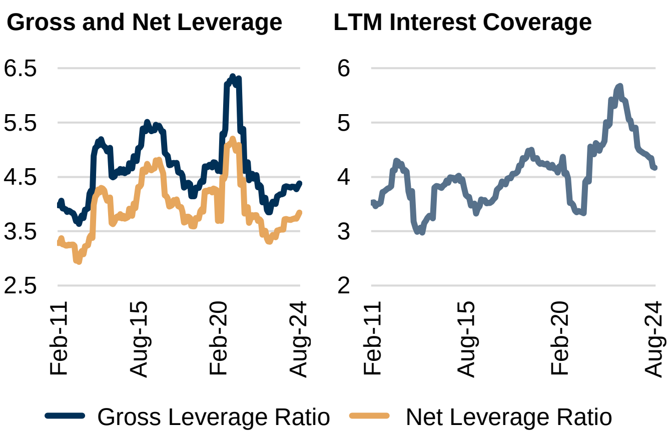
Figure 2: Investment Grade Fundamentals are Moderating



Data as of June 30, 2024
Source: JP Morgan

Credit fundamentals should continue to provide solid support, resulting in range-bound credit spreads from current levels. Leverage metrics remain contained, and while interest coverage has been declining for many issuers (due mainly to higher rates), the easing cycle should reverse this trend. Investors can still look to take advantage of attractive all-in yields. However, an area of focus for us is the consumer cyclicals sector, particularly the auto industry, where slowing demand and weaker financial conditions among lower-income consumers have put pressure on the sector's performance.

Figure 3: High Yield Fundamentals Remain Supportive



Data as of September 30, 2024
Source: BofA Securities

Valuations Should Temper Generic Beta Trades, So Emphasize Selection

Despite the favorable macroeconomic backdrop, stretched valuations across many fixed income sectors warrant caution. Yields have compressed significantly, but many bonds are still trading at a discount. Investors should be wary of potential risks in stretching for yield, so security selection and credit quality will be crucial in navigating this environment. We also believe Treasuries are overbought, so investors should be cautious about extending duration. The yield curve is likely to continue to steepen with a 4% rate on the 10-year as the fulcrum point.

Conclusion

The fixed income outlook following the Fed rate cut presents a mixed picture. While lower rates, moderating inflation and a healthy labor market create a supportive backdrop for fixed income, current valuations require a selective approach. In our view, investors should consider diversifying their portfolios, focusing on solid structures, higher quality and durable cash flows. Delve into niche sub-sectors to identify compelling income generation opportunities and total return potential. At the same time, remain vigilant regarding macroeconomic indicators that could influence future rate decisions. Balancing the pursuit of yield with an awareness of valuation risks will be essential in navigating this evolving landscape.

Our multi-sector investment approach is predicated on four critical principles that we believe will serve investors well heading into the end of the year:

- Exploit the whole credit toolkit and avoid over reliance on any one sector
- Focus on misunderstood and underappreciated sectors
- Take advantage of generalized sell-offs to identify strong names in weak sectors
- Recognize the value in complexity and lean into research as an edge

High Yield 4Q2024

Andrew Susser, Executive Managing Director,
Head of High Yield

Joseph Maietta, CFA, Client Portfolio Manager

Outlook

U.S. high yield's hot streak has continued year to date. The ICE BofA US High Yield Index's 1.6% September return marked its fifth consecutive month of gains. Since November 2023, the high yield index has returned 17.1% (with only April 2024 showing a monthly loss). This represents the index's best eleven-month performance period since the 2020–21 V-shaped recovery following the COVID sell-off.

The recent performance of CCC bonds is unprecedented in a "non-stressed" market environment. Historically, the strongest CCC returns — both relative and absolute — have followed periods of market stress, when the broad high yield market has bottomed and is in its early stages of recovery. In other words, when CCC-rated bonds rally significantly, the starting spread of the broad high yield market has always been wide.

Specifically, distressed high yield bonds have been the real winners. After languishing in the first half of 2024, the ICE BofA US Distressed High Yield Index — a subset of the US High Yield Index comprised of bonds with more than 1,000 basis points (bps) option-adjusted spread (OAS) — soared 20.6% in Q3, including a 9.1% gain in September alone.

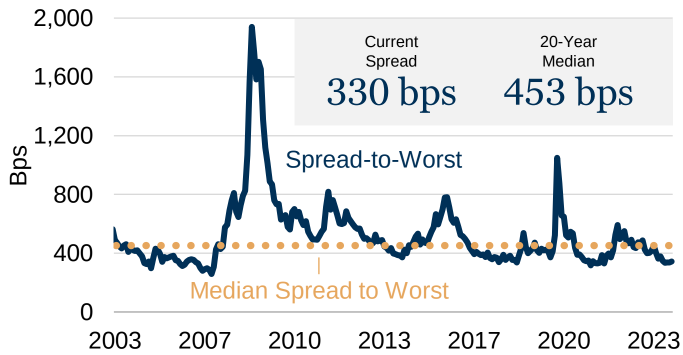
In our view, the recovery in distressed issuers has been warranted in some cases due to an improvement in credit fundamentals, such as M&A or asset sale announcements. More often, however, we see soaring distressed bond prices simply as a reflection of excessive optimism on credit risk.

Demand for leveraged credit has overwhelmed the supply of high yield bonds, as evidenced by strong retail fund flows. However, the real demand has come from institutional investors. Anecdotally, they are turning to high yield to generate total returns without the increased volatility associated with U.S. equities, which trade near all-time highs. Institutions are also allocating to high yield through multi-sector and multi-asset strategies. Private credit funds flush with cash and "pods" of large hedge funds have also piled in.

There are simply not enough new high yield bonds to meet this demand. While new issue activity has rebounded — $250 billion of high yield bonds have been issued so far in 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. Moreover, new supply this year is still approximately 38% below the average volumes between 2019 and 2021 (Source: JP Morgan). 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 leveraged buyout (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 market and, to a lesser extent, the high yield markets.

Valuations reflect these near-perfect conditions. As of September 30, the ICE BofA US High Yield Index spread-to-worst of 330 bps is lower than the 20-year median of 453 bps and sits at the lower end of the post-GFC "non-panic" range of 325-525 bps, as illustrated below:

Figure 1: Spread-to-Worst



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

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.

Convertibles 4Q2024

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

Performance

The third quarter saw equity performance broaden out to the benefit of smaller-cap issuers that comprise much of the U.S. convertible market. For the first time in over a year, the smaller-cap Russell 2000 outperformed the S&P 500 and NASDAQ Indexes. The S&P 500 Index trailed the performance of the average of its equal-weighted constituents by 370 bps. The investor shift to smaller-caps benefited the U.S. convertible market, which advanced 5.27% in the third quarter versus a 5.88% and 2.76% gain for the S&P 500 and NASDAQ Indexes, respectively. The small-cap Russell 2000 rose 9.27% during the third quarter. Despite this positive quarterly performance, the year-to-date advance of 7.51% in the ICE BofA U.S. Convertible Index falls short when compared to the S&P 500's 22.07% and NASDAQ's 21.84% gains. Nevertheless, it captures about 70% of the Russell 2000's year-to-date rise of 11.16% and 50% of the equal-weighted S&P 500's 15.15% gain, as of September 30.

As smaller-cap and mid-cap stocks continue to trade at a significantly lower valuation to large-cap equities, our expectation is that these equities may continue to outperform their large-cap peers. We believe this should benefit the performance of the U.S. convertible market.

Issuance

Issuance of convertible securities for the first three quarters of 2024 has been strong, with $51.7 billion of new issuance coming to the market. With higher interest rates and a wave of maturing debt, companies were 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.

Our expectation is that issuance will meet or exceed $70 billion this year, which compares to $53.4 billion of new issuance in 2023 and $28.7 billion of new issuance in 2022. The pace of issuance may slow slightly from here, as interest rates have dropped from the beginning of the year but still remain well above where they were just two to three years ago. New issuance is generally a positive for the convertible market. 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 its 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.

Positioning and Outlook

While the economy continues along at a fairly steady pace, albeit with new job creation slowing, we are not incorporating any macroeconomic views into our investment decisions. Our investment process is focused on company-specific fundamentals. While corporate earnings have generally been better than expected, much of that good news may have already been reflected in stock prices, absent additional cuts in interest rates. We are also agnostic about the outcome of the presidential and congressional elections in November. We believe that the outcomes of elections usually have little impact on the economic cycle and securities markets, or have an outcome that is counter to general expectations. As such, we continue to invest in companies with strong fundamentals and attractive valuations. This has led to a large overweight to the Healthcare sector and an underweighting to the Financials, Materials and Utilities sectors. We believe that companies with strong fundamentals and attractive free cash yields can continue to deliver compelling returns for the balance of the year.

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Past performance is not indicative of future results.

ABOUT RISK

High yield securities have speculative characteristics and present a greater risk of loss than higher-quality debt securities. These securities can also be subject to greater price volatility

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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ICE BofA utilizes its own composite scale, similar to those of Moody’s, S&P and Fitch, when publishing a composite rating on an index constituent (eg. BBB3, BBB2, BBB1). Index constituent composite ratings are the simple averages of numerical equivalent values of the ratings from Moody’s, S&P and Fitch. If only two of the designated agencies rate a bond, the composite rating is based on an average of the two. Likewise, if only one of the designated agencies rates a bond, the composite rating is based on that one rating.

COMPARISONS TO AN INDEX

Comparisons to a financial index are provided for illustrative purposes only. Comparisons to an index are subject to limitations because portfolio holdings, volatility and other portfolio characteristics may differ materially from the index. Unlike an index, individual portfolios are actively managed and may also include derivatives. There is no guarantee that any of the securities in an index are contained in any managed portfolio. The performance of an index may assume reinvestment of dividends and income, or follow other index-specific methodologies and criteria, but does not reflect the impact of fees, applicable taxes or trading costs which, unlike an index, may reduce the returns of a managed portfolio. Investors cannot invest in an index. Because of these differences, the performance of an index should not be relied upon as an accurate measure of comparison.

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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.

IMPORTANT DISCLOSURE

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 U.S. stock market. More specifically, this index encompasses the 2,000 largest U.S.-traded stocks, in which the underlying companies are all incorporated in the U.S.

JPMorgan CEMBI Broad Diversified High Yield Index is a sub components of the JPMorgan CEMBI Div Broad Composite Blended Yield Index, which cover the sub-investment-grade part of this composite index.

JPMORGAN GOVERNMENT BOND–EMERGING MARKET INDEX: JPMorgan GBI-EM Global Diversified (GBI-EM) series, launched in June 2005, is the first comprehensive global emerging markets index of EM local government bond debt. There are three root versions of the GBI-EM with a Diversified overlay for each version; GBI-EM Broad / GBI-EM Broad Diversified, the GBI-EM Global / GBI-EM Global and the GBI-EM / GBI-EM Diversified.

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