Quarterly Commentary

EAGLE Asset Management

Fixed Income

Second Quarter | 2024

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Market Overview[1,2]

The bond market, as measured by the Bloomberg U.S. Aggregate Bond Index, finished relatively flat in the second quarter returning just 0.07%. The slightly positive return can largely be attributed to positive performance in May and June as interest rates reset lower following a sharp run-up in April. The yield on the benchmark 10-year U.S. Treasury note increased 48 basis points from 4.20% in March to 4.68% at the end of April before consolidating lower to 4.40% by the end of the quarter. Abrupt movements among interest rates continue to be impacted by mixed economic signals and their influence on the repricing of future monetary policy scenarios.

Portfolio Review[1,2]

Taxable Portfolios

Investment-grade corporate bonds, as measured by the Bloomberg U.S. Corporate Bond Index, fell marginally by -0.09% during the quarter. The negative quarterly performance was driven by both a rise in interest rates and corporate credit spread widening. The average corporate credit spread moved 4 basis points higher from 0.90% at the end of March to 0.94% at the end of June. Corporate credit spreads tightened to 0.85% at the end of May, the lowest level since November 2021, before persistently widening in June as geopolitical events sparked a flight to quality. Still, credit spreads remain historically tight.

Corporate bonds underperformed all other major taxable fixed-income sectors on a total return basis and slightly underperformed U.S. Treasuries on a duration-adjusted basis. Government-related securities and securitized products (asset-backed, mortgage-backed, and commercial mortgage-backed securities) posted positive total returns during the quarter and mixed results relative to Treasuries with government-related securities outperforming.

Tax-sensitive Portfolios

Total return for the month of June was positive for municipal bonds with the Bloomberg Municipal Bond Index up 1.53%, ending the quarter down -0.02%. June's rally alleviated much of the year's negative performance, bringing year-to-date total return to -0.40%. Over the quarter, total return performance was mixed across the curve, with the Bloomberg 1-year Municipal Bond Index up 0.82%, the 5-year index down -0.42%, the 10-year index down -1.04%, the 15-year index down -0.15%, and the 22+ year index up 0.83%. Municipals underperformed U.S. Treasuries by 12 basis points during the quarter, with the U.S. Treasury Index up 0.10%; however, on a year-to-date basis municipals have outperformed by 46 basis points. The May selloff brought municipal bond prices down to more desirable levels, resulting in a June rally due in part to the seasonally high redemption period and healthy new issuance supply. Given the excess of new issuance volume this year, attractive tax-equivalent yields, and continued strong demand, we continue to have a constructive view on the municipal market going into the second half of the year.

AAA municipal to Treasury ratios decreased across the curve, with the 5-year, 10-year, 15-year and 30-year ratios cheapening by roughly 2 to 5 percentage points over the month, ending the quarter at 68%, 65%, 69%, and 84%, respectively. Despite the richness, we believe there is still value for investors who may want to consider locking in tax-efficient income from coupon payments. As of the end of June, the Bloomberg Municipal Bond Index's yield-to-worst was 3.72%, a tax-equivalent yield of 6.28%. Yield-to-worst for the 7-year and 15-year benchmarks was 3.46% and 3.69%, respectively. Given the relative richness of the market and continued rate volatility, our programs remain barbelled with a focus on reinvesting bond proceeds in the longer portion of the curve, where we believe there is more value. In addition, we will look for opportunities in the market to sell credits that we believe are at peak prices and/or are showing weakness in their credit fundamentals.

Net municipal bond funds were slightly positive in June with net inflows of $255 million, bringing year-to-date net inflows to $2 billion. New issuance surged this quarter, with June's new issuance totaling $44.8 billion, bringing year-to-date issuance to $238.8 billion — up 31% year over year and 20% above the 10-year average. The increase in supply was driven primarily by tax-exempt issuance, up 38% year over year at $222 billion. Taxable municipal issuance totaled $16.7 billion, down 22% year over year. The supply and demand imbalance has resulted in many new issue deals being oversubscribed and then re-priced at higher prices. As a result, we expect prices to remain relatively expensive and range-bound in the near term. New issuance will likely remain strong during the summer and early fall, as many issuers will likely try to come to market prior to the November presidential election. In addition, municipal research professionals continue to increase their annual supply issue forecasts, now ranging from $430 billion to $450 billion.

Credit quality remains strong for most sectors, with both S&P and Moody's reporting upgrades exceeding downgrades by 4.2x and 3.6x in 2023, respectively. The preponderance of upgrades is due to continued economic stability and strengthening of finances, particularly in the local government sector. As discussed in prior commentaries, we remain cautious within the healthcare and higher education sectors as both experienced significant margin compressions in 2023 due to higher labor and supply costs. As inflation comes down, we expect expenses to moderate, which should bring revenues and expenses into balance. For these two sectors, both credit agencies reported downgrades exceeding upgrades. In recent headlines, tobacco bonds secured by Master Settlement Agreement (MSA) payments have been feeling the pressure as declines in smoking as well as higher taxes on the purchase of cigarettes have driven the payments that back the securities to a record low. According to the U.S. Centers for Disease Control, the percentage of Americans who smoke has declined from 21% in 2005 to 12% in 2021. The decline has been going on for decades, but with the launch of alternatives such as electronic vaping and smokeless tobacco options, the decline has certainly accelerated in recent years. While we do invest in this sector, our focus is primarily on newer tobacco deals that have more bondholder-friendly features, including shorter final maturities, traditional amortization schedules, and most importantly more realistic breakeven consumption decline estimates. As we dive into the second half of the year, we will follow these sectors and others, adjusting our holdings as necessary.

Outlook[1,2]

As we enter the second half of 2024, our outlook continues to call for a slower growth environment, while our expectations for inflation remain elevated. We have long been advocates for a higher for longer restrictive monetary policy as we do not believe there is enough evidence that inflation can durably return to the U.S. Federal Reserve's (Fed) stated target of 2%. Mixed economic signals continue to present complexities in the immediate path of monetary policy.

Economic data for the second quarter has largely come in mixed to weak from a rate of change perspective. The Institute for Supply Management's Services ISM® Report on Business® showed broader signs of cooling demand in June as it unexpectedly weakened to contractionary territory with a sharp deterioration in business activity and orders placed. June's ISM manufacturing Purchasing Managers' Index came in at 48.5, remaining within the contractionary threshold now for three straight months. Looking ahead to the third quarter, the economy will almost certainly experience a deceleration in growth as we lap the base effects from a relatively strong quarter of 2023, including peak government spending, "Barbenheimer," and the Taylor Swift concert effect.

The labor market simply isn't as tight as it was just a year ago. There is evidence of additional cracks forming as jobless claims experience an uptrend and continuous claims rise. Over the past two months, the ratio of job openings per available worker has fallen below 1 (0.89 for May, which is back to pre-pandemic levels). This ratio is important as the risk is that a continued uptick in layoffs will directly reflect in higher unemployment as it becomes much harder to find a replacement job. Should the labor market continue to worsen, and household financial flexibility diminishes, growth could slow much more intensely.

At this time in the inflation cycle, it is essential we distinguish between our shorter-term cyclical and longer-term structural views on inflation. Over the next three months, inflation

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has the highest probability of showing signs of abating. Base effects will be relatively mixed or flattish, shelter costs still have about three to six months of disinflation left, and pro-inflationary effects of container shipping costs due to Middle East turmoil won't be fully realized for another few months. However, base effects will then ease meaningfully heading into the fourth quarter. Shelter will move from a disinflationary tailwind to an inflationary headwind just as the lag in container shipping costs begins to take hold. These factors combined with broader trends in deglobalization and long-tailed ripple effects of the post-pandemic economy will serve to sustain inflationary pressures. We believe the Fed will ultimately need to revise its inflation target considering this structural inflation dynamic as it is unlikely 2% inflation can be achieved without a recession.

In the Fed's June summary of economic projections (SEP) report, we recognized an implicit acknowledgment of this view as Fed officials revised their inflation forecasts higher over the next two years. Despite these higher inflation expectations, and previous upward revisions to anticipated economic growth and lower unemployment projections, the Federal Open Market Committee median dot plot still calls for interest rate one cut, with eight of the 19 officials calling for two, by the end of this year. While inflation remains comfortably higher than the target, the Fed's continued support for cuts before year-end all but serves as a de facto adjustment to its inflation mandate (i.e., higher than 2%), without officially signaling it as such. We have always believed the Fed's original dot plot for 2024 was erroneous. However, and without trying to contradict ourselves, any imminent labor market deterioration coinciding with a third-quarter growth slowdown and easing cyclical inflationary pressures could allow for the Fed to justify one or two cuts before year-end.

A continuation of the mixed signals outlined above and their impacts on Fed rhetoric/policy are likely to keep volatility elevated across financial markets. Adding to potential headwinds on the horizon is the looming impact of the U.S. election and the economic implications the respective nominees will present. Geopolitical tensions also remain turbulent as ongoing conflicts proceed, while trade tensions between the United States and other parts of the world (e.g., China) continue to pose additional risks.

We continue to believe the fixed income market presents investors with attractive opportunities to benefit from historically high all-in yield levels that will help hedge against future volatility. We expect persistent releases of varied economic data will likely keep the 10-year U.S. Treasury rate within a range of 4% to 4.75%. Should the economic environment progress in accordance with our outlook, we would expect rates in the interim to bounce around the mid- to higher end of the range. Any consolidation near the upper end of that range, and without any meaningful change to our outlook, would warrant a buying opportunity.

References to specific securities are intended to illustrate the types of securities Eagle may hold in this portfolio. They are not intended as representations of specific investment recommendations that would have been profitable to an investor. Past performance is not a guarantee of future results. Opinions and estimates offered constitute Eagle's judgment and are subject to change without notice as are statements of financial-market trends, which are based on current market conditions. Investing involves risk, including the possible loss of principal.

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2. Sources: Investor Tools Perform and Yield Book

Investing in bonds involves risks that may adversely affect the value of your investment such as inflation risk, credit risk, call risk, interest rate risk, and liquidity risk, among others. The two most prominent factors are interest rate movements and the credit worthiness of the bond issuer. Investors should pay careful attention to the types of fixed income securities that comprise their portfolios and remember that, as with all investments, there is the risk of loss of capital. A Real Estate Mortgage Investment Conduit (REMIC) is a type of multiclass mortgage-related security in which interest and principal payments from mortgages are structured into separately traded securities. These classes are distinguished by their sensitivity to the prepayment risk of the underlying mortgage-related collateral. Therefore, they may be more or less sensitive to prepayment risk, bear different interest rates, and have various average lives and final maturities.

Asset-backed securities (ABS) and mortgage-backed securities (MBS) are created by pooling loans from a variety of sources and issuing bonds that are backed by these loans. Creditworthiness stems from the credit quality of the underlying loans, as opposed to corporate bonds in which creditworthiness is derived from the earning power of the issuing company. The primary risk of these securities is interest-rate risk. Rising interest rates might cause loan principal prepayments to slow, resulting in less available principal to invest at prevailing higher rates. Conversely, rate decreases might accelerate prepayments, leaving more dollars to invest at lower rates.

Investment-grade refers to fixed-income securities rated BBB or better by Standard & Poor's or Baa or better by Moody's.

Convertible securities and preferred stock combine the fixed income characteristics of bonds with some of the potential for capital appreciation of equities and, thus, may be subject to greater risk than pure fixed-income instruments. Unlike bonds, preferred stock and some convertible securities do not have a fixed par value at maturity, and in this respect may be considered riskier than bonds. Convertible securities may include convertible bonds, convertible preferred stocks and other fixed-income instruments that have conversion features.

Investments in high-yield bonds and convertible securities are subject to the client's authorization, as set forth in the Investment Management Agreement. Such investments may be subject to greater risks than other fixed-income investments. The lower rating of high-yield bonds (less than investment grade) reflects a greater possibility that the financial condition of the issuer or adverse changes in general economic conditions may impair the ability of the issuer to pay income and principal. Periods of rising interest rates or economic downturns may cause highly leveraged issuers to experience financial stress, and thus markets for their securities may become more volatile. Moreover, to the extent that no established secondary market exists, there may be thin trading of high-yield bonds, which increases the potential for volatility.

Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.

Bond Ratings: Ratings are by Moody's, S&P, and/or Fitch. Ratings provided by nationally recognized statistical rating organizations, also called ratings agencies, are appraisals of a particular issuer's creditworthiness, including the possibility that the issuer will not be able to pay interest or repay principal. Ratings are not recommendations to buy, sell or hold a security, nor do ratings remove market risk. Securities with the same rating can actually trade at significantly different prices. In addition, ratings are subject to review, revision, suspension, reduction or withdrawal at any time, and a rating agency may place an issuer under review or credit watch. Additionally, Fitch reports are available for municipal bonds. More about ratings is available at moodys.com, standardandpoors.com, and fitchratings.com.

Definitions

The AAA Municipal general obligation bond to Treasury yield ratio is a comparison of the yield of AAA municipal general obligation bonds to U.S. Treasuries. It aims to ascertain whether AAA municipal general obligation bonds are an attractive buy in comparison.

An all-in yield refers to a yield, whether in the form of an interest rate, margin, original issue discount (OID), upfront fees, Eurodollar Rate floor and/or Base Rate floor, or otherwise, that does not include arrangement fees, structuring fees, commitment fees and underwriting fees or other fees not paid generally to all lenders of such Indebtedness.

A barbell investment strategy in fixed income typically entails investing half the portfolio in long-term bonds (generally those with maturities of 10 years or more) and the other half in short-term bonds (generally those with maturities of five years or less), with little or nothing in between. Barbell strategies can allow investors to benefit from current interest rates by investing in short-term bonds and also benefit from the higher yields of holding long-term bonds. The risks associated with using a barbell strategy include interest rate risk and inflation risk.

Basis points (bps) are measurements used in discussions of interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

Breakeven estimates pertaining to declines in the consumption of tobacco and tobacco products play a role in municipal bonds tied to settlement payments owed to states under the 1998 Master Settlement Agreement, which settled tobacco liability claims between the states and tobacco companies. Assumptions about the future consumption of tobacco plays a role in the value of the future settlement payments backing the bonds.

Continous claims , also referred to as insured unemployment, is the number of people who have already filed an initial claim and who have experienced a week of unemployment and then filed a continued claim to claim benefits for that week of unemployment. Continued claims data are based on the week of unemployment, not the week when the initial claim was filed.

A credit spread is the difference in yield between a U.S. Treasury bond and another debt security with the same maturity but different credit quality. Also referred to as "bond spreads" or "default spreads," credit spreads are measured in basis points, with a 1% difference in yield equaling a spread of 100 basis points. Credit spreads reflect the risk of the debt security being compared with the Treasury bond, which is considered to be risk-free. Higher quality securities have a lower chance of the issuer defaulting. Lower quality securities have a higher chance of the issuer defaulting.

Credit spread widening occurs when the difference in yields between U.S. Treasuries and other types of bonds, like corporate credit, increases. This widening occurs because the prices of the non-Treasury bonds have decreased (with yields moving in the opposite direction of prices), in response to concerns about credit quality or fears about deteriorating economic conditions that cause investors to prefer the comparable safety of U.S. Treasuries.

Credits are a generic term for fixed-income securities such as corporate bonds, mortgage- or asset-backed securities, municipal bonds, or emerging market bonds.

Cyclical forces describe trends and changes in market conditions that occur as the economy passes through the business cycle's stages of expansion, peak, recession, and recovery.

Disinflation refers to the temporary slowing of the pace of price inflation and describes what happens when the inflation rate is marginally lower over the short term. Disinflation refers only to the rate of change in the rate of inflation. In this, it is distinct from inflation and deflation, which describe the direction of prices.

Duration incorporates a bond's yield, coupon, final maturity and call features into one number, expressed in years, that indicates how price-sensitive a bond or portfolio is to changes in interest rates. Bonds with higher durations carry more risk and have higher price volatility than bonds with lower durations.

The U.S. Federal Reserve dot plot is a chart summarizing the Federal Open Market Committee's (FOMC) outlook for the federal funds rate. Each dot represents the interest rate forecasted by one of the 12 members of the committee.

The Federal Open Market Committee (FOMC) consists of 12 members: the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining 11 Reserve Bank presidents, who serve one-year terms on a rotating basis. The FOMC holds eight regularly scheduled meetings per year at which it reviews economic and financial conditions, determines the appropriate stance of monetary policy, and assesses the risks to its long-run goals of price stability and sustainable economic growth.

The Federal Reserve's inflation target rate is the rate of price increases prefers to see to ensure the economy will remain stable. Generally, the Fed's target rate is 2%, as measured by Personal Consumption Expenditures (PCE) Price Index.

Fund flow is the net of all cash inflows and outflows into and out of a particular financial asset, sector, or index. It typically is measured on a quarterly or monthly basis. Investors and others look at the direction of fund flows for indications about the health of specific securities and sectors or the overall market.

Headwind is a term used to describe events or market forces that hinder the prospects for performance in an individual investment or group of investments.

The Institute for Supply Management (ISM) Purchasing Managers' Index (PMI) measures the prevailing direction of economic trends in the manufacturing sector. It consists of an index summarizing whether market conditions as reported in a monthly survey of supply chain managers are expanding, staying the same, or contracting.

The Institute for Supply Management (ISM) Services ISM® Report on Business® is based on data compiled from purchasing and supply executives in a wide variety of industries nationwide. Survey responses reflect the change, if any, in the current month compared to the previous month in supplier deliveries along with seasonally adjusted business activity, new orders, and employment.

Long-tailed effects are trends and phenomena that take place over long periods of time, often at increasingly lower though still often meaningful levels.

Margin compression is what happens when input costs rise faster than the sale price of a product. As a result, the producer's profit margins decline over time.

The Master Settlement Agreement (MSA) was agreed to in 1998 by the four largest tobacco companies in the United States and 52 state and territory attorneys general to settle dozens of state lawsuits brought to recover billions of dollars in health care costs associated with treating smoking-related illnesses. Eventually, more than 45 tobacco companies settled with the Settling States under the MSA. Florida, Minnesota, Mississippi, and Texas are not signatories to the MSA, but reached their own individual tobacco settlements prior to the MSA. As part of the MSA, tobacco manufacturers are obligated to make annual payments to the settling states in perpetuity, as long as cigarettes are sold in the United States by companies that are parties to the settlement.

Range-bound is a condition where the value of a security keeps vacillating between the low and high ends of a narrow range. For example, if the 10-year Treasury yield repeatedly vacillated between 3.75% and 4.25%, it would be described as "range-bound."

Securitized products, such as asset-backed securities (ABS) and mortgage-backed securities (MBS), are created by pooling loans from a variety of sources and issuing bonds that are backed by these loans. Creditworthiness stems from the credit quality of the underlying loans, as opposed to corporate bonds in which creditworthiness is derived from the earning power of the issuing company. The primary risk of these securities is interest-rate risk. Rising interest rates might cause loan principal prepayments to slow, resulting in less available principal to invest at prevailing higher rates. Conversely, rate decreases might accelerate prepayments, leaving more dollars to invest at lower rates.

The summary of economic projections is produced following meetings of the Federal Open Market Committee and includes meeting participants' projections of the most likely outcomes for real gross domestic product growth, the unemployment rate, and inflation for a forward-looking three-year window and over the longer run.

Tailwind is a term used to describe events or market forces that exert a positive influence on an investment's performance.

Tax-efficient income refers to income generated by investments that seek to maximize returns by limiting losses to taxes.

Tax-equivalent yield is the interest rate that a taxable bond must pay to provide the same yield as a comparable tax-exempt municipal bond.

Total return, when measuring performance, is the actual rate of return of an investment or a pool of investments over a given period. Total return includes interest, capital gains, dividends, and distributions realized over the specified period. Total return accounts for two categories of return: income including interest paid by fixed-income investments, distributions, or dividends and capital appreciation, representing the change in the market price of an asset.

A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity.

Yield to worst is a measure of the lowest possible yield that can be received on a bond with an early retirement provision. It is a type of yield that is referenced when a bond has provisions that would allow the issuer to close it out before it matures. The yield to worst metric is used to evaluate the worst-case scenario for yield at the earliest allowable retirement date. It is always less than yield to maturity because it represents a return for a shortened investment period.

Indices

The Bloomberg U.S. Aggregate Bond Index is composed of the total U.S. investment-grade bond market. The market-weighted index includes Treasuries, agencies, commercial mortgage-backed securities (CMBS), asset-backed securities (ABS) and investment-grade corporates.

The Bloomberg U.S. Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market.

The Bloomberg Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market.

The Bloomberg 1-Year Municipal Bond Index is an unmanaged index comprised of investment-grade municipal bonds with maturities of one to two years.

The Bloomberg 5-Year Municipal Bond Index is the five-year component of the Municipal Bond Index. It is an unmanaged index comprising investment-grade municipal bonds with maturities of four to six years.

The Bloomberg 10-Year Municipal Bond Index is an unmanaged index comprising investment-grade municipal bonds with maturities of 8 to 12 years.

The Bloomberg 15-year Municipal Bond Index is the 15-year component of the Municipal Bond Index. The Bloomberg 15-year Municipal Bond Index is an unmanaged index comprising investment-grade municipal bonds with maturities of 12 to 17 years.

The Bloomberg 22+ Year Municipal Bond Index is an unmanaged index comprised of investment grade municipal bonds with an average maturity of more than 22 years.

The Bloomberg U.S. Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

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