Quarterly Commentary

EAGLE Asset Management

Vertical Income Portfolio

Second Quarter | 2024

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Market Overview[1]

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.

Portfolio Allocation Review[1,2]

The portfolio's allocation to common stocks and preferred securities was relatively flat during the quarter following an increase by almost 5 percentage points during the first quarter. We are closely monitoring developments in names we find attractive and are looking to opportunistically add risk to the portfolio where the relative value makes sense.

Within the corporate bond portfolio, we continue to take a barbelled approach to duration relative to the index as the curve continues to be inverted through its belly. This approach allows for high yields on the short end with available liquidity while also profiting from the roll-down effect as bonds move down the curve. The bond sleeve continues to be rotated into higher coupon-paying bonds to emphasize cash flow as opportunities present themselves. The preferred portfolio continues to emphasize utilities, which is the largest allocation of preferreds, especially relative to the broader index. The consistent cash flows that come from these companies support the structure of preferred securities well. Our financials allocation has remained static and is notably underweight relative to the broader index. The focus on the highest-quality financials, typically outside of the regional banking sector, makes increasing the allocation to this sector difficult.

Outlook

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's) 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, we expect that 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 diminish, 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 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 one interest rate cut by the end of this year, with eight of the 19 officials calling for two. 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.

Vertical Income Portfolio

1. 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.

2. This information is not intended to serve as investment, tax, legal, or accounting advice. It should not be considered a recommendation to engage in or refrain from taking a particular course of action and is not an endorsement, recommendation, or sponsorship of any securities, services, or other investment property. It has been prepared for informational purposes only, and you should consult your own investment, tax, legal, and/or accounting professionals before engaging in any transaction. Any discussion of tax matters contained herein is not intended or written to be used, and cannot be used, for the purpose of avoiding any penalties that may be imposed under federal tax laws. The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients or any of its or their respective affiliates. Views expressed are as of the date indicated and may change based on market and other conditions. The accuracy of the content and its relevance to your particular circumstances is not guaranteed.

The product described is a separately managed account with fixed-income components and is subject to interest-rate risk, inflation-rate risk and may experience a loss of principal. Other products may be more appropriate, depending on your investment needs. As with all investing, there is the risk that an unexpected change in the market or within the company itself may have an adverse effect. As with all investments, there is the risk of the loss of capital. High-yield securities may be subject to greater risk than pure fixed-income instruments.

Equity Income investing is based upon the identification of companies that possess both moderate growth rates as well as higher-than-average and consistent dividend distributions. There are risks associated with dividend investing, including that dividend-issuing companies may choose not to pay a dividend, may not have the ability to pay, or the dividend may be less than what is anticipated. Dividend-issuing companies are subject to interest rate risk and high dividends can sometimes signal that a company is in distress. Historically, dividend yields have been relatively constant and therefore have created a cushion for investors when stock prices have declined. However, there is the risk that a company will not achieve its expected earnings results, or that an unexpected change in the market or within the company will occur, both of which may adversely affect investment results. The biggest risk of equity investing is that returns can fluctuate and investors can lose money. Investment-grade refers to fixed-income securities rated BBB or better by Standard & Poor's or Baa or better by Moody's.

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.

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.

Definitions

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 entails investing in a mix of higher-risk and very low-risk assets while avoiding investments in the middle range of the risk-reward spectrum.

Base effects describes the practice of making comparisons between current trends, such as the rate of inflation, and the same trends from a previous period, such as a month or a year before.

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%.

Consolidation in the technical analysis of market dynamics refers to an asset trading within a well-defined pattern of trading levels

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.

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.

The 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.

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 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.

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 meaninful levels.

Preferred securities, or preferreds, are fixed income instruments that typically sit above common equity but below traditional senior and subordinated debt in a company's capital structure. These may also be referred to in the market as hybrid securities since they have both debt- and equity-like characteristics.

Roll-down refers to the practice of selling a bond as it approaches its maturity date and its initial higher interest rate declines.

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.

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.

Underweight describes a portfolio position in an industry sector or some other category that is less than the corresponding weight level in a benchmark portfolio.

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. Investors and market analysts watch certain yield curves for signs of inversion, when yields for longer-term debt instruments fall below yields on short-term debt with the same credit quality. Inversions are watched as potential signs of a weakening economy and in certain cases, a harbinger of recessions.

Index

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

Indices are unmanaged, and one cannot invest directly in an index.

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