



CIM Market Commentary & Outlook

February 2024

Higher For Not Much Longer

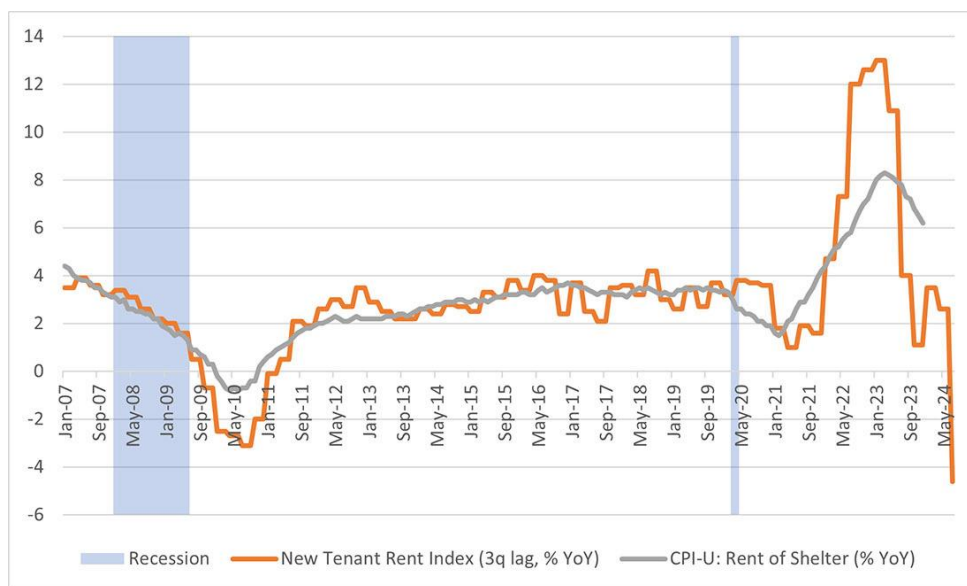
- The reinvestment rate risk and opportunity cost associated with cash and cash equivalent investments, can be extremely high if one is sub-optimally positioned.
- Wall Street economists' and strategists' fears that higher interest rates would be sustained "for longer", were overstated by orders of magnitude.
- Our Credit Opportunities composite returned +7.52%, net-of-fees, while our intermediate Market Duration composite returned +6.33%, net-of-fees.
- Three and five-year areas of the muni curve were among the worst performers, returning +3.46% and +4.31% respectively in 2023.
- Those able to look past the next few months, will likely be well-served, as interest rates are expected to be materially lower in the years ahead.
- We have now seen the largest drop in the recorded history of the Federal government's New Tenant Rent Index.
- For those investors who remain underweight fixed income, and munis in particular, who may be concerned that they may have missed the peak in rates, we have some good news. The average, cumulative magnitude of rate cuts, during every prior Fed easing cycle, is roughly 500 basis points.
- Investor inflows into Clinton Investment's strategies in 2023 exceeded \$900 million.
- We are very proud to have been selected by MassMutual Investments to sub-advise three new open-end municipal bond funds that will be managed consistent with our Short, Market Duration, and Credit Opportunities strategies.

We received confirmation, in the fourth quarter of 2023, that the powerful inflationary impulse that had plagued the US economy, for the prior eighteen months, was indeed transitory after all. We also learned that the views expressed by Wall Street economists and strategists, fearing that higher interest rates would be sustained "for longer," were overstated by orders of magnitude. The error in their position is evidenced by the extremely attractive total returns fixed income delivered in 2023. The broader market appeared to have concluded that the Fed would continue to steadily raise rates throughout 2023, as ten-year Treasury bond yields surged toward 5.00%. The well-worn narrative of "higher for longer" had become so pervasive in the media and across major financial services companies, that many investors were caught offside when the Fed unexpectedly pivoted, which resulted in a powerful bond rally, as investors repositioned portfolios for the new, expected lower rate regime.

Clinton Investment Management (CIM) clients and readers have known, for many months, that not only was inflation moderating, but they were also aware of our expectations that the Fed was more likely to begin cutting interest rates, rather than raise rates further. Few shared our outlook, just a few months ago. It appears the broader market is now solidly in line with our views. The confidence we had in our conviction benefited our client portfolios accordingly. We are, therefore, deeply grateful that our clients and strategies were well positioned for the powerful decline in yields and rally in bond prices that we witnessed in the fourth quarter, as the Fed pivoted from a tightening bias to a pause. Our client portfolios fully participated in the bond rally and the outperformance of the municipal bond sector, in particular, as we delivered absolute and relative returns that were amongst the highest in our firm’s history. Our Credit Opportunities composite returned +7.52%, net-of-fees, while our intermediate Market Duration composite returned +6.33%, net-of-fees. For those in the highest tax brackets, the taxable equivalent returns we delivered were meaningfully higher. Municipal bonds in the three and five-year areas of the muni curve were among the worst performers, returning +3.46% and +4.31% respectively in 2023, according to Bloomberg. The fourth quarter served as a painful reminder, to the underinvested, that the reinvestment rate risk and opportunity cost associated with cash and cash equivalent investments, can be extremely high if one is sub-optimally positioned. To this point, while short-term rates rose to the highest levels in over a decade, we have been imploring investors, for many months, to consider the likely fleeting nature of these higher yields. We now know, from the Fed’s recent meeting and corresponding commentary, that not only is the Fed likely finished raising rates, but they are, in our view, also going to be cutting rates by a meaningful degree, in the months ahead. While there is uncertainty regarding the exact timing of when these rates cuts might begin, we believe that the outcome is undeniable. Therefore, those able to look past the next few months, will likely be well-served, as interest rates are expected to be materially lower in the years ahead.

The harsh reality investors now face is that the extremely attractive yields investors have enjoyed in cash and cash equivalent securities will likely materially decline going forward. For investors concerned that inflation may remain stubbornly high, keeping rates aloft, we encourage them to consider the components of Consumer Price Index (CPI) that are currently overstating the level of inflation, including Owner’s Equivalent Rent (OER)/Shelter. For example, if OER accurately reflected current, as opposed to lagging, rental renewals, the CPI would already be below the Fed’s 2% target, according to recent comments from Campbell Harvey, Professor of Finance Duke University. We have also seen the largest drop in the recorded history of the Federal government’s New Tenant Rent Index, indicating to us that further material declines in OER and inflation should be expected in the months ahead (see Figure 1).

Figure 1.



Source: Bureau of Labor Statistics Haver Analytics

Moreover, the real-time CPI data implies that the current level of real interest rates are substantially restrictive. They are now approaching the roughly 2.4% real rates that persisted during the Great Financial Crisis, when accounting for real-time data. We believe this reality is the primary motivation behind the Fed's decision to rapidly pivot to an easing posture.

As we consider the outlook for municipal bonds in this environment, we see strong demand for the tax-free cash flow that munis offer persisting over time. This is evident in the asset class's recent outperformance relative to Treasuries and corporate bonds. While some have pointed to lower 'AAA' muni yields, compared to Treasuries, as an indication that the asset class has richened on a relative basis, we would like to remind investors that we have been recommending an underweight position to 'AAA' rated munis for some time. Yields available on 'AA', 'A', and 'BBB' rated munis remain extremely compelling, on a taxable equivalent basis, in our view, especially for those in the highest tax brackets. We continue to overweight 'A' and 'BBB' rated bonds in our client portfolios, as a result. The municipal bond yield curve also remains meaningfully inverted from 2 to 13 years, while the curve from 2 to 30 years remains positively sloped by over 80 basis points, at the time of this writing. The municipal yield curve's persistent dislocation from the inverted Treasury curve continues to present investors with an excellent opportunity to reposition their holdings away from low yielding, short and intermediate maturities, where many investors are over exposed, while reallocating to the highest yield and structurally mispriced longer duration areas of the muni curve. We believe longer duration munis will continue to outperform in 2024, as they did in 2023. Now that the Fed has indicated their rate hiking cycle is over, they will likely be cutting short-term yields in the future, which should benefit longer duration securities from a total return perspective. It is also worth noting that our outlook for municipal credit quality remains constructive. Record rainy-day and general fund balances buffer our long-held view that municipalities have substantial cash reserves sufficient to ride out a slowing economic environment in the future.

In summary, our outlook for the future direction of interest rates is guided by the dramatic decline in interest rates we have witnessed since their peak in the fall of 2023. We must also consider the potential for further rate declines and the cumulative degree to which rates can fall. For those investors who remain underweight fixed income, and munis in particular, and who may be concerned that they have missed the peak in rates, we have some good news. The average, cumulative magnitude of rate cuts, during every prior Fed easing cycle, is 500 basis points. Given the Treasury market has only priced in roughly 100 basis points of cuts to-date, we believe there is considerably more room for rates to fall from here. Therefore, investors waiting for an attractive entry point into fixed income should act expeditiously as the current levels of yields may not be around much longer.

CIM Firm Update

Not only did our clients enjoy one of our firm's best years, from a performance perspective, but our firm also celebrated our strongest year of growth since our founding in 2007, both in terms of new members of our team as well as growth in assets under management (AUM). Investor inflows into our strategies in 2023 exceeded \$900 million, while we welcomed a new General Counsel, Lane Bucklan, a new Director of Research, Shivani Singh, and a new Business Development Associate, Sean Coffey. We are also very proud to have been selected by MassMutual Investments to sub-advise three new open-end municipal bond funds that will be managed consistent with our Short, Market Duration, and Credit Opportunities strategies. We are particularly proud of this achievement given the thorough nature of MassMutual's granular, industrywide muni manager search. We believe our selection is a clear illustration of the consistency with which we have delivered meaningful value to our clients, over time, together with the rigor of our risk management culture.

If you should have any questions regarding where we are seeing the best value and opportunities in the municipal bond market today, please do not hesitate to reach out to us directly.

Best Regards,

Andrew Clinton
CEO

Important Disclosure Information

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