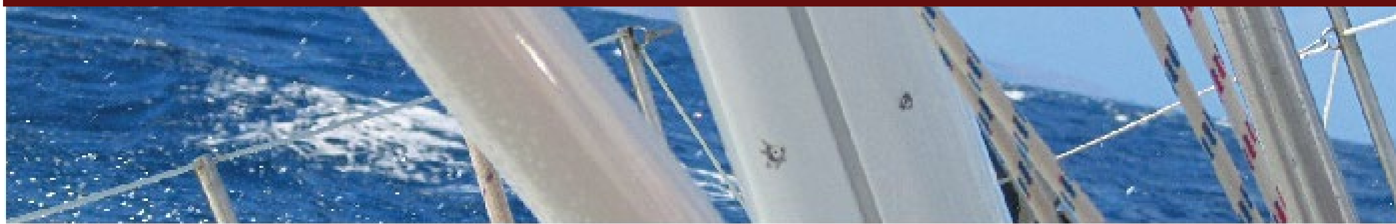
CARRET
Asset Management

April 2024

Carret Credit Insights



It's Good the FED's Plan Was in Pencil

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Firm AUM

$3.139 Billion

In the first quarter of 2024, the fixed income market experienced a blend of volatility and resilience amidst shifting economic dynamics and changing Federal Reserve (FED) fiscal policy expectations. Government bond yields experienced a modest uptick, reflecting concerns over inflationary pressures and the FED tightening stance. U.S. Treasury (UST) yields had plenty of fits and starts to begin the new year. The 10 Yr UST yield began the year at 3.88%, drifted higher as the quarter progressed, and closed the quarter at 4.20%. The FED's plan to relax monetary policy contributed to fluctuations in UST yields, with investors closely monitoring central bank data for signals regarding the pace and magnitude of future policy actions. At this juncture, the FED has been "on hold" since July of 2023. Amidst this backdrop, investment grade (IG) and high yield (HY) corporate bond markets displayed relative stability, buoyed by strong corporate earnings and investor appetite for higher-yielding assets. Municipal bond ratios (vs. USTs) remain below historical norms with ratios running near their richest levels in three years. Corporate and municipal market valuations are elevated despite lingering concerns over geopolitical risks, the upcoming U.S. elections, and sector-specific challenges.

We often remark that we should never be compelled to make a change for change's sake. It is clear to us that market psychology / expectations have shifted again. Global central bank rate cuts should begin later, proceed more gradually, and conclude at a higher level than anticipated entering 2024. The case for maintaining current monetary policies is supported by a series of higher-than-expected inflation figures, strong economic growth, a robust job market, and above average wage growth. If U.S. data continues to show strength, we believe the FED will opt to delay rate cuts, indicating a high bar for a significant hawkish policy shift. At the same time, strong data reduces the prospect of sharp declines in UST yields. As a result, we expect U.S. rate volatility to remain lower compared to levels seen in the past few years. Despite increased uncertainty regarding the precise timing and magnitude of rate moves, our intermediate-term stance remains unchanged, affirming an overall downward trend for rates over the next 18 months.

Key Market Levels	3.31.24	12.31.23	12.31.22
Fed Funds Rate	5.25% – 5.50%	5.25% – 5.50%	4.25% – 4.50%
3 Month U.S. T-Bill	5.35%	5.35%	4.41%
10 Yr U.S. Treasury Bond	4.20%	3.88%	3.88%
5 Yr AAA Municipal Bond	2.51%	2.28%	2.52%
5 Yr A Corporate Bond	5.12%	4.41%	5.22%

Source: Municipal Market Data (MMD) and FactSet

Looking ahead, the fixed income markets face a confluence of opportunities and challenges as economic uncertainties persist. While the prospect of higher interest rates and inflation remains a key focus, investors are also focused on geopolitical developments, supply chain disruptions, and the evolution of the post-pandemic recovery. Against this backdrop, portfolio diversification, creativity, patience, and an active management approach are paramount. Recent inflationary pressures certainly indicate that yields may increase further,

in the near term, as market expectations shift towards a slower pace of rate cuts. While we are not market timers and will never successfully pinpoint yield peaks and valleys, we find current yield levels attractive and see value in extending duration in both our Municipal Fixed Income and Taxable Fixed Income strategies while continuing to manage our Opportunity Fixed Income strategy with a shorter dated focus.

U.S. Treasury Bond Market Update

The 1st Q saw the yield on the 6 Month UST increase 6 bp from 5.26% to 5.32%. Ultra-short rates increased nominally, as inflation lingers and investors anticipate the FED will not cut rates in the 2nd Q, keeping short rates attractive.

During the Q, the yield on the 5 Yr UST increased 37 bp from 3.85% to 4.22%. Intermediate rates increased during the Q as investors' expectations for multiple FED rate cuts faded. The last mile of bringing inflation to 2.0% is proving difficult and thus, investors who, on average, were anticipating six rates cuts in 2024 at the beginning of the year, now anticipate only 1-2 cuts.

Taxable Bond Market Update

In the 1st Q, the U.S. corporate bond market saw interest rates climb alongside UST despite corporate spread tightening. IG issuance in the 1st Q was the highest in the first three months of a year dating back the last ten years as companies aimed to take advantage of tight spreads. This supply was met by ample demand from investors. As rates have risen, companies have issued more short-term debt than during the previous low-rate cycle, decreasing the overall duration of bonds in the market.

HY spreads, as measured by BB rated credits, are the tightest they have been since 2007, indicating investors see minimal volatility in "risk assets" in the years ahead – we don't necessarily agree. We are in the risk taking business and welcome opportunities to add risk; however, we want to capture higher returns when doing so. In today's low spread environment, we believe HY investors should remain short duration focused and defensive in nature. Fund flows remained solid during the Q as HY companies issued debt with shorter average maturities than over the past decade to maintain financial flexibility on expectations for a future FED pivot to lower rates.

Investor concerns of a slowing economy have not yet materialized. Corporate bankruptcies have fallen from their bump in late 2023. IG upgrade/downgrade ratios from the major ratings agencies are improving as balance sheets strengthen. The "debt maturity wall" remains a popular topic to discuss among HY circles as small cap companies have maturities concentrated in the 3 to 5 Yr range. Investors continue to invest into both IG and HY U.S. corporate bonds at a significant pace. We anticipate that lingering inflation, a cautious FED, and solid corporate earnings will hold yields at attractive levels providing strong cash flows and total returns for investors in 2024/2025.

Municipal Bond Market Update

2024 started on a high note after experiencing the strongest quarterly return in over 40 years during the 4th Q of 2023 – resulting in richer municipal valuations to begin the year. Favorable 1st Q technicals and a consensus view that the global interest rate rally would persist, encouraged market participants to expect the good times to continue. The rally was short-lived, however, as the market could not overcome elevated new issue supply and a rising rate environment.

During the 1st Q, Moody's upgrades outpaced downgrades at a ratio of 2:1, albeit slower than last year's 1st Q which saw a respective ratio of 3:1. The solid rating activity continues to be driven by strong tax revenue, reserves benefitting from pandemic aid, and a growth trajectory in the aggregate local government sector. The overall market outlook continues to remain positive for 2024.

Strong returns to end 2023 and hopes for a positive 2024 fueled demand for municipals with January experiencing $2 billion+ of inflows. February flows were flat as the market became less optimistic on the broader interest rate environment, but March did however generate positive fund flows as investors added to long-term and high yield municipal funds. In aggregate, the 1st Q of 24 accumulated $7 billion of inflows — a notable reversal from the 1st Q which saw $2 billion of outflows. Mutual funds have reaped the lion's share of inflows so far this year, while ETFs have experienced negative flows. Separately Managed Accounts (SMAs) continue to garner solid inflows.

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New issue supply got off to a fast start with January experiencing one of the highest volumes for that month in recent years — a surprise to market participants expecting issuance to start off slow and remain tepid for the year. February and March supply levels were also strong — 20% higher year-over-year. Overall volumes were 25% higher than the 1st Q of 23 and on par with the 4th Q of 23, a seasonally higher volume quarter. There were two main reasons for the 1st Q uptick in supply — multiple mega deals (17 $1 billion+ new issue offerings) and Build America Bonds refinancings (taxable municipal new issues).

From a tax perspective, 37 states enacted tax cuts for fiscal 2024, while only 3 states adopted tax increases. Although the net impact of $13 billion of reduced revenues in 2024 is relatively minor (and for some issuers, temporary), the tax relief efforts highlight confidence in the municipal sector's overall fiscal stability.

1 Yr municipal bonds continue to yield more than 10 Yr municipal bonds — a phenomenon that up until late 2022 had never occurred in the municipal market. This relationship became more pronounced in the 1st Q as 1 Yr municipal yields increased by 24 bp while 10 Yr municipal yields decreased by 1 bp. While the belly of the municipal yield curve remains inverted, we continue to find value in both long-term and short-term municipal bonds.

Data as of March 31, 2024	**Taxable Fixed Income**	**Municipal Fixed Income**	**Opportunity Fixed Income**	**Enhanced Cash**
Maturity	3.8	6.2	2.9	0.21
Duration / Dur to Worst	3.5	5.2 / 3.6	2.7	0.21
YTM / YTW	5.14%	3.50% / 3.06%	6.32%	5.59% [3]
Taxable Equiv YTM/YTW		6.77% / 5.92% [1]		5.99% [1,2,3]
Coupon	3.86%	4.53%	5.24%	1.45%
Credit Rating	A-	AA	BB+	A+

Sector Allocations:				
U.S. Treasury	11%	1%	3%	53%
Government Agency	9%			4%
Corporate - Inv Grade	73%	2%	40%	24%
Corporate - High Yield			48%	
Preferreds	5%		7%	
Convertible				
Municipal		96%		3%
Cash	2%	1%	2%	16%

[1] Assumes a combined federal and state effective tax rate of 48.30% [2] Assumes a state tax rate of 7.50% [3] Yield on Invested Assets

Taxable Fixed Income Strategy:

- The Taxable Fixed Income Strategy outperformed the Bloomberg Intermediate Gov't Credit Index during the Q with a gross return of 0.5% and net return of 0.4% versus the index's negative return of -0.2%.
- The IG corporate bond yield curve remained inverted during the 1st Q.
- IG spreads, as measured by the 3-5 Yr A rated FactSet Index, tightened by 16 bp during the Q, decreasing from 110 bp to 94 bp.
- IG spreads, as measured by the 3-5 Yr BBB rated FactSet Index, tightened by 18 bp during the Q, decreasing from 134 bp to 116 bp.
- Strategy duration, at 3.5 Yrs, has remained near the low end of the strategy's stated range of 3-7 Yrs for the last several Qs. Long-term corporate yields climbed alongside UST yields during the Q despite tightening spreads. We remain patient in anticipation of an opportunity to extend the strategy duration.
- Average portfolio quality remained steady Q / Q at A-.

- The strategy's Yield to Maturity (YTM) increased during the Q from 4.89% on December 31st, 2023 to 5.14% at Q end.
- The strategy's top three economic sectors are Financials, Utilities, and Information Technology.
- The strategy's overweight exposure to corporate bonds contributed to outperformance relative to the index. Corporate bonds contributed positively on a cash flow basis due to higher coupon cash flows relative to the index. The overweight position positively impacted performance on a price basis versus the index as corporate bond spreads finished the Q tighter than where they began 2024.
- The strategy's 5% allocation to preferred securities provides higher yields and aims to capture incremental cash flows.
- We continue to find value in corporate credits and remain overweight vs the index with an allocation of 73% to corporate bonds. Additionally, government agency bond valuations are attractive, boasting healthy spreads above UST. During the Q, exposure to Preferred Securities decreased 1% to a total of 5% and U.S. Agencies increased from 8% to a 9% allocation.
- During 2024, the strategy aims to capitalize on swap opportunities as well as the reinvestment of maturities, calls, and coupon cash flows while maintaining patience in the face of tighter credit spreads. Our duration management allows for flexibility in a dynamic rate environment over a long-term investment horizon – we do not chase yield!

Municipal Fixed Income Strategy:

- Representative AAA rated 5 Yr Municipal Bond yields rose by 23 bp during the 1st Q, moving prices lower and leading to muted returns. For the Q, 5 Yr UST yields rose by 37 bp.
- The 2Yr-to-10Yr municipal curve continues to be inverted. The level of inversion began the Q at -24 bp and closed the Q at an all-time inverted level of -48 bp. Prior to this Q end, the previous maximum inversion was -46 bp (May 2023).
- The Municipal Fixed Income Strategy was impacted by the rise in yields [decline in bond prices] in the 1st Q. Price cuts / yield increases were steady throughout the Q as a shift in certain key economic metrics confirmed the FEDs expectation of higher (rates) for longer. Municipal market credit and fundamentals remained encouraging / resilient during the Q. The Municipal Strategy gross return for the 1st Q was -0.3% and net return was -0.4% while the Bloomberg 5 Yr Muni Index returned a negative -0.4%. We have opportunistically added both short-term and long-term bonds to capture the benefits of a barbelled (maturity) approach. The strategy continues to be anchored in high-quality essential revenue and GO credits.
- The strategy's top three municipal sectors are General Obligation, School District, and Utilities.
- The Strategy finished the Q with a duration-to-worst of 3.6 and a duration-to-maturity of 5.2. The Bloomberg 5 Yr Muni Index duration-to-worst was 3.6 at Q end.
- Average portfolio quality remained steady Q / Q at AA-.
- The strategy's YTM increased during the Q from 3.26% on December 31st, 2023 to 3.50% at Q end. The strategy's YTW increased during the Q from 2.74% on December 31st, 2023 to 3.06% at Q end.

Opportunity Fixed Income Strategy:

- The Opportunity Fixed Income Strategy outperformed the Bloomberg Intermediate Gov't Credit Index during the 1st Q, with a gross return of 1.9% and a net return of 1.7% versus the index's negative return of -0.2%. Our outperformance during the Q was a result of our shorter duration structure in a rising interest rate environment, tightening corporate credit spreads, coupled with a focus on the sweet spot of the yield curve.
- HY rates (as measured by the iBoxx HY Index) increased from 7.58% on December 31st, 2023 to 7.77% at Q end, a nominal increase of 19 bp.
- HY spreads tightened during the Q, decreasing from 373 bp on December 31st, 2023 to 355 bp on March 31st, 2024, a tightening move of 18 bp.

- IG spreads, as measured by the 3-5 Yr BBB rated FactSet Index, tightened by 18 bp during the Q, decreasing from 134 bp to 116 bp.
- The strategy's YTM decreased from 6.58% on December 31st, 2023 to 6.32% at Q end.
- The strategy's top three economic sectors are Consumer Discretionary, Financials, and Industrial.
- The strategy's duration held constant at 2.7 Yrs during the Q.
- Average portfolio quality held constant Q / Q at BB+; additionally, IG exposure at Q end was 48% versus 53% at the end of the 4th Q.
- With the yield curve remaining inverted and credit spreads at tight levels, we continue to utilize ultra-short UST as both a liquidity sleeve (opportunistic cash) and a vehicle to generate return in addition to short duration corporate bonds – both HY and IG.
- We remain defensively positioned and have ample flexibility to add value as credit and interest rate opportunities arise – nearly 38% of the strategy holdings mature in the next 12 months and almost 75% of the strategy holdings mature in the coming 36 months.

Enhanced Cash Strategy:

- Ultra-short-term interest rates remain compelling as the yield on the 6 Mo UST increased 6 bp during the Q, rising from 5.26% to 5.32%. The 1 Yr UST finished the Q yielding 5.02%, moving 24 bp higher.
- Due to the UST yield curve inversion, ultra-short-term bonds continue to offer the highest yields across the curve.
- IG spreads, as measured by the yield of the ICE BofA 0-1 Yr A-AAA U.S. Corp Index relative to the ICE BofA 0-1 Yr UST Index, tightened during the Q, decreasing from 52 bp to 37 bp. During the Q, short-term UST yields increased, while short-term corporate yields were relatively flat, resulting in tightened spreads.
- Average portfolio quality declined slightly during the Q, decreasing from AA- on December 31st, 2023 to A+ at Q end.
- Average duration remained steady Q/Q at 0.21 Yrs.
- The strategy's YTM increased from 5.22% on December 31st, 2023 to 5.59% at Q end.
- The Enhanced Cash Strategy performed well during the Q, with a gross return of 1.3% and net return of 1.1%, outperforming the ICE BofA 0-1 Yr UST Index return of 1.1%.
- The FED left interest rates unchanged in the 1st Q as it assessed stubborn inflation, which presents further uncertainty around the timing of future rate cuts. Given the level of FED uncertainty, we expect ultra-short rates to remain elevated for the immediate future, offering meaningful opportunities for Enhanced Cash Strategy investors.

Separately Managed Account Strategies:

Taxable: Carret's Taxable Bond Strategy seeks to achieve above-average total returns with an emphasis on preservation of capital and consistent cash flow. We utilize investment grade fixed income securities and shift across bond sectors based on changing market conditions. Our intermediate duration approach (3 - 7 Yrs) seeks to identify the sweet spot on the yield curve and structure maturities accordingly. Active management of the strategy includes forecasting the long-term direction of interest rates and credit spreads. Our fundamental credit research and active portfolio management process has provided consistent and attractive risk adjusted returns.

Municipal: Carret's Municipal Bond Strategy seeks to maximize tax efficiency through opportunistic portfolio management while preserving principal through practical portfolio structuring and fundamental credit analysis. We actively manage investment grade portfolios with a diversified blend of issuers, sectors, and maturities aimed at delivering consistent, risk adjusted returns with an emphasis on tax-efficient cash flows. Carret uses a value approach when buying and selling bonds. This method recognizes the inefficiencies of the municipal marketplace and enables clients to benefit from our expertise and market knowledge.
Our high-quality, intermediate-maturity bias is designed to balance preservation of principal, total return, and tax-exempt cash flows. We opportunistically add value through credit research, bond structuring, and yield curve

positioning. Our municipal bond portfolios are actively managed as either state-specific or state-focused (general market in approach, otherwise). Essential service revenue bonds and high-quality general obligation bonds make up the framework of our municipal bond portfolio strategy. The strategy's primary focus is on high-quality, investment-grade municipal bonds with an intermediate duration of approach (3 - 7 Yrs), which enables us to utilize bonds in the 2 - 12 Yr maturity range.

Opportunity: Carret's Fixed-Income Opportunity Strategies seeks to generate a higher level of current income with a secondary focus on long term capital appreciation. We utilize various types of higher yielding fixed income securities and shift among types based on changing market conditions. We actively manage risk, respond quickly to market movements, and utilize interest rate hedges to limit duration risk. We focus on high quality high yield and low-quality investment grade bonds, and couple them with preferreds and broken convertibles to try to generate above average levels of cash flow.

Our intermediate duration approach (2 - 10 Yrs) seeks to identify the sweet spot on the yield curve and structure maturities, accordingly. Active management of the strategy includes forecasting the long-term direction of interest rates and credit spreads. Our fundamental credit research and active portfolio management process has provided consistent and attractive risk adjusted returns.

Leveraged Opportunity: Carret's Fixed Income Leveraged Opportunity Strategy seeks to utilize low cost leverage and favorably negotiated release rates to potentially enhance our existing Opportunity Strategy returns. We actively manage leverage to augment opportunities within the high yield and investment-grade sectors of the fixed income market.

Enhanced Cash: Carret's Enhanced Cash Strategy seeks to provide excess returns above those offered by cash equivalents, while focusing on capital preservation and liquidity. The strategy invests in ultra-short-duration investment grade bonds – those with a maximum maturity of 12 months, and a typical duration of less than 6 months.

Our custom, tailored approach opportunistically utilizes a thoughtful mix of Investment Grade Corporate debt, U.S. Treasury and Agency securities, as well as taxable and tax-exempt Municipal bonds to enhance overall after-tax returns.

Mutual Fund Strategy:

Kansas Tax-Exempt: The Carret Kansas Tax-Exempt Bond Fund seeks to preserve capital while producing current income that is exempt from both Federal and Kansas state taxes. The Fund seeks to generate monthly income and principally invests in investment-grade bonds of intermediate maturity.

For more complete information on the Carret Kansas Tax Exempt Bond Fund, you can obtain a prospectus containing complete information for the Funds by calling 888.266.8787 or by downloading it from Carret's web site. You should consider the Fund's investment objectives, risks, charges, and expenses carefully before you invest or send money. Information about these and other important subjects is in the Funds' prospectus. The prospectus and, if available, the summary prospectus, should be read carefully before investing. Shares of the Carret Kansas Tax Exempt Bond Fund are distributed by ALPS Distributors, Inc., which is not affiliated with Carret Asset Management, LLC.

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