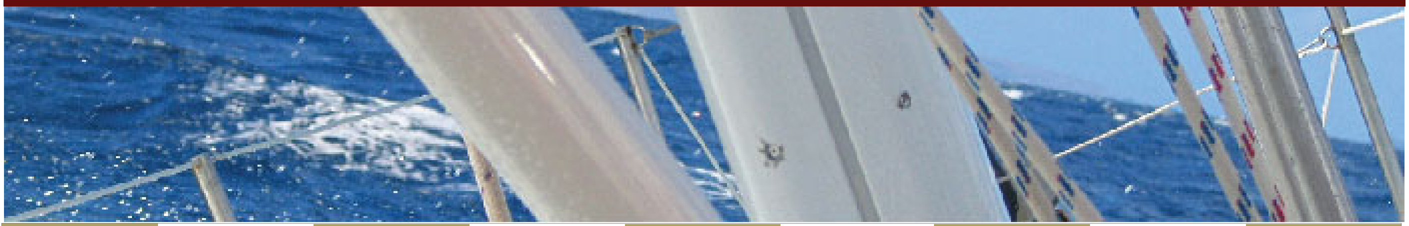
CARRET
Asset Management

January 2024

Carret Credit Insights



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Firm AUM

$3.116 Billion

Firm Fixed Income AUM

$2.279 Billion

What's in Store for 24?

We were presenting our market outlook to a group in Kansas in the final week of October. Our presentation was solid - full of interesting, colorful charts on economic growth, unemployment, inflation, monetary policy, credit spreads, etc. – exciting stuff - when a simple, but profound question was posed, "**when will investors make money again in fixed income"?** Our simple response, **"when interest rates stop going up".**

After two negative years of fixed income returns caused by the FED's aggressive monetary tightening commencing in March of 2022 and lasting until July of 2023, bond investors were fatigued and simply wanted to know when *normalcy* would return and when they would make money.

Heading into that October meeting, our fixed income strategies were at a break-even to slightly positive return for the year. The 10 Yr U.S. Treasury (UST) stood at 4.86% after peaking a few days earlier at just over 5%. Not only did rates stop going up in late October, but bond investors received a huge holiday gift in the form of a FED pivot, sending 10 Yr UST rates down 98bp to 3.88% by year-end. This was one of the most dynamic rate declines in history, sending bond prices higher. Equity markets loved the pivot as well. Stocks rose on expectations of lower interest rates; in turn, credit spreads tightened adding to corporate bond performance in November and December.

Key Market Levels	12.31.23	12.31.22	12.31.21
Fed Funds Rate	5.25% – 5.50%	4.25% – 4.50%	0.00% – 0.25%
3 Month U.S. T-Bill	5.35%	4.41%	0.05%
10 Yr U.S. Treasury Bond	3.88%	3.88%	1.51%
5 Yr AAA Municipal Bond	2.28%	2.52%	0.59%
5 Yr A Corporate Bond	4.41%	5.22%	1.86%

Source: Municipal Market Data (MMD) and FactSet

After a very solid 2023, the next question becomes… what's in store for 24? On the surface, we remain in a complex risk environment as the war in Ukraine and Russia lingers, the conflict in the Middle East could expand, oil prices create uncertainty, global inflation remains stubborn, a recession in Europe looks inevitable, China's economic growth is slowing, and we all await what is sure to be a fascinating election in November.

Given these risks, it seems odd for us to state that 2024 will be a return to *normalcy*. However, with 5 Yr UST rates at roughly 4.0% remaining near 15 Yr highs and credit spreads adding another 100 – 350 bp of incremental yield, fixed income assets are compelling. Thus, we see a conservative FED, a soft landing, and a pretty good year for bond investors.

Taxable Bond Market Update

In the 4th Q of 2023, the U.S. corporate bond market saw interest rates decline as market yields fell and spreads tightened on the back of investor expectations of future FED rate cuts. Investors rushed to extend portfolio durations to lock in higher rates near what was perceived as a peak in yields; the 10 Yr UST touched 5.0% for the first time since 2007 – a 16 Yr high.

Carret Credit Insights

Falling rates allowed issuers to borrow at lower costs throughout the Q. In the high yield (HY) market, companies issued debt with shorter average maturities than over the past decade – an attempt to wait out the FED funds rate increases for a future pivot to lower rates.

Investors are navigating a delicate balance between the search for yield and concerns about an expected slowing economy. Corporate bankruptcies remained elevated throughout 2023 and accelerated in the 2H while credit downgrades outpaced upgrades across the HY market. The "debt maturity wall" remains a popular topic to discuss as small cap companies have maturities concentrated in the 3 to 5 Yr range. Despite these concerns, investors continue to invest money into both investment-grade (IG) and HY U.S. corporate bonds at the most significant pace in years. We anticipate that declining inflation, expected FED rate cuts, and solid earnings will provide confidence, stability, and attractive returns for taxable bond investors in 2024.

Municipal Bond Market Update

At the beginning of the Q, the municipal market faced strong headwinds with yields reaching 15 Yr highs following the upward trend in UST yields. Negative factors, such as increased supply and a lack of reinvestment capital, added pressure to municipal performance, casting doubt on the possibility of a recovery in 2023 following a challenging 2022. Despite these obstacles, municipal bonds made a remarkable comeback in November and December, delivering historic performance as domestic yields dropped significantly and investors deployed cash before year-end. November generated the best monthly return in over 40 Yrs. The 5 Yr Bloomberg Municipal Bond Index recorded a return of 5.2% for the three months ending 2023.

Heading into year-end, municipal credit quality continued to demonstrate strength, showing a positive trend with ratings upgrades surpassing downgrades by a large margin. We acknowledge that adjustments may be necessary for some municipalities to adapt should the economy soften and federal support diminish. The upcoming budget season will unveil the states and major issuers that may need corrective measures to ensure balanced budgets. Despite these considerations, we maintain confidence that reserves are generally sufficient for municipalities to address any potential imbalances that may arise in 2024.

Data as of December 31, 2023	Taxable Fixed Income	Municipal Fixed Income	Opportunity Fixed Income	Enhanced Cash
Maturity	3.9	6.2	2.9	0.2
Duration / Dur to Worst	3.5	5.1 / 3.5	2.7	0.2
YTM / YTW	4.89%	3.26% / 2.74%	6.58%	5.22% [3]
Taxable Equiv YTM/YTW		6.31% / 5.30% [1]		5.60% [1,2,3]
Coupon	3.84%	4.46%	5.30%	2.09%
Credit Rating	A-	AA	BB+	AA-

Sector Allocations:				
U.S. Treasury	11%	2%	3%	48%
Government Agency	8%			8%
Corporate - Inv Grade	73%	2%	41%	27%
Corporate - High Yield			46%	
Preferreds	6%		8%	
Convertible			1%	
Municipal		94%		4%
Cash	1%	2%	1%	13%

[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

U.S. Treasury Yields

- During the 4th Q, the yield on the 6 Month UST decreased 29 bp from 5.55% to 5.26%, while the YTD increase was 60 bp having started the year at 4.66%. Ultra-short rates increased during the year as the FED tightened monetary policy via the FED Funds Rate; however, rates declined in the 4th Q as investors' expectations of rate cuts in 2024 materialize.
- During the 4th Q, the yield on the 5 Yr UST decreased a material 76 bp from 4.61% to 3.85% while the YTD decrease was a nominal 15 bp having started the year at 4.00%. Intermediate rates were volatile for the year, but settled at levels close to where they began 2023 as investors initially reacted to FED tightening and then adjusted to rate cut expectations in 2024.

Taxable Fixed Income Strategy:

- The Taxable Fixed Income Strategy underperformed the Bloomberg Intermediate Gov't Credit Index during the Q with a gross return of 4.3% and net return of 4.2% versus the index's return of 4.6%. YTD, the strategy outperformed the index with a gross return of 6.6% and net return of 6.2% versus the index's return of 5.3%.
- The IG corporate bond yield curve remained inverted during the 4th Q.
- IG spreads, as measured by the 3-5 Yr A rated FactSet Index, tightened by 14 bp during the Q, decreasing from 124 bp to 110 bp. Over the year, IG spreads tightened by 11 bp from 121 bp to 110 bp.
- IG spreads, as measured by the 3-5 Yr BBB rated FactSet Index, tightened by 24 bp during the Q, decreasing from 158 bp to 134 bp. Over the year, IG spreads tightened by 32 bp from 166 bp to 134 bp.
- 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 fell alongside UST during the Q. Duration extension during the year from 3.0 to 3.5 contributed to attractive performance. We remain patient in anticipation of an opportunity to extend duration further.
- Average portfolio quality remained steady Q / Q at A-.
- The strategy's Yield to Maturity (YTM) decreased during the Q from 5.72% on September 30th to 4.89% at Q end.
- The strategy's top three economic sectors are Financials, Utilities, and Communication Services.
- 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 year tighter than where they began in 2023.
- The strategy's 6% 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% (down from 75% at the start of the Q) to corporate bonds; however, government agency bond valuations are growing more attractive, boasting attractive spreads above UST. During the Q, exposure to UST decreased 1% to a total of 11% and U.S. Agencies increased from 5% to an 8% allocation.
- During 2024, the strategy aims to capitalize upon the reinvestment of maturities, calls, swaps, and coupon cash flows while maintaining patience in the face of a falling yield environment and tighter credit spreads. Our emphasis on credit research allows the strategy to boast conviction in the holdings over a long-term investment horizon – we do not chase yield!

Municipal Fixed Income Strategy:

- Representative AAA rated 5 Yr Municipal Bond yields fell by 118 bp during the 4th Q of 2023 driving prices higher and generating strong returns. The index's YTM began the Q at 3.40%, reached a peak of 3.56% on October 30th, and closed the Q at 2.22%. For the Q, 5 Yr UST yields fell by 76 bp.

- The 2Yr-to-10Yr municipal curve spread continues to be inverted. The level of inversion began the quarter at -21 bp and peaked at -11 bp on October 30th before returning to -23 bp of inversion at quarter-end. The greatest point of inversion for the year occurred in May 2023 at -46 bp.
- The Municipal Fixed Income Strategy was impacted by the decline in yields (rise in bond prices) in the 4th Q. Price increases / decline in yields accelerated in November and December as a shift in certain key economic metrics pointed to an anticipated FED pivot.
- Municipal market credit and fundamentals remained encouraging / resilient during the Q.
- The Municipal Strategy gross return for the 4th Q was 5.0% and the net return was 4.9% while the Bloomberg 5 Yr Muni Index returned 5.2%. YTD, the strategy performed in line with the index with a gross return of 4.2% and net return of 3.8% versus the index's return of 4.3%.
- The Strategy's duration-to-worst is 3.5 while the duration-to-maturity is 5.1 at Q-end. The Bloomberg 5 Yr Muni Index duration is 3.6 Yrs. We have taken a near neutral duration stance while opportunistically adding longer-term bonds. We continue to see inversion-driven opportunities in both shorter-term and longer-term segments of the yield curve.
- Average portfolio quality continues to be AA. The strategy continues to be anchored in high-quality essential revenue and GO credits.
- Following two consecutive years of double-digit gains, General Fund revenues, according to the National Association of Budget Officers, slowed in fiscal year 2023, posting modest growth of 0.9%. Even with the softening revenue inflows, overall revenue collections outpaced key estimates and 47 states reported tax collections above forecast. Please note that most 2023 budgets were drafted during the spring of 2022 (for a July 1 fiscal year start) when market indicators were pointing to a potential recession. Forward looking spending plans project further revenue softness in 2024.
- The 4th Q began with negative fund flows in October as higher yields generated negative returns and, subsequently, outflows accelerated as the month progressed. Outflows did moderate and turn positive as the bond rally took hold in November. December did see a trickle of outflows that were generally attributed to year-end tax loss harvesting. Overall, the 4th Q generated net outflows of $5.4 billion. This is a more favorable outcome when compared to the $30 billion in outflows experienced during the 4th Q of 2022. The net negative flows for the year stem primarily from Mutual Funds as both municipal focused ETFs and SMAs saw positive flows in 2023.
- 4th Q new issuance was $100 billion which is $25 billion ahead of 4th Q 2022. Overall new issuance for 2023 is $378 billion which is the lightest amount since 2018 and is running 7% lower than the 10 Yr average issuance. Taxable Muni new issuance is down significantly at only $37 billion compared to the last 3 Yr average of $107 billion. New project financing accounted for nearly 80% of total new issuance.
- 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.

Opportunity Fixed Income Strategy:

- The Opportunity Fixed Income Strategy underperformed the Bloomberg Intermediate Gov't Credit Index during the 4th Q, with a gross return of 3.6% and a net return of 3.5% versus the index's return of 4.6%. Our underperformance during the Q was primarily a result of our shorter duration structure in a falling rate environment. However, YTD the strategy outperformed the index with a gross return of 7.3% and 6.7% net versus the index's return of 5.3%.
- HY rates (as measured by the iBoxx HY Index) decreased from 8.91% on September 30th to 7.58% on December 31st, a material decrease of 133 bp.
- HY spreads tightened during the Q, decreasing from 430 bp on September 30th to 373 bp at year-end, a tightening move of 57 bp.
- IG spreads, as measured by the 3-5 Yr BBB rated FactSet Index, tightened by 24 bp during the Q, decreasing from 158 bp to 134 bp.

- The strategy's YTM decreased from 7.12% on September 30th to 6.58% at year-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 53% versus 45% at the end of the 3rd Q. With HY spreads in the 370 bp range and interest rates trending lower during the Q, we have increased our exposure to IG credit and patiently await HY volatility and spread widening. While corporate bankruptcies have been rising since the middle of 2023, we remain void of the noise in the lower quality sectors of the HY marketplace.
- 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.
- We remain defensively positioned and have ample flexibility to add value as credit and interest rate opportunities arise – nearly 40% of the strategy holdings mature in the next 12 months and almost 80% of the strategy holdings mature in the coming 36 months.

Enhanced Cash Strategy:

- Ultra-short-term interest rates remain elevated despite the yield on the 6 Mo UST decreasing 29 bp from 5.55% to 5.26% during the Q. Despite declines in the 4th Q, the 6 Mo UST increased 60 bp YTD.
- While some normalization of the front-end of the curve occurred during the 4th Q, ultra-short-term bonds still offer the highest yields across the inverted curve.
- IG spreads, as measured by the ICE BofA 0-1 Yr A-AAA US Corp Index, tightened during the Q, decreasing from 58 bp to 34 bp. Tightening IG spreads were driven mostly by an increasingly dovish tone from the FED as the likelihood of a soft-landing increased.
- Average portfolio quality remained steady Q/Q at AA-
- Duration decreased from 0.27 Yrs to 0.21 Yrs, driven primarily by the concentration of value in the 1–3 month segment of the yield curve, compared to the end of the 3rd Q, where value was more evenly distributed across ultra-short-term bonds.
- The strategy's YTM decreased from 5.54% on September 30th to 5.22% at year-end.
- The Enhanced Cash Strategy performed well during the 4th Q, with a gross and net return of 1.4%, with the ICE BofA 0-1 Yr UST Index rising 1.5% over the same period. YTD, the strategy had a gross return of 5.0% and a net return of 4.7% compared to 5.1% for the index.
- The FED left interest rates unchanged in the 4th Q as it assesses lingering inflation and strong labor markets, presenting uncertainty around the timing of future rate cuts. Given this 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.

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