PPM AMERICA

QUARTERLY INSIGHTS – OCTOBER 2024

WEIGHING WHAT MATTERS

VISUALIZING CHINA'S ECONOMIC ISSUES
INFOGRAPHIC

TACTICAL FOCUS AMID VOLATILITY
INVESTMENT GRADE

POSITIVE CREDIT CONDITIONS
HIGH YIELD

A LIFT FROM LOWER RATES
COMMERCIAL REAL ESTATE

Letter From The CIO

As we head into the home stretch of 2024, investors appear focused on a handful of near-term factors and are trying to discern their impact on financial markets.[1] The conflict in the Middle East, the ongoing war in Ukraine, the outcome of the US Presidential election and the progression of the Federal Reserve's (Fed) easing cycle – these are some of the events that present risks but also opportunities for investors. In this newsletter, we try to cut through the noise and determine how some of these events are likely to affect investment outcomes for our clients.

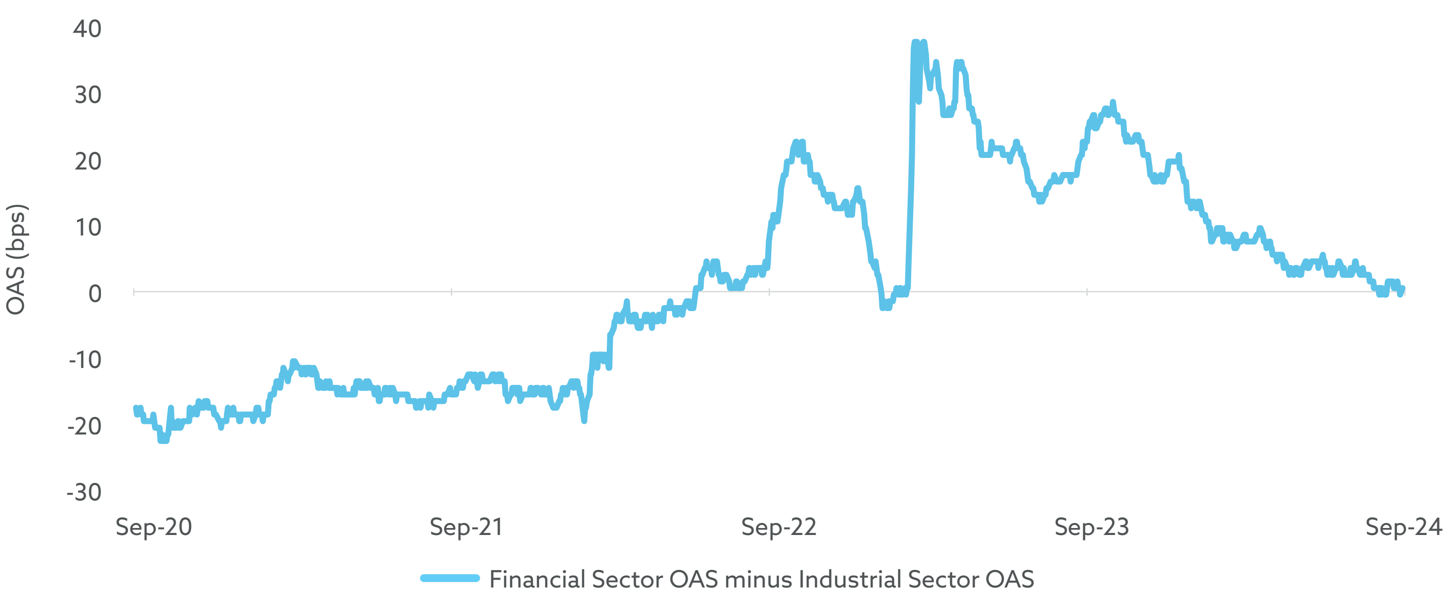
Given its renewed intensity and dominance of the news cycle, the conflict in the Middle East and its potential to result in negative market outcomes may be top-of-mind for many investors. While the trajectory and eventual outcome of the conflict are difficult to predict, our analysis of the history of prior conflicts, both in the region and globally, suggests that markets have generally absorbed geopolitical turmoil quite well. Although the initial reaction may be negative, markets typically revert to having the prevalent economic outlook drive performance. As a result, we believe that any market sell-off solely attributable to the Middle East conflict represents a buying opportunity, all other things being equal. Along similar lines, we believe the same conclusion equally applies to any sell-off driven by the war in Ukraine.

The US presidential election is another issue of pressing importance for investors, especially given that it is less than two weeks away. In previous letters, we opined on how the results of previous presidential elections have impacted US equity and bond markets. Since 1960, stocks have reacted positively to a Republican win six times from election night to year-end and negatively twice; for Democrats, those splits are five and three.[2] Although a small sample size, history suggests that the stock market does not prefer one party over the other but rather reflects economic circumstances at the time of the election.

Regardless of the outcome, we view this year's election as a clearing event that will remove an element of uncertainty from the markets. This may open the door for businesses that have been putting off investments and hiring to begin to do so, which, when combined with lower rates, may likely lead to a more constructive economic and market outlook in 2025. Consistent with this view, we note that historically US bond markets have rallied the year after presidential elections, a pattern that would provide an additional impetus to bond returns in 2025 if repeated.[3]

On the subject of lower rates, the FOMC mildly surprised markets by delivering an initial 50-bp rate cut instead of a more modest 25-bp cut at their September meeting. Following this decision, market participants have been actively debating the pace and magnitude of this new easing cycle with almost every additional data release leading to a repricing of the Fed's reaction function. At PPM, we remain in the higher-for-longer camp and believe that the cutting cycle that just commenced is more likely to be shallow than deep. A shallower trajectory is

SPREAD BETWEEN FINANCIALS AND INDUSTRIALS HAS TURNED NEUTRAL[4]



(1) As of 23 October 2024. Unless otherwise stated, the information presented has been prepared from market observations and other sources believed in good faith to be reliable. Information and opinions expressed by PPM are current as of the date indicated and are subject to change without notice. Past performance is no guarantee of future results. Forward-looking statements are subject to uncertainties that could cause actual developments and results to differ materially from the expectations expressed. (2) J.P. Morgan. Data through 31 December 2020. (3) Morningstar. 2 July 2024. Total returns for the Bloomberg US Credit Index, the ICE BofA US High Yield Index and the Morningstar LSTA US Leveraged Loan Index. (4) ICE Data Services. Daily OAS through 30 September 2024. Spread between the sectors calculated by PPM and does not adjust for duration or other sector-specific metrics.

also more consistent with a constructive outlook on the US economy post the November presidential election. Having said that, as a bottom-up, research-driven fixed income asset manager, we believe that our core competence does not lie in predicting the speed of rate cuts by the Fed. Rather, we intend to generate alpha for our clients by understanding what sectors and individual credits will be most impacted by lower interest rates, regardless of how quickly rates are cut.

So, given our view of the likely outcomes of the events discussed above, how have we positioned our clients' portfolios for the fourth quarter and 2025? In both the investment grade and high yield universes, our aim is to hold core positioning to participate in a rallying market, but with an up-in-quality bias given tight spreads. In doing this, we will continue to leverage our credit analyst team and seek alpha through security and sector selection.

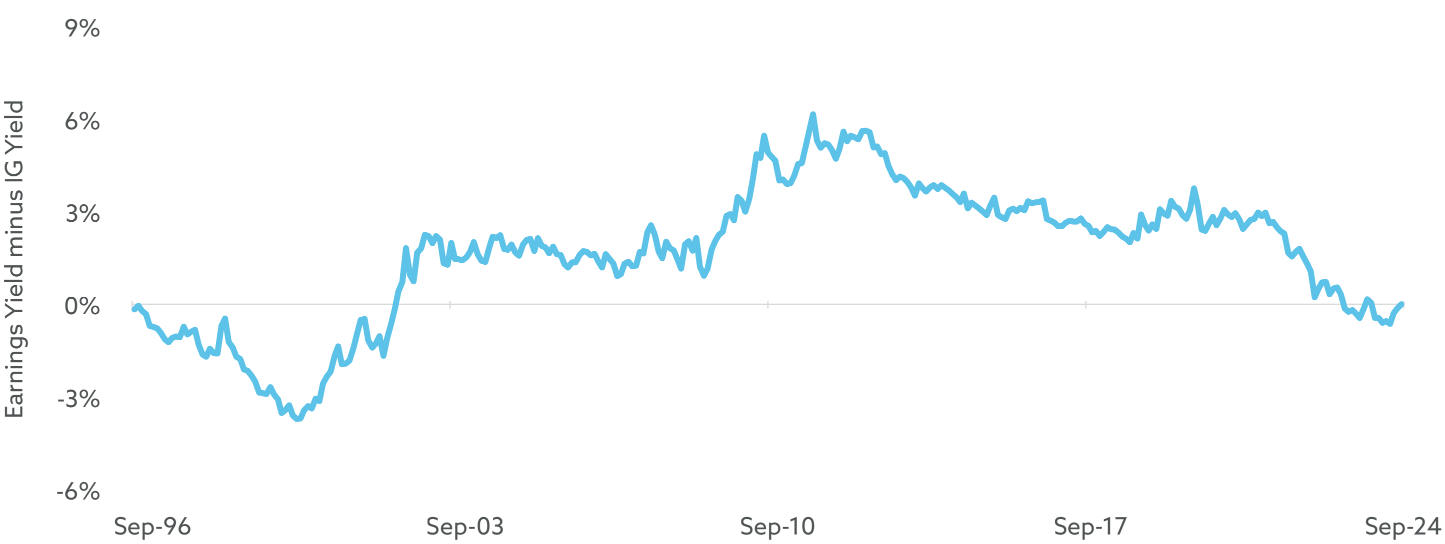
For example, we have looked to rotate out of our overweight positions in the Banking sector as the spread between Financials and Industrials currently sits close to even for the first time since Q3 2022. Up until now, this overweight has benefited portfolios due to the tightening of the spread. We believe Utilities are attractive because the spread between the sector and higher beta sectors is smaller than usual, which reflects potential relative value. Additionally, Utilities may benefit from lower rates, given their significant and recurring financing needs.

There may also be opportunities in real estate, especially for borrowers in non-structurally impaired property types who may benefit from lower rates. Finally, we are seeing issuance starting to pick up in the investment grade private credit space, which can provide clients with some additional spreads as well as increased covenant protection without sacrificing credit quality.

On a final note, outside of sector- and name-specific opportunities, another factor that is supportive of investors increasing exposure to the fixed income asset class is the attractive yield, relative to the earnings yield in equities (this is the inverse of the P/E ratio). Until recently, the earnings yield on stocks was considerably higher than the yield on investment grade bonds (many S&P 500 companies are investment grade). This largely reflected the Fed's monetary policies and historically low interest rates. However, the situation has reversed and the earnings yield of stocks is now lower than the investment grade yield (4.63% vs. 4.67% as of September 2024), highlighting the potential income available in US fixed income.[5] Our view is that all things being equal, the current equity/bond yield differential indicates a more attractive valuation for fixed income when compared to stocks.

OGECHI NWACHUKWU
Deputy CIO

FIRST NEGATIVE EQUITY PREMIUM SINCE 2002[5]



(5) FactSet. Monthly data through September 2024. Monthly earnings yield of the S&P 500 Index less the yield to worst of the Bloomberg US Credit Index. Earnings yield calculated as the inverse of the P/E ratio.

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INVESTMENT GRADE

The Fed's easing cycle has arrived and, with it, lower Treasury yields and notable total returns for US investment grade. But spreads were already historically tight when the cutting cycle began. Our focus is on maintaining an up-in-quality bias within client portfolios while taking idiosyncratic investment opportunities amid supportive technicals and fundamentals. If factors such as the Fed, US election or geopolitics create volatility, we expect to be opportunistic.

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HIGH YIELD

The US high yield market saw robust 3rd quarter returns, fueled by a concentrated set of distressed issuers. Credit conditions trended positively – there were more upgrades than downgrades and both the default rate and distress ratio declined. We saw opportunities to swap into sectors with recurring revenue and improving credit profiles, reduce overall exposure in Energy and shift the higher-quality portion of our portfolios from BBs into BBBs.

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COMMERCIAL REAL ESTATE

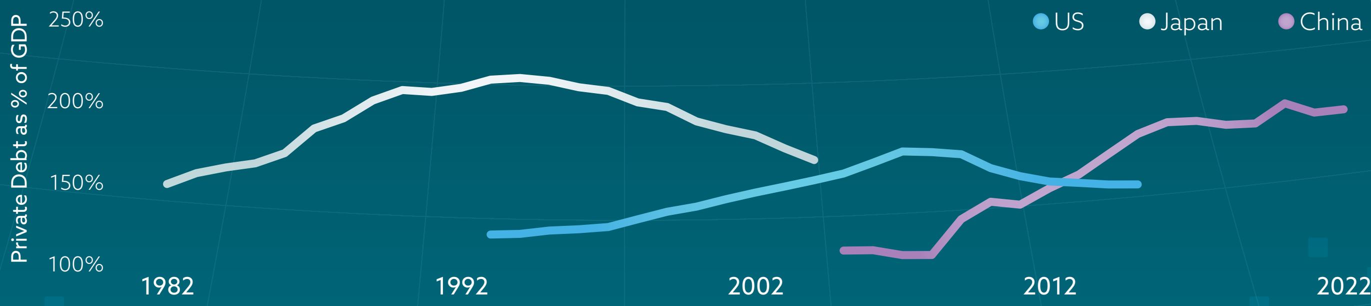
For commercial real estate investors, the onset of the Fed easing cycle should be a boon from a loan refinance and valuation perspective. A lowering in long-term interest rates should result in a healthier financing environment, increasing origination loans and easing refinancing burdens. Fundamentally, we see opportunity for Core Plus lending in the four major property types outside of office. In our view, now could be a great time to invest as quality opportunities may dwindle as interest rates decrease, negative headlines become less frequent and more debt capital comes back to the sector.

Visualizing China's Economic Issues

China has announced a series of monetary and fiscal stimulus measures to address its weaker economy. So far, we feel the *tangible* measures announced have focused on monetary/credit conditions, which benefit financial assets but are unlikely to affect necessary household deleveraging. This said, the intention to do more, including fiscal measures, is clearly coming through. We believe additional stimulus that focuses on stabilizing China's property sector and sustainably improving social services has the highest likelihood of working beyond the short term. However, we are not talking about a return in the private sector's appetite to borrow – more like a bottoming.

STRUCTURAL BALANCE SHEET RECESSION[1]

China's private debt-to-GDP has spiked over nearly two decades. There is too much debt, particularly with households, and real estate prices and incomes are making that debt untenable. Countries like Japan and the US experienced similar high leverage periods, where necessary deleveraging can take more than a decade.

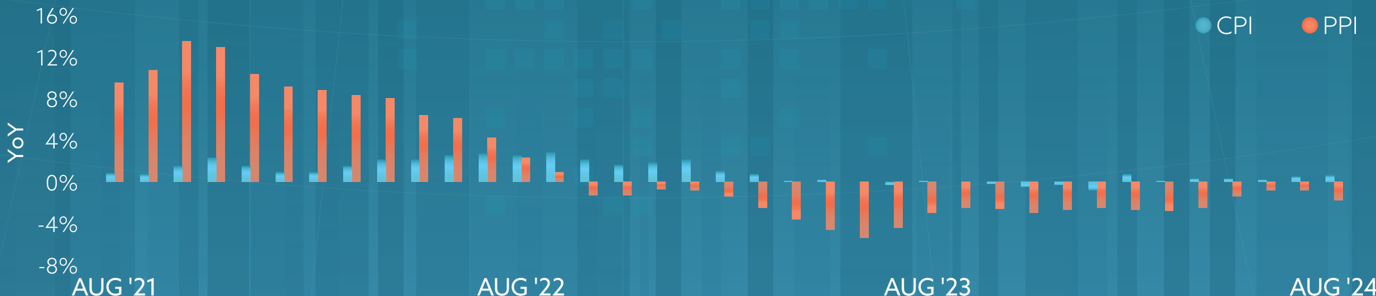


NEGATIVE REAL ESTATE INVESTMENT[2]

The Chinese economy is dealing with a number of headwinds. In addition to weak demographics and a manufactured goods surplus, the real estate sector has transitioned from growth to contraction.

DEFLATION, NOT INFLATION[2]

China is also dealing with the contractionary effects of deflation, whereby lower nominal incomes make the repaying of debts more difficult, requiring additional cuts to spending and, thus, lower growth. Fiscal stimulus could help address this threat.



(1) IMF Global Debt Database (September 2023). As generated on 3 October 2024. Total stock of loans and debt securities issued by households and nonfinancial corporations as a share of GDP. (2) Bloomberg. 1 October 2024.

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KEY TAKEAWAYS

> The Fed's easing cycle has arrived and, with it, lower Treasury yields and notable total returns for US investment grade; but spreads were already historically tight when the cutting cycle began

> Our focus is on maintaining an up-in-quality bias within client portfolios while taking idiosyncratic investment opportunities amid supportive technicals and fundamentals

> If factors such as the Fed, US election or geopolitics create volatility, we expect to be opportunistic

A Treasury rally drove notable total returns in US investment grade in Q3 2024, with the Bloomberg US Credit Index (Index) surging 5.71%.[1] Spreads played a part too, tightening 4 bps over the quarter to 84 bps.

The market drove Treasury yields lower in anticipation of the Fed's easing cycle. If the Fed follows through with additional cuts, Treasury yields could continue to move lower and credit total returns could continue higher. There are no guarantees around Fed rate cuts, however, and we would note Treasury yields are higher in October to-date.

The market also tightened spreads in anticipation of the Fed, meaning they were already trading at historically tight levels when the cutting cycle began. We reduced risk in Q3 2024 as a result, preferring to keep client portfolios up-in-quality with an eye on being tactical. Risks have risen and could induce volatility, not just around Fed execution but the upcoming US election and geopolitical strife.

TECHNICAL, FUNDAMENTAL TAILWINDS

Strong technicals continue to support tight valuations. Investment grade experienced its seventh consecutive quarter of inflows ($68B), which was even larger than Q3 2023 ($30B).[2] Gross corporate issuance totaled $362B, considerably more than the $258B issued in Q3 2023. We believe companies will continue to issue so long as demand remains for investment grade corporate bonds.

Fundamentals have also been supporting valuations. Leverage levels are elevated, but strong earnings have been an offset. S&P 500 companies reported 11% earnings growth in the second quarter and are projected to show growth of at least 4% in the third quarter.[3] Margins have held up better than expected (12% in Q2 and an expected 12% in Q3). What's more, the fourth quarter is currently projected to show earnings growth of 15%.

MOVES AT THE MARGIN

Our client portfolios have maintained their up-in-quality bias, given tight spreads and rising risks. We continued to make positioning moves at the margin in the third quarter. For instance, we reduced Energy from overweight to equal weight across client portfolios on oil imbalance concerns. We also maintained or even added to ABS positioning, as the asset class is trading cheap to certain front-end corporate bonds.

TREASURY SUPPLY

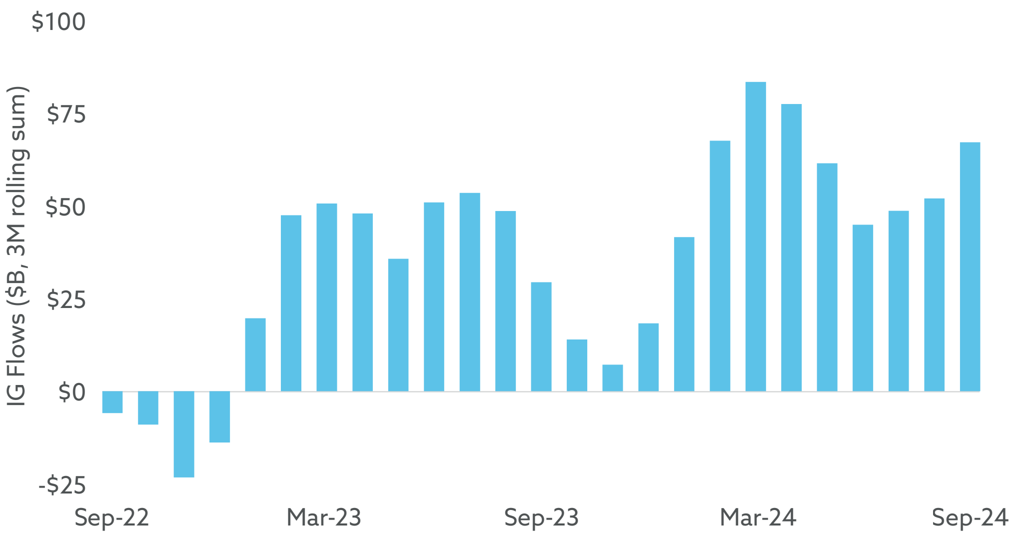
While our focus is on relative value and producing excess returns for our clients, an upcoming item of importance is the US Treasury refunding announcements. Whether in the fourth quarter or later in the first quarter of 2025, there is the potential for the Treasury to not just increase the sizes of its auctions, but to move funding out on the curve. This has the potential to impact longer-term Treasury yields and would have total return implications.

(1) Unless indicated, data sourced from Barclays. 1 October 2024. (2) Morningstar. Based on aggregated monthly flows for the US OE Corporate Bond, Intermediate Core Bond, Intermediate Core-Plus Bond, Long-Term Bond, Short-Term Bond and Ultrashort Bond categories (including ETFs) through 30 September 2024. (3) FactSet. Earnings Insight. 4 October 2024.

BBB CREDITS TRADING HISTORICALLY TIGHT[4]

As 2024 has progressed, our client portfolios have moved up-in-quality given tightening spreads and rising risks (US election, geopolitics, etc.). The overall move tighter in spreads has been led by the BBB segment – a trend that began in late 2022 – and it is now trading historically tight to AAA-A bonds. As a result, we have relied on our strength in security selection to rotate out of BBBs and into higher-rated bonds. In addition to the potential benefits amid any market volatility (spread widening is typically led by lower-rated bonds), such positioning also allows us the optionality to tactically shift into risk.

STILL ELEVATED YIELDS DRIVING CONTINUED INVESTMENT GRADE DEMAND[5]



Investment grade experienced its seventh consecutive quarter of inflows ($68B) in Q3 2024. Historically high yields have driven investors into the asset class. Even as yields come off of their highs – the Index yield to worst has been trending lower since May in anticipation of the Fed's easing cycle – we expect them to remain higher than the post-GFC period. Both the easing cycle and relatively higher yields should drive continued inflows, providing a technical tailwind that could help offset already tight valuations.

(4) FactSet. Daily data for rating segments in the Bloomberg US Credit Index through 4 October 2024. (5) Morningstar. Monthly data through 30 September 2024. Aggregated flows for the US OE Corporate Bond, Intermediate Core Bond, Intermediate Core-Plus Bond, Long-Term Bond, Short-Term Bond and Ultrashort Bond categories (including ETFs), shown as a 3-month rolling sum.

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KEY TAKEAWAYS

> The US high yield market saw robust 3rd quarter returns, fueled by a concentrated set of distressed issuers

> Credit conditions trended positively – there were more upgrades than downgrades and both the default rate and distress ratio declined

> We saw opportunities to swap into sectors with recurring revenue and improving credit profiles, reduce overall exposure in Energy and shift the higher-quality portion of our portfolios from BBs into BBBs

The high yield market returned an impressive 5.28% in Q3 2024, underpinned by returns from the CCC & Lower segment of 11.55%.[1] CCC returns were driven by a handful of large, stressed issuers in the Technology, Media and Telecom sectors. US Treasuries rallied on weaker employment trends, benign inflation and the beginning of the Fed cutting cycle. Economic growth slowed but remained comfortably positive, reinforcing the soft-landing narrative in the market.

POSITIVE FUNDAMENTAL, TECHNICAL TRENDS

Fundamental indicators are trending positively. The upgrade/downgrade ratio has shifted to net upgrades on a trailing three-month basis for the first time since Q4 2023 (see next page).[2] The distress ratio declined to 5.12% from 7.33% during the quarter, and the default rate declined slightly to 2.45% from 2.72%.[3] The distress ratio is pricing in a benign default environment.

Technicals remained strong in Q3 2024. The asset class experienced a fourth straight quarter of inflows ($14B), up significantly from the previous quarter ($3B).[4] High yield companies issued $74B in bonds during the quarter, a modest decrease from Q2 2024 ($78B) but up significantly from Q3 2023 ($40B). Year-to-date issuance has increased 80% to $239B. The elevated level of supply follows easier financial conditions and supports leveraged issuers through better opportunities to refinance.

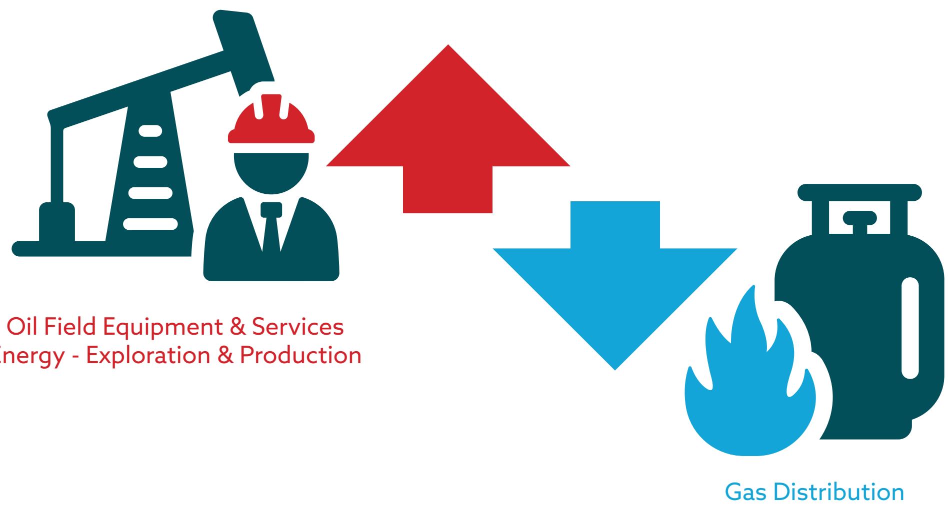
POSITIONING INTO YEAR-END

The strategy increased exposure to the Telecommunications and Utility sectors during Q3 2024, adding to names with recurring revenue and improving credit profiles. Conversely, we reduced exposure to Healthcare and Energy.

The strategy net added BBB exposure, both from rising stars and actively adding several names where we view the value and convexity as more attractive than BBs in high yield. In turn, we reduced BB exposure due to holdings being upgraded from high yield to investment grade and active sales.

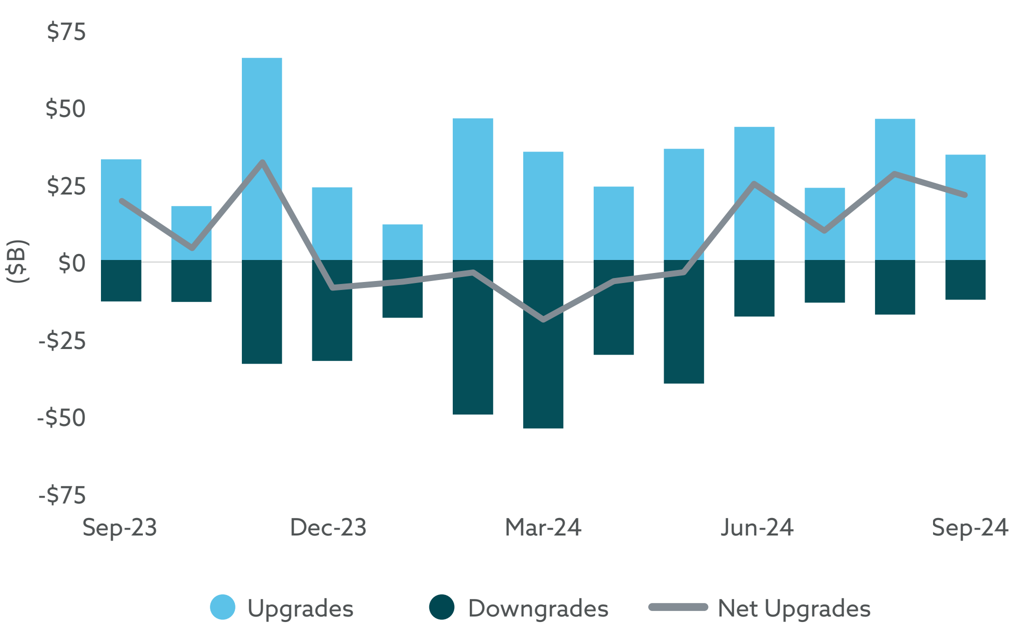
(1) ICE Data Services. 1 October 2024. Total returns for the ICE BofA US High Yield Constrained Index. (2) BofA Global Research. 1 October 2024. (3) Default rate calculated at the issuer level for the last 12 months. Distress defined as bonds with spreads above 1,000 bps on a par basis. (4) Morningstar. Based on monthly flows for the US OE High Yield Bond category (including ETFs) through 30 September 2024.

OIL PRICE SENSITIVITY[5]



Reducing exposure to Energy was a theme across our clients' high yield portfolios in Q3 2024. We cut exposure to commodity-sensitive sub-sectors – Exploration & Production and Oil Field Services – and increased exposure to Gas Distribution, favoring fee-based businesses with lower sensitivity to oil prices.

HIGH YIELD HAS SHIFTED TO NET UPGRADES[6]



The upgrade/downgrade ratio has shifted to net upgrades, specifically over the last four months. The asset class had seen net downgrades for the previous six months (December 2023 through May 2024).

(5) For illustrative purposes only. (6) BofA Global Research. 1 October 2024.

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KEY TAKEAWAYS

> For commercial real estate investors, the onset of the Fed easing cycle should be a boon from a loan refinance and valuation perspective

> Fundamentally, we see opportunity for Core Plus lending in the four major property types outside of office

> In our view, now could be a great time to invest as quality opportunities may dwindle as interest rates decrease, negative headlines become less frequent and more debt capital comes back to the sector

AN EVOLVING MARKET

The onset of the Fed easing cycle and potential future rate cuts should be a boon for CRE from a loan refinance and valuation perspective. As the chart on the next page indicates, we believe valuations have generally bottomed and started to rise over the last three months.

Fundamentally, we see opportunity for Core Plus lending in the four major property types outside of office. Retail, especially strip centers, and hotels show strong occupancy and rent growth.[1] Though industrial and multi-family are hampered by oversupply, we believe those concerns will abate in 2025 as fewer new properties are delivered into the market. Drilling down further, we find multi-family fundamentals to be market specific. Coastal primary markets have held up quite well, but we see increasing vacancy and limited rent growth in the Sunbelt.

As for office, we are seeing signs of slight improvement. A handful of companies such as Amazon are calling for employees to come back to the office full-time, or at least close to full-time. In certain markets, tenants are signing long-term leases for little to no reduction in square footage. Although we believe some markets are at or near a bottom, the continued lack of sales activity does not provide any clarity vis-a-vis office values.

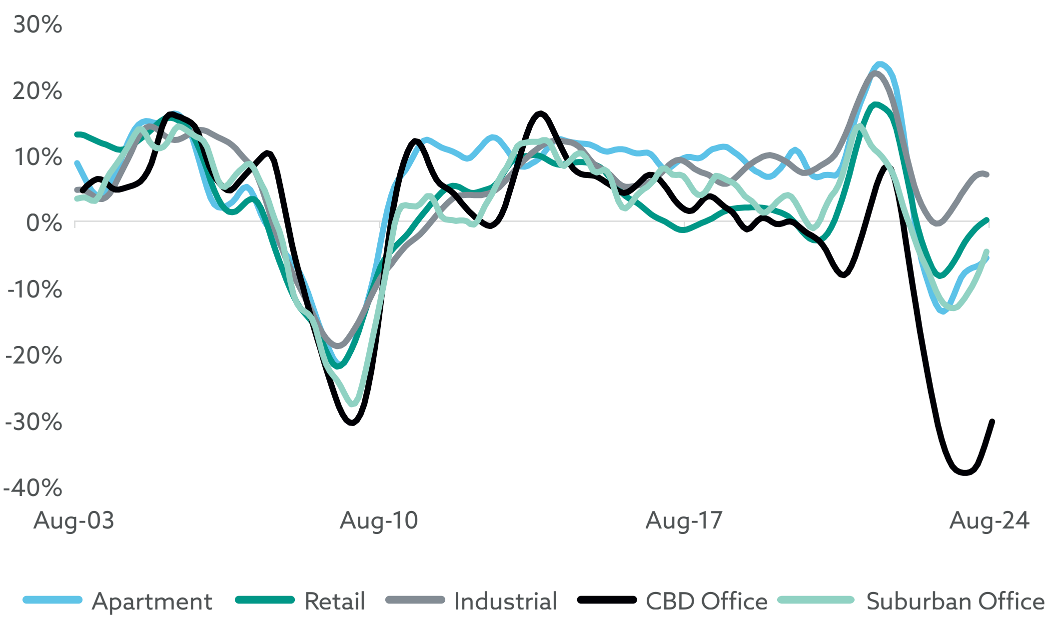
DEFINING THE OPPORTUNITY

With a significant amount of debt coming up for maturity, the refinance situation outside of office is much healthier overall given the viewpoint that rates will move lower. Also, with capitalization rates decreasing, we should see more transactions, which are typically drivers of all kinds of lending opportunities, especially bridge loans.

However, this investment window is not as wide open as it once was. Yes, banks are still on the sideline of the commercial debt market, and negative headlines today are keeping investors conservative with their underwriting and willingness to put money to work. But, in our view, now could be a great time to invest as quality opportunities may dwindle as these doom-and-gloom stories become less frequent and interest rates decrease.

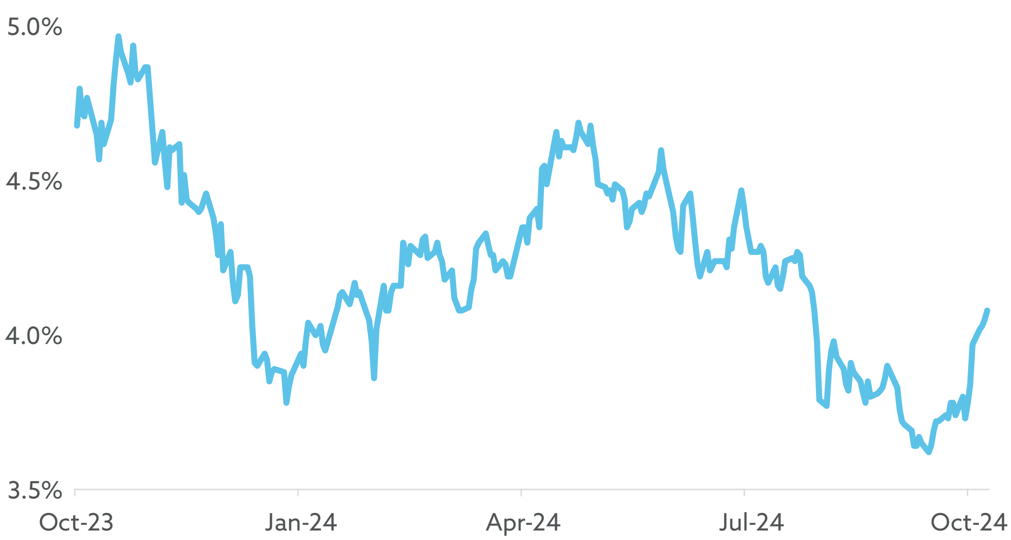
(1) Based on CBRE figures for Q2 2024.

GROWTH MAY BE ON THE REBOUND[2]



Impacted by the rising interest rate environment, year-over-year growth across the major property types either slowed or turned negative over the last two years. However, as the CRE market began to anticipate the Fed cutting rates, prices came off their lows. We anticipate this trend continuing as the impact of lower rates makes its way through the market.

DROP IN INTEREST RATES MAY HELP ORIGINATIONS[3]



Since a year ago, 10-year US Treasury yields have dropped nearly 100 bps to 4.09%. In September, the Fed initiated its easing cycle by lowering the Fed Funds rate 50 bps, with an indication of future cuts on the horizon. A lowering in long-term interest rates should result in a healthier financing environment, increasing origination loans and easing refinancing burdens.

(2) Bloomberg. Year-over-year changes of the RCA CPPI Indices. Monthly data through August 2024. (3) FactSet. Daily 10-year US Treasury yields. 11 October 2024.

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The **ICE BofA US High Yield Constrained Index** provides a measure of below investment grade bonds, is constructed based on the ICE BofA US High Yield Index and imposes a 2% issuer cap. The **ICE BofA US High Yield Index** provides a broad measure of below investment grade, USD-denominated fixed rate corporate debt. It includes corporate bonds with risk exposures to countries that are members of the FX-G10, Western Europe or territories of the US and Western Europe.

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(1) AUM includes committed but unfunded capital for PPM's private equity and commercial real estate businesses.

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