

Brandes Investment Partners
Core Plus Fixed Income Strategy Notes
Third Quarter 2024 (July 1 – September 30, 2024)

The Brandes Core Plus Strategy rose 4.64% net of fees and 4.74% gross of fees, underperforming its benchmark, the Bloomberg U.S. Aggregate Bond Index, which rose 5.20% in the quarter. Year-to-date the strategy has outperformed the benchmark by 0.70%.

Annualized total return as of September 30, 2024	1-year	5-year	10-year
Brandes Core Plus Fixed Income Composite (net)	11.85%	1.40%	2.22%
Brandes Core Plus Fixed Income Composite (gross)	12.15%	1.66%	2.49%
Bloomberg U.S. Aggregate Bond Index	11.57%	0.33%	1.84%

Past performance is not a guarantee of future results. One cannot invest directly in an index. Returns include reinvestment of all dividends and are reduced by any applicable foreign withholding taxes, without provisions for income taxes, if any.

It's hard to believe that we are now three-quarters of the way through 2024. There have already been several plot twists in the bond market saga this year, spurred by political developments, economic data and the impact of the ubiquitous "Fed watchers". And we still have three months left before 2024 is in the history books! With the Fed (Federal Reserve) embarking on a new rate cut cycle and a tight electoral contest still in front of us, the last three months of the year will likely yield more twists and turns.

Yields declined during the third quarter as the Federal Reserve telegraphed the beginning of a rate cut cycle for much of the period and then ultimately delivered a larger than expected 50 basis points cut in the fed funds rate in mid-September. With the rate cut cycle now underway, the next question to focus on is where the neutral fed funds rate will ultimately shake out.

Markets are pricing continued aggressive rate cuts by the Fed, with another 100 basis points in cuts forecast before the end of January. The consensus market forecast is for the fed funds rate to bottom out eventually at 2.75% in early 2026. This strikes us as optimistic.

Financial conditions remain easier than when the Fed began hiking rates in March 2022, equities are near all-time highs, credit spreads are near multi-decade lows, and retail sales and employment remain strong. All of these suggest to us that the fed funds rate may not be as restrictive as many seem to assume. That would suggest to us that the neutral fed funds rate may ultimately settle in at a higher level than the market expects.

For a recent illustration that rate cuts may not proceed in a straight line downwards, consider Brazil. This is far from an apples-to-apples comparison, but Brazil's central bank was ahead of the pack when it came to rate cuts, delivering its first interest rate reduction of this cycle about a year ago. Yet in September the Brazilian central bank reversed course and raised rates again. Brazil's pivot may ultimately not have relevance to the U.S., but it should give food for thought to those who believe the fed funds rate is on a straight-line path downward. To quote a line from early-1990s legendary one hit wonder C+C Music Factory, Brazil's move can likely be filed away as "things that make you go hmmm..."

Credit markets performed well. Yield spreads continued to hover near the lowest levels in several decades, but investors appear to be less concerned with the limited additional compensation current yield spreads offer in favor of attractive total yields – buoyed by U.S. Treasury rates at significantly higher levels than a few years ago. The corporate bond market appears to be *priced for perfection* in our view, placing a premium on credit analysis and security selection going forward.

Portfolio Performance

In the third quarter, the Brandes Core Plus portfolios delivered positive returns but had negative relative performance versus their benchmark, the Bloomberg U.S. Aggregate Bond Index.

Term-structure positioning was a negative factor during the quarter. U.S. Treasury yields declined steadily during the period. Near the end of September 2023, we had moved the duration of the portfolios to 90% of the benchmark's duration and we have maintained that stance since then.

The portfolios' underweight to agency mortgage-backed securities (MBS) detracted from returns as the MBS sector posted positive returns versus U.S. Treasuries.

Additionally, the portfolios' focus on shorter-maturity corporate bonds also detracted from returns. Longer-maturity corporate bonds outperformed shorter maturity corporate bonds by approximately 40 basis points.

The portfolios received positive contributions from corporate bond holdings in telecom (Telecom Italia), banking (US Bank), and media (Univision and Netflix). Select holdings in energy (Range Resources and Transocean) modestly detracted from returns.

Portfolio activity was light during the quarter. We added new positions in pharmaceutical company Organon & Company (4.125% coupon, maturing 4/30/28, rated Ba1/BB) and aerospace company Spirit AeroSystems (9.375% coupon, maturing 11/30/29, rated Ba2/BB-). We also added to our existing position in Goldman Sachs (3.80% coupon, perpetual, 5/10/26 call, rated Ba1/BB+).

Outlook

While the ten-year U.S. Treasury yield declined by over 60 basis points during the quarter, surprising many market participants, that included a rise of approximately 15 basis points from the September Fed meeting through quarter-end.

We've been asked how we can square our modest duration underweight with the Fed apparently being on the precipice of a rate cut cycle. Key factors that we consider in this context include:

- **Shorter-term rates may not fall as far as expected.** The market may be underestimating the ultimate neutral (also known as terminal) fed funds rate. The Fed is guiding, and the market is pricing, a neutral fed funds rate of 2.75%. While we have seen a modest softening in recent economic data, most economic markers are still positive and financial conditions are easier than when the Fed began raising rates in March 2022. This suggests to us that the ultimate neutral fed funds rate may be higher than the market expects, especially if Fed cuts begin to stimulate additional economic activity.
- **Even if they do, there may be limited scope for decline in 10-year Treasury yields.** Shorter-term interest rates have begun to come down after the Fed's 50 basis point cut and will likely continue to move lower with additional cuts. However, the Fed has less direct influence on longer-term interest rates. We examined data over the last 25 years and found that the average slope between 3-month U.S. T-Bills (as a proxy for the fed funds rate) and the 10-year U.S. Treasury when the fed funds rate was at a cycle low (i.e. at a neutral rate) has been 2.25%. That slope has been under 1.00% less than 10% of the time. If we assume market pricing is correct and that the fed funds rate eventually settles at the market's expected level 2.75%, the quarter-end yield of 3.78% for the 10-year U.S. Treasury would produce a slope of just 1.03%, towards the bottom end of the historical range for that statistic. That suggests to us very limited scope for further declines in the 10-year yield, even if the Fed's rate cuts proceed as expected.
- **Services inflation is sticky, and the fiscal situation is appalling.** While headline inflation continues downward towards the Fed's target of 2%, this movement has largely been driven by a steep decline in goods inflation. Goods prices have been negative each month for the past eight months, while services inflation in particular has been sticky and its monthly level has yet to dip below 4.25% this year. The services component comprises about one-third of the inflation measures, suggesting that the last mile of inflation reduction may continue to prove challenging. We discussed the hot mess that is the U.S. fiscal situation last quarter. It is unlikely to get better anytime soon. The markets do not seem to care, however, but at some point, the long dormant bond vigilantes may awake from their slumber and seek to impose some discipline on the fiscal situation. Finally, twice during the 1970s the Fed declared victory over inflation and began aggressively cutting rates only to see inflation reignite and move meaningfully higher, forcing the Fed to reverse course on rate cuts. This is not a prediction but something to bear in mind for those who believe that it is Mission Accomplished on taming inflation.

Based on the above, we believe a continued modest underweight to duration is a prudent strategy.

We continue to share optimism around fixed income as overall yields in the core plus portfolios are near the highest they have been since 2009. Our main caution, however, is that we believe it is important to remain disciplined in what one buys. The takeaway in our view is that deep, measured, fundamental research is essential as we move forward in an

environment where idiosyncratic risks appear to be on the rise. We believe it's critical to be patient in adding to a portfolio. Don't just know what you own but know why you own it.

For a considerable period now, we have attempted to tilt the Brandes Core Plus portfolios into what we believe is a defensive posture to manage market risks in both yield levels and spreads. Accordingly, the portfolios continue to favor shorter-maturity corporate bonds and those that we believe exhibit strong, tangible asset coverage. We are managing duration approximately 10% shorter than the portfolios' benchmark. We have a meaningful allocation to U.S. Treasuries and if market uncertainty and volatility continue to cause credit fundamentals to become mispriced relative to our estimates of intrinsic value, then we will look to redeploy some of those Treasury holdings thoughtfully and effectively to take advantage of opportunities.

We remain underweight agency mortgage-backed securities.

As we move forward, we believe prudence dictates that we continue our search for value in a measured and deliberate manner while continuing to tilt the portfolios to what we believe is a relatively defensive posture.

We remain optimistic about the prospects for the Brandes Core Plus Portfolios.

Sincerely,



Timothy M. Doyle, CFA
Fixed Income Portfolio Manager

Term definitions: <https://www.brandes.com/termdefinitions>

The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. This index is a total return index which reflects the price changes and interest of each bond in the index.

The neutral rate is the theoretical federal funds rate at which the stance of Federal Reserve monetary policy is neither accommodative nor restrictive. It is the short-term interest rate consistent with the economy maintaining full employment with associated price stability.

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