

## QUARTERLY COMMENTARY

### QUARTER IN REVIEW AND HIGHLIGHTS

The U.S. economy continues to show surprising resilience to the Federal Reserve's (Fed) extended monetary tightening cycle with most recession forecasts being pushed out into the second half of 2024. The recent decline in oil prices helped bring inflation closer to the Fed's 2% target. Year-over-year personal consumption expenditures (PCE) inflation declined to 2.6% in November, the lowest level since the Fed started hiking rates in March 2022.

- **The Fed's unexpected shift toward accommodative monetary policy fueled a strong recovery in financial markets during the final two months of the year...** The equity market rally broadened out beyond the large-cap technology names. Many of the sectors struggling under the weight of higher interest rates, including banks and real estate investment trusts (REITs), led the fourth quarter rebound.
- **During its December meeting, the Fed signaled not just the conclusion of its rate-hiking cycle but advanced the timeline for potential interest rate cuts...** Investment-grade corporate credit spreads tightened, with spreads closing near the tightest levels since the Global Financial Crisis. The high-yield market also finished the year strongly, up more than 7% during the fourth quarter.
- **Third quarter gross domestic product (GDP) came in at 4.9%, the highest level since 2021...** Labor market conditions in the U.S. have also exceeded expectations but pockets of weakness are appearing in certain employment measures including lower labor force participation and a decline in weekly average hours worked.
- **Treasury yields moved materially lower during the fourth quarter as bond investors welcomed the Fed's pivot...** The 10-year Treasury yield peaked near 5% in mid-October but fell steadily thereafter, closing the fourth quarter at 3.88% — exactly where it started the year.

Our investment capabilities incorporate a unified investment philosophy and process across the risk spectrum

Enhanced Cash	Short Duration Bond	Strategic Income	Short Duration High Yield	Core Plus Bond	High Yield Bond	Balanced Income
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### SHORT DURATION BOND STRATEGY

The Short Duration Bond Strategy outperformed its benchmark, the Bloomberg U.S. Government/Credit 1-3 Year Bond Index, during the fourth quarter and year-to-date. The Fed is now projecting three interest rate cuts by the end of 2024. The two-year Treasury note yield fell during the period, closing December at 4.25%.

The U.S. economy continues to show surprising strength despite the sharp increase in interest rates. Strong labor market conditions have supported consumer spending with the service sector being the primary beneficiary. Improving inflation trends contributed to the sooner than expected shift in Fed policy.

Active duration management and credit sector spread tightening contributed to the outperformance during the quarter. Overweights by sector include high-quality collateralized loan obligations (CLO), student loan asset-backed securities and Treasury Inflation Protected Securities (TIPS).

### STRATEGIC INCOME STRATEGY

The Strategic Income Strategy outperformed its benchmark, the ICE BofA 3-Month U.S. Treasury Bill Index, during the fourth quarter and year-to-date. Financial markets welcomed the unexpected shift in Fed policy, rallying strongly as the year came to a close. The bond market registered its highest two-month return in November and December in more than four decades. Inflation continues to moderate from the highest levels in over four decades with headline inflation moving closer to the Fed's 2% target.

Credit markets also posted strong performance after the Fed's U-turn in monetary policy. Investment-grade corporate credit spreads tightened by 22 basis points (bps), outperforming duration-matched Treasuries by 203 bps while the high-yield market registered a total return of 7.2%.

Strategy overweights include high-quality CLOs, residential mortgage-backed securities (RMBS) and Treasury Bills. We are remaining opportunistic with duration and yield curve management as the bond market adjusts to the shift in monetary policy.

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### ABOUT US

Penn Mutual Asset Management (PMAM) is an institutional asset management firm located just outside of Philadelphia, PA. Since 1989, the firm has been dedicated to creating value through a prudent, thoughtful and rigorous investment decision-making process. With over \$33 billion in assets under management, PMAM is committed to offering fixed income investment solutions and client-focused services.

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## SHORT DURATION HIGH YIELD STRATEGY

The Short Duration High Yield Strategy outperformed its benchmark, the ICE BofA 0-2 Year Duration BB-B U.S. High Yield Constrained Index, since its inception on October 1, 2023.

The final two months of the year proved to be a very strong period in the high-yield market. For the majority of 2023, interest rates had been rising and lower-quality credit materially outperformed more rate-sensitive bonds.

The Strategy ended the year with a portfolio duration of just under two years, slightly longer than the benchmark. Average portfolio credit quality was in the BB category with only one CCC credit, while the average position size was approximately 1%. Floating-rate exposure via bank loans and a few higher-quality CLO tranches stood at approximately 5% of the portfolio. The Strategy will be patient in adding new risk positions as valuations appeared fully valued at year end given the strong fourth quarter rally.

## CORE PLUS BOND STRATEGY

The Core Plus Bond Strategy underperformed its benchmark, the Bloomberg U.S. Aggregate Bond Index, during the fourth quarter but outperformed during the full year 2023. In a welcome surprise to investors, the Fed signaled the end of its tightening cycle during its December meeting. Interest rate cuts are now expected to begin in the first half of 2024. Inflation trending back toward the Fed's 2% target enabled the Fed to end its commitment to "higher for longer" interest rates.

Long-term Treasury yields continued to move higher in October, moving above the 5% level for the first time since 2007. Treasury yields fell sharply thereafter with the 10-year Treasury moving back below 4% by year-end. Credit markets also posted strong performance after the Fed's U-turn in monetary policy.

New purchase activity during the quarter included agency guaranteed RMBS and high-quality CLOs. We continue to reduce corporate bond holdings to source more attractive relative value in the securitized credit markets. Strategy overweights by sector include TIPS, RMBS and CLOs.

## HIGH YIELD BOND STRATEGY

The High Yield Bond Strategy underperformed its benchmark, the Bloomberg U.S. High Yield BA/B 2% Issuer Capped Index, during the fourth quarter and year-to-date.

The final two months of 2023 marked a sharp reversal in risk sentiment with virtually every financial asset class rallying materially. The reversal was a very strong period for high-yield credit with over half of the annual performance occurring in the final two months of the year. The year-end rally was driven largely by a 90-basis-point and 110-basis-point drop in 2- and 10-year Treasury rates respectively, which in turn was the result of declining inflation readings and signals by the Fed that rate cuts were coming in 2024.

For the bulk of 2023, interest rates had been rising and lower-quality credit materially outperformed more rate-sensitive bonds as the total return for CCC credit exceeded BB credit by over 600 bps. Gross new issuance was up over 50% but was still the second lowest total since the Global Financial Crisis. From an earnings perspective, it wasn't a strong year as revenue and margins were hurt by lingering supply chain issues and inventory destocking across many sectors. In addition, higher interest rate levels started to impact companies with large amounts of floating-rate debt or those that had to refinance debt during the year. Still, corporations demonstrated resilience. Overall, other than a handful of distressed situations, default rates remained benign.

The Strategy's up-in-quality positioning and shorter duration spread contributed to its underperformance versus the benchmark. The Strategy added risk positions during the fourth quarter opportunistically in an effort to position for a more constructive macroeconomic backdrop in 2024.

## BALANCED INCOME STRATEGY

The Balanced Income Strategy underperformed its benchmark, the Morningstar Moderately Conservative Target Risk Total Return USD Index, during the fourth quarter and year-to-date. Both stocks and bonds posted a magnificent two-month rally to close out 2023 positively on an absolute basis. The Strategy's equity portfolio performed well on a relative basis while the portfolio's underweight to high-yield bonds on the fixed-income side detracted from performance.

The fourth quarter was incredibly wild for both stocks and bonds. After hitting lows in terms of bond prices (and high yields) in October, both bonds and then stocks posted a historic rally to close the year. The all-cap positioning in the equity portfolio did not help to add value this quarter, as it lagged its benchmark. On the fixed-income side, the Strategy's higher-quality credit positioning also did not contribute to performance, but we believe this positioning should provide downside protection if the credit markets stumble under the weight of higher refinancing rates and/or if the economy slows.

In terms of overall allocation (stock, bond and cash weightings), the quarter-ending allocation changed modestly from the end of the third quarter, with 35% in common stock, 63% in fixed income and 2% in cash. If we are near the peak of this inflationary cycle and consumer and producer prices moderate from here; and/or if economic growth faces a slowdown, then this positioning should help to support the net asset value. Additionally, on the corporate bond side, the Strategy has focused primarily on companies that possess net debt free and/or improving balance sheets. Companies with these attributes will be much less sensitive to the current level of interest rates in terms of interest expense. Further, companies with significant cash balances are witnessing higher levels of interest income earned which will provide them room to maneuver from a financial standpoint.

This positioning can provide the potential for higher portfolio yields while its focus on great balance sheets may help to protect future downside volatility. We will continue to monitor our investable universe for any opportunity to add value. We believe this focus on individual security selection will help to decrease the portfolio's exposure to market beta while allowing for positive alpha generation.

## OUTLOOK

The financial market's euphoria in response to the Fed's U-turn in monetary policy is likely to gradually give way to the reality of "sticky" inflation and rapidly increasing Treasury bond issuance keeping interest rates above current expectations.

## INDEX DEFINITIONS:

**Bloomberg U.S. Aggregate Bond Index** – An index that is a broad-based flagship benchmark that measures the investment grade, US dollar denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

**Bloomberg U.S. Government/Credit 1-3 year Bond Index**– The Bloomberg U.S. Government/Credit Bond Index is a broad-based benchmark that measures the non-securitized component of the US Aggregate Index. It includes investment grade, US dollar-denominated, fixed-rate Treasuries, government-related and corporate securities.

**Bloomberg U.S. High Yield Ba/B 2% Issuer Capped Index** – This index measures the performance of fixed-rate dollar-denominated debt securities with rating Ba/B. The securities instruments are non-investment grade. There is a limit of 2% maximum exposure to any one issuer.

**ICE BofA 0-2 Year Duration BB-B U.S. High Yield Constrained Index** – This index measures the performance of ICE BofAML 0-2 years Duration BB-B U.S. High Yield Bond. It's all securities in the ICE BofAML U.S. High Yield Index rated BB1 through B3 and with a duration-to-worst less than two years, but caps issuer exposure at 2%.

**ICE BofA 3-Month U.S. Treasury Bill Index** – This index measures the performance of a single issue of an outstanding treasury bill which matures closest to, but not beyond, three months from the rebalancing date. The issue is purchased at the beginning of the month and held for a full month; at the end of the month that issue is sold and rolled into a newly selected issue.

**Morningstar Moderately Conservative Target Risk Total Return USD Index** – The Morningstar Target Risk Index family is designed to meet the needs of investors who would like to maintain a target level of equity exposure through a portfolio diversified across equities, bonds and inflation-hedged instruments. The Morningstar Moderately Conservative Target Risk Index seeks approximately 40% exposure to global equity markets.

## DISCLOSURES:

The views expressed in this material are the views of PMAM through the quarter ending December 31, 2023 and are subject to change based on market and other conditions without further notice.

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