Credit Market Themes in 5 Charts

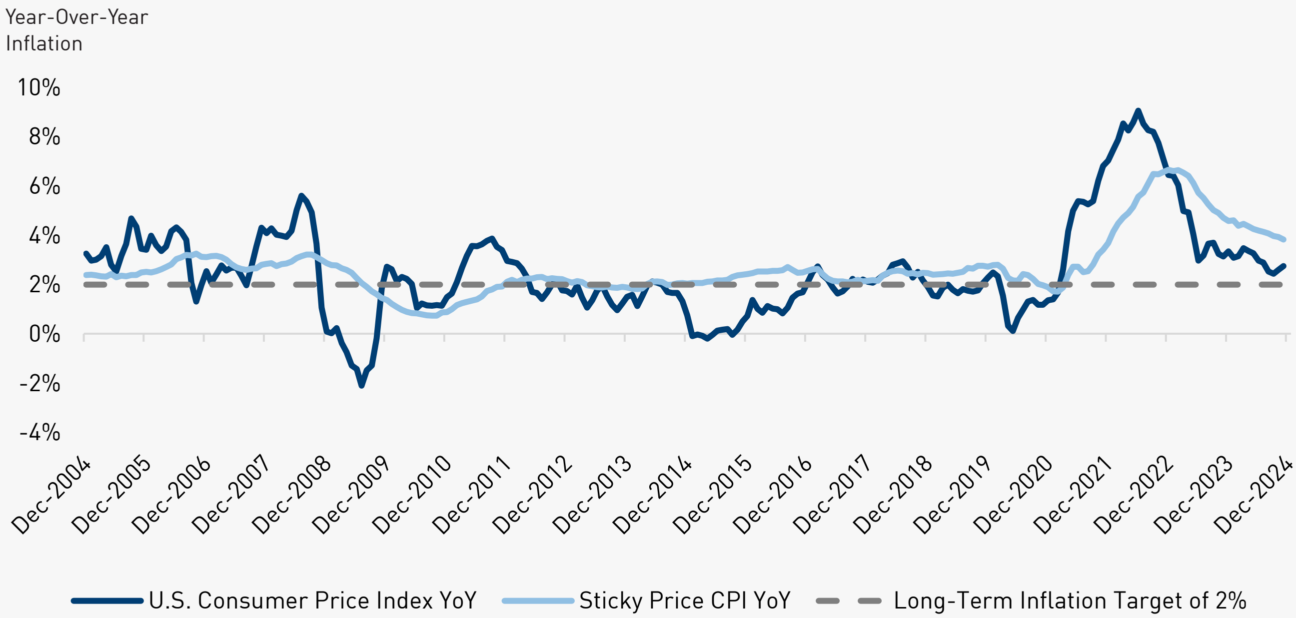
Q4 2024

1 Sticky Inflation May Limit the Depth of Rate Cutting Cycles

Recent data in the U.S. shows signs that the decline in inflation has stalled, with most measures settling above the 2% target. Moreover, there is a risk of reacceleration if Trump enacts his potentially inflationary policies.

U.S. inflation data will be critical in determining whether we see further interest rate cuts in 2025, or whether the Fed will need to pause altogether or even increase the overnight rate. These dynamics will likely influence the Bank of Canada's monetary policy decisions, as policymakers must balance a much weaker economic backdrop with the potential impact of higher-for-longer U.S. rates. Predicting the future path of monetary policy and risk-free yields is challenging, so we plan to continue to rely on data and take an active and flexible approach when determining our interest rate exposure.

Sticky Inflation in the US May Make Monetary Policy Unpredictable



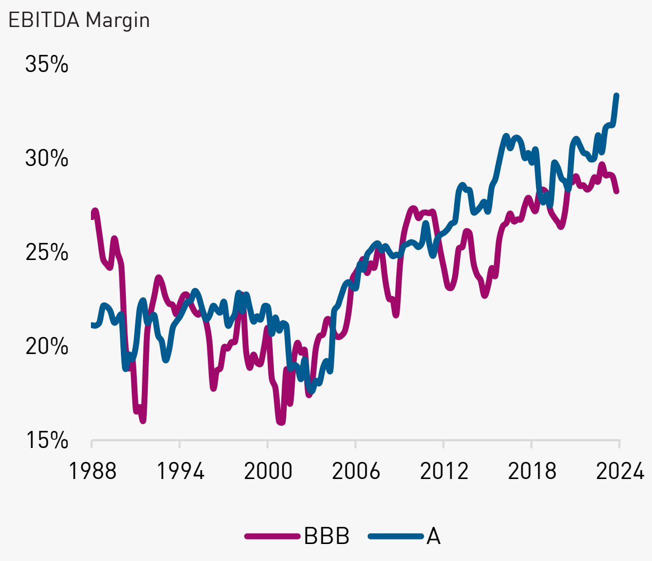
Source: Bureau of Labor Statistics, Federal Reserve Bank of Atlanta.
Data as of November 30, 2024.

2 Corporate Fundamentals Support Credit Valuations

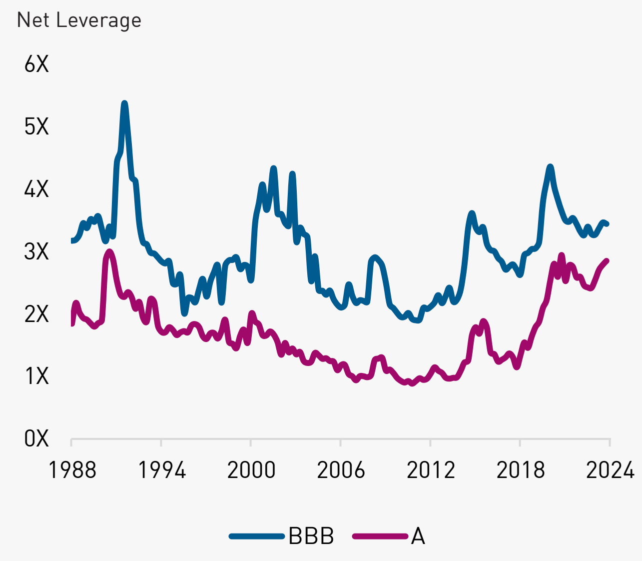
Despite tighter monetary conditions, profit margins for investment grade issuers have continued to expand this year. Although leverage has ticked up, it is, on average, still within its historical range. Considering global central banks have cut policy rates, corporate balance sheets can continue to be quite strong and can underpin resilient credit spread valuations.

Nonetheless, balance sheet strength varies across sectors and geographies, especially when accounting for potential geopolitical implications. As such, we believe active management and acute credit selection will be paramount to generating alpha in 2025.

EBITDA Margins Have Been Steadily Increasing...



While Net Leverage Has Risen Only Slightly



Source: Barclays.
Data as of September 30, 2024.

3 Yield Sensitive Buyers Continue to Drive Demand for Bonds

All-in yields of corporate bonds (i.e., the risk-free yield plus credit spread) were above 5% for most of 2024 – the most attractive levels since the Great Financial Crisis. As a result, yield-focused buyers who conduct liability management (like pensions and insurance companies) maintained robust demand for credit in 2024.

In fact, U.S. annuity sales, which contribute to strong credit demand, were on a record pace through the first three quarters of 2024. With all-in yields still well above the 5% mark entering 2025, we expect the trend of strong annuity sales to continue and act as a tailwind for credit.

U.S. Annuity Sales Continue to Hover Around Record Highs

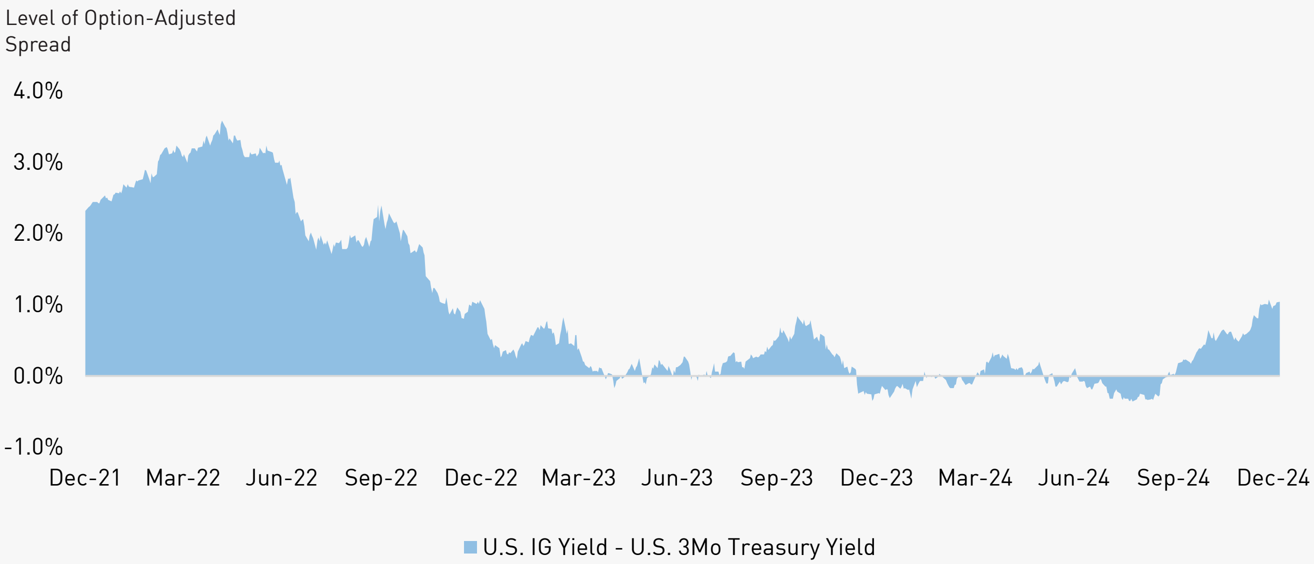
Source: Source: LIMRA.
Data as of September 30, 2024.

4 Normalizing Yield Curve Could Ignite the Redeployment of Money Market Assets

Assets in money market instruments currently sit at all-time highs (~$6.8T) as elevated short-term yields incentivized investors to pile in during 2023 and 2024. This capital can be viewed as cash on the sidelines or dry powder as investors await better opportunities further out the curve. Ultimately, we expect a normalizing yield curve to ignite a rotation out of money market funds and into bonds.

This phenomenon is occurring alongside central bank rate cuts, making the opportunity cost of sitting in cash expensive again. In fact, yields on investment grade credit now yield >1% more than short-term treasury bills for the first time in two years. We believe that a continued normalization of the yield curve could fuel the redeployment of money market assets and drive fixed income demand in 2025.

U.S. Investment Grade Bonds Yield >1% More Than Short-Term Treasury Bills for the First Time in Two Years



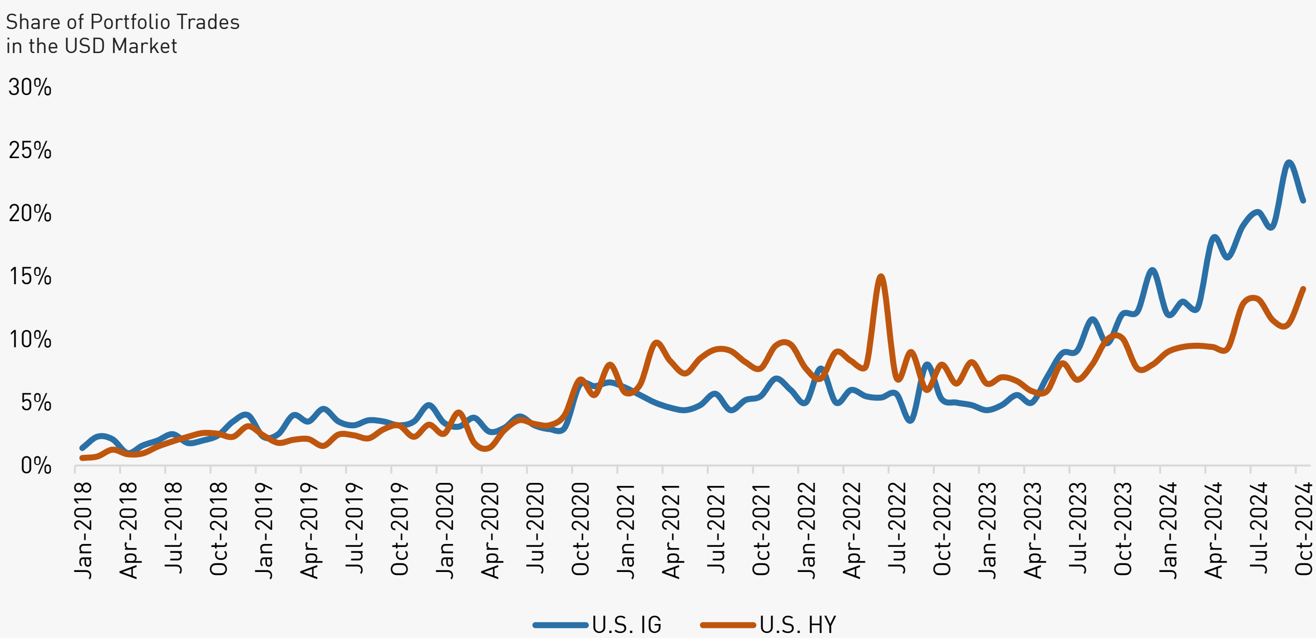
Source: ICE BofAML, Department of the Treasury.
Data as of January 6th, 2025.

5 Growing Popularity of Portfolio Trades Can Dampen Volatility

A key theme in the public credit markets in 2024 was the sharp growth in Portfolio Trades ("PT") – a way of executing trades of large baskets of bonds in a simple transaction. Within the investment grade market, PT accounted for almost a quarter of all trade volumes this year. The strong growth in PT enhances liquidity across the bond market and offers another avenue for large bond managers to access liquidity.

PT adoption is expected to continue growing in 2025, a trend that many market participants believe will act as a volatility dampener as the price discovery process in credit markets becomes more efficient.

Portfolio Trades Constituted a Growing Portion of the Bond Market in 2024



Source: Bloomberg.
Data as of October 31, 2024.

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RPIA

43 Hazelton Ave.
Toronto, ON
M5R 2E3

www.rpia.ca
General Line: +1 647 776 1777
Investor Services: +1 647 776 2566