

Brandes Investment Partners
Core Plus Fixed Income Strategy Notes
Second Quarter 2024 (April 1 – June 30, 2024)

The Brandes Core Plus Strategy rose 0.21% net of fees and 0.27% gross of fees, outperforming its benchmark, the Bloomberg U.S. Aggregate Bond Index, which rose 0.07% in the quarter.

Annualized total return as of June 30, 2024	1-year	5-year	10-year
Brandes Core Plus Fixed Income Composite (net)	4.44%	0.73%	1.74%
Brandes Core Plus Fixed Income Composite (gross)	4.71%	0.98%	2.01%
Bloomberg U.S. Aggregate Bond Index	2.63%	-0.23%	1.34%

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.

Yields marched modestly higher for much of the quarter but fell in June as some weaker economic reports released that month shifted market perception towards a belief that the long anticipated economic slowdown is beginning to take shape, leading many to believe that interest rate cuts are just around the corner. The main catalyst was the May year-over-year CPI report which came in at 3.3% versus consensus expectations of 3.4%. This is the first time since October 2023 that the headline CPI number has come in below expectations.

Credit markets performed well in the quarter. Yield spreads continue to hover near the lowest levels in several decades, but investors appear to be less concerned about the limited additional compensation offered by current yield spreads and more enamored of attractive total yields, buoyed by U.S. Treasury rates that are around their highest levels since the global financial crisis.

At the May Federal Open Market Committee meeting, the Fed (Federal Reserve) downshifted their expected reduction in rates to a single 25-basis-point (bps) cut this year, down from three projected cuts in March. This change in stance did little to dissuade the financial markets from their seemingly undying belief that the Fed will have to be more aggressive in cutting rates. The market has priced a 25bps cut in the fed funds rate in September as a near certainty, followed by an additional 25bps reduction before year-end.

There is an adage that monetary policy works with long and variable lags and the recent slowing in inflation, employment, and consumer spending is put forth as evidence that this remains true in today's market. Perhaps so.

Nevertheless, despite the recent slowdown in inflation, it isn't dead yet. Consumer prices are 3.3% above their level twelve months earlier as measured by the Consumer Price Index (CPI). We've discussed the *stubborn* and *sticky* supercore CPI (CPI services less housing) in previous quarters, and this is up 4.8% over the past twelve months. Core CPI (CPI less food and energy) is up 3.4%. As a reminder, this is still materially higher than the Fed's 2% inflation target.

The labor market has shown signs of slowing but remains strong. Consumer spending has also slowed but continues to be solid, and financial conditions remain easier than when the Fed began this current rate hike cycle in March 2022.

To this curmudgeonly fixed income team, we believe the current resilience in the economy means it is prudent to continue cautious about the chance of aggressive rate cuts in the remainder of this year.

Portfolio Performance

In the second quarter, the Brandes Core Plus portfolios delivered modestly positive returns and positive relative performance versus their benchmark, the Bloomberg U.S. Aggregate Bond Index.

Corporate bonds provided the largest positive contribution to returns during the quarter. Within corporate bonds, performance during the period was led by corporate bond holdings in banking (US Bank and Goldman Sachs), and food processing (Pilgrim's Pride).

Term-structure positioning was a positive factor during the quarter. U.S. Treasury yields rose modestly during the period. Near the end of September 2023, we had moved the duration of the portfolios up modestly to 90% of the benchmark's duration, and we have maintained that level ever since.

The portfolios' underweight to agency mortgage-backed securities (MBS) aided returns as that sector was one of the few taxable fixed income sectors to post negative returns versus U.S. Treasuries.

Select holdings in media (Univision Communications) and telecom (Telecom Italia) modestly detracted from performance.

Portfolio activity was light during the quarter. The portfolios added to our existing position in first lien bonds from Univision Communications (8.00% coupon, maturing 8/15/28, rated B1/B+).

While activity was light there were a handful of corporate bonds for which the investment committee established buy targets during the quarter. We would like to add these to the portfolios, but they have not quite reached those target prices. We remain hopeful that the market will provide us with an opportunity to add a number of new positions to the portfolios over the second half of the year.

We experienced a full call in our holding of FirstEnergy Corp (7.375% coupon, maturing 11/15/31, rated Baa3/BBB-). We also participated in tender offers for our holdings in Charter Communications (4.908% coupon, maturing 7/23/25, rated Ba1/BBB-) and Pulte Group (5.50% coupon, maturing 3/1/26, rated Baa2/BBB+), as each issuer tendered for bonds at a premium to the level where their bonds were trading in the market.

Outlook

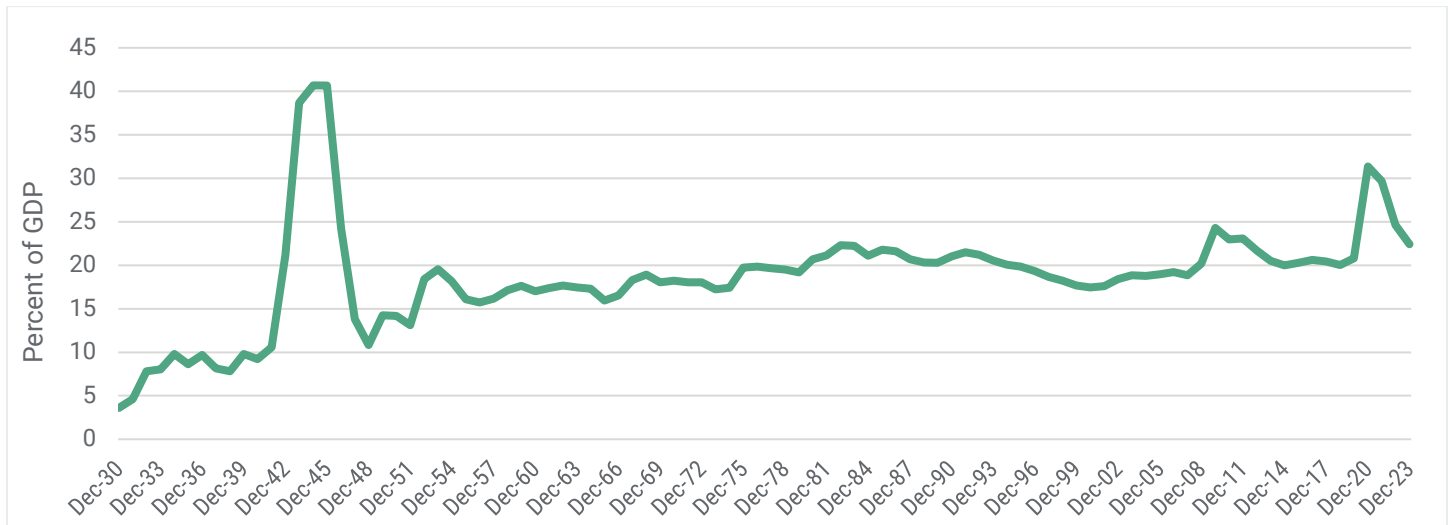
With the recent presidential debate behind us and the political party convention season fast approaching, like it or not, election season is upon us. We spend a considerable amount of time each quarter dissecting monetary policy. This appears like a good time to briefly address U.S. fiscal policy. The short story is that it is a mess. The other takeaway is that almost no one seems to care.

The figures are so absurd that it can be difficult to contextualize or *get your head around* the data. Take for example the announcement by the Congressional Budget Office (CBO) on June 18 that it is raising its forecast for the U.S. fiscal deficit this year by 27% to \$1.9 trillion from \$1.5 trillion.¹ You may think, as we do, "that sure seems like a lot." You might also question, "well, how long ago was the previous estimate made?" The previous estimate was four short months earlier in February.

In April, the net interest outlays by the U.S. Treasury hit a nominal record of \$85 billion. As a percentage of gross domestic product (GDP), it was the highest level since 1990.² Remember that we are only recently removed from the lowest interest rates in our lifetimes.

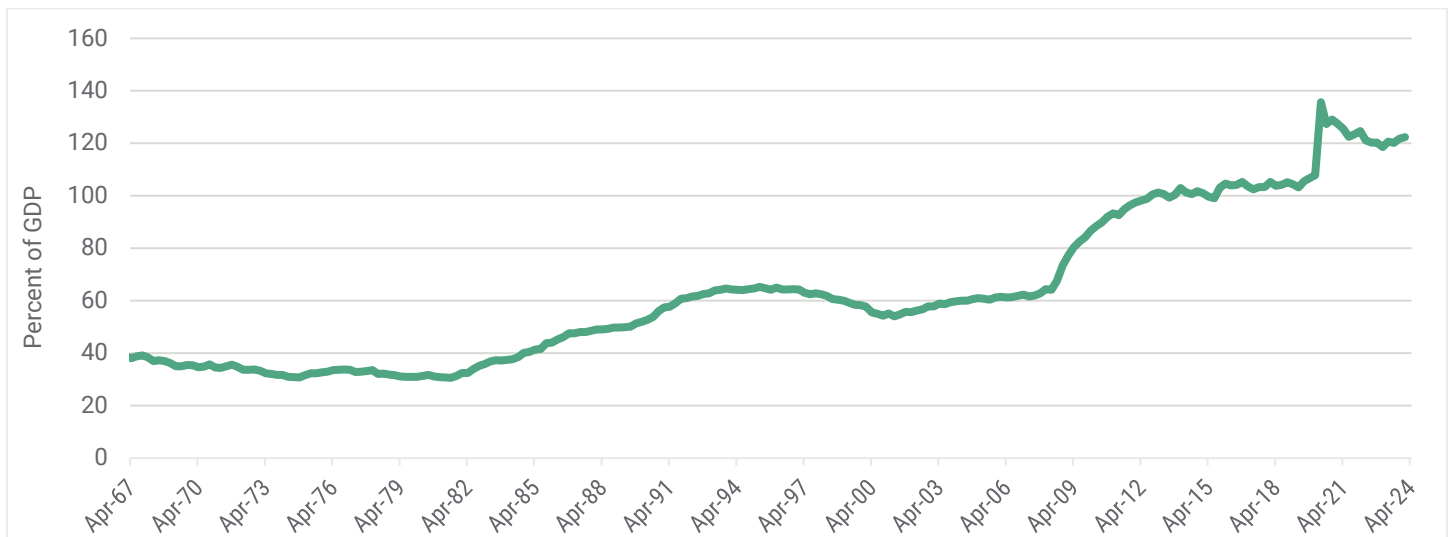
In addition, we present two charts below to reinforce the point about the lack of fiscal restraint. The long-term trends in federal spending and federal debt relative to GDP seem inexorably upwards over the decades.

Exhibit 1. Annual Federal Net Outlays as a Percent of Gross Domestic Product



December 31, 1930 To December 31, 2023 | Source: Bloomberg. Federal net outlays are the difference between government revenues and government expenditures. Data is updated annually.

Exhibit 2. Federal Debt as a Percentage of GDP Is Near All Time Highs



Federal Debt as a Percentage of GDP From April 1, 1967 to April 1, 2024 | Source: Federal Reserve Bank of St. Louis, Total Public Debt as Percent of Gross Domestic Product (GDP) measured quarterly.

Both exhibits paint the same ugly picture, and it is likely to get worse. With a tight race for the White House, each major candidate appears to be willing to play fast and loose with the budget by throwing bribes (sorry, I meant to say *targeted incentives*) towards the electorate. I doubt there are many serious skeptics who will take the other side on the U.S. fiscal position, leading to the important question of: does it matter? The market's answer to date has been an emphatic no.

A more nuanced answer is that it is difficult to say. Back in the 1990s, the term *bond vigilantes* was coined as the bond market imposed swift and ruthless discipline on profligate federal spending. I believe there is an argument today that the bond vigilantes of yesteryear have largely been *neutered* by the Fed's enormous balance sheet expansion and asset

purchase program. As a result, the bond market is now less equipped to be a healthy check on any lack of fiscal discipline.

I believe that you can build a cogent case for a *slow bleed*, however. The more the U.S. government is forced to borrow, the greater the chance it may end up in a vicious cycle in which increased government debt and interest rates drive one another higher. A cynic may also posit that a rising debt burden increases the pressure on the Fed to devalue the U.S. debt by allowing inflation to continue to run a little *hot* – leading to the higher-for-longer interest rate narrative.

In our view, U.S. fiscal policy has been largely a mess for a considerable time, and it appears to have had scant effect on yields. Thus I come back to the earlier assertion – *no one cares*. Whether that continues to be the case as we move through the election season and beyond is an open question.

However, if we look at the fiscal picture alongside the still solid economic data we discussed earlier, we believe it is prudent to stay a bit cautious on interest rates and the bond market going forward.

Turning back to the portfolios, we share some of the optimism around fixed income given that 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: not just know what you own but 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 mitigate some of the potential detrimental impact of rising interest rates and widening yield spreads. We believe that this remains a risk. 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,

A handwritten signature in black ink, appearing to read "Timothy M. Doyle". The signature is fluid and cursive, with the first name being the most prominent.

Timothy M. Doyle, CFA
Fixed Income Portfolio Manager

¹ Jefferies, Greed & fear: Fiscal rot and Thailand, 6/27/24

² Bloomberg, US Interest Burden Will Bite Whoever Wins in November: Macro Man, Cameron Crise, 6/5/24

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.

First lien bonds are senior to all other bonds of an issuer so that first lien bond holders are paid back before all other debt holders. A lien is the legal right of a creditor to seize property from a borrower that has failed to repay the creditor.

The portfolio characteristics shown relate to a single account deemed by Brandes to be generally representative of the strategy as of date noted. Not every account will have these exact characteristics. The actual characteristics with respect to any particular account will vary based on a number of factors including but not limited to: (i) the size of the account; (ii) investment restrictions applicable to the account, if any; and (iii) market exigencies at the time of investment. Data is updated on a quarterly basis.

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