

Presenter:

Benjamin Streed, CFA
Chief Investment Officer

Benjamin.Streed@deepblue-inv.com

813-440-5088



Investing In Today's Interest Rate Environment

June 17, 2024

Today's Objectives

Part 1: Economic Update

- Health of the consumer
- Job market and unemployment
- Inflation *still* matters

Part 2: Interest Rates & Fixed Income Markets

- Inflation → interest rates
- Rate expectations for 2024-25

Part 3: Fixed Income Strategies and Considerations

- Credit spreads and yields
- Duration: when to add?
- What's working now?

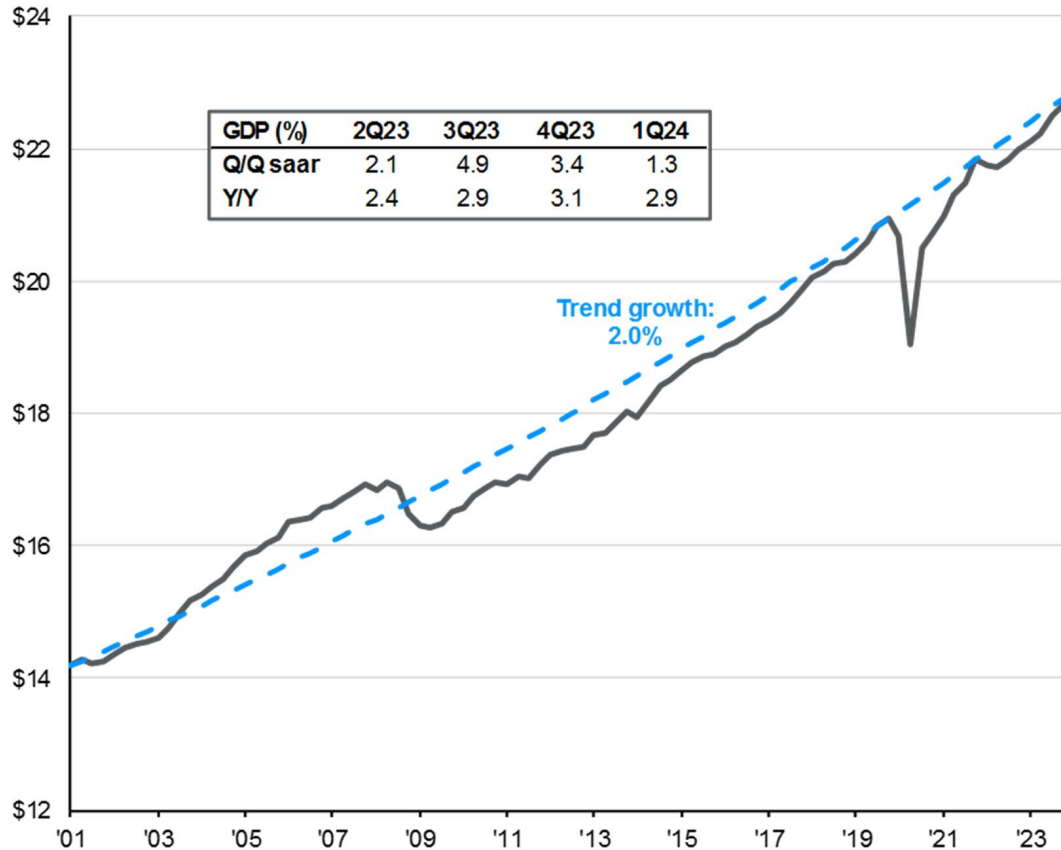
Part 1: Economics

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Gross Domestic Product: Still Strong

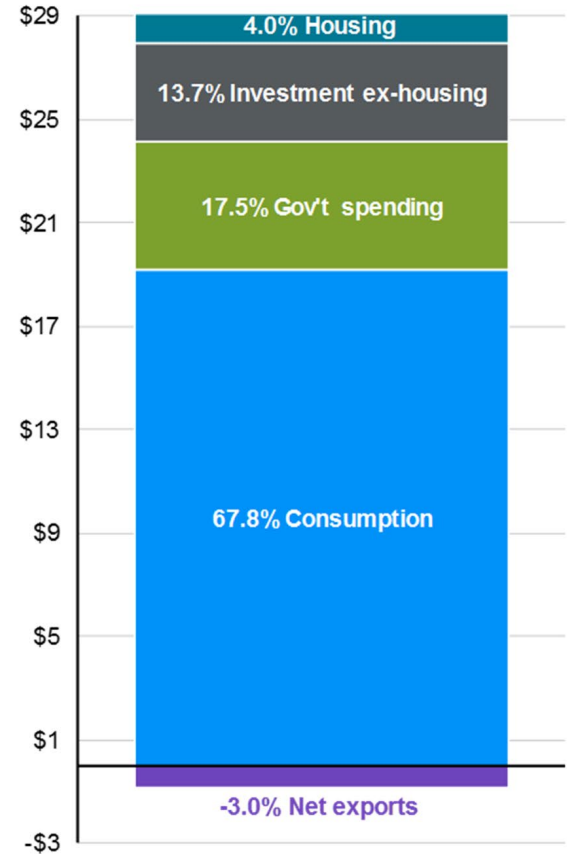
Real GDP

Trillions of chained (2017) dollars, seasonally adjusted at annual rates



Components of GDP

1Q24 nominal GDP, USD trillions

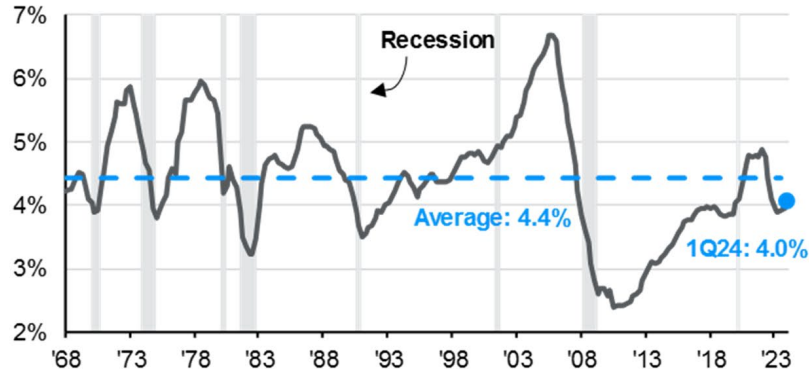


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Cyclical Sectors: What do they signal?

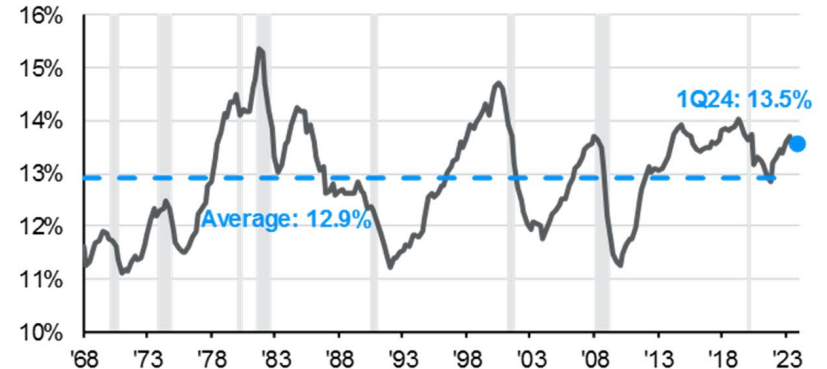
Residential investment as a % of GDP

Quarterly, seasonally adjusted



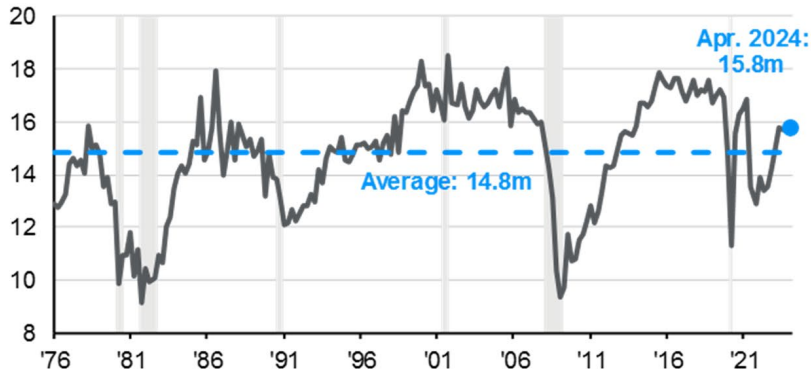
Business fixed investment as a % of GDP

Quarterly, seasonally adjusted



Light vehicle sales

Mil vehicles, seasonally adjusted ann. rate



Total business inventory/sales ratio

Days of sales, monthly, seasonally adjusted

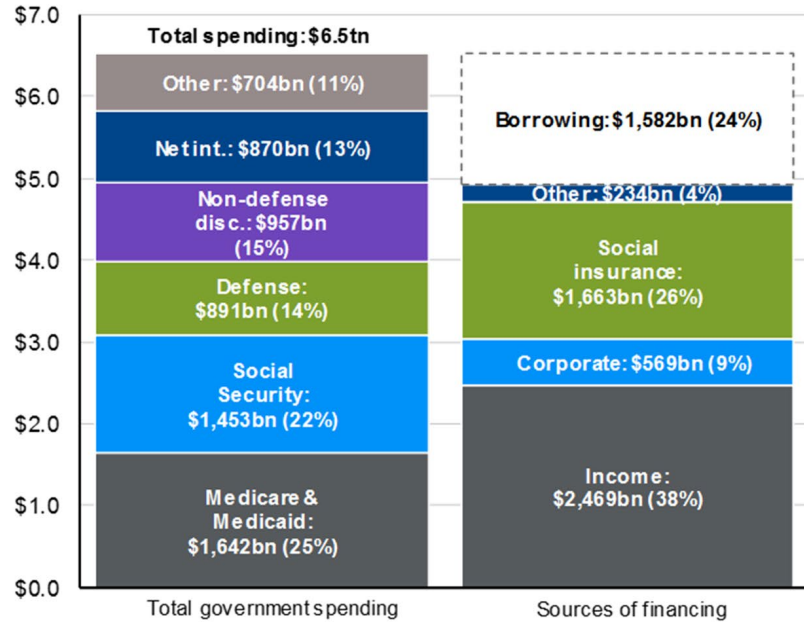


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Federal Finances:

The 2024 federal budget

USD trillions

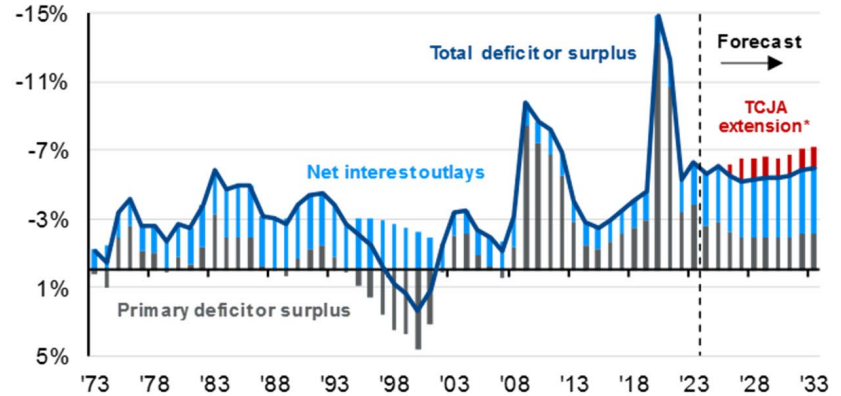


CBO's Baseline economic assumptions

	2024	'25-'26	'27-'28	'29-'34
Real GDP growth	1.8%	2.1%	2.1%	1.9%
10-year Treasury	4.6%	4.3%	3.8%	4.1%
Headline inflation (CPI)	2.6%	2.4%	2.2%	2.2%
Unemployment	4.2%	4.4%	4.4%	4.5%

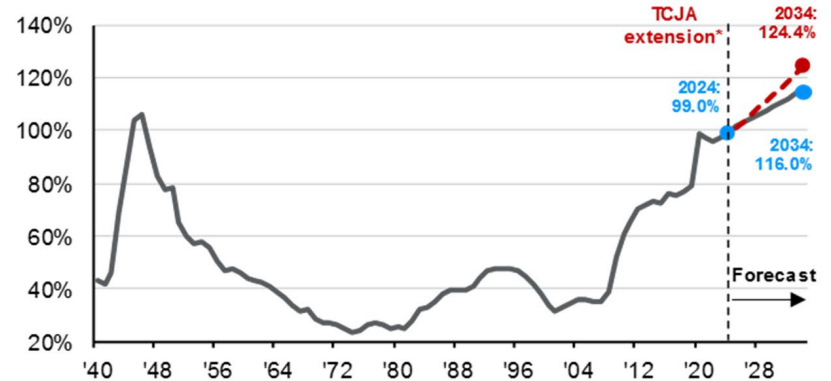
Federal deficit and net interest outlays

% of GDP, 1973-2034, CBO Baseline Forecast



Federal net debt (accumulated deficits)

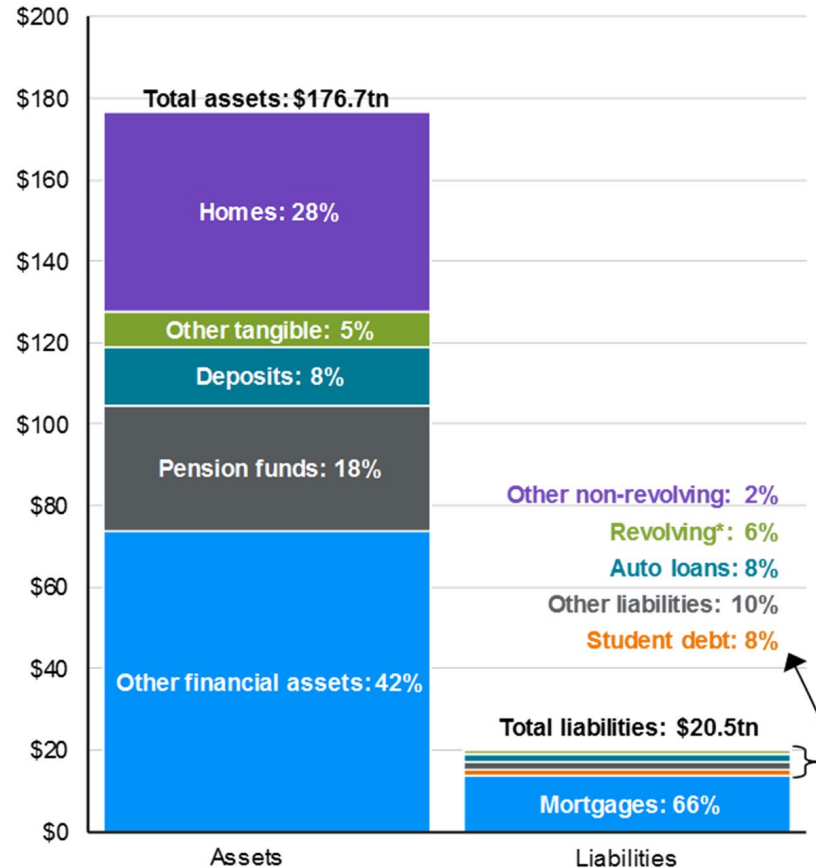
% of GDP, 1940-2034, CBO Baseline Forecast, end of fiscal year



Consumer Finances: Doing Well

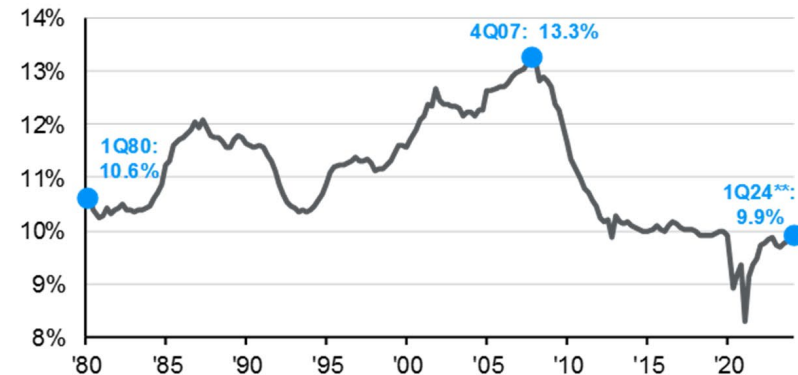
Consumer balance sheet

4Q23, USD trillions, not seasonally adjusted



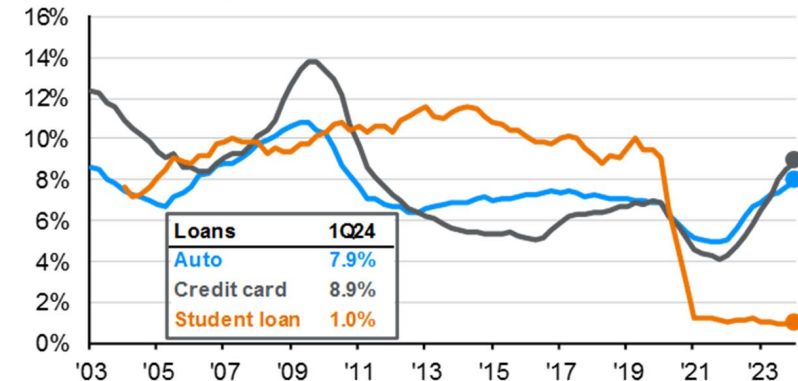
Household debt service ratio

Debt payments as % of disposable personal income, SA



Flows into early delinquencies

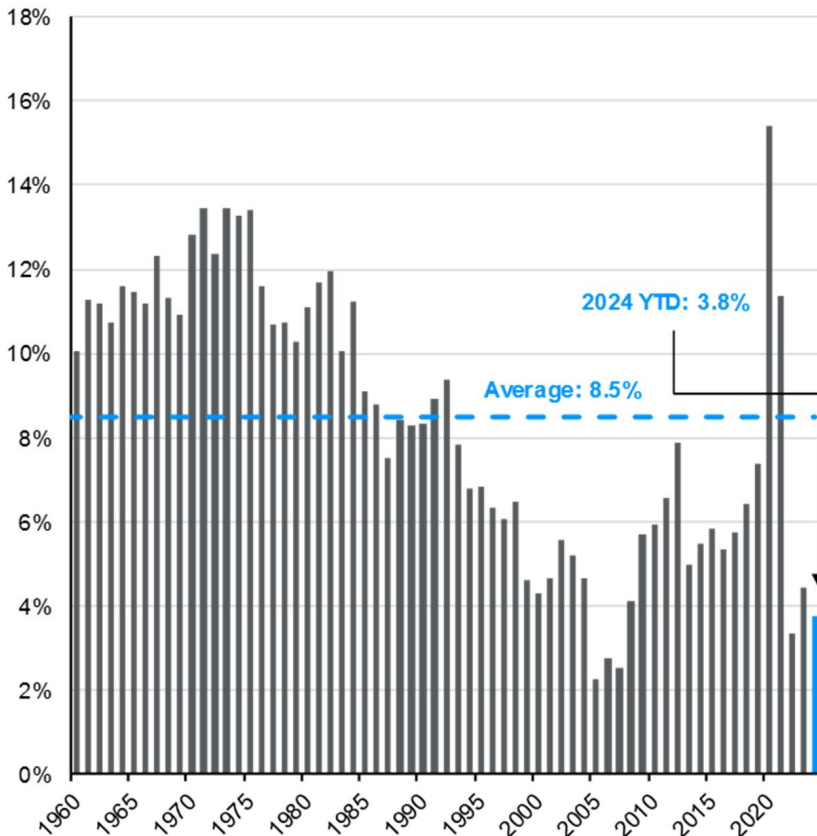
% of balance delinquent 30+ days



Consumer Savings: Heading Lower

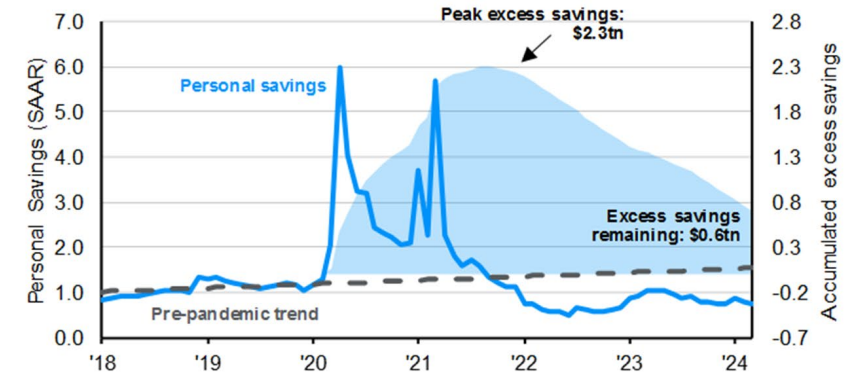
Personal saving rate

Personal savings as a % of disposable personal income, annual



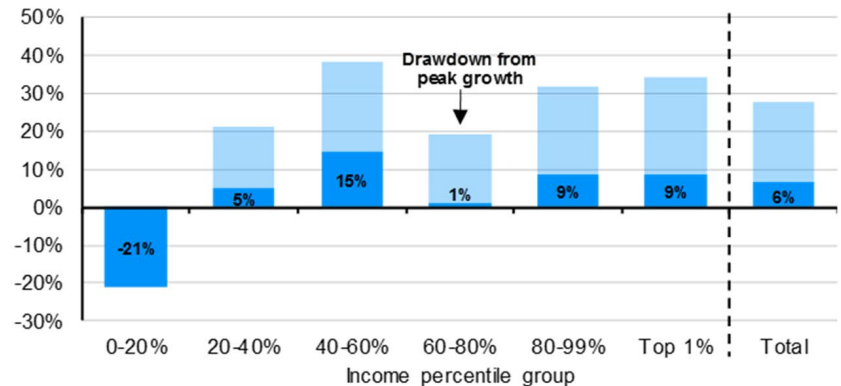
Household excess savings

Trillions of USD



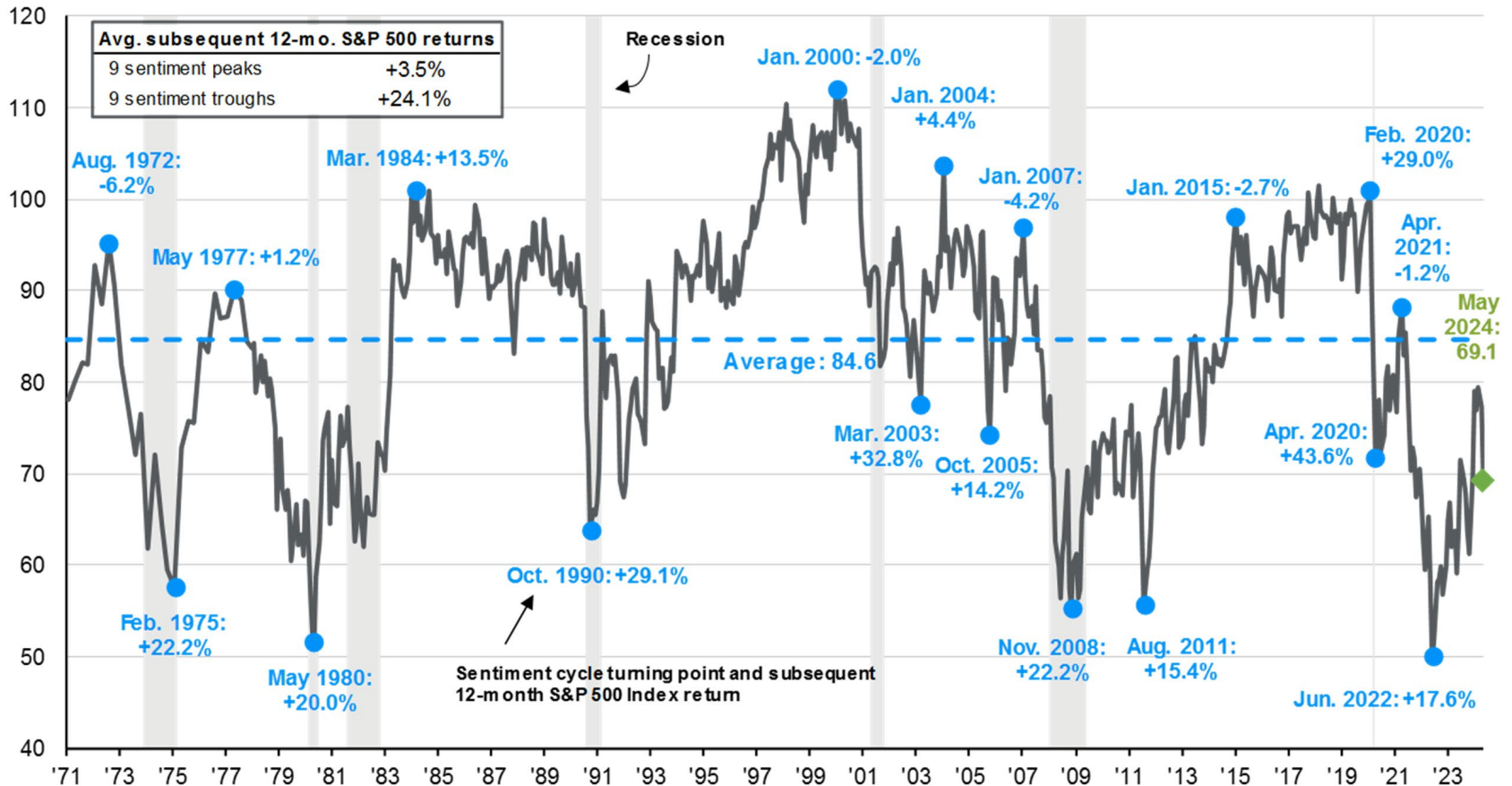
Inflation-adjusted growth in deposits by income percentiles

Checking and savings account balances, % ch 4Q19-4Q23



Consumer Confidence is Fading

Consumer Sentiment Index and subsequent 12-month S&P 500 returns

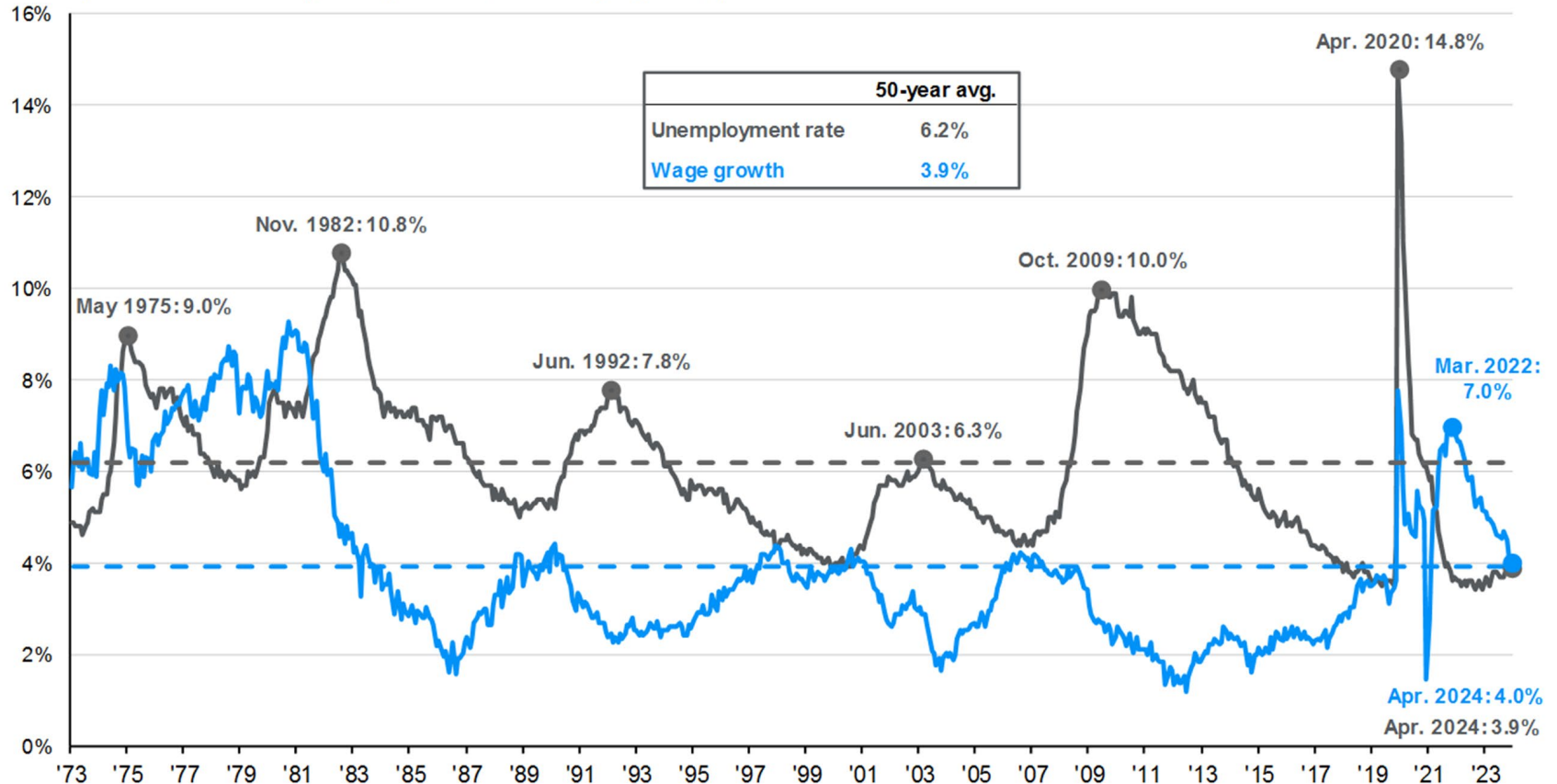


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Unemployment vs. Wage Growth

Civilian unemployment rate and year-over-year wage growth

Private production and non-supervisory workers, seasonally adjusted, percent



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Labor Demand: Still Strong

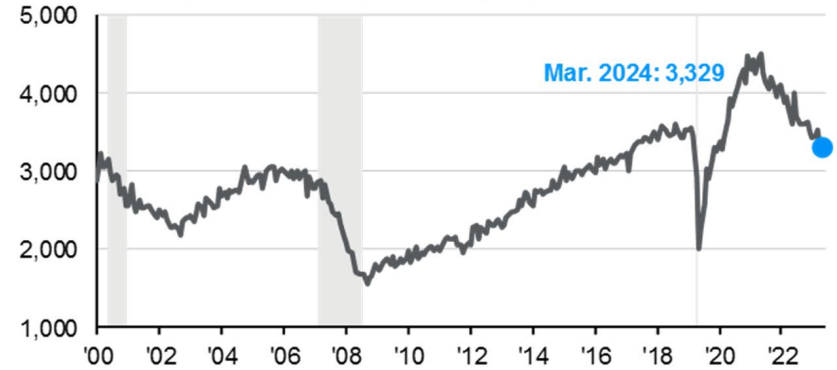
JOLTS job openings*

Total job openings, thousands, seasonally adjusted



JOLTS quits

Total nonfarm quits, thousands, seasonally adjusted



JOLTS layoffs

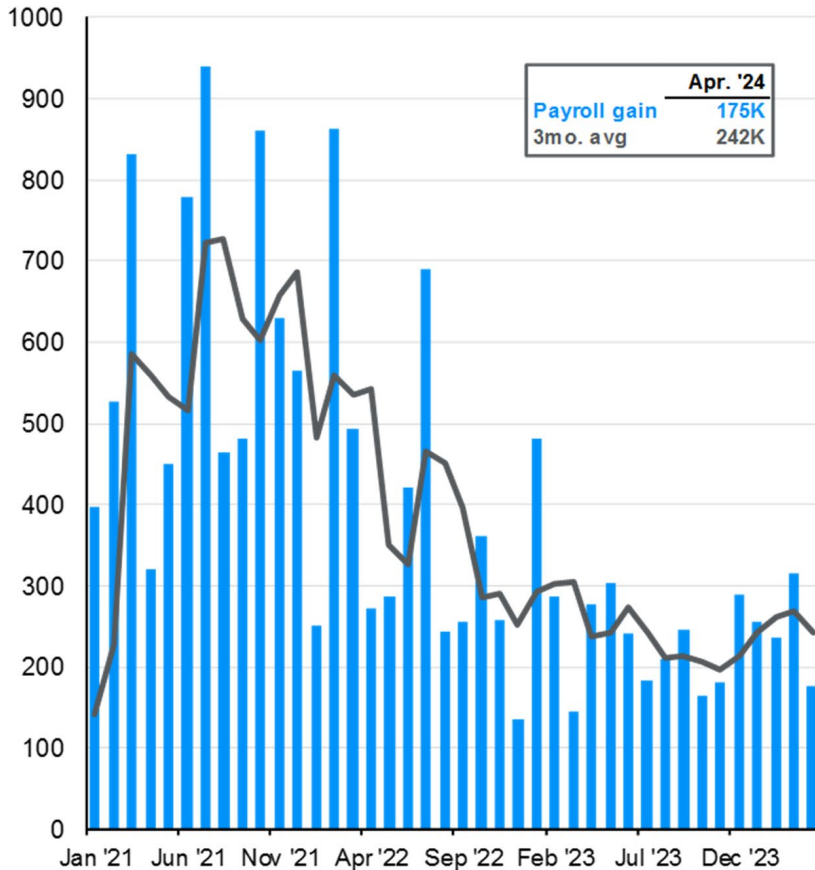
Total nonfarm layoffs, thousands, seasonally adjusted



Labor Supply

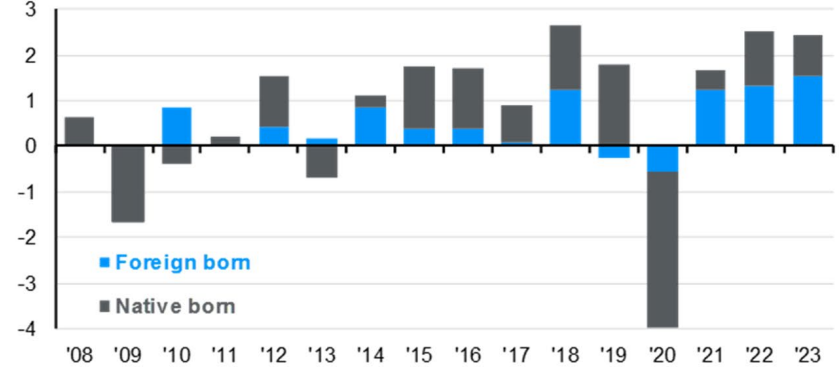
Nonfarm payroll gains

Month-over-month change and 3mo. moving average, SA



Labor force growth, native and immigrant contribution

Year-over-year difference, end of year, aged 16+, millions



Labor force participation

% of civilian noninstitutional population, SA

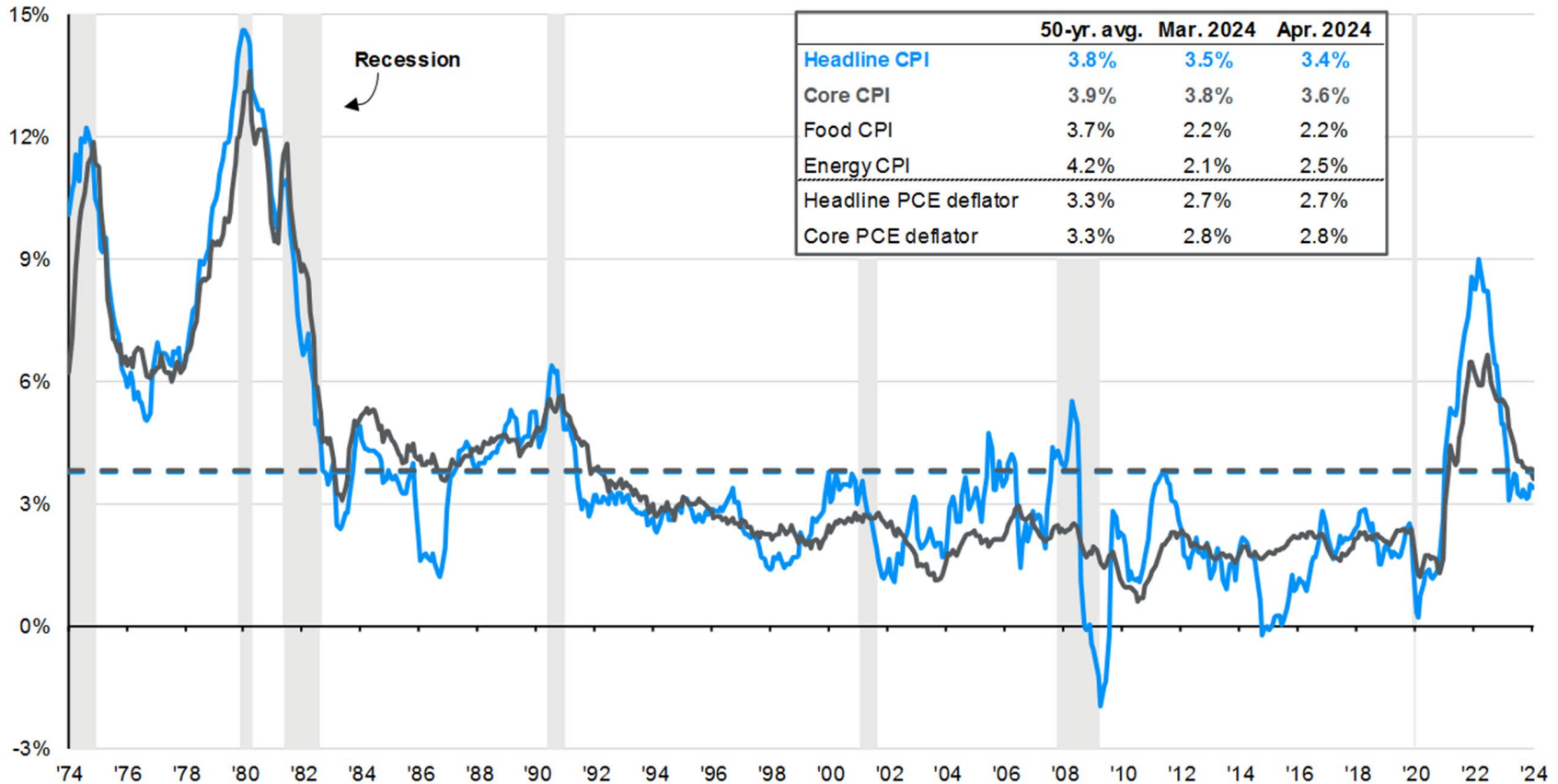


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“Sticky” Inflation: CPI vs Core CPI

CPI and core CPI

% change vs. prior year, seasonally adjusted

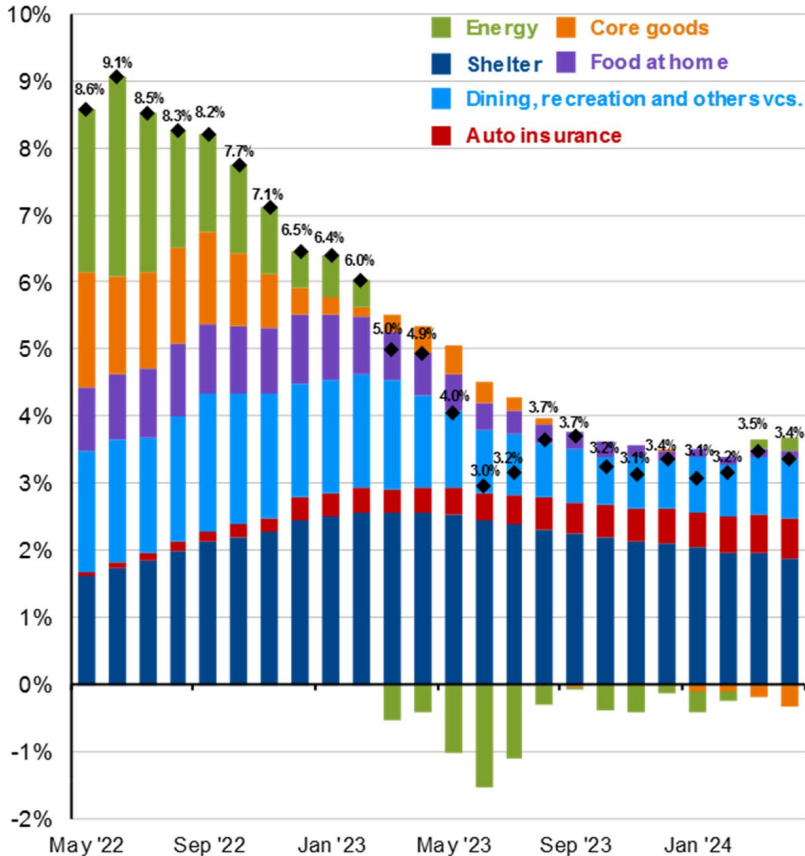


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CPI: Components

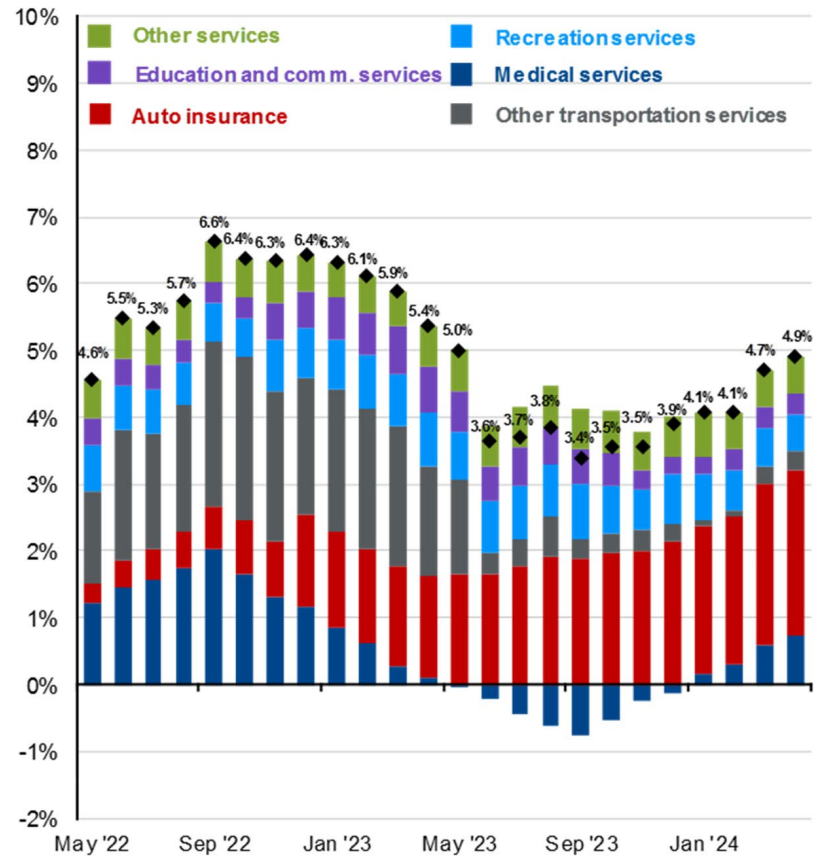
Contributors to headline CPI inflation

Contribution to y/y % change in CPI, non-seasonally adjusted



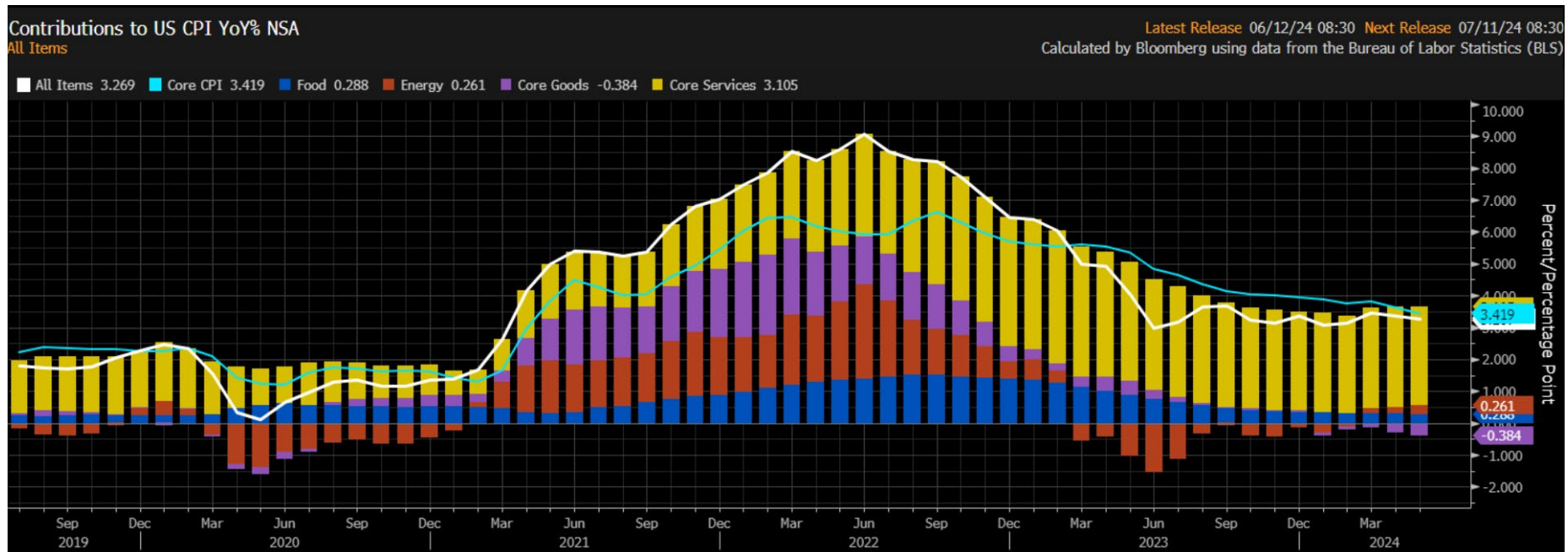
Contributors to core services ex-shelter CPI inflation*

Contribution to y/y % change in custom CPI index, non-seasonally adj.



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CPI: Key Considerations



- Core Services = 58.32% of the headline CPI figure, running at 3.10% y/y.
 - Shelter alone is ~35% of total CPI.
 - This alone is contributing ~2% to the headline figure.
 - Auto insurance → 0.53%
 - Education
- There is NO WAY for headline inflation to reach the Fed's goal of 2% unless we slow or eliminate the rise in housing costs.
- **Interest rates along are unlikely to solve housing/shelter prices alone!**

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CPI: Key Considerations

Contributions to US CPI YoY% NSA

Latest Release 06/12/24 08:30 Next Release 07/11/24 08:30
 Calculated by Bloomberg using data from the Bureau of Labor Statistics (BLS)

Table Show Weights Show Heat Map Show Tickers Show Less Hide Table

Series	Sep-23	Oct-23	Nov-23	Dec-23	Jan-24	Feb-24	Mar-24	Apr-24	May-24	Weight
All Items	3.700	3.241	3.137	3.352	3.091	3.153	3.477	3.357	3.269	100.000
▼ Core Services	3.261	3.155	3.158	3.089	3.129	3.057	3.176	3.153	3.105	58.317
▶ Shelter	2.391	2.259	2.208	2.117	2.082	1.990	1.971	1.936	1.898	34.674
▶ Medical Care Services	-0.179	-0.132	-0.059	-0.032	0.042	0.071	0.141	0.173	0.198	6.400
▼ Transportation Services	0.517	0.528	0.577	0.556	0.550	0.583	0.639	0.672	0.635	5.915
▶ Motor Vehicle Insurance	0.457	0.473	0.479	0.509	0.518	0.521	0.564	0.577	0.523	2.628
▶ Motor Vehicle Maintenance	0.109	0.103	0.092	0.078	0.073	0.075	0.093	0.086	0.083	1.110
▶ Public Transportation	-0.079	-0.079	-0.072	-0.054	-0.034	-0.023	-0.022	-0.002	0.000	0.828
▶ Motor Vehicle Fees	0.009	0.014	0.011	0.013	0.014	0.012	0.015	0.019	0.018	0.490
▶ Car And Truck Rental	-0.012	-0.013	-0.014	-0.015	-0.019	-0.013	-0.010	-0.012	-0.011	0.119
▶ Leased Cars & Trucks	0.032									
▶ Education And Communication	0.124	0.116	0.068	0.063	0.063	0.075	0.072	0.080	0.098	4.821
▶ Recreation Services	0.197	0.175	0.147	0.175	0.165	0.141	0.142	0.130	0.124	3.110
▶ Other Personal Services	0.096	0.094	0.088	0.092	0.098	0.073	0.078	0.072	0.060	1.458
▶ Water, Sewer and Trash Collection	0.055	0.056	0.056	0.055	0.059	0.057	0.056	0.056	0.051	1.060
▶ Household Operations										
▶ Core Goods	0.014	0.028	0.013	0.037	-0.064	-0.076	-0.153	-0.284	-0.384	21.378
▶ Food	0.498	0.444	0.398	0.366	0.348	0.303	0.302	0.298	0.288	13.431
▶ Energy	-0.073	-0.386	-0.431	-0.140	-0.322	-0.130	0.152	0.190	0.261	6.874
Core CPI	4.147	4.031	4.007	3.930	3.862	3.753	3.801	3.610	3.419	

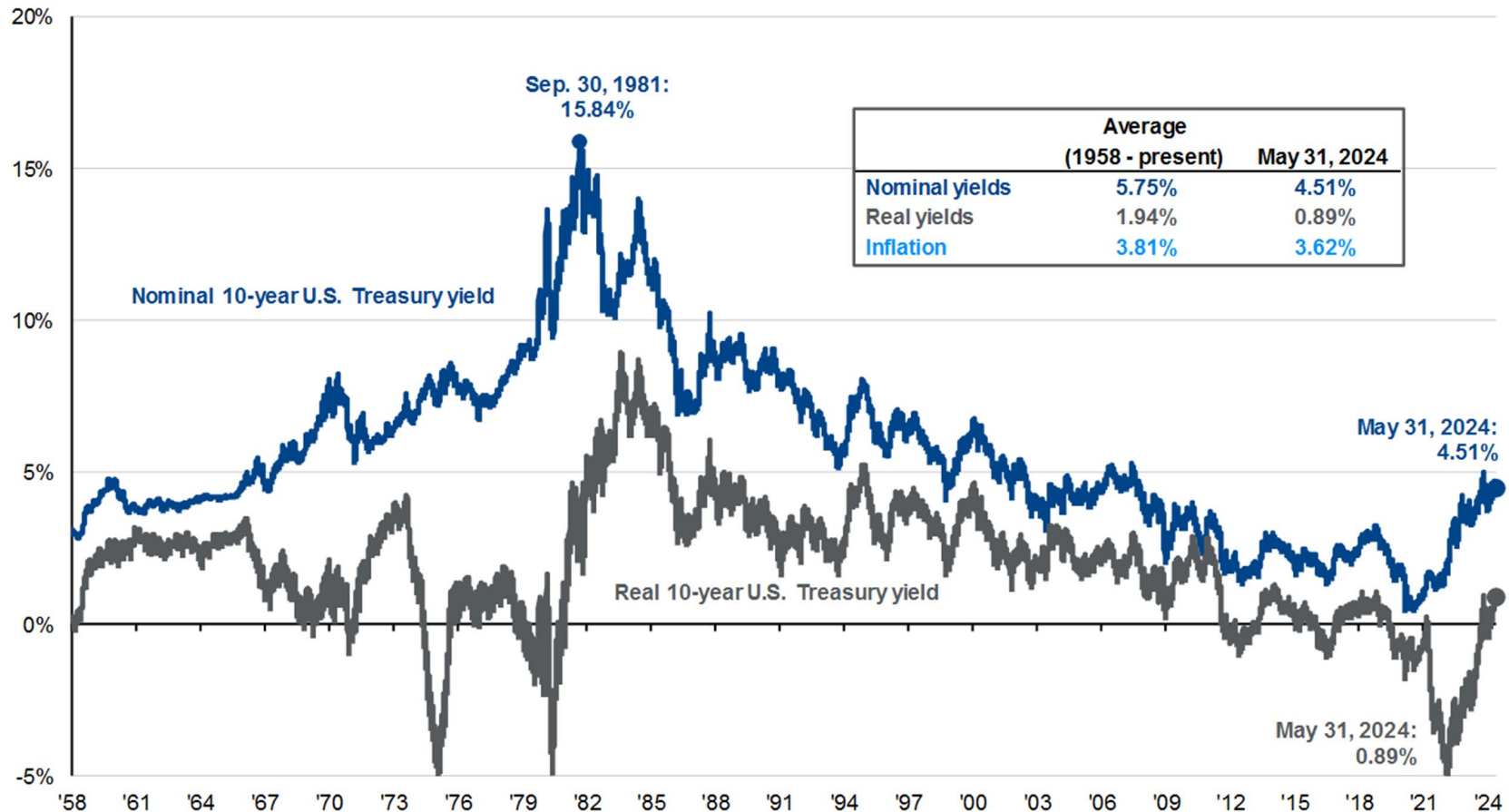
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Part 2: Interest Rates

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Interest Rates & Inflation

Nominal and real U.S. 10-year Treasury yields

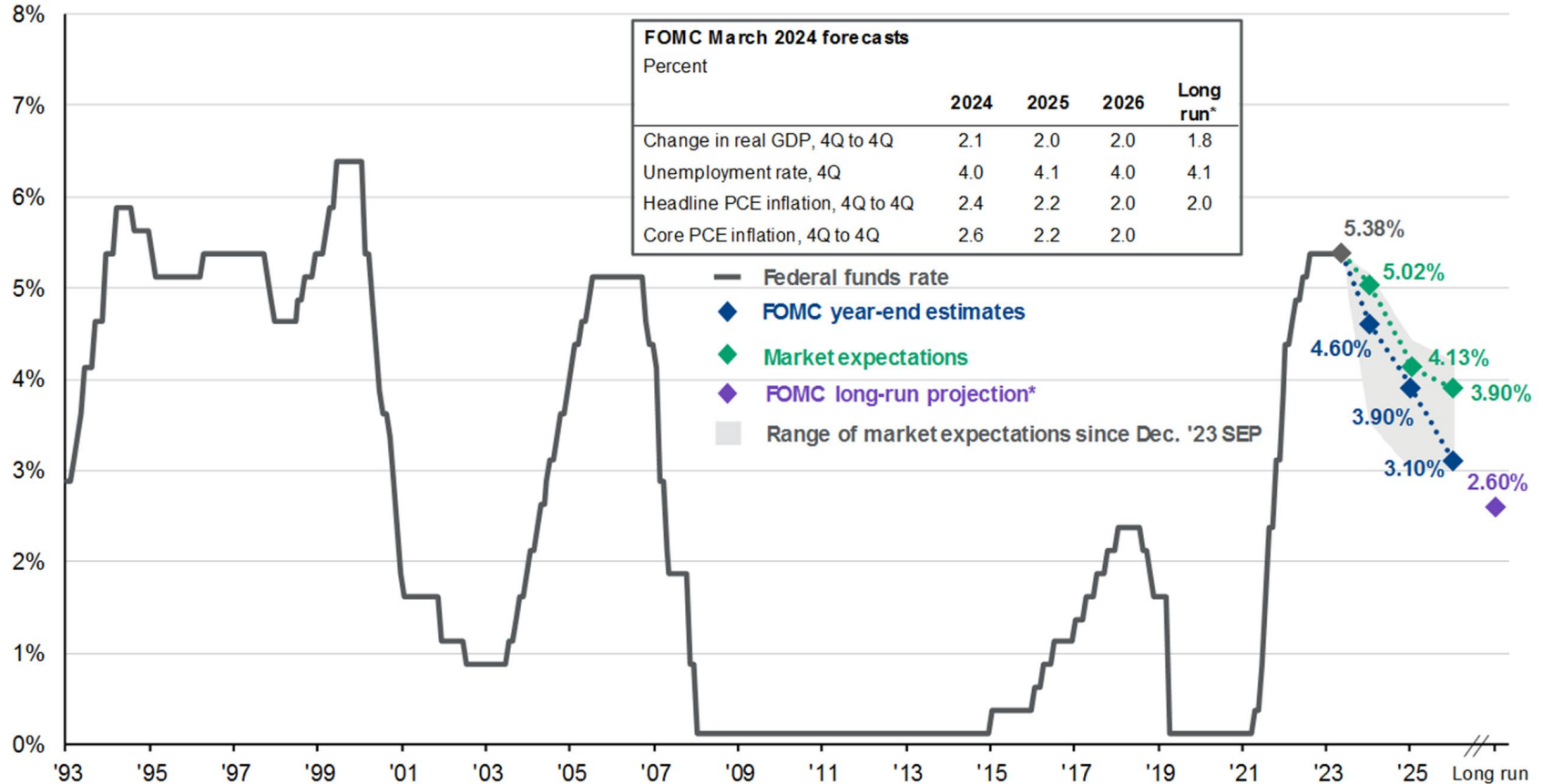


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FOMC and Historical Rates

Federal funds rate expectations

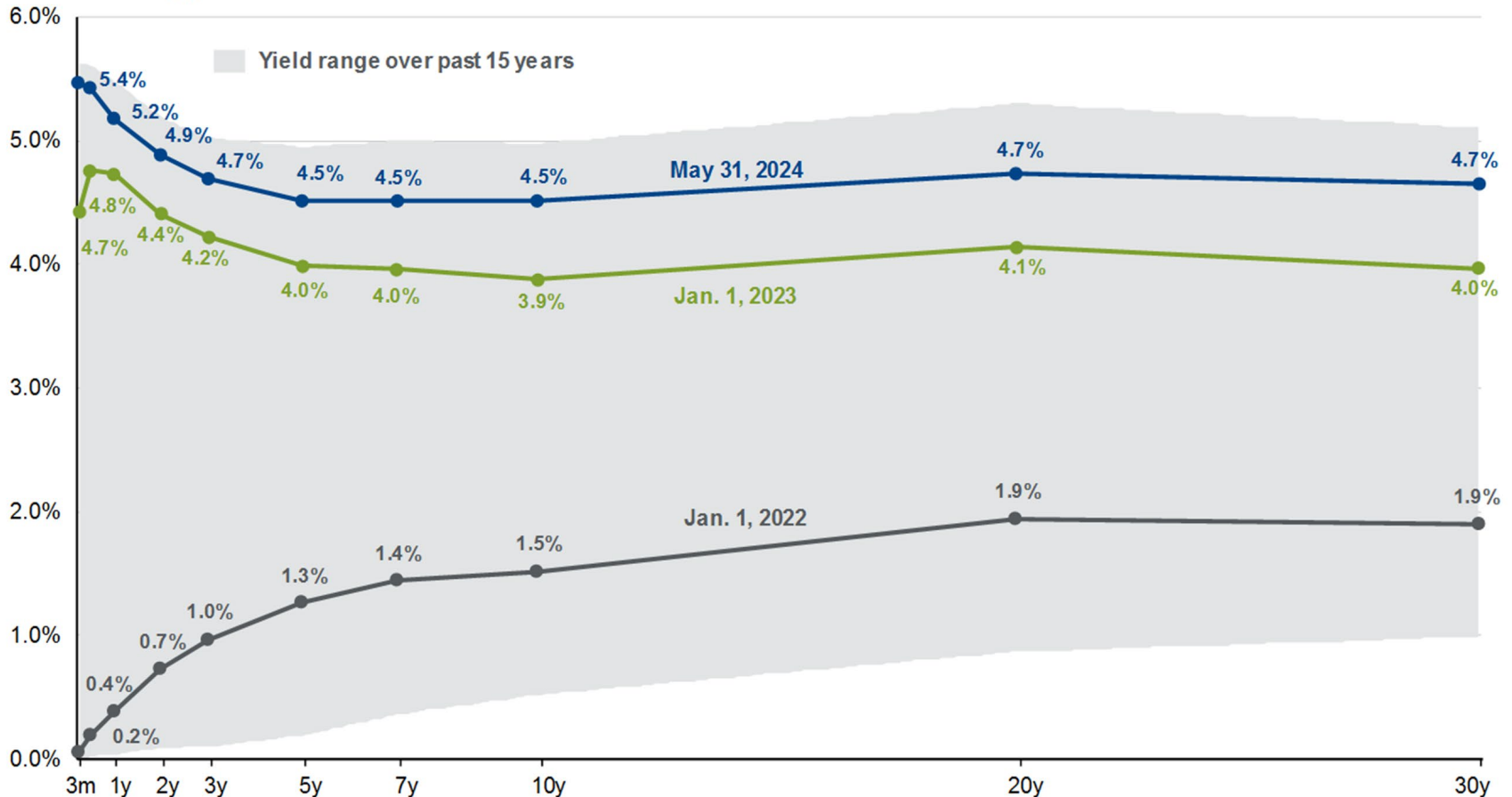
FOMC and market expectations for the federal funds rate



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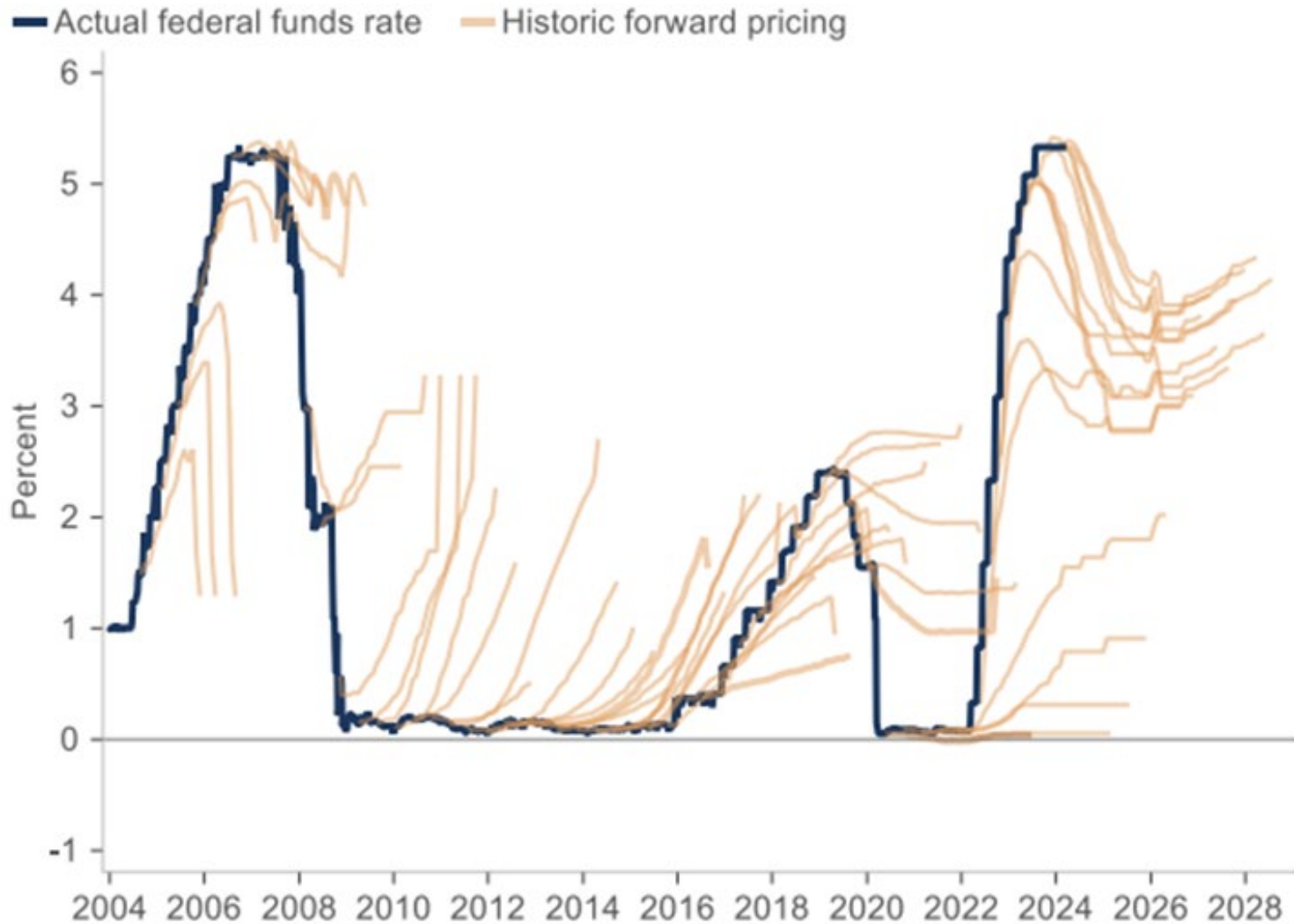
Treasury Yields: Historical

U.S. Treasury yield curve



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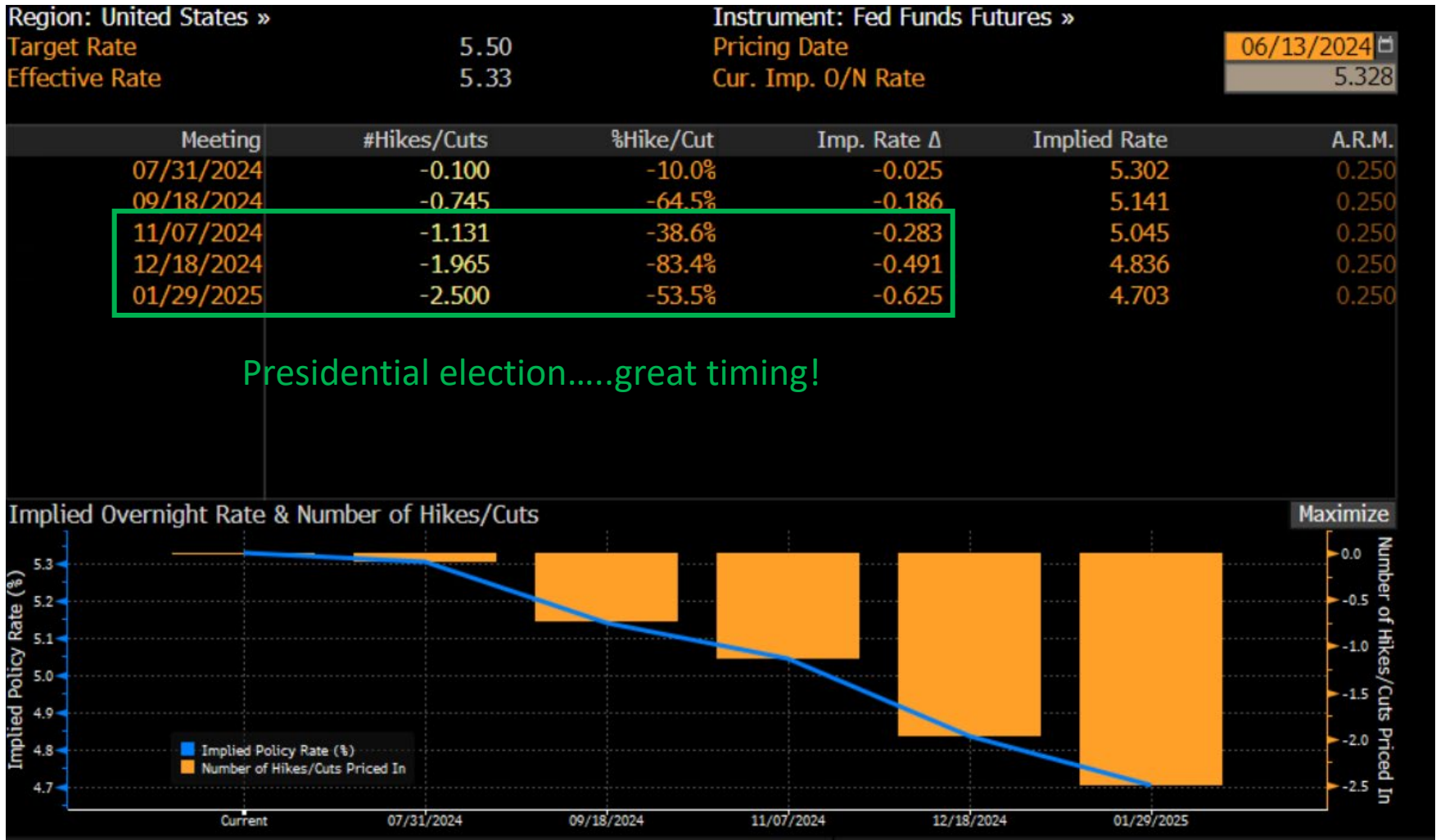
Rate “Expectations” vs Reality



Sources: New York Life Investments Global Market Strategy, Federal Reserve Bank of New York, CME Group, Macrobond, April 2024.

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How Many Rate Cuts, and When?



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NEW CPI/data

Wednesday we had the much -anticipated FOMC Meeting, see below for a brief summary:

- The Fed leaves rates unchanged with the target rate remaining at 5.25% -5.50%, citing a need to gain greater confidence that inflation is heading back to their 2% target. Fed Chair Powell emphasized that decisions will be made “meeting by meeting”.
- The Summary of Economic Projections (SEP) showed a median forecast of 25 basis points of rate cuts in 2024, down from the last dot plot release in March 2024 which showed 75 basis points of cuts.
- The SEP did show four rate cuts in 2025, up from three in the March SEP.
- FOMC median 2024 GDP forecast was unchanged at 2.1%.
- FOMC median 2024 Core PCE Inflation estimates increased to 2.8% from 2.6%.

Market Impact:

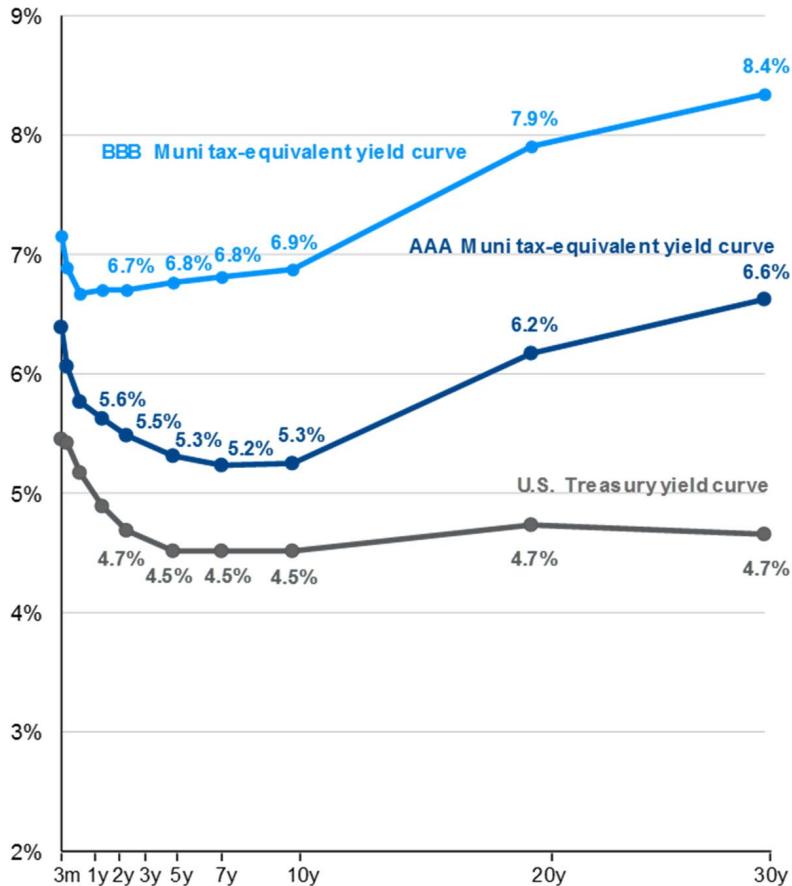
A few hours before Fed chair Powell’s announcement, we received one of the most encouraging CPI reports that we have seen in quite a while.

This caused yields to drop by double digits across the interest rate curve. However, Powell's unexpected announcement of just one rate cut in 2024 (down from three) tempered the initial market reaction, albeit not entirely. Despite this, yields closed lower for the day.

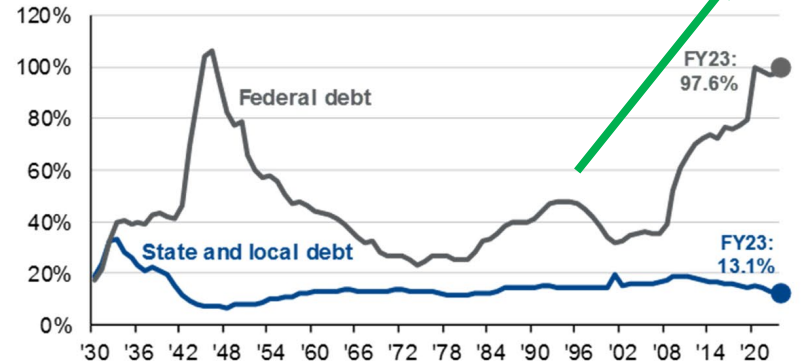
Thursday, the release of further job and inflation data, both of which were weaker than expected, continued to exert downward pressure on yields. Given the influx of information, we anticipate ongoing volatility as market participants digest these developments.

Municipal Finance vs Federal

Muni tax-equivalent and Treasury yield curves

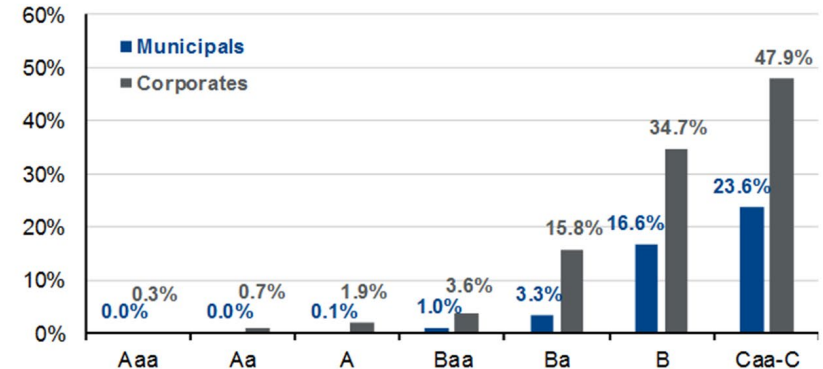


State and local and federal net debt
% of GDP, 1930-2023, end of fiscal year



Muni and corporate default rates

% of issuers defaulting within 10 years, 1970-2022

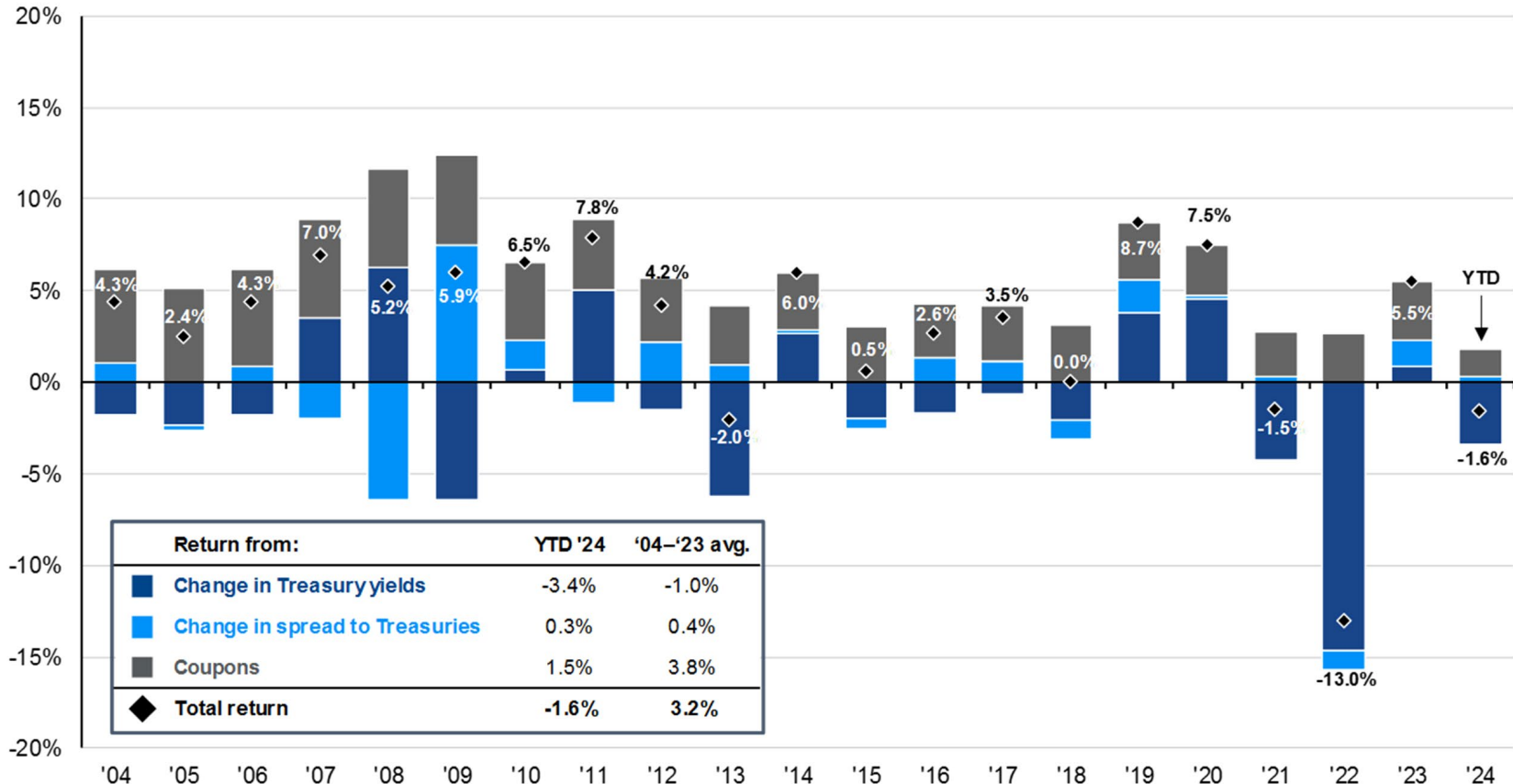


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Bond Market Total Returns

Bloomberg U.S. Aggregate annual total return

Total return broken into change in Treasury yields, change in bond spreads over Treasuries and coupon



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Part 3 : Investment Strategy

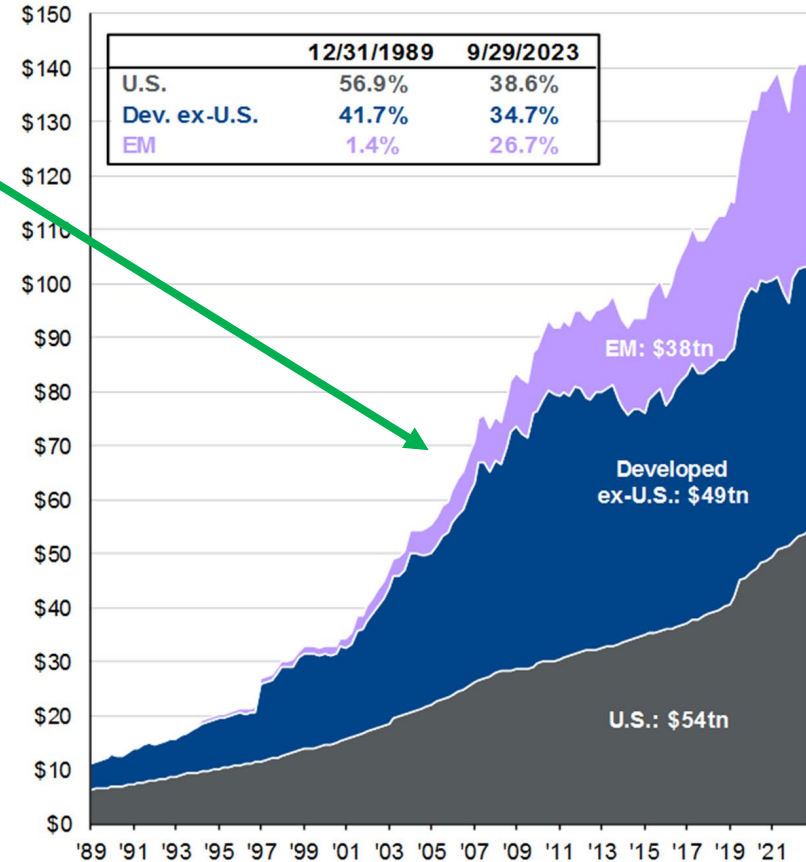
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Global Fixed Income

Aggregates	Yield		2024 Return		Duration	Correlation to U.S. 10yr
	5/31/2024	12/31/2023	Local	USD		
U.S.	5.10%	4.53%	-1.64%	-1.64%	6.1 years	0.92
Gbl. ex-U.S.	3.25%	2.87%	-	-4.34%	6.8	0.64
Japan	1.17%	0.76%	-2.76%	-12.76%	8.8	0.64
Germany	3.29%	2.73%	-1.93%	-3.62%	6.2	0.57
UK	4.70%	4.10%	-2.99%	-3.11%	7.8	0.56
Italy	3.78%	3.40%	-0.08%	-1.80%	6.1	0.44
China	2.29%	2.62%	2.92%	0.76%	6.0	0.55
Sector						
Euro Corp.	3.92%	3.56%	-0.12%	-1.84%	4.4 years	0.45
Euro HY	6.91%	7.35%	2.77%	1.00%	3.1	0.05
EMD (USD)	8.42%	7.84%	-	1.72%	5.7	0.37
EMD (LCL)	6.61%	6.19%	0.70%	-2.66%	5.0	0.26
EM Corp.	6.79%	6.81%	-	2.89%	4.9	0.27

Global bond market

USD trillions

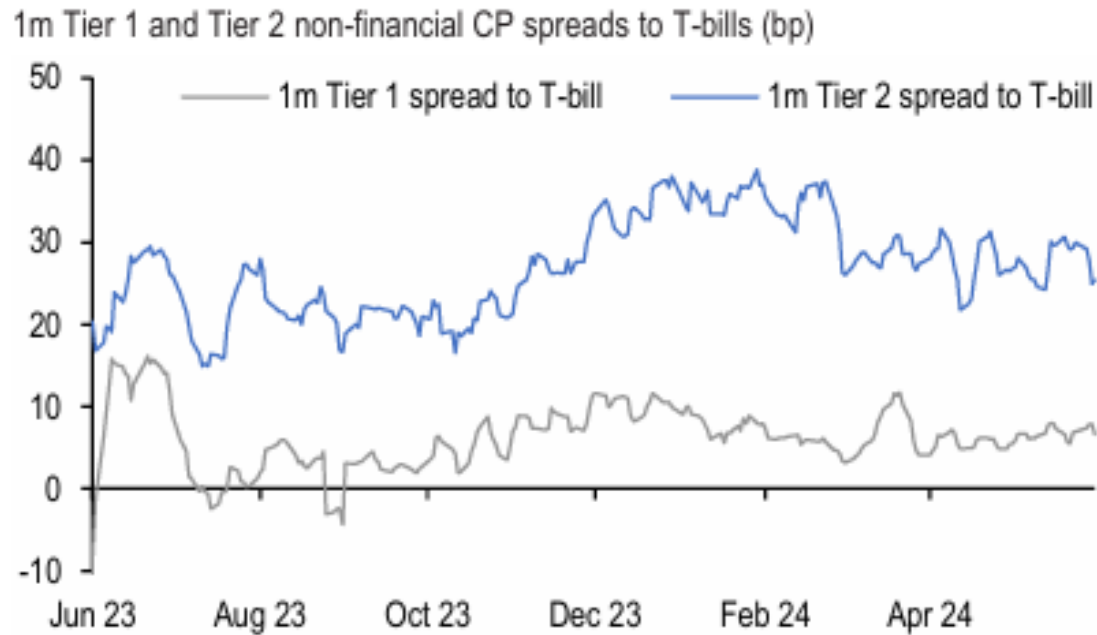


*“There isn’t enough high -quality debt” (especially with any yield)
US Treasury remains the best game in town...but there are concerns*

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Commercial Paper: Spreads

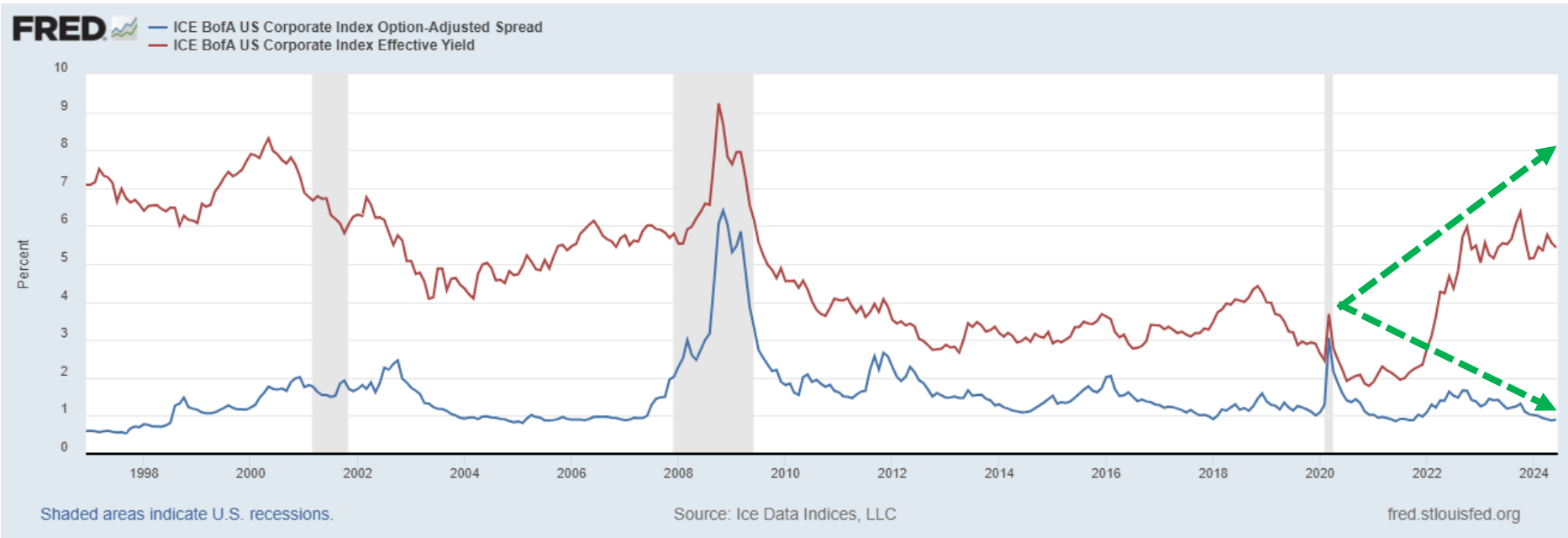
Figure 8: Tier 1 and Tier 2 yield spreads to bills have traded mostly in a narrow range over the past year, reflecting continued demand for corporate supply



Source: DTCC, J.P. Morgan

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Spreads vs Yield: What Matters?



- Yield Spreads: The additional interest/yield required above a comparable maturity risk -free bond (US Treasury).
- Everyone is looking at yield, but not so much at spread.
- Complacency? Or is this normal?

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The best time to plant a tree
was 20 years ago.
The second best time
is now.



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Duration: When to Add?

	Peak inversion date	30-day Treasury bills	5-year U.S. Treasury	20-year U.S. Treasury
Next 3 years	2/29/1980	12.00%	17.70%	16.50%
	3/31/1989	6.90%	11.40%	12.40%
	3/31/2000	3.40%	10.50%	11.20%
	11/30/2006	2.20%	7.30%	6.90%
Next 5 years	2/29/1980	10.90%	14.30%	12.20%
	3/31/1989	5.40%	10.20%	12.10%
	3/31/2000	2.50%	6.70%	8.70%
	11/30/2006	1.40%	7.00%	9.40%
Next 10 years	2/29/1980	8.80%	12.70%	13.60%
	3/31/1989	5.20%	8.50%	11.00%
	3/31/2000	2.60%	6.10%	6.90%
	11/30/2006	0.70%	4.20%	6.40%

Sources: Morningstar Direct, DWS Investment GmbH as of 9/20/23
DWS calculation from 31st May 1976 to 30th June 2023

Long Duration Treasuries > T -Bills at the end of a cycle

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Strategy for 2024 - 2025

We believe the Fed will do everything in its power to fulfill its mandate of “stable prices” (aka 2% inflation goal) by raising short-term rates and keeping them high until CPI is convincingly low.

1. **Quality Focus and US Domestic Bias** : Emphasizing investments with the strongest credit profiles, including state and/or federally guaranteed issuers . Consider US Treasuries, US Agencies, high-quality municipal bonds and tier-one (highest rated) commercial paper where appropriate .
 2. **Add Duration (where appropriate)** : *markets remain volatile . When rates rise on disappointing economic data (CPI, employment, etc.) consider adding duration .*
 3. **Call Protection** : *consider instruments that will pay high-quality income for the long-haul . Avoid callable securities with large, current coupons that will likely be called when rates eventually fall . Instead, use market selloffs to add duration (item 2 above) .*
- **T-bills and US Treasuries** : spreads are low, consider adding Treasuries as they are non-callable and supply is plentiful, keeping yields up (for now).

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Questions & Comments



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Presenters' Bio

Benjamin Streed

Benjamin Streed, CFA

Chief Investment Officer

17 Years Investment Experience

Benjamin Streed is the Chief Investment Officer. As CIO, he is an integral component of our firmwide commitment to attract and retain industry leaders who will better service our clients and local communities. His focused efforts to build out our front, middle, and back office will position us for continued growth.

Before becoming CIO, he served as Director of Fixed Income for several years. In this role he worked with investment professionals to deliver comprehensive, custom, diversified portfolio management strategies for separately managed accounts, consulting clients, and the U.S. Fixed Income Trust local government investment pools. Benjamin will continue directing the Portfolio Management team and serving on the firm's investment and credit committees. He will further develop as a thought leader in the investment space — attending industry seminars and speaking engagements to educate our clients and prospects.

Prior to joining Deep Blue, Benjamin served as a fixed income strategist with Wells Fargo Private Bank. Prior to this role, he was a strategist with Raymond James Financial, where he was a member of the investment strategy committee and the strategic and tactical asset allocation sub-committees. He has also served as an investment analyst and portfolio manager at Merrill Lynch.

Benjamin earned a Bachelor of Science degree in business administration with a focus on finance from Emory University and a Master of Science in finance (MSF) from Georgetown University where he graduated as class valedictorian. He is a CFA® charter holder and frequently volunteers his time with the CFA curriculum advisory committee and the Georgetown MSF alumni council.

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Citations

Bloomberg LP, DBIA

JPMorgan Asset Management: Guide to the Markets (as of 5/31/2024)

<https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/guide-to-the-markets>

<https://fred.stlouisfed.org>

US Department of the Treasury

US Bureau of Labor Statistics

Contact Information

EXECUTIVE

Brent Wertz	Managing Partner	brent.wertz@deepblue -inv.com	813-321-3249
David Jang	Managing Partner	david.jang@deepblue -inv.com	407 -618-4269
Soth Chin	Chief Compliance Officer	soth.chin@deepblue -inv.com	202 -503 -9669

BUSINESS DEVELOPMENT

Frederick Berretta	Managing Director	frederick.berretta@deepblue -inv.com	813-313-9659
Ken Couch	Director - Texas	ken.couch@deepblue -inv.com	210-888 -0452
George Yao	Director – Florida	george.yao@deepblue -inv.com	813-321-4804

INVESTMENT ADVISORY

Dominick Cristofaro	Director	dominick.cristofaro@deepblue -inv.com	813-556 -9778
John Scott	Associate	john.scott@deepblue -inv.com	813-556 -9775

CLIENT SERVICES

Ed Polansky	Director	ed.polansky@deepblue -inv.com	813-992 -3145
Grant Presson	Associate	grant.presson@deepblue -inv.com	813-321-3254

PORTFOLIO MANAGEMENT

Benjamin Streed, CFA	Chief Investment Officer	benjamin.streed@deepblue -inv.com	813-440 -5088
Dan Marro, CFA	Portfolio Manager	dan.marro@deepblue -inv.com	813-321-3253

OPERATIONS & REPORTING

Jeff Harvey	Director of RIA Operations	jeff.harvey@deepblue -inv.com	813-556 -9777
Tim Bafaloukos	Business Analyst	tim.bafaloukos@deepblue -inv.com	813-321-3251
Vito Resciniti	Market Strategy & Research Analyst	vito.resciniti@deepblue -inv.com	813-556 -9774
Liz Gonzalez	Director of Reporting	liz.gonzalez@deepblue -inv.com	813-321-3255
Courtney Hislop	Senior Reporting Analyst	courtney.hislop@deepblue -inv.com	813-556 -9779

ADMINISTRATION

Suanne Lee	Director of Admin and Finance	suanne.lee@deepblue -inv.com	813-321-3250
Liz Albert -Ramos	Administrative Assistant	liz.albert -ramos@deepblue -inv.com	813-321-4008

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