

Neuberger Berman Tax-Exempt Short Core Fixed Income Portfolio

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Performance Highlights

The Neuberger Berman Tax-Exempt Short Core Fixed Income Portfolio ("Portfolio") posted a positive return in the third quarter of 2024 but underperformed the benchmark.

Market Context

Fixed income market performance was supported by declining interest rates as the Fed cut policy rates by a greater-than-expected 50 basis points in September. There was a significant rally in interest rates at the start of the month due to weaker non-farm payroll data and the expectation that the Fed would announce the first rate cut after two and half years of a tightening regime. A sell-off in equities and credit markets occurred earlier in September but a rally ensued just before and after the Fed announced its 50 bps decision.

The August employment report was weaker than expected, with non-farm payrolls increasing by +142,000 (vs. +165,000 consensus). Average hourly earnings rose by +0.4% MoM (vs. +0.3% consensus). The unemployment rate came in at 4.2% (vs. 4.2% consensus) and declined from the prior month's report. August inflation continued to moderate, with headline inflation meeting expectations, as headline CPI was +2.5% YoY (vs. 2.5% consensus). Core CPI, which excludes food and energy prices, was in line with expectations at +3.2% YoY (vs. +3.2% consensus). Consumer spending was slightly above expectations as seasonally adjusted U.S. retail sales increased by +0.1% MoM (vs. -0.2% consensus).

The Fed announced a 50 basis point reduction in the federal funds rate target range to 4.75 to 5.00%. Economic activity is expanding, but job gains have slowed, and inflation, while progressing towards the 2% goal, remains slightly above the Fed's target. The Fed remains committed to achieving maximum employment and a 2% inflation rate, continuing to reduce its holdings of Treasury and agency securities. The decision had majority support, with one member preferring a smaller rate reduction.

Despite pockets of volatility in the month and quarter, rates eventually settled at lower levels across the Treasury curve and equity and credit markets rallied after the market sell offs. U.S. government yields moved lower across the curve during the quarter, supporting positive performance across fixed income

markets. The 2-year decreased by -112 bps to 3.64%, the 10-year decreased by -62 bps to 3.78%, and the 30-year decreased by -44 bps to 4.12%.

Investment grade U.S. municipal bond returns, as measured by the ICE BofA Municipal Securities Index, delivered strong returns of 2.73% during the third quarter. However, returns varied depending on curve positioning. For the quarter, 1-3 year munis generated a return of 1.95% and the 3-7 year part of the curve outperformed at 2.96%. Longer maturities, in the 22+ year range, also performed well with a return of 2.99%. The Bloomberg Taxable Municipal Index significantly outperformed with a return of 5.42%.¹ Per Bloomberg, total municipal issuance (tax-exempt and taxable) for the quarter was \$134.4 billion or 44% higher than it was for the same quarter a year earlier. With regard to credit, BBB rated securities slightly outperformed AAA rated bonds during the quarter. Revenue bonds and general obligations delivered comparable returns during the quarter and housing related credits outperformed. Tobacco related bonds underperformed.

Portfolio Review

The Tax-Exempt Short Core Fixed Income Portfolio posted a positive return in the third quarter of 2024 but underperformed the benchmark. Overall duration and sector decisions were positive contributors while positioning across the yield curve and security selection factors were a drag on performance.

Outlook

While elevated supply has caused the muni market to lag other high-quality fixed income asset classes such as U.S. Treasuries, we have been impressed with how orderly the market has been, given that new issue volume is up 40% relative to the first nine months of 2023. Dealers have been careful to build in appropriate price concessions for new issues to make sure they clear the market. Demand is clearly there when you consider that mutual fund flows have been positive by roughly \$25 billion since December. Separately, managed account flows are a bit harder to track, but all

signs point to strong flows in that investment vehicle, which continues to grow in popularity.

The bright side of all this supply is better valuations and more potential excess income on a taxable-equivalent basis. For example, intermediate munis ended the third quarter yielding roughly 2.83%, which equates to a taxable-equivalent yield of 4.78% or 112 basis points higher than intermediate Treasuries.

From an economic standpoint, our base case remains for a soft landing for the U.S. economy. In our view, that should bode well for municipal credit quality, which already benefits from strong reserve levels and generally prudent fiscal management. Lower-rated investment grade (A and BBB rated) and high yield munis have meaningfully outperformed the highest-rated bonds so far this year. With nearly half of all municipal fund flows in 2024 going into high yield, we believe the market for lower-rated munis is well supported from both technical and economic standpoints. However, given the outperformance of lower-rated bonds over the past two years, security selection will likely be an important differentiator when adding any credit exposure moving forward. Our overall bias is “up in quality.”

Looking ahead, we remain constructive on the municipal market. We expect elevated supply to continue as we move closer to the election, which will give investors a unique opportunity to deploy capital and also participate in deals with price concessions. As mentioned, we believe muni valuations are attractive on a tax-adjusted basis. Finally, if volatility increases due to the U.S. election

or geopolitical issues, we think munis will continue to deliver for investors as a safe-haven asset class.

¹Source: Bloomberg

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Through December 31, 2023, the Index consists of 50% ICE BofA 1-3 Year US Municipal Securities Index and 50% the ICE BofA 3-7 Year US Municipal Securities Index. From January 1, 2024 and onward, the Index consists of ICE BofA 1-5 Year US Municipal Securities Index.

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