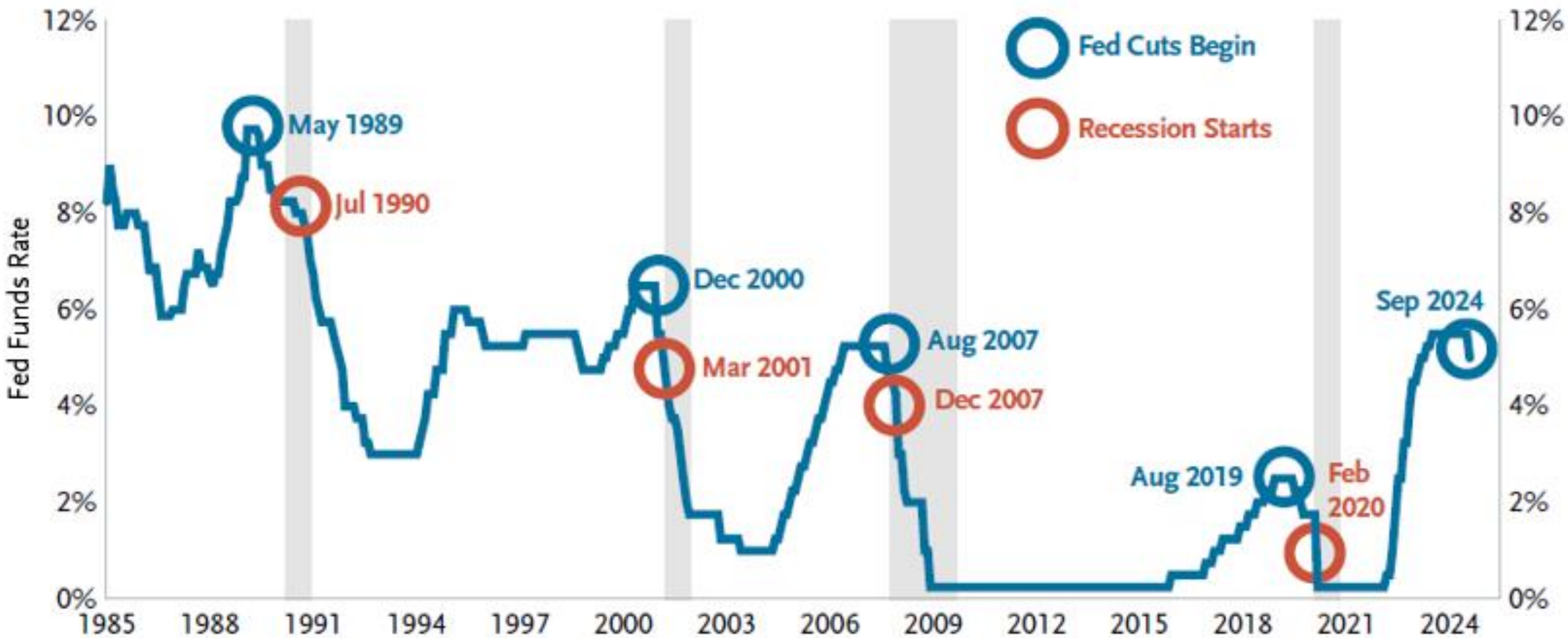
3Q 2024: Nightmare on Easing Street

3Q 2024: Recessions Often Start Not Long After the Fed Begins Easing



Source: Bloomberg

Our View: This time is not likely to be different. The Fed is easing not because they can, but because they have to. We expect that to become increasingly clear in the months ahead as a hard landing becomes more and more evident.

3Q 2024: Labor Market Weakens Further

- After nascent signs of weakness throughout the first half of the year, the labor market experienced a more pronounced deterioration in the third quarter as the unemployment rate continued to climb higher, highlighted by July's 4.3% reading – the highest level in nearly three years, and a far cry from the cycle low of 3.4% in April of 2023*.

- The pace of hiring has also slowed dramatically, bringing the Job Openings Rate significantly lower. The Beveridge Curve relates Job Openings to unemployment, and the recent decline in openings puts us much closer to the kink in the curve where fewer job openings translate to meaningfully higher unemployment. This is a typical pattern in a slowing economy as employers shift from hiring new workers, to not hiring workers, to ultimately cutting jobs.

- Though labor market weakness was increasingly more broad-based over the quarter, many market participants, especially those in the soft-landing camp, still referenced positive monthly nonfarm payroll figures as the key guidepost for conditions in the job market. However, the three-month trend rate of growth fell to the lowest levels since the pandemic and below the equilibrium rate, while revisions to the prior year's data showed payrolls were overstated by more than 800k jobs, bringing them much more into line with other indicators.

- Meanwhile, worsening labor market conditions also appeared in survey-based data, where respondents indicated a souring outlook for future wage growth and job prospects. In fact, the jobs gap, or the share of respondents in the Conference Board's gauge of consumer confidence indicating "jobs are plentiful" minus the share indicating "jobs are hard to get", declined for the eighth straight month to close the quarter at 12.6%. This marked the lowest reading since 2021, when the unemployment rate was over 6%*.

Our View: Conditions in the labor market are likely to continue worsening in the coming quarters as still-restrictive monetary policy takes a toll, driving further increases to both the level and rate of change of the unemployment rate. The state of the jobs market is the key determinant for the depth of the recession and the pace of the Fed's easing cycle, and we expect to see material signs of deterioration through the remainder of 2024 and into 2025.

*Unemployment data from BLS

3Q 2024: Consumers No Longer Operating from a Position of Strength

- Consumer spending, one of the few pillars supporting the economy, faded over the quarter amid still-elevated price levels and a shifting macroeconomic backdrop. Per the U.S. Census Bureau, growth in retail sales fell to 2.1% on a year-over-year basis, below the 4.5% average spanning the past thirty years of data. Moreover, slumping retail sales highlight a shift in consumption patterns, whereby more discretionary items are foregone in favor of essentials like food and services.

- In addition to higher price levels in recent years, consumers have borne the burden of higher financing rates, producing a challenging set of circumstances for those that relied heavily on debt instruments and credit card utilization to navigate a materially higher cost of living. As a result, delinquency rates on credit cards are at the highest level in a decade, while auto loan delinquencies are also at elevated levels as households struggle to make ends meet.

- Presenting a further headwind to consumer balance sheets has been the steady drawdown in household savings as measured by the personal savings rate, which the Bureau of Economic Analysis measures as the amount of personal savings as a percentage of disposable personal income. This figure fell as low as 2.9% over the quarter, suggesting current consumption is unsustainable for the long-term.

- Though lower risk-free rates are on the horizon, the typical stimulatory impact of an easing Fed on the housing sector is likely to be more muted than it has been in the past given the prevalence of low, fixed rate mortgages. Just as those mortgages served to blunt the impact of higher rates for homeowners as rates were rising, so too will they reduce the effectiveness of monetary easing as homeowners will be unable to refinance their mortgages at lower rates to free up more monthly spending power.

Our View: We continue to anticipate further increases in delinquency rates and a more broad-based slowdown in consumption as still elevated interest rates and the lack of cushioning typically afforded by excess savings or the ability to refinance a mortgage, weigh on consumers. This stress, coupled with likely higher unemployment creates a challenging environment for spending, and ultimately for economic growth.

3Q 2024: The Fed's Easing Cycle Begins

- Markets were expecting a 25 bp cut to the Fed Funds rate about a week before the September meeting. With no meaningful data appearing in the interim, it appears clear that FOMC Chair Powell deftly manipulated market expectations in the days before the meeting to raise those expectations. Shortly thereafter, the committee voted to reduce the benchmark rate by 50 bps in the first rate cut since March of 2020.

- The shift in FOMC projections from June to September was dramatic and provided some insight into the committee's view of the economy and outlook for future conditions. Illustratively, at the June meeting, Fed officials projected just one 25 bps cut by year-end, while the most recent projections showed four total cuts by year-end (inclusive of the 50 bps move), a drastic shift that underscores the committee's sense of urgency.

- Another topic of conversation over the prior months as the cutting cycle drew near was the notion of where the appropriate neutral rate of interest lies in a post-pandemic world. While that level can't be known in real time, the median FOMC projection of the Fed Funds rate in the long term came in at 2.9%, or more than 200 bps lower than current levels even after the September rate cut.

- With the Fed Funds rate all but certain to move lower over the coming quarters, the focus then turns to the timing and path of rate cuts. Though both the market and Fed officials currently project a gradual pace of easing towards the long-term rate, historical precedent instead suggests that the Fed will ease more aggressively than what is priced into markets at the start of the cutting cycle, and that they are likely to overshoot the target, cutting rates below neutral levels for some time.

Our View: There will always be some disagreement about the true neutral level of interest rates, but it is widely agreed that rates at current levels are restrictive. Rates will also be restrictive after another 50 bp cut, and for at least 100+ bps of cuts after that. Fed officials have stated that the risks to inflation and full employment have moved into better balance recently, implying rates should be at or near neutral now, yet we remain far from those levels. That suggests to us that cuts will be faster and greater in magnitude than is currently expected by markets.

3Q 2024: Global Economies Slowing Substantially

- Numerous developed market central banks (outside of Japan) either initiated or continued their easing cycles given a moderating pace of global inflation. The Bank of England lowered their bank rate for the first time in four years, while the European Central Bank followed June's rate cut with an additional reduction in September as Eurozone inflation fell to 2.2% in August, down from 5.2% a year ago. Similarly, the Swiss National Bank enacted its third 25 bps cut amid cooling price pressures.

- Despite lower inflation, many regions faced continued headwinds to growth, especially the Eurozone given weakness in the manufacturing sector. The most recent S&P Global manufacturing PMI for the region was the lowest reading this year, weighed down by Germany, which continued to struggle amid production cuts, declining demand out of China, structurally higher energy prices, and auto market weakness. Including the country's services sector as well, employers in Germany shed jobs at the fastest pace in fifteen years (excluding COVID).

- Meanwhile, the sluggish recovery of the Chinese economy continued for much of the quarter amid ongoing property sector woes and flagging domestic demand. To help spur a recovery and support asset prices and sentiment, Chinese authorities announced a large-scale stimulus package in late September focused on monetary and liquidity tools, including lower reserve requirements for banks, reduced rates on outstanding mortgages, and improved access to bank lending for publicly listed equity companies.

- These actions proved timely and well-received by the market as Chinese equities and China-exposed stocks surged in response. The Chinese counterpart to the S&P 500, the CSI 300, gained over 27% in the final two weeks of the quarter, including an 8.5% gain on the final trading day. While the stimulus provided a quick boost, the Shanghai composite has lagged the S&P500 for years, suggesting more dramatic support is needed to reinvigorate markets in the world's second largest economy.

Our View: A start to the Fed's easing cycle opened the floodgates of looser monetary policy across the globe, especially for countries whose currencies would have fallen with pronounced policy divergence. However, with the Fed likely easing aggressively going forward, we expect further dollar weakness ahead, as central banks singularly focused on inflation follow a slower rate cutting path.

3Q 2024: Credit Markets Still Priced to Perfection

- Credit spreads on the Bloomberg U.S. Credit Index tightened modestly over the quarter to end the period at 84 bps over Treasuries, just 4 bps above the cycle-low of 80 bps in May and less than 10 bps away from the post-GFC tights of 76 bps in 2021. Though spread compression has been a consistent theme this year across all types of credit, such tight levels imply poor performance ahead as history suggests forward excess returns (performance relative to duration-matched Treasuries) will suffer as spreads eventually return to more normal levels.

- In addition to narrowing credit spreads, credit markets this year have been defined by a notable lack of volatility. Spreads on the Bloomberg U.S. Credit Index traded within a 24 bp range year-to-date, with most months experiencing just a single-digit range. In fact, most of the YTD range stems from August, when the short-lived market selloff on August 5 temporarily pushed spreads wider and resulted in the first and only day this year spreads closed above 100 bps.

- Meanwhile, the Bloomberg U.S. High Yield Index experienced an even greater degree of spread compression over the quarter to end the period at 295 bps, significantly lower than the 380 bps average level observed over the past two years, in a clear expression of positive investor sentiment and expectations for a no-default environment. As a result, high yield issuance was strong over the quarter as borrowers sought to capitalize on favorable levels and a receptive lender base.

- Despite lower risk-free and base rates, the loan sector continued its run of strong performance over the quarter given a supportive backdrop of positive retail flows and sustained demand from CLOs that helped push spreads tighter and keep prices high. Illustratively, over 70% of the J.P. Morgan Leveraged Loan index is priced above $99, with 33% of loans priced above par.

Our View: While a hard landing is the most likely outcome, credit markets are priced as if there were no chance of anything except a perfect soft-landing scenario. That leads to a growing disconnect between market-assessed valuations across credit sectors and the economic realities of a slowing economy that are likely to challenge these valuations, making current spread levels insufficient to justify taking meaningful risk in credit markets.

3Q 2024: Securitized Sectors Look More Attractive Than Corporate Credit

- Agency mortgages were one of the standout performers of the quarter given the sizeable move lower in Treasury yields and steepening of the curve, helping the sector rebound from early-year struggles. Performance wasn't uniform across the coupon stack, however, as the quickly shifting interest rate backdrop drove increased prepayment concerns for higher coupon bonds, which underperformed relative to lower and belly coupons that benefitted from their longer duration profiles and pull-to-par price appreciation.

- Non-agency MBS also performed well in the third quarter, with spreads generally ending the period lower after a brief spike during August's volatility. The sector continues to be supported by solid home prices and lower loan-to-value ratios, making it an attractive option to investors looking for fundamentally sound yield. This drove outsized spread compression among subordinated tranches, which was further supported by lower rates and investor demand for these riskier tranches given their typically longer duration profiles.

- Despite ongoing challenges to certain subsets within the sector, broad CMBS returns over both the quarter and year-to-date period have been solid. Demand returned after last year's reticence in the wake of the regional banking concerns, which has also helped spur an increase in issuance and activity. Like other credit assets, CMBS credit curves have compressed this year, illustrated by the nearly 400 bps narrowing in the difference between spreads on AAA and BBB- rated conduit CMBS deals within the Bloomberg U.S. Aggregate Index.

- Receptive capital markets and ongoing demand for yield also translated to a significant amount of issuance across ABS deal structures and collateral types, including in sectors not typically included in traditional fixed income indices. Issues backed by data centers have become increasingly more prevalent alongside growing artificial intelligence demands, presenting opportunity for those willing to do nuanced credit work in a relatively new sector to earn healthy spread premiums relative to more traditional segments of the market.

Our View: Though spreads have tightened across the securitized landscape, many sectors still trade wide relative to similar quality and similar duration corporates. Agency MBS remains one of our highest conviction trades given current valuations, liquidity, and the government guarantee, while parts of the non-agency MBS market like legacy collateral provide attractive return potential. Meanwhile, the heterogenous makeup of the CMBS and ABS sectors underscores the need for, and potential opportunities created by, disciplined credit selection.

3Q 2024 Core and Core Plus Fixed Income Positioning Summary

Positioning remains defensive given the likelihood of a recession and current market valuations that do not uniformly reflect this risk. We believe this cautious positioning provides ample dry powder as we look to capitalize on opportunities created by a slowing economy and stressed markets.

Characteristic	**Positioning**	**Comments**
Duration	Approximately 0.6 years long versus the benchmark	Although the Fed began cutting rates in September, rates remain restrictive and above fair value, especially in an economy marked by easing inflation and a softening labor market
Curve	Expectations for a steeper curve	Overweight short and intermediate tenors of the curve given expectations that the Fed will have to ease aggressively to support the economy
Governments	Small underweight, with an emphasis on on-the-run securities	On-the-run Treasury securities provide much greater liquidity
MBS	• Agency MBS – large overweight • Non-Agency MBS – maintain allocation, bias to add further	• Prefer specified pools given better convexity characteristics but maintain exposure to TBAs for liquidity • Emphasize lower coupon (<3.5%) issues for upside price potential, and middle coupons (4% - 4.5%) given a more favorable mix of spread and convexity relative to current coupons • Maintain emphasis on high quality legacy non-agency MBS bonds, as well as newer issues, especially those backed by legacy collateral
ABS	Small overweight	• Prefer AAA and AA rated CLOs that offer liquidity, robust structures, and attractive spreads • Reduce senior FFELP student loan ABS, with a preference for higher yielding subordinates
CMBS	Small overweight	Cautious overall with targeted exposures to trophy property types via single asset single borrower non-agency CMBS deal structures
Investment Grade Credit	Large underweight	• Positioning remains concentrated in high conviction names and defensive sectors like communications and consumer non-cyclicals • Underweight banks given the potential for spread widening in a recession • Minimal exposure to cyclical credit sectors and non-corporate credit
High Yield	Minimal allocation	Target high conviction issuers and idiosyncratic credits over broad-based exposure given aggregate valuations
International	Small allocation	• Allocations among DM countries favor European corporates with attractive spreads • Minimal EM exposure as slowing global growth typically presents challenges for EM issuers

All information is as of the date of this presentation unless otherwise indicated.

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