Where Do We Go from Here?

Leave it to the Fed to create even more market volatility. This week's FOMC meeting and inflation data set the stage for an everything rally in the markets that now has the market, once again, shifting sentiment. This time from the 'higher for longer' mindset to a 'pause and pivot' mindset. The market is now pricing aggressive eases on Fed Funds in 2024. With the change brought a very quick revaluation of markets and the important question – Where do we go from here?

The FOMC projections presented this week along with Powell's commentary suggest a shift from a hawkish to a more neutral position on monetary policy. Some would even argue that the Fed was outright Dovish. The subsequent reaction from markets was dramatic in both its breadth and its depth, with lower quality risk assets taking the lead. From a 5,000-foot perspective, the overall rally seems to be overdone, with the US Treasury market feeling overbought, but it would be foolish to ignore the fact that data could continue to support this sentiment in the short term.

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Buyers of money markets and shorter duration yield may now be realizing the effects of the front end “yield trap” that we have written and spoken to throughout the year. Getting yield without duration proved painful over the last 30 days as long duration fixed income has produced 7-9 percent returns. Our frequent conversations with clients around when is the right time to extend duration have shifted to questioning if the opportunity has been missed. Our strongly felt response is NO. The Treasury market is once again behaving like it should, providing investors not only with yield, but a place of safety against risk asset volatility. The power of positive real yield is showing itself. Looking out on the horizon, the demand and need for duration could continue to drive longer rates lower.

Those who have been over-indexed to long credit have been rewarded over the past few weeks after suffering through some very challenging years. When we take a step back after the recent historical rally, we see a number of factors that could reverse sentiment. The large deficits the government continues to run will require heightened levels of treasury issuance, contributing to a negative supply technical for rates. There is also significant corporate and loan issuance on the horizon. The regional banks will be another great source of issuance in 2024 as they put layers of protection into their capital structures to protect depositors. Unemployment is broadly expected to increase above 4% in 2024, and with credit spreads at historic tights (note 30-year IG credit near 30-year tights), there isn’t much room for error outside a perfect soft landing. Quantitative tightening (QE) continues to operate in the background, removing liquidity from the system and putting supply back into the market.

Overall, we will continue to be diligent about managing short-term drivers while being cognizant of potential headwinds long-term when considering portfolio management strategies.

Considering the recent dramatic market moves, the investment team held a roundtable discussion to digest the new information and determine positioning and strategy going forward – the proverbial “Where do we go from here” conversation. A synopsis of our conversations is attached below:

Lindsay Bernum

Head of Macro & Rates

The outsized rally in rates likely continues momentum through year-end and into early 2024 as the soft-landing narrative is widely adopted on the back of a more dovish Fed and easing inflation data. Near-term data is likely to be supportive of this view, and we need to acknowledge that market dynamics may unwind from Fed actions as forecasts are revised. The economic foundation is still strong, and inflation is easing, but it will be the looser financial conditions created in this new market sentiment that drives demand and ultimately keeps the Fed on hold longer than expected. In previous easing cycles, 2-year rates typically trade 50-75bps through the Fed Funds (FF) rate when the terminal rate has been reached and the Fed has signaled a pivot. As of 12/14/23, we are 111 bps through FF, suggesting an overreaction from the market to this pivot. Similarly, 10s run 50-100 bps through FF during this point in the cycle vs the current level of 158 bps through. The more rates and equities continue to rally, the more upside risk is posed to inflation down the road and the longer the Fed can be on hold. Easier financial conditions will keep the economic engine running, as opposed to the Fed having to jump start it by cutting rates. In the fight of the market vs. the Fed, the market seems to have won this battle, but will it win the war?

Jonathan Aal

Portfolio Manager | Co-Head of Credit Research | IG Credit

The Fed has changed its stance from hawkish to neutral where continued disinflation is embedded in forward expectations. Current IG spreads are implying a soft-landing scenario occurs without a hitch. While the possibility of this occurring is hard to dismiss, the probability of this outcome as implied by spreads is likely too straight forward. In 2019, BBB spreads tightened approximately 40bps from just prior to the first dovish Fed cut to the beginning of the pandemic*. Over this period the Fed cut rates three times; 25bps each. Importantly, however, the spread rally was not linear or without its bouts of volatility. Today, BBB spreads in the current environment have accelerated this path, tightening more than 30bps before a cut has even occurred**. Easing financial conditions, disinflation, and risk-on momentum are positive for markets short-term, but forward fundamentals may not be as constructive. IG corporate leverage is up, interest coverage is down, margins have contracted, and debt is elevated relative to the same quarter last year. As in 2019, it will likely similarly prove foolish to expect such straight-line tightening in credit spreads without several bouts of volatility in 2024. Overall, we anticipate and position for opportunities to manage IG credit exposure amidst our expectations for a non-linear pathway.

*3-June 2019 to 19-Feb 2020; Bloomberg Barclays BBB spreads.

**1-Nov 2023 to 13-Dec 2023; Bloomberg Barclays BBB spreads.

Garrett Olson *CFA®*

Portfolio Manager | Co-Head of Credit Research | HY Credit

While the market has taken the change in the Fed's Summary of Economic Projections (SEP) and Powell's commentary as a clear sign towards a dovish pivot, there is not much that has changed fundamentally other than revised economic projections. We believe this doesn't change the fact that the lagged impacts of restrictive monetary policy are still in the early stages of filtering through the economy. High yield fundamentals are deteriorating, albeit off record strength, and will likely face continued headwinds going forward. Positive risk sentiment has had strong momentum since November, aided by net inflows into HY credit. The recent rate moves and spread compression in HY means that on a relative value basis, there could be opportunities in select leveraged loans where investors can pick up incremental carry without giving up too much on the convexity side, as long as one can get comfortable with the resiliency of the underlying credit. Lower yields will likely be a catalyst for a slew of new issuance as companies look to term out higher coupon debt and address near-term maturities, potentially creating attractive risk/reward opportunities in the primary market. Emphasis should continue to be placed on higher quality credits to secure carry but avoid outsized fundamental deterioration as headwinds emerge. In terms of upcoming catalysts, how the Treasury chooses to finance large deficit spending could serve as a source of volatility in 2024.

Eric Bernum *CFA®*

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The Fed's dovish pivot and the outsized market reaction anticipating Fed cuts are likely too optimistic on the downward path of inflation. Easing financial conditions will likely bolster inflation, specifically in shelter as housing affordability stays skewed towards renting vs buying at elevated housing price levels. Powell may be using his credibility gained in the fight against inflation to allow financial conditions to ease and bolster economic expansion along the lines of his statements in 2019 about being focused on the sustainability of expansions. At current valuations, the overall math behind the market doesn't work for an economy built on 2% rates. Rates are still restrictive, and there are additional headwinds going forward - including earnings deterioration and continued quantitative tightening (QT) in the background. Previously, the Fed was the largest buyer of volatility under a quantitative easing (QE) regime but has flipped to being the largest seller and valuations in the mortgage space make it tough to step in front of that headwind. Recent moves in mortgages echo that of late 2022 – rallying late in the year to a tight of ~40bps then bleeding wider. Despite spreads being historically tight, there are still opportunities in new production CMOs with lower loan balances where prepayments are typically low, as well as in deep-discount 30-year low coupons with attractive yields for potential pre-payment accretion. The preferred space is not as attractive under the expectations of large supply needs in both AT1s in Europe as well as domestically from both regionals and money centers in early next year.

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