ACADEMY ASSET MANAGEMENT

Market Update

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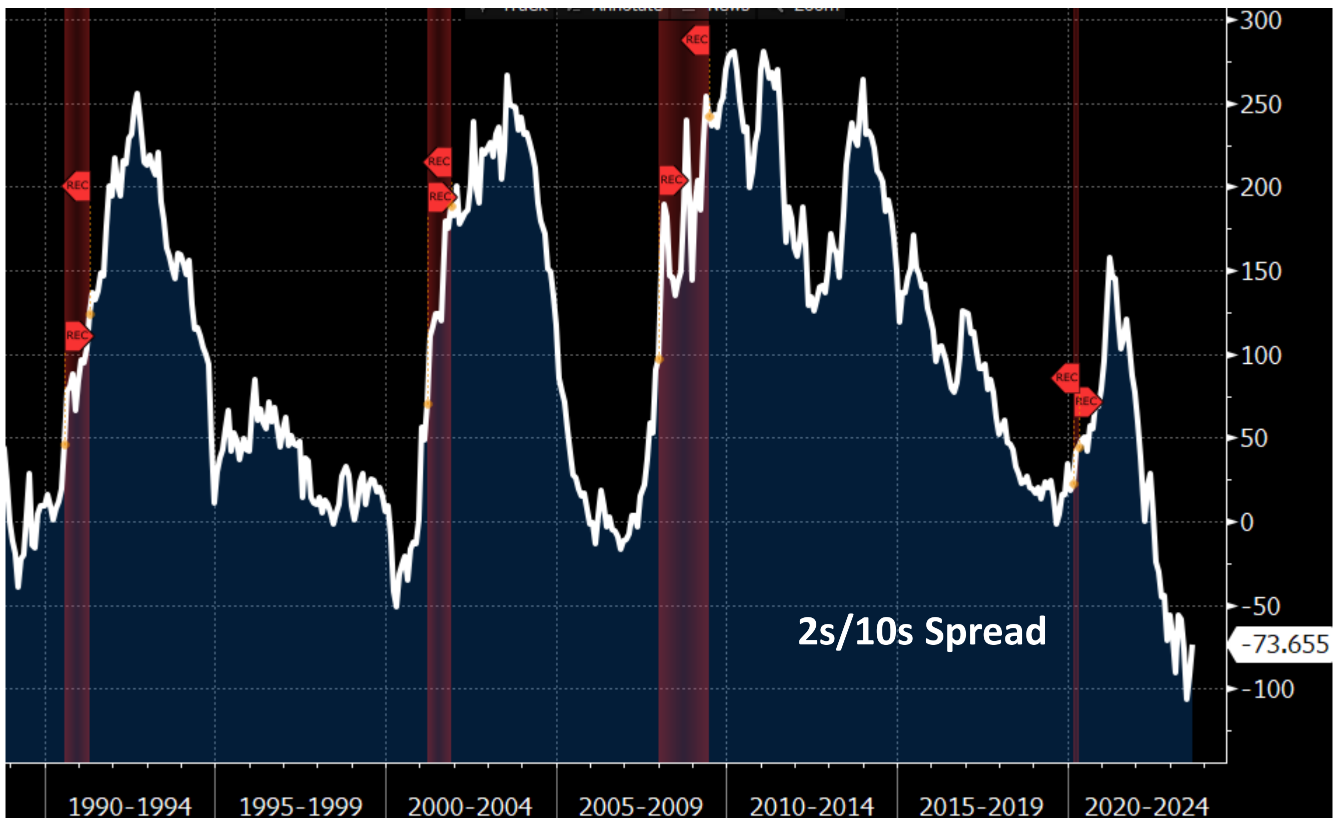
Recent headlines have revolved around the Fitch downgrade of the U.S. debt rating. While there's widespread agreement that this will unlikely impact borrowing costs and the U.S. will still be perceived as the ultimate risk-free asset. Our focus turns to the potential derivative impacts of this downgrade, notably a shift towards tighter fiscal policies.

In recent months, we've closely monitored several key indicators that have displayed warning signs. These encompass tightening bank lending standards and ISM indices. As these indicators persistently signal concerns, our attention is now particularly honed in on the yield curve. While the inverted yield curve has traditionally been seen as an omen of an impending recession, we also recognize the significance of observing a steepening yield curve from its inverted state (graph below). Historical data since 1998 reveals that this steepening has frequently acted as a near-term precursor to economic downturns, with the last four recessions showcasing this pattern. We are vigilantly observing this trend to discern whether the recent steepening is reaction to anticipated Treasury supply or a genuine omen of an approaching economic downturn.

We have moved beyond the June 2022 inflation peak, which no longer supports a decrease in year-over-year (YoY) inflation. Additionally, the recent payroll report from last Friday indicated average hourly earnings remain robust. These factors, along with consumer resilience, have heightened our attention to the possibility of additional tightening measures by the Federal Reserve, likely to involve only one or two more rate hikes.

In conclusion, our conviction remains that leading indicators, along with the cascading effects of tightened credit and the delayed impacts of monetary policy, will ultimately exert a negative influence on the economy. While these anticipated effects might be unfolding at a slower pace than initially anticipated, we believe they are more likely to materialize in 2024. Our perspective diverges from the consensus view of a soft landing, as we anticipate a more uneven trajectory, with various sectors encountering varying levels of distress.



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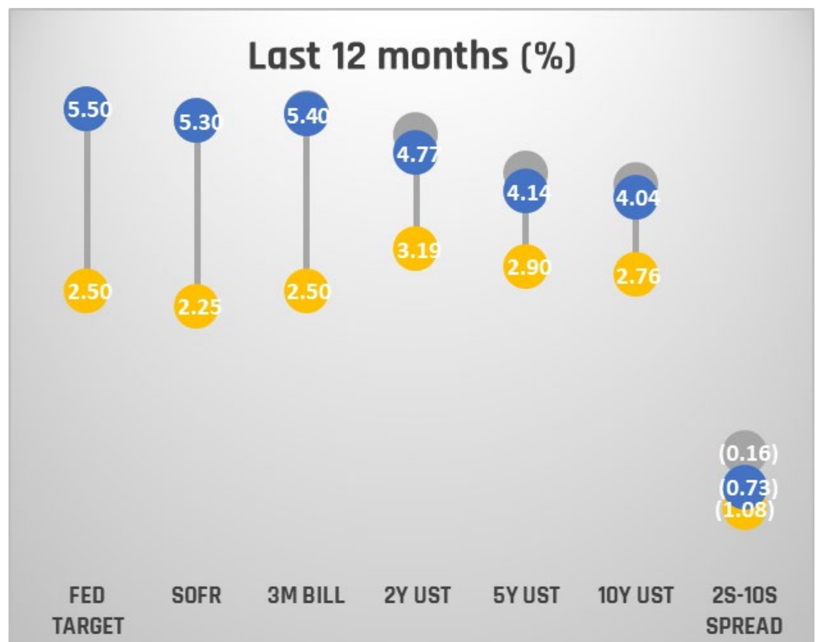
Product Views

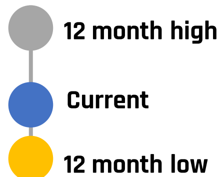
Rates- The pullback in further anticipated Fed tightening has led to a rally in the front end of the curve. Despite our disagreement with the Fed Funds market, we hold a neutral stance on short-term rates as Treasuries are factoring in approximately 25 basis points of tightening beyond the Fed funds market. Although we anticipate inflation to moderately surpass the Fed's 2% target in the near term, market confidence in preventing runaway inflation remains. Therefore, we see value with the 10 year where it currently stands north of 4.00%

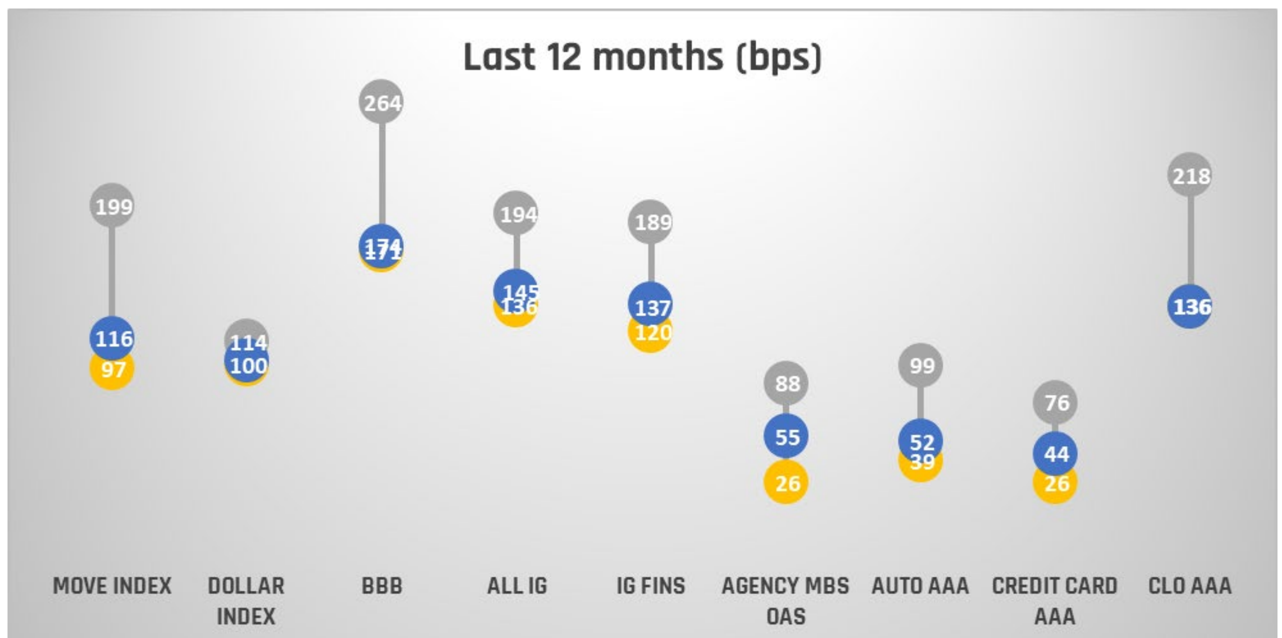
Credit- Credit spreads are trading at the bottom end of their 12 month range, we remain neutral and an up in quality bias. In general, we are cautious on the consumer focused sectors as they appear priced for perfection.

Securitized- We maintain a favorable view on mortgage-backed securities (MBS), considering them appealing especially when compared to other asset classes. MBS exhibits attractive value in terms of both nominal spreads and option-adjusted spreads (OAS). For premium mortgages, we propose paying for implicit or explicit prepay protection.

Municipals- While trading at a slight spread discount to corporates, taxable municipals appear fairly valued to corporates, especially given the lower anticipated default rates of the muni sector.







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