ACADEMY ASSET MANAGEMENT

Market Update

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December 2024

The U.S. economy maintained solid growth in the third quarter of 2024, expanding at an annual rate of 2.8%. This marks the 10th consecutive quarter of robust economic activity, slightly below the second quarter's 3.0% growth. Consumer spending remains strong, demonstrating the resilience of American consumers despite higher interest rates and inflationary pressures.

The 2024 presidential election saw former President Donald J. Trump win a second, non-consecutive term, with Republicans gaining control of both chambers of Congress. This outcome has alleviated market anxiety by providing clarity and reducing fears of a contested election. We view the incoming administration's tariff proposals as a negotiating tactic to achieve broader goals. During his first term, President Trump used the threat of tariffs to secure new trade deals with Mexico and Canada. While higher tariffs are likely, we believe currency adjustments and lower tax rates will largely mitigate the risk of importing inflation via tariffs.

Inflation has made progress toward the Federal Reserve's 2% target. The Personal Consumption Expenditures (PCE) Price Index stood at 2.3% in October, a slight increase from September, while Core PCE was 2.7%. Housing-related costs continue to prevent a more significant decline in inflation. However, the FOMC can take comfort in the easing of long-term inflation expectations over the past month after a notable increase earlier in the year.

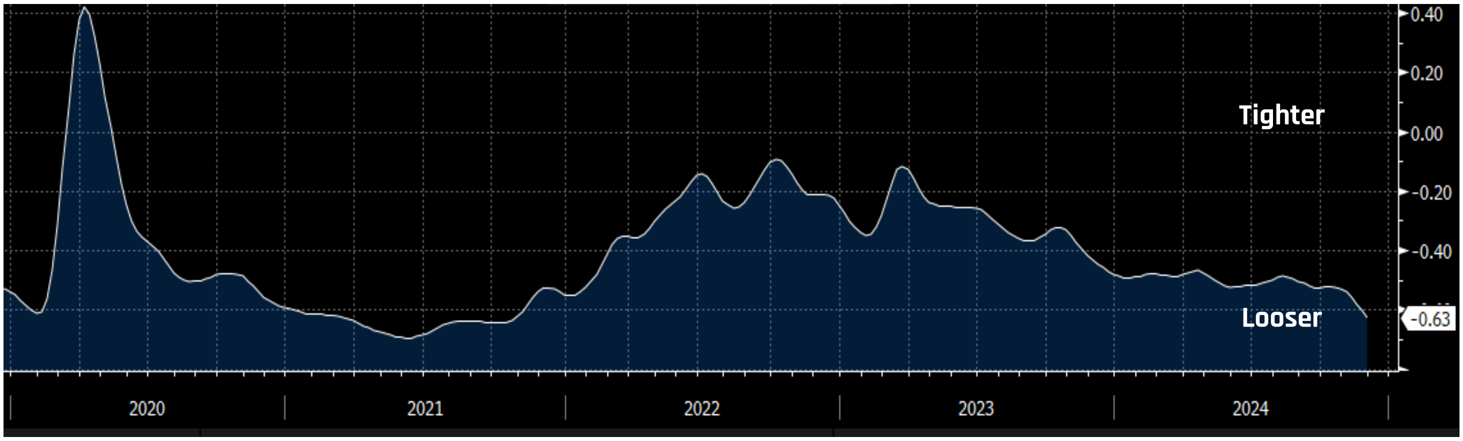
The December jobs report highlighted labor market resilience, with nonfarm payrolls increasing by 227,000. However, the unemployment rate edged up to 4.2%, accompanied by a declining participation rate. These solid figures challenge expectations of a labor market slowdown and may influence the Federal Reserve's approach to monetary easing.

The Federal Reserve is expected to continue its rate-cutting cycle at the December FOMC meeting, with markets anticipating another quarter-point reduction. This follows the November cut, which lowered the target range to 4.5%-4.75%. Considering the labor market's relative strength, stabilized inflation, and easing financial conditions, we believe the FOMC will use the meeting to communicate a less aggressive easing path for 2025.

The prospect of President-elect Trump's tariff policies, alongside indications that the Federal Reserve may temper its easing stance, has strengthened the U.S. dollar significantly. We are closely monitoring the USD's relative strength due to its potential impact on emerging markets.

As 2024 draws to a close, the U.S. economy remains the primary global bright spot while it balances growth moderation with inflation control. The Fed's easing policy, despite the absence of traditional triggers, has fostered accommodative financial conditions, reducing the likelihood of an imminent economic slowdown. We are closely watching the December FOMC meeting communication and the new administration's transition, as both will play a critical role in shaping market expectations and the economic trajectory.

Chicago Fed National Financial Conditions Index



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Product Views

Rates: The 10-year Treasury yield has declined to 4.15% as long-term inflation expectations ease, narrowing the 2s10s yield curve spread to just 5 basis points. While markets have priced in three 25-basis-point rate cuts by year-end 2025, we expect only two. However, the historically wide spread between Treasury yields and market anticipated overnight rates mitigates duration risk. Therefore, we remain modestly constructive on the short end and belly of the curve while staying vigilant about the potential for rising term premiums on longer-duration Treasuries.

Credit: This month, investment-grade (IG) and high-yield spreads saw slight widening after reaching 10-year lows in mid-November. While credit fundamentals remain strong overall, the potential for further spread tightening appears limited, offering less attractive relative value. Even a modest risk-off event could trigger significant widening, warranting a cautious approach.

Securitized: The richness of credit spreads has driven some investors toward securitized products, leading to the tightest spreads seen in the past year across ABS and MBS. Over 3-, 5-, and 10-year horizons, ABS and MBS still show potential for further tightening. For investors with the risk tolerance and expertise, we favor sectors like data center ABS and CMBS. However, thorough diligence is essential, as not all pools are created equal.