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Market Update

January 2024

As 2023 concludes, the market trajectory reflects a wild ride, ultimately landing us almost where we started, with the 10-year Treasury closing at 3.88, merely a basis point off from the 2022 year-end value. Most major bond indices experienced a positive year following two consecutive negative ones. Looking ahead to 2024, we anticipate another robust year driven by the current yield environment and the conclusion of tightening monetary policy.

December's FOMC meeting provided a dovish stance from the Fed, which was favorable for risk assets, subsequently moving the Financial Conditions Index to the most accommodative level since early 2022. However, the market's pricing of a 125-basis-point cut doesn't feel likely from our perspective unless a recession occurs. Historical data spanning 30 years (table below) reveals the FOMC's tendency not to ease policy when core PCE remains above target, unemployment is below 5%, and GDP surpasses 2%. It's notable that central banks historically haven't preemptively cut rates to avoid a recession but instead have made aggressive cuts during periods of economic contraction coinciding with rising unemployment rates.

Some concern exists from our perspective that the Fed might repeat the mid-1970s error, assuming victory over inflation prematurely. Similar mistakes back then led to inflation resurgence in the late 1970s, eventually subsiding in the early 1980s due to specific factors.

Regular readers of our commentary will note our surprise at the continued strength of the consumer. We are focused on lower-income households meeting financial obligations, which will be highlighted in the upcoming Q4 Fed delinquency data release. This will offer critical insights into the socio-economic impact amid evolving economic dynamics.

Looking into 2024, geopolitics continue to loom large on the horizon. Globally, a record number of people will be impacted by elections across 50 countries, including the US, India, Taiwan, and Russia. Supply chain disruptions from Houthi attacks in the Red Sea and drought in the Panama Canal remain a focal point, potentially triggering inflationary consequences. We will remain vigilant regarding how geopolitical events unfold.

A History Lesson in Fed Easing

				Core PCE			
Date	Initial Cut	Total Cuts Cycle	Recession	YoY	3m Ann	Unemp	GDP
Jul-90	(25)	(500)	Y	4.1	4.5	5.3	1.5
Jul-95	(25)	(75)		2.1	2.4	5.7	1.2
Sep-98	(25)	(75)	Y	1.4	1.0	4.5	5.1
Jan-01	(50)	(475)	Y	1.9	2.0	3.9	2.4
Nov-02	(50)	(75)		1.8	2.1	5.7	1.6
Sep-07	(50)	(475)	Y	2.0	1.8	4.7	2.3
Aug-19	(25)	(75)		1.7	1.8	3.6	3.4
Mar-20	(50)	(150)	Y	1.7	1.8	3.8	(5.3)
Current				**3.2**	**2.2**	**3.7**	**4.9**

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Product Views

As we look forward to 2024 and provide our product perspectives, the nearing end of the cycle anticipates the Fed's probable entry into an easing policy later this year. Examining the performance of various asset classes leading up to and following the first Fed cut can offer valuable insights, considering that while history doesn't always repeat, it often echoes similar patterns.

Rates- Post December's FOMC meeting, rates fell about 30 basis points from 2 years and out the curve while term premiums collapsed. Despite this move, we maintain a neutral stance on rates, identifying pockets of value amidst this shift. The market might be slightly ahead in pricing 125 bps of cuts, with 2 and 3-year Treasuries trading about 25 basis points cheaper relative to Fed Funds expectations for those respective periods. We see the potential for countervailing factors between slower growth and lower inflation offsetting a return to elevated term premiums because of deficit/supply concerns.

Credit- Credit performance seems tethered to the depth of a potential the economic downturn. With the Fed primed to act swiftly at the earliest signs of distress, we project limited deterioration. While corporate fundamentals appear stronger compared to previous cycles, our preference still leans towards higher-quality credits.

Securitized- Mortgage-Backed Securities (MBS) have historically aligned closely with the Agg Index in performance leading up to easing policy. However, our inclination towards increased MBS exposure stems from its historical role as a hedge against credit, reflecting our belief in a less probable soft landing than perceived by the market. Moreover, we maintain our positive outlook on MBS, anticipating a reduction in interest rate volatility and potential bank re-entry not fully priced into market expectations. Within ABS, Prime auto spreads are flat to IG corporates with a similar duration and offer an interesting alternative to corporate credit.

Municipals- Leading up to easing cycles, munis have generally underperformed other asset classes. 10-year municipals have reached their lowest levels as a percentage of Treasuries on record. While muni credit fundamentals are generally solid, we prefer other asset classes currently.

Index Performance Pre and Post Initial FOMC Easing

	U.S. Agg		MBS		5-10 yr. Credit		Intermed Treasury		Long Treasury		Munis		SPX	
	Prev 6 mos.	Post 6 mos.	Prev 6 mos.	Post 6 mos.	Prev 6 mos.	Post 6 mos.	Prev 6 mos.	Post 6 mos.	Prev 6 mos.	Post 6 mos.	Prev 6 mos.	Post 6 mos.	Prev 6 mos.	Post 6 mos.
Jul-90	5.5%	5.8%	6.5%	6.3%	[redacted]		5.0%	6.0%	4.7%	6.5%	4.8%	4.2%	8.2%	-3.4%
Jul-95	9.0%	7.3%	8.6%	6.1%	11.4%	8.7%	7.3%	5.8%	13.2%	12.6%	7.6%	6.9%	19.5%	13.2%
Sep-98	6.1%	-0.2%	3.8%	1.8%	6.3%	-0.6%	6.3%	-0.2%	12.5%	-5.2%	5.1%	1.5%	-8.5%	26.5%
Jan-01	8.1%	4.2%	8.2%	4.0%	9.4%	5.4%	7.0%	4.0%	8.5%	3.1%	6.5%	3.4%	-4.5%	-11.3%
Nov-02	5.0%	6.3%	3.8%	2.5%	5.1%	12.3%	5.1%	4.5%	9.6%	12.6%	3.7%	6.5%	-12.3%	2.9%
Sep-07	2.3%	5.2%	2.1%	5.6%	0.9%	3.1%	3.5%	8.3%	2.9%	9.8%	1.1%	0.7%	7.5%	-13.4%
Aug-19	8.0%	1.6%	4.8%	1.5%	10.1%	2.8%	5.3%	1.0%	23.5%	-0.1%	6.2%	1.7%	5.1%	10.2%
Mar-20	3.3%	3.6%	3.6%	0.9%	-2.7%	11.6%	5.3%	0.7%	15.9%	0.0%	0.1%	4.0%	-13.2%	35.4%

Recession

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