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Market Update

January 2025

The U.S. economy expanded at an annualized rate of 3.1% in the third quarter of 2024, exceeding earlier estimates and marking the strongest growth of the year. Consumer spending, a primary driver of economic activity, grew at a robust 3.7% pace. Looking ahead to 2025, we expect GDP growth to moderate slightly while remaining healthy.

Inflation has shown progress towards the Federal Reserve's 2% target. The Personal Consumption Expenditures (PCE) Price Index, the Fed's preferred inflation gauge, increased by 0.1% month-over-month in November, below expectations. The annual PCE inflation rate accelerated slightly to 2.4%, while core PCE inflation held steady at 2.8%. These figures suggest that while inflationary pressures have eased, they remain a concern for policymakers.

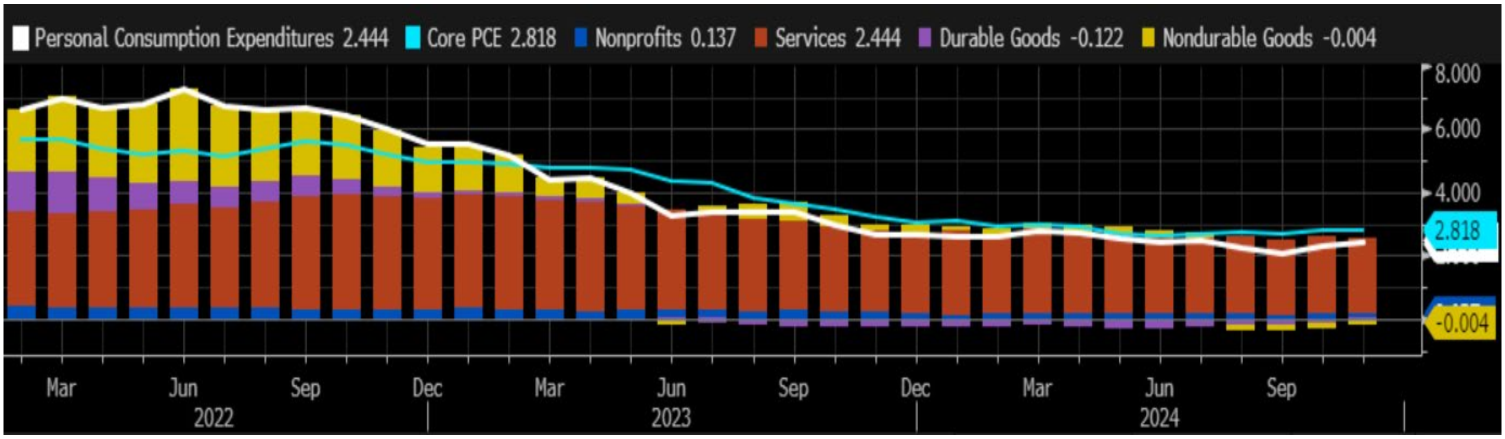
Nonfarm payrolls increased by 256k in December, significantly surpassing the consensus forecast of 165k. This marks a robust finish to 2024, with employers adding 2.2 million workers over the year. The unemployment rate ticked down to 4.1% from 4.2% in November, indicating continued labor market resilience. Key sectors contributing to job growth included health care, leisure and hospitality, and government. Average hourly earnings rose by 0.3% for the month, resulting in a 3.9% increase year-over-year. While this represents a moderation from previous months, it still suggests ongoing wage pressures that could impact inflation.

The transition to the Trump administration has introduced both optimism and uncertainty into financial markets. Proposals to lower the corporate tax rate and reduce regulatory burdens have been viewed positively by investors, potentially boosting corporate earnings and economic growth. However, the full impact of these policies may not be felt until later in 2025. Markets are balancing enthusiasm for pro-growth measures against concerns about potential inflationary pressures and long-term fiscal implications. The Federal Reserve faces the challenge of threading the needle on inflation, balancing the need to maintain price stability with supporting economic growth. The new administration's policies, particularly those aimed at reducing regulation, could potentially reignite inflationary pressures, complicating the Fed's task.

Term premium has been a focus over the past year due to rising deficits and debt. While the Department of Government Efficiency (DOGE) may not meet the original $2 trillion reduction target set by Elon Musk. We anticipate the scrutiny of government spending programs is expected to yield reasonable success. If effective in reducing spending, DOGE could potentially result in a reduction in term premium over the long run.

Stronger-than-anticipated job growth may influence the Federal Reserve's approach to interest rate decisions. This robust employment data could support a "longer pause" in the Fed's rate-cutting cycle, as policymakers balance concerns over inflation with the need to sustain economic growth. We continue to hold the view of one more easing in 2025, short of a significant disruption in market function.

Contributions to US Personal Consumer Expenditure (PCE) Price Index YoY%



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Product Views

Rates: The 10-year Treasury yield has risen to 4.75%, reflecting increased growth potential, while the 2s10s yield curve spread has steepened to levels last seen in Q1 2022. Markets have priced in only one 25-basis-point rate cut by year-end 2025, largely aligning with our outlook. We maintain a modestly constructive stance on the short end and belly of the curve while remaining vigilant about potential rising term premiums on longer-duration Treasuries.

Credit: This month, investment-grade (IG) credit spreads widened modestly, while high-yield spreads remained relatively stable. Despite generally robust credit fundamentals, the potential for further spread compression appears limited, reducing the relative value proposition for credit investors. Even a minor risk-off event could trigger significant spread widening, particularly in the more volatile high-yield sector. This asymmetric risk profile underscores the need for a cautious approach to credit markets. Given the current tight spread environment and economic uncertainties, active management and rigorous credit selection will be crucial for navigating potential volatility in the coming months.

Securitized: We continue to observe investors migrating into ABS and MBS markets, driving spreads tighter. The potential release of Fannie and Freddie from conservatorship may influence mortgage rates, but we anticipate a positive impact on legacy pool spreads. Furthermore, regulatory relief for banks under the new administration could boost demand for MBS. We favor MBS over Credit given this dynamic.