ACADEMY ASSET MANAGEMENT

Market Update

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Another month has passed, and our view on the market remains consistent across several themes. However, it appears it will take longer for these to play out.

Truflation, which provides a more up-to-date measure of inflation, is currently at 3.9%. This compares to headline CPI at 5.0% and PCE at 4.2%. One thing that bears watching is the Truflation number has leveled out for the last couple of months. One benefit will come from lower oil prices, despite the announcement of OPEC production cuts. The Fed is keenly watching wages, which had been coming down until the April employment data showed an uptick in hourly earnings.

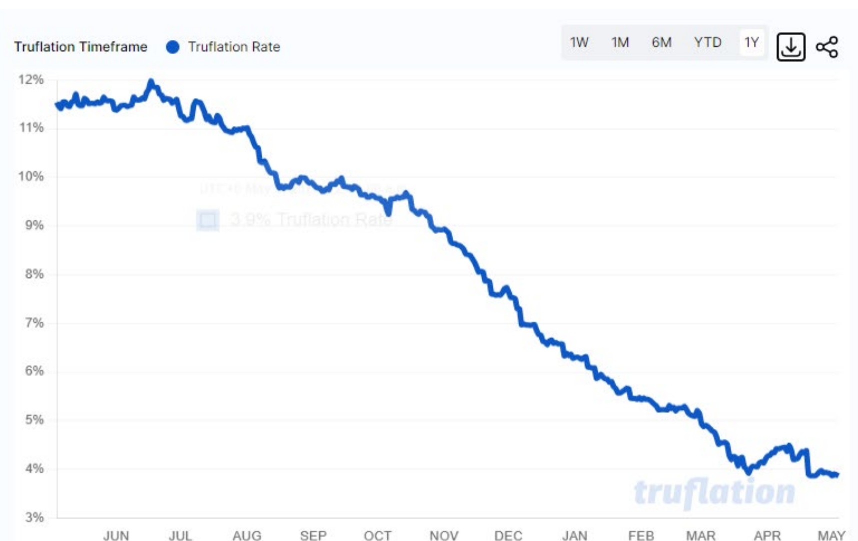
Last month, we discussed the challenges in the commercial real estate sector, and we believe we are still in the early stages. One note that didn't get much publicity was Alphabet reporting a $564 million charge due to office space reductions. We believe more of these will be coming, putting further pressure on the sector.

The recent Zoom between Chair Powell and pranksters pretending to be President Zelensky provided important insights into the Federal Reserve's policy outlook. During the conversation, Chair Powell noted that the market is currently expecting two more rate hikes (May and June), and that the Fed will assess the situation after these hikes to determine if additional ones are necessary. He also acknowledged that a recession is as likely as a slow-growth scenario, which is different from his comments at the May FOMC press conference where he indicated that a soft landing was his base case.

Some of the key factors we watch, including bank credit tightening and leading indicators, continue to trend adversely and would not suggest a soft landing.

While the "X" date has been moved to June 1, our base case remains that the debt ceiling will be resolved. However, given the polarization of Congress, there is a reasonable probability (~25%) that we could see a technical default. The market is already fragile and doesn't need additional uncertainty.

Fed funds futures are pointing to 75 basis points of rate cuts by the end of the year. We don't see rate cuts this year unless something substantially "breaks," significantly more bank failures, or a US debt technical default.



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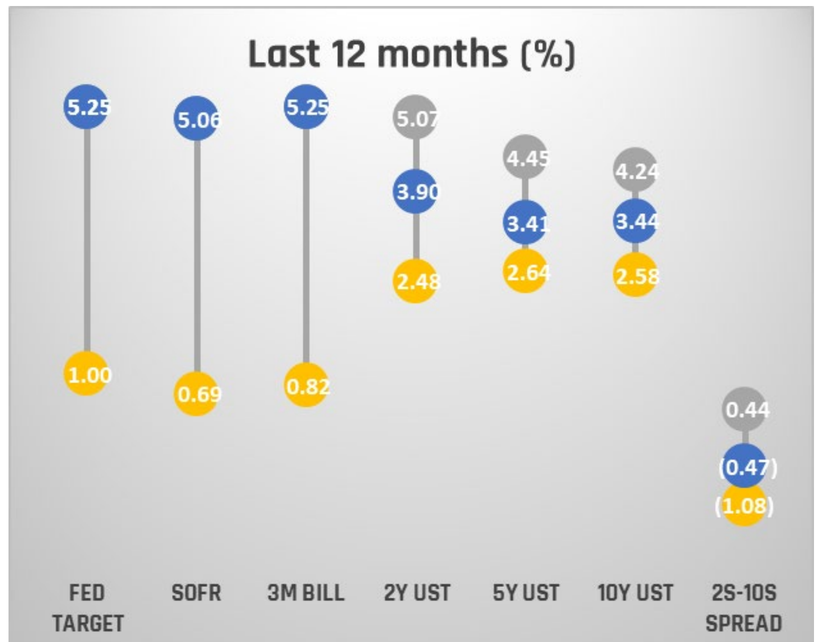
Product Views

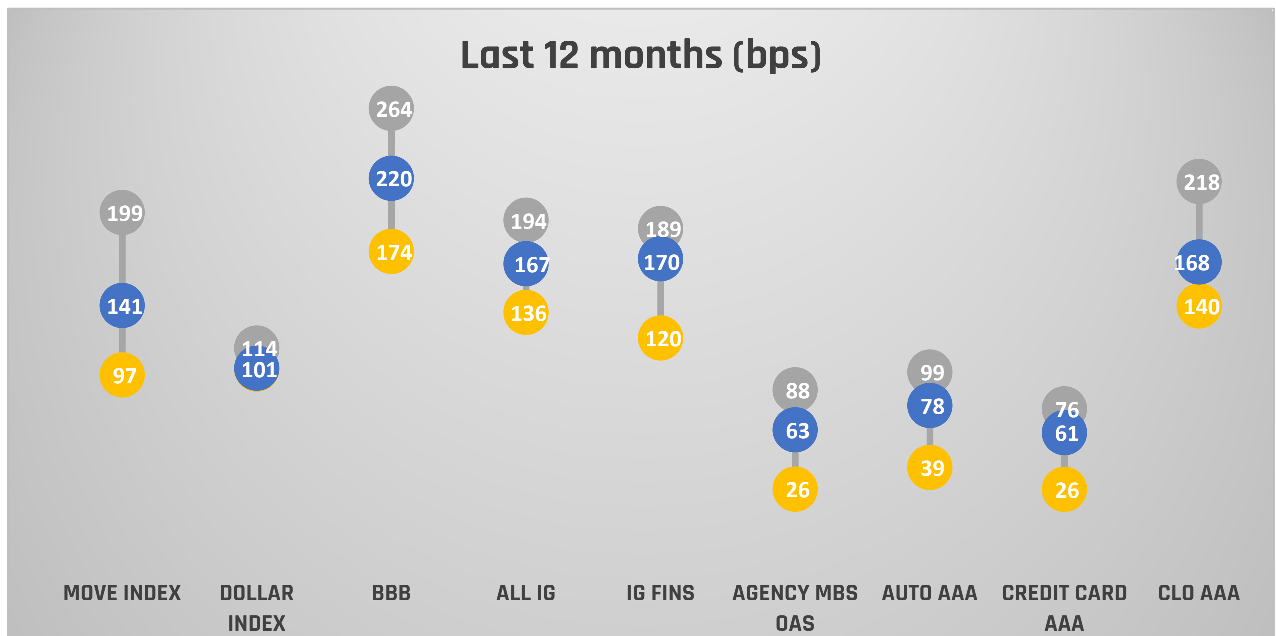
Rates- The recent gap between 1 month bills and 1 month overnight index swaps (OIS) has widened to levels last seen during the global financial crisis, suggesting potential market liquidity concerns. However, the excessive inflow into money funds may have contributed to this move. In light of this, we recommend maintaining a neutral duration target but anticipate further volatility and recommend taking advantage of any opportunities that arise from backup in yields.

Credit- Ongoing bank concerns have led to a 15 bps widening in credit spreads since the close of March. While we still believe that corporations are generally in good shape and default risk is contained, we maintain a bias towards higher quality and are focusing on sectors that are likely to be less affected by an economic downturn. We suggest being highly selective when considering financials, as not all companies in this sector are equal.



Securitized- We believe that mortgage-backed securities (MBS) look attractive given the widening in option-adjusted spreads (OAS) resulting from the FDIC liquidation of failed bank portfolios.

Municipals- Taxable municipals have not participated significantly in the recent widening, leading to a gap between the yields of taxable and tax-exempt municipals. We suggest waiting until the relative gap between these two asset classes is more aligned before making adding exposure here.



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