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Q3 Round Up: Fed Expectations, 'Soft Landing' Growth and Potential for Unstable Inflation

Fed has Finally Embarked on a Rate Cutting Cycle

The Federal Reserve (Fed) seems to be content that inflation is progressing closer to long-run target levels, moving away from its restrictive policy stance with a 50 basis point (bps) interest rate cut in September of this year. With some recent softening in economic data, the Fed's dual mandate of pursuing maximum employment and price stability is back in focus. As we enter the fourth quarter of 2024, the market has priced in approximately eight interest rate cuts and a terminal rate in mid-2026 of just under 3%. Further incoming economic data, along with the impact of the US presidential election and broader geopolitical events, will likely shape the speed and magnitude of future Fed cuts. The Treasury curve shifted lower during the quarter, with the 10-year US Treasury declining from 4.40% to 3.78%, and steepened on increased expectations for Fed cuts. Investment grade and high yield spreads, which experienced pockets of volatility on increasing fears of recession, ended the quarter slightly tighter, supported by strong investor demand for yield.

Growth is Moderating but Continues to Remain Positive, Potential for Unstable Inflation

Our base case continues to call for trend/below trend US economic growth. Recent economic data points to a moderation of growth but stops well short of signaling a potential recession. The US labor market is still strong, but the average payroll gain in each of the past three months has declined and unemployment has ticked up from a very low level. In addition, corporate fundamentals have remained stable and are supportive of economic activity. We expect the pace of economic growth to downshift to approximately1.50-1.75%, consistent with a "soft landing" scenario in the coming quarters. As we move through the end of 2024 and into 2025, we believe there is a risk that the market experiences a "growth scare" if one or two quarters are on the softer side. In this scenario, we'd expect market volatility to increase, however, even in our downside scenario, we think any downturn would likely be mild. On a global basis, European growth is gradually improving but we see inflationary risks persisting, which informs our expectation of a relatively limited European Central Bank (ECB) rate-cutting cycle. In Japan, we expect increased tolerance for higher yields by the Bank of Japan (BOJ) if the bank's confidence grows regarding the achievement and sustainability of 2% inflation. Lastly, the People's Bank of China (PBOC) announced an extensive monetary policy package to address economic challenges. Fiscal support quickly followed as policymakers reiterated their commitment to achieving annual economic goals. They emphasized that China will ensure necessary fiscal spending to bolster growth, however, we believe uncertainty remains regarding the scale and effectiveness of such measures.

Cyclically, we are anticipating US inflation to continue bottoming in the coming months before leveling out somewhere just above the Fed's 2% target. Long-term, we believe inflation may remain unstable and potentially experience higher lows due to structural factors, such as the fiscal deficit, trade protectionism, deglobalization, decarbonization and aging demographics. As such, we think inflationary pressures could begin to build with a lag now that the Fed has finally embarked on a rate-cutting cycle and the economy potentially builds momentum. We believe the size of the initial cuts are less important than what the trough will be for the policy rate at the end of this cycle. In our opinion, the market and the Fed are overestimating the total number of cuts. We have moderated our view of future Fed cuts for a shallower cycle with a trough rate expectation of low to mid-3% to be hit in 2026.

Combining our cyclical and structural views suggest the yield curve will steepen further, which means the short to intermediate part of the yield curve will likely be a strong beneficiary. We see little scope for the10-year and longer maturities to rally as the US deficit and expected Treasury supply continues to be atopic of heavy discussion, which will likely have a significant influence over long-end Treasury yields. Regardless of the US presidential winner, we believe the fiscal deficit is structural in nature and neither party will risk taking a hawkish stance on fiscal responsibility. This potentially leads to continued growth in the deficit and significant Treasury issuance over the coming years, which we believe could increase rate volatility and put a floor under long-term Treasury yields. We believe long-term fair value for the 10-yearUS Treasury is approximately 4.25-4.50%, based on a 1.50-2.00% real rate and 2.25-2.50% breakeven rate, however, we expect the trading range to be lower in the short-term.

Stable Corporate Fundamentals and a Benign Loss Environment

In our view, the credit cycle is firmly in the late cycle stage. Corporate fundamentals appear stable and earnings growth is robust. In our opinion, corporate balance sheets remain healthy and can weather potential volatility in the macroeconomic backdrop. Our Credit Health Index (CHIN) and risk premium framework within investment grade and high yield suggest defaults/losses will be below historical averages for this part of the cycle. Given our expectation for low losses, corporate risk premiums are fairly valued in our opinion. Technicals remain supportive as investment grade issuance has surprised to the upside but has been meet with strong investor demand, and we continue to see this trend going forward where demand out-paces supply. In addition, specific to the high yield market, defaults may have already peaked for this cycle and most signs of distress seem idiosyncratic, in our view. The high yield maturity wall also seems manageable through 2025, not posing a major threat after a wave of refinancing earlier in the year, in our view.

Carry May Drive Fixed Income Returns

We believe that long-term value has returned to fixed income markets with a combination of discount-to-par (positive convexity) and favorable yields. In our view, bond markets will likely be supported with strong demand as investors sit on record levels of cash that will be seeking yield as the Fed continues to cut rates on the front end. We are mindful of the risks going forward, such as geopolitical risk, trade protectionism, a growing US deficit and the upcoming US and global presidential elections. Although risks exist, spreads have moved to the tightest levels of this cycle. We are not surprised by how buoyant credit markets are these days – fundamentals are stable with the potential for losses to remain benign, and buyers are showing up with an almost insatiable demand. Our view is that investors can feel comfortable going for the extra spread pick-up available in the credit markets. We feel potential fixed income returns will be driven by carry going forward and it will be prudent to maintain a balanced risk profile between interest rate and spread risk. Spreads will likely live in a range that is typical of a non-stressed market, which for high yield corporates tends to be in the +300 to +450bps range.

Please see Important Disclosure on following page, an integral part of this document.

Meet the Team

Matt Eagan, CFA
Head of Full Discretion, Portfolio Manager

Brian Kennedy
Portfolio Manager

Todd Vandam, CFA
Portfolio Manager

David Zielinski, CFA
Investment Director

Cheryl Stober
Investment Director

Kristen Doyle
Associate Investment Director