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# Extra Credit

## Q1 Round Up: Resilient Growth, Unstable Inflation and the Prolonged Rate Cutting Cycle

### Expectations for Fed Rate Cuts Lowered in Q1

The Federal Reserve (Fed) appears to be comfortable with the current fundamental backdrop of resilient economic growth, an unemployment rate below its estimate and inflation that continues to decline from its mid-2022 peak. At this point, the Fed is data dependent, noting supply and demand conditions have continued to come into balance, as further incoming data will be required to assess ongoing progress towards the inflation goal. Economic data surprised early in Q1, suggesting that inflation moderation is looking bumpy, coupled with volatile economic activity data and a strong, but moderating, labor market, in our view. Coming into the year, the market was pricing in six rate cuts from the Fed in 2024. As of the end of Q1, however, the market had shifted to three rate cuts based upon the Fed's message that it is committed to its inflation target and that rate cut expectations should be lowered. Investors now seem to be grappling with the potential for the Fed to indicate two rate cuts this year (versus three), as well as a more shallow cutting cycle than previously indicated by the Fed. During the quarter, investment grade and high yield spreads tightened on a more positive growth outlook. Interest rates moved higher, though, which resulted in negative total returns from most fixed income sectors outside of high yield corporates.

### Resilient Growth with Unstable Inflation

In our view, the credit cycle is firmly in the 'late cycle' stage. Monetary policy is in restrictive territory and lending standards have tightened as the US economy still remains resilient. Up to this point, the US labor market has continued to remain strong and underpinned consumer spending, while corporate fundamentals are stable and also have been supportive of economic activity. Looking forward, our base case calls for trend, or slightly below trend, with US growth in 2024 consistent with a 'resilient economy.' We do not anticipate a technical recession of back-to-back quarters with negative gross domestic product (GDP) as the probability of a 'no landing' scenario has started to tick higher. On a global basis, we expect European growth to still remain stagnant while economic growth in China is showing signs of bottoming, but continues to still remain sluggish.

We believe that inflation has peaked and positive real rates should have the effect of slowing growth and continuing lower inflation over time. In our view, the market's expectation for a 'soft landing' implies inflation continues, unabated, back to the 2% Fed target with growth holding up. Our base case calls for 'unstable' inflation. Even though we expect inflation to bottom this year, we think it will be a recurring problem going forward based on long-term structural themes, such as deglobalization, decarbonization and the greenification of energy sources, aging demographics and growing government deficits. We expect the path to 2% to be a bit rocky and anticipate dips in

inflation as cycles progress, but we also expect to experience higher lows than what we've experienced over the last 15 years. We have moderated our view of future Fed cuts with the expectation that the cutting process will be more drawn out with less cuts in 2025 and a trough rate expectation of 3.75% to be hit in 2026. We see long-term fair value in the 10-year US Treasury at 4.50% and believe the current range is 3.75-4.50%. We believe the prospect of a Fed easing cycle keeps investors willing to add duration and we are once again receiving value for taking on duration risk.

### Stable Corporate Fundamentals Support Our 'Resilient Economy' View

Corporate fundamentals appear stable and while there has been some recent weakness in broader fundamentals, factors such as leverage and interest coverage ratios still remain strong in a historical context. Profit margins still remain healthy as the pass through of higher prices to consumers continues and free cash flow (FCF) generation still remains solid. First quarter issuance, particularly in investment grade corporates, appeared significant as corporations potentially tried to issue debt ahead of what could be a volatile US Presidential election later this year. In addition, specific to the high yield market, the maturity wall seems manageable, in our opinion, through 2025. Our Credit Health Index (CHIN) suggests defaults/losses will still remain relatively low, while slowly increasing to more normal levels associated with a 'late-cycle' environment.

### Carry May Drive Fixed Income Returns in 2024

We believe that long-term value has returned to fixed income markets and a combination of discount-to-par (positive convexity), favorable yields and an increase in issuer performance dispersion is helping to create opportunities in the bond markets. 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 potentially cuts rates on the front end.

We are mindful of the risks going forward, such as tighter financial conditions and their impact on the financial system, slower Chinese economic growth, geopolitical risk, the broader economic impact of a further decline in the commercial real estate market and the upcoming US Presidential election. 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, losses will still remain benign and buyers are showing up with an almost insatiable demand for paper. Our view is that credit remains well supported and investors can feel comfortable going for the extra spread pick up available in the credit markets. This view hinges somewhat on our expectation that any potential downturn will be mild, driven by a belief that unemployment will still remain low and a healthy consumer combined with stable corporate fundamentals should serve to minimize the potential for a hard landing by providing a floor to economic activity.

Based on this backdrop, we feel 2024 will likely be an environment where returns are driven by carry and it will be prudent to maintain a balanced risk profile between interest rate and spread risk.

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

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