Seelaus Asset Management Market Update

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Current Market Environment

We are amazed at the number of situations that exist today that arguably have market implications but there seems to be very little focus from market participants. Maybe that means the market has priced these all in and we just need to move on? Or maybe all the inputs are suggesting to stay the course until something changes. In short, at close to all time equity highs, the market lacks conviction. The problem is that "something" could be one of the many items we will list below, or it's the culprit that we mentioned in our August Market Update that you never suspect. Either way, in the short-run, we believe risk assets will continue to be in favor for both fundamental and technical reasons:

- With the Fed on a well telegraphed path lower in the Fed Funds rate, the equity market is well supported. We would argue that inflation is not their focus going forward but instead the health of the consumer which seems to be doing ok enough to maintain their trajectory. U.S. Initial Jobless Claims were 227k for the week of 10/19, which is off this year's hurricane impacted highs and below the pre-pandemic long term average of 352k. In addition, U.S. change in Non-Farm payrolls appear to be bouncing off the near-term lows of 108k in April 2024, continue to get revised higher, and it's worth reiterating this is above the 30-year payroll average pre-pandemic (1989-2019) of 117k.
- U.S. earnings seem to be starting off on a positive note with ~6% aggregate positive surprise in earnings vs. estimates according to Bloomberg.
- According to the Milliman 100 Pension Funding Index pensions are currently 102.4% funded which means they will likely need to rebalance out of equities and most likely into fixed income to align with their liabilities. In addition, we continue to focus on the ICI Money Market fund assets which are just slightly off the all-time high but still sit ~$6.5tn. As the Fed continues to ease, those assets will likely look to replace their lost yield in other riskier asset classes.

As much as we believe we are in a relatively stable short-run environment, it is becoming more relevant to maintain focus on the following situations and be prepared to adapt to the potential impact from each. The VIX seems to agree with us as it has recently started trending higher (~19.5) and is above the YTD average of 15.3.

(Data noted above as of 10/24/24 per Bloomberg)

What, Me Worry?

1. The U.S. Election is less than 2 weeks away

The Issue: Despite how contested the election appears on the surface, by nature of how close the polling is between the candidates, other than the rising VIX, the market does not appear to be focused on it. That might be because at the end of the day, the resulting policies of either candidate, from a fiscal standpoint, both point in the same direction (higher spending). Sure, one of the tail risks is an all-blue government if Harris wins, but the more volatile tail risk (and hopefully it really is a tail) would be a no decision, or contested vote count, on election day.

The Potential Impact: Interestingly, for the non-tail scenarios, we believe leads to a higher rate environment and steeper yield curve. This probably also holds true for the all-blue scenario. For the more volatile scenario, expect massive rate and equity volatility to the downside (higher rates, lower stocks).

2. Global Unrest

The Issue: Global conflict is becoming something we are used to. The two current multinational conflicts, Russia vs. Ukraine and Israel vs. a number of countries and groups (Hamas, Hezbollah, Palestine, Lebanon, Iran), are becoming the norm. When does it become an issue again for the market? When more entities start getting more explicitly involved:

- There are reports that Israel is attacking UN outposts in Southern Lebanon which means that peacekeeping forces that are typically represented by Western European nations are at risk.
- Will the U.S. get directly involved with Israel vs. Iran conflict? Once the election clears, we may know more.
- All efforts to isolate Russia during their conflict with Ukraine do not appear to be working as some 22+ nations leaders showed up in Kazan, Russia Tuesday (10/22) for the BRIC Summit including China, Iran and India among others. In addition, using North Korean troops to fight Ukraine changes the rubric as well.

The Potential Impact: Escalation and inclusion of additional nations to these conflicts would likely lead to lower rates and a lower equity market as investors de-risk and fly to safety.

3. AI

The Issue: One could argue the current equity market premium has been driven by a limited number of stocks that invested heavily in AI. To put it another way, without AI, US stocks would not be where they are today. We do not believe that this is necessarily another dot com boom and bust. The companies that have led this rally due to AI investment fall into the mega cap category. They are spending large sums, but they are already profitable from other business lines. The issue will be the smaller cap upstream AI participants that benefitted from that capex spend that may not be able to survive the time required for the AI cycle to become more relevant and profitable.

The Potential Impact: Equities will look through the short-run challenges which will avoid major sell off although heightened volatility is a logical result.

4. Cybersecurity

The Issue: The last situation we thought is worth highlighting is the ageing infrastructure of developed market countries like the U.S. Outdated infrastructure is susceptible to cybersecurity incursion. These threats, both successful and unsuccessful, will impact the utility resources of a nation which may very well be the future of global conflict and create its own form of global unrest.

The Potential Impact: In this scenario, we see lower rates and a lower equity market.

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What to Focus on Going Forward

- We continue to recommend being nimble with a liquid portfolio to manage volatility and proactively engage dynamic investment opportunities created by the situations we noted and any other market events that are not expected.
- Despite relatively tight historical credit spreads, all in corporate yields remain relatively attractive. As such, we continue to believe high quality, short duration credit will outperform other parts of the market with an easing Fed and steepening yield curve.
- Within the MBS market we continue to believe deep discount, long duration investments offer the best value as they are still priced to extremely slow prepayment assumptions, offer cheap convexity, and have attractive current yields.
- In equities, we recommend shifting to a more value orientation, given currently high valuations. In addition, we like adding cyclical and commodity exposure to benefit from a potential for pickup in economic activity with rate cuts over the next 12-18 months.
- The overall feel of the Treasury market is presently quite sloppy, and munis will find it hard, for the time being, to escape that general tone. In addition, there remains the usual seasonal volume in the new issue market to deal with over the next month. For those two reasons, munis will have to wait a bit to get to a more positive environment. In short, if we are dealing with a generally accommodative Fed, economic activity that is slowing but not rolling over, inflation that is close to the Fed's 2% goal, reduced muni bond supply in the December through February period, and ongoing robust demand for munis, then these broader forces should pave the way for reasonable total returns in the muni bond space over the next 2 to 9 months. With the recent upward move in Treasury and muni bond yields, that day has been put off a bit.