Seelaus Asset Management Market Update

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SEELAUS ASSET MANAGEMENT

Current Market Environment

The last Fed meeting of the year conveyed everything that the market expected. They cut the Fed funds rate 25bps; noted that inflation is not at target yet but is (hopefully) heading that way; labor market is okay; and the economy is growing faster than expected. What was not expected was the violence of the market reaction. Volatility screamed higher, S&P 500 had the second biggest selloff of the year and U.S. Treasury yields dramatically moved higher. From a statement perspective, the only change in language, other than the rate change, was the addition of the "extent and timing of" language to the target range for the Fed fund rates. Combine that with a rate cut dissenter, dot plots that suggests only 50bps of cuts in 2025, and Jerome Powell's press comments, and we are now getting a hawkish tilt to Fed policy. So where does that leave us as we close 2024?

- The S&P 500 is up ~26%, similar to 2023 performance after being down ~19% in 2022. Although just off the all-time highs, we are rooting for equities to completely recover from the market correction experienced after the December Fed meeting to get us back to record levels. What is more relevant to note is the performance of the S&P 500 equal-weighted index is only up ~12% YTD. This highlights the fragility of the S&P 500 level as performance has been driven by a handful of AI and energy stocks.
- From a credit spread perspective, using the Bloomberg Agg Corporate Index as our barometer, spreads tightened by 22% on the year to bring us close to the tights for the year. We are currently at the tightest levels in corporate bond spreads since before the Great Financial Crisis (GFC). Maybe more importantly, the yield to worst on the same index is ~5.5% higher on the year. While we are not at record yield levels in history, and not even at the highs for the year, since 2022 (when the Fed started hiking off the 0% Fed funds target post pandemic), we have experienced greater than 5% 10-year yields (which we have also not experienced since the GFC).
- The main driver of those corporate yields has been the Fed funds defying U.S. Treasury yields which are ~22% higher on the 10-year point. Similar to corporate yields, we are not at record yields or even the highs for the year, but we are back to yields not seen since *before* the Financial Crisis and before the Fed started easing into the crisis. Interestingly, at that time, Fed funds were locked at 5.25% which was the last time the Fed used a single point to set policy. Since the GFC, the Fed has used a range for Fed funds to give them more flexibility. To put this in perspective, the Fed funds range today is 4.25-4.5%.
- From an economic perspective, data has generally been encouraging. Q3 GDP beat expectations at 3.1% which is close to the long-term average of 3.2%. November unemployment came in at 4.2% which is below the 5.7% average since 2000 (which also turns out to be the long-term average as well). Finally, both CPI and PCE are well off the highs from 2022, currently at 2.7% and 2.8%, respectively. Unfortunately, these levels are off the recent lows in 2024 and are not back to lower levels seen pre-pandemic. The Fed's new hawkish stance is most likely meant to manage this risk that inflation doesn't maintain a downward trajectory. The big question will be whether they can manage inflation with current restrictive policy via a pause, or will they have to hike to have an impact on inflation? The latter being a more challenging environment for risk assets and the trajectory of the economy.

What to expect in 2025?

Our approach to prepare for the new year, was to reflect on the data and trends to identify potential themes:

- Animal spirits are here – Michigan Consumer Sentiment has been trending higher since the Fed started hiking in 2022; mutual fund and ETF flows into both equities and bonds, globally, have each averaged ~$13bn per week for 2024; and a new administration that is viewed as pro-business and pro-America will continue to support higher equities, and tight spreads.
- Geopolitical risks are becoming the norm – As terrible as it is to say, conflicts are becoming more pervasive, and the market is beginning to accept that. In addition, a Trump administration that wants to get the developed world to pay their share for global security while also making a deal between Ukraine and Russia, could ultimately be positive for U.S. markets.
- Inflation and economic growth may not be the only reasons for higher U.S. Treasury yields – Despite the proposed presidential advisory commission DOGE, U.S. Treasury debt outstanding, currently at $36tn is growing unsustainably, up ~6.5% YTD, and up ~56% since the end of 2019 as the Fed raised debt to support the economy during the pandemic. To put that in perspective, annual interest on that debt is currently ~$883bn per year which is up 69% since the end of 2019. The U.S. will have a long way to go to dig out of that hole with a $1.8tn deficit in FY2024 alone which is 7% of GDP. Because of these facts, despite an easing Fed, higher rates for longer may be a continuing theme. As much as higher yields are opportunities for lenders they can be challenges for borrowers if left unchanged for long periods of time.
- Along these lines, the Fed's balance sheet, now at ~$7tn, has been a large positive driver of the market. As the Fed has been easing, this has continued to decline. If this trend continues, the liquidity and support the market has grown used to could become a drag on performance.
- With U.S. equity markets near all-time highs, M&A will likely be a major theme in the new year. Not only will this lead to industry consolidation, but this could lead to increased corporate leverage. In an environment that could see higher yields for longer, this could create cash flow challenges for companies to service their increased debt and in turn could become a spread widening event for some corporates or industries. This will create opportunities for lenders on a credit-by-credit basis.

The above are examples of some of the themes we believe are important to focus on to identify opportunities in the new year. In our view, the themes that could pose to be the biggest risks to the market are a higher rate for longer environment, as well as the shrinking balance sheet of the Fed. Of course, as mentioned in previous commentaries, there is always the risk of the unknown as well.

We want to wish all of you a joyous holiday season and a healthy and prosperous 2025!

(Data noted above as of 12/26/24 per Bloomberg, JP Morgan)

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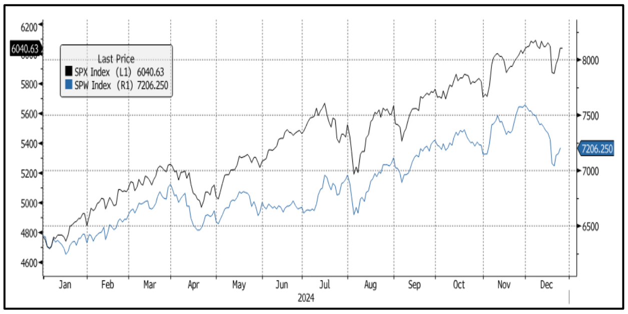
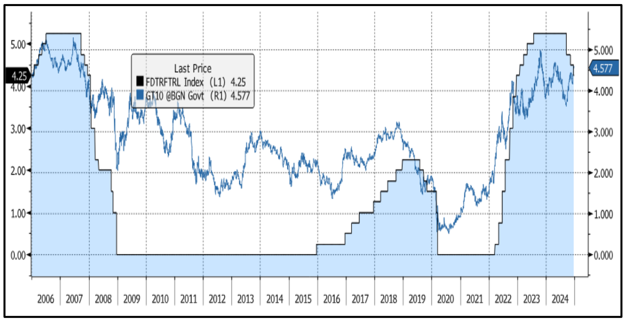
Visual Context

SPX vs. SPW

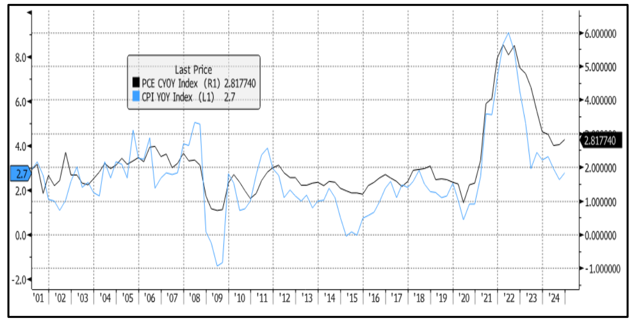


Bloomberg US Agg Corporate Average OAS vs. YTW

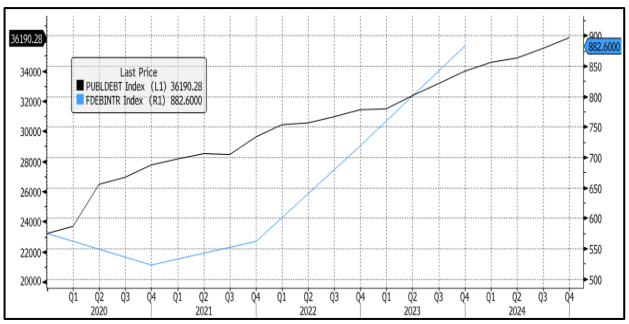
Fed Funds Lower Target – Lower Bound vs. 10yr U.S. Tsy Yield



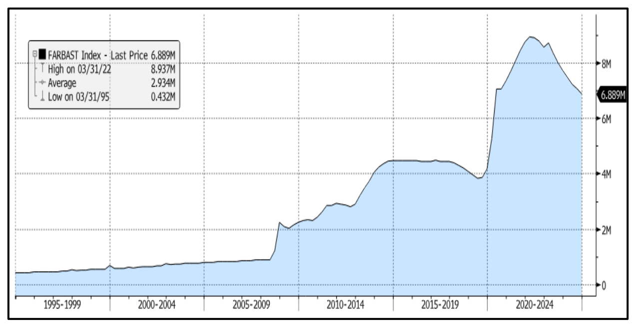
PCE vs CPI



U.S. Tsy Public Debt Outs. vs. U.S. Interest on Tsy Securities



Federal Reserve Bank Assets



(Data and charts as of 12/26/24 per Bloomberg)

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