

Current Market Environment

A feeling of uncertainty is creeping into the market. According to the recent Fed minutes released on February 19th, “A majority of participants observed that the current high degree of uncertainty made it appropriate for the committee to take a careful approach in considering additional adjustments to the stance of monetary policy.” In other words, the Fed is just as confused as the rest of the market about the impact of tariffs, executive orders, and any other rhetoric or policies the new administration has proposed or is yet to propose. Since the December meeting, inflation had been the sole focus for the Fed as the data was not indicating the trend lower they were hoping to see. Unfortunately, it appears now that the Fed may have to start fighting a two-front battle as it appears there could be some economic challenges on the horizon as well. Recently released data showing a declining housing market and consumer sentiment may indicate that the uncertainty of the Fed may not last for long if we see a consistent downward trend in consumer health. Although monetary policy is not necessarily trying to solve for sentiment or housing data, it could be a leading indicator for concern around the jobs market and the impact of higher prices on consumers, so the data points still matter. These factors have not been lost on the market, but the lack of clarity is palpable. Market expectations for Fed cuts in 2025 decreased earlier this month to one 25bps cut but are now pricing in a higher probability of two 25bps cuts. Despite these new inputs, our view has not changed (yet) as we still do not see the Fed choosing to make any moves this year. Originally, that opinion made sense when the Fed only had to focus on inflation since the economy seemed stable and we were comfortable that QT (Fed continuing to shrink their balance sheet) would have the needed impact to control inflation as opposed to a rate hike. Now that we are seeing some signs of potential economic weakness, we still do not believe the Fed will be able to cut without risking higher inflation. Obviously, this is a challenging position for the Fed, as well as our view, so here is what we are focused on to inform our position:

- As we have stated previously, the yield curve has been steepening since the election but it's safe to say that trend is over. UST 2s10s spread was at its highest level since 2022 of 42bps in January. Today, we have cut that in half to ~20bps via a bull flattener. In addition, the 10yr treasury yield reached its highest level since 2023 of ~4.80% only to recently re-trace back down to the lowest level of 2025 at 4.30% currently. The market is telling us that future expectation for growth and maybe, in turn, inflation, is potentially decreasing.
- There are a lot of factors driving the market right now but the most prevalent seems to be lower consumer sentiment data (U. of Mich. Sentiment, Conf. Board Consumer Confidence), declining home sales and rising initial jobless claims which are off the 12-month low from early January 2025. Add on top of that the numerous layoff announcements from the end of last year that are continuing into this year, plus the uncertain impact to consumers around tariffs, and you have an environment that is creating a lot of concern for the consumer and may reflect their declining willingness to spend in the near term.
- Relatedly, credit card delinquencies, although off the near-term highs, have been consistently trending higher since 2021 and are currently at levels not seen since 2012.
- Important upcoming data releases that the Fed (and us!) will have a keen eye on are GDP on February 27th and unemployment on March 7th.

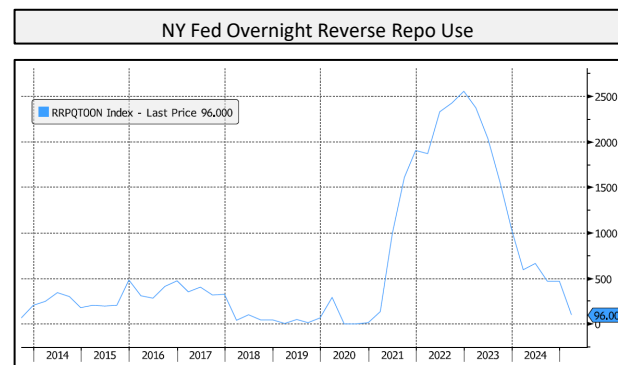
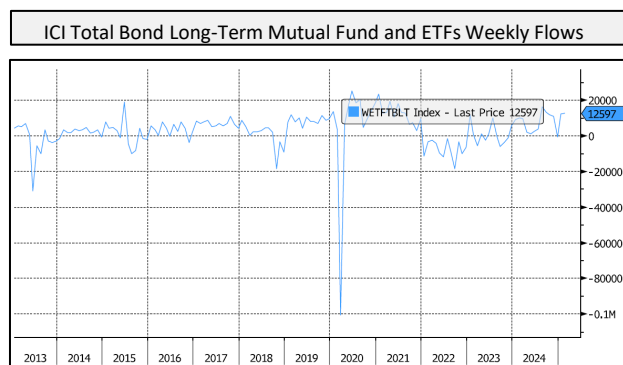
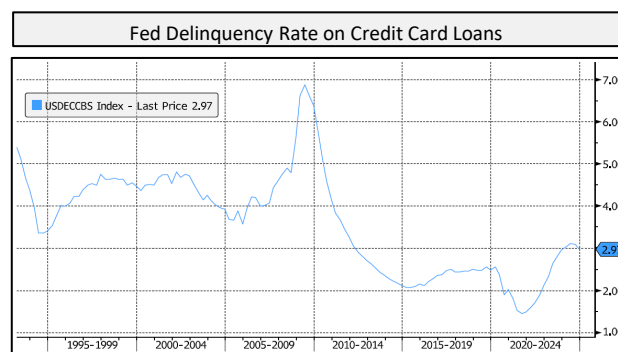
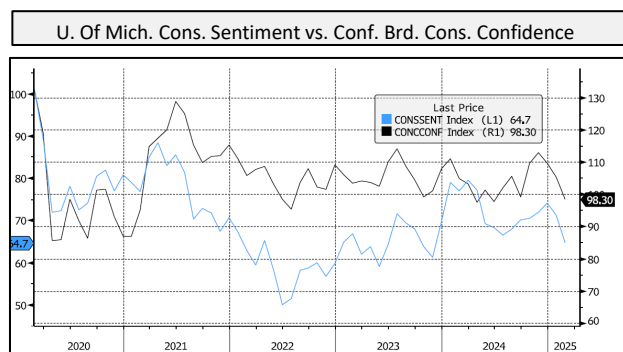
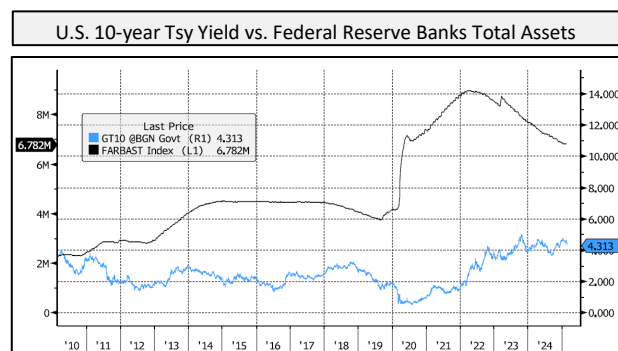
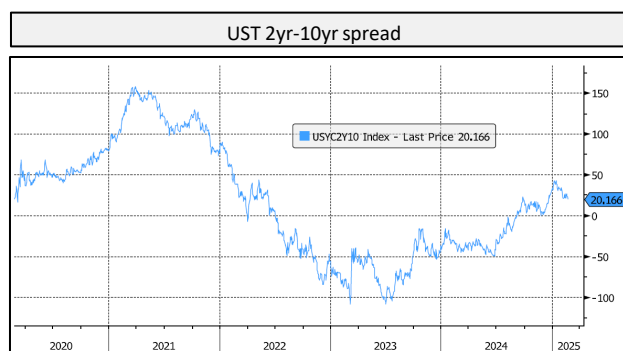
Despite uncertainty, we still see reasons for risk assets to hang in there, but we need to be prepared for volatility

- Companies still have significant access to the public capital markets as evidenced by continued positive weekly inflows into bond mutual funds and ETFs. In addition, the private credit markets also continue to have significant capital to be put to work as evidenced by J.P. Morgan allocating \$50bn into the space. It is estimated that the U.S. private credit market is now at ~\$1.7tn in assets and continues to grow. Despite that additional liquidity, if it is locked up money, will it be able to provide any real-time support in periods of stress?
- The market has responded positively this time around to reduced liquidity from the Fed (QT in this instance) with no dramatic shock to rates that were experienced during the 2013 taper tantrum (slowing of QE in 2013). The Fed balance sheet has shrunk almost \$2tn since April 2022 and it is interesting to note a similar decline in the same time period for the Fed's reverse repo facility. Maybe assets have found better uses for their cash than lending to the Fed but it is another sign of a potential shock absorber being removed from the financial markets.
- The new administration, for better or worse, is likely to do what they say they are going to do. The end result is not always clear but it is clear that whatever the administration sets out to do is that there will be some impact. For example, it is on the agenda to find a deal for the 2 major conflicts outstanding in Israel/Gaza and Russia/Ukraine. Although it is not clear what the result will look like, less geopolitical conflict is a positive and if every administrative action leads to some sort of “deal” we could experience positive secondary impacts. In this example, could a deal lead to an increase in Russian oil or Ukrainian minerals to the market? This could provide a positive effect on commodity pricing for consumers. In addition, another agenda item such as deregulation could also have a similar price impact to industries that may not have to bear the cost to fulfill regulatory compliance requirements in the future. The way the administration negotiates, though, is never a straight line and could lead to short-term volatility while investors await the end result.
- We have mentioned this in previous commentaries, but we think the precedent to address government efficiency and optimization is a very good one. We will not comment on the administrations approach but for some time now, the Federal deficit has needed to be a prioritized topic and, over time, will likely have a positive effect on a lower rate environment (less government debt) assuming there is some legitimacy to the efforts of DOGE. Again, there is risk for volatility as the impact of DOGE efforts could have short-term consequences such as a negative impact on jobs numbers for example.
- Even though we are highlighting concerns around layoff announcements, although short-term discouraging, this could be the beginning of the labor force adjustment to the impact of AI. So, what does the new normal look like? Time will tell, and may create volatility along the way, but the labor force will need to go through some form of retraining and upskilling to be able to find complementary ways to work with AI as a tool that can be leveraged to enhance productivity. If other technological advancements are a window into the future, this will not be a long-term negative but instead a massive increase in global production.

As you can see, each one of these points to support the market has some version of potential volatility associated with it. As active investors, volatility is not something to be feared but more so to be prepared for, as it is an event that can create investment opportunity.

(Data noted above as of 2/25/25 per Bloomberg)

Visual Context



(Data and charts as of 2/25/25 per Bloomberg)

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