

Current Market Environment

The impetus for the increased volatility we have experienced to start August has a number of suspects ranging from almost certainty of a Fed rate cut in September, payroll number weakness, and the Yen carry trade to name a few. Despite the finger pointing, we believe the U.S. economy does not look all that different than it did the last week of July:

- U.S. unemployment sits at 4% as of 6/30. Off the lows of 3.5% in March of this year but still below the ~5.7% long-term average.
- PCE (the Fed's preferred measure of inflation) has declined steadily from the highs of ~5.5% in February 2022 to 2.6% at the end of June. Still at a level not seen since the early 1990s and maybe still indicative of the Fed's current positioning.
- Finally, non-farm payrolls of 114k for July vs. an expectation of 175k may look bad vs. recent history post pandemic but is not too far off the 30-year payroll average pre-pandemic (1989-2019) of 117k! In addition,

What is changing is the U.S. Treasury curve, which continues to steepen more dramatically with 2s10s only -6bps vs. -110bps in March 2023. There is also a definitive increase in market volatility (VIX at 23.1 vs. an average of ~16 since March 2023), which may be due to summer equity trading volumes/staffing, and increased expectations of the number of Fed cuts before the end of the year (now pricing ~100bps cuts). *(All market data as of the morning of 8/7/24)*

Despite those changes, we believe there are three themes that are critically important for active investors to focus on as we continue to navigate this market.

Three Themes

1. We are moving from a “policy driven” priced market to a “market driven” priced market... good news is now good news and vice versa.

It is challenging to determine if the Fed has lost the ability to positively impact the market in the short-term. Time will tell if they are behind the tape. If they are not, then the market could find bullish support in their easing. That said, as mentioned earlier, the market has already priced in cuts so that could indicate that we would need to see outsized cuts (exceed expectations) to get a definitive market reaction. What is unclear, though, is if that action would be viewed positively (Fed can fix anything) or negatively (economy is worse than expectations). In addition, if they have to fight a recession and geopolitics (war in Iran/Lebanon/Israel/Venezuela), do they have enough firepower (no pun intended)?

2. Record cash “on the sidelines” will need to reach for yield.

\$6tn in money market balances will create demand for risk assets as investors seek yield and are incentivized to actively manage cash balances. Fortunately, the environment creates opportunities for those looking to reallocate cash. Lower rates for corporates, with perceived sizeable investor demand, will incentivize continued funding. Add that cash horde to the imminent Fed easing and the market will experience an increase in liquidity which will be positive for higher yielding risk assets.

3. The culprit is never what you expect.

In our view, neither a Fed policy misstep, the results of the U.S. election nor geopolitics will be the straw that breaks the markets back. The culprit will be something more obvious than the pandemic but unexpected nonetheless – the regional bank crisis that resulted in the collapse of Silicon Valley Bank in March 2023 or the funding crisis that led to a market wide liquidity crisis in September 2019 are both examples of something that flashed signs of stress but wasn't priced in until it became a reality.

To help identify the impact of an unsuspected culprit, we are focused on the following:

- Risk of wealth destruction – The consumer is already showing signs of stress through auto and credit card delinquencies which is a shift away from the wealth accumulation of the pandemic. The U.S. personal savings rate as percent of disposable income was 3.4% at the end of June and continues to trend lower from the spike during the pandemic (10.6% average 2020-2022). Unfortunately, the current rate is also below the 8.7% long-term average pre-2020. Jobs will impact savings over time, so we need to see some stability in the unemployment rate if the consumer is going to hang on.
- Market liquidity – The evolution of global market structure has brought with it a double-edge sword. A shift away from bank to HFTs as market makers has led to an increase in trading volumes and tightening of bid/ask but that also brought liquidity challenges in times of stress – HFTs are less likely to keep making markets when volatility is high which is unlike the historical accountability from the traditional bank market makers.
- Private Credit – In a similar vein, the shift in lending from banks to private funding on the back of the global financial crisis continues to grow. More financing than ever before is supporting a record number of company financings, and it is not liquid or transparent. In addition, these private credit platforms are now pushing to get access to retail client assets!

What to Focus on Going Forward

- We recommend being nimble with a liquid portfolio to manage volatility and proactively engage investment opportunities.
- We continue to believe high quality, short duration credit will outperform other parts of the market with an easing Fed, steepening yield curve and the potential allocation from money market funds.
- Within the MBS market we still 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 a higher quality/value focus. This means identifying strong balance sheet companies that can withstand economic uncertainty and benefit from lower rates in a volatile market. Look for opportunities to rotate into stocks that have lagged, are trading at reasonable valuations, have strong growth prospects (some even AI-driven), and may see outsized benefits from easing monetary policy over the coming months (e.g., small caps, utilities, cyclicals).
- For retail investors, the municipal bond market still has some catching up to do to U.S. Treasuries in terms of lower yields. If there is continued volatility, the flight to quality generally and, munis in particular, should support municipal bond prices. If equity markets are volatile and continue to carry high uncertainty, that could lead to additional demand for munis as a relatively safe place to be.

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