First Quarter 2024

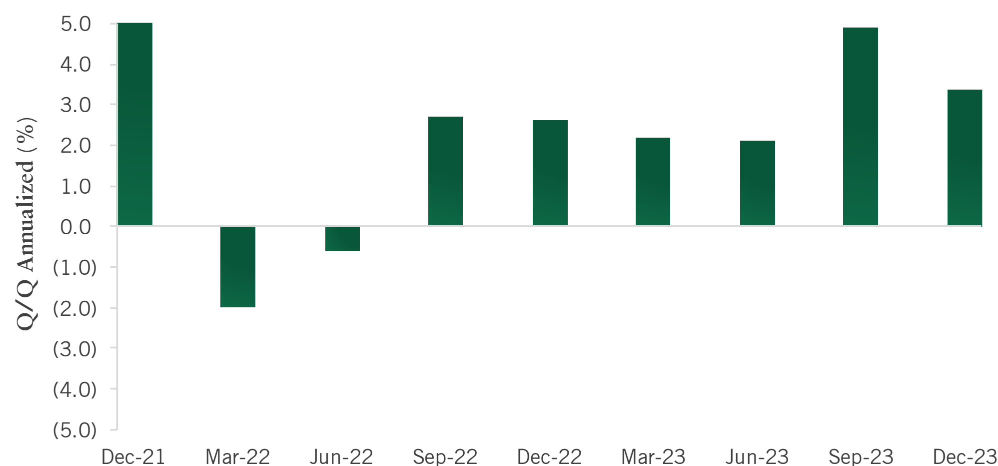
Longest Inversion On Record Likely…

- Forecasts at year end were calling for aggressive policy rate cutting to start as early as March, yet here we sit with virtually no change in policy stance and no cuts, interest rates selling off, and a yield curve that remains inverted. The curve has been inverted for the past 21 months. This matches the longest inversion on record, and it is worth noting that it could go on for considerably longer.
- Importantly, there is nothing indicating the curve needs to "normalize" anytime soon. The Federal Reserve (Fed) has signaled it is more than comfortable being patient and short rates have already stayed "higher for longer" than anyone expected.
- 4Q GDP growth measured 3.4% q/q annualized, bringing full-year 2023 growth to 3.1% y/y. Personal consumption accelerated again to 3.3% q/q annualized from 3.1% q/q annualized in 3Q. Looking ahead, 1Q GDP growth is expected to be 1.5%-2.5% q/q annualized, with continued consensus regarding economic strength and the avoidance of recession.

…As Economy Remains Resilient

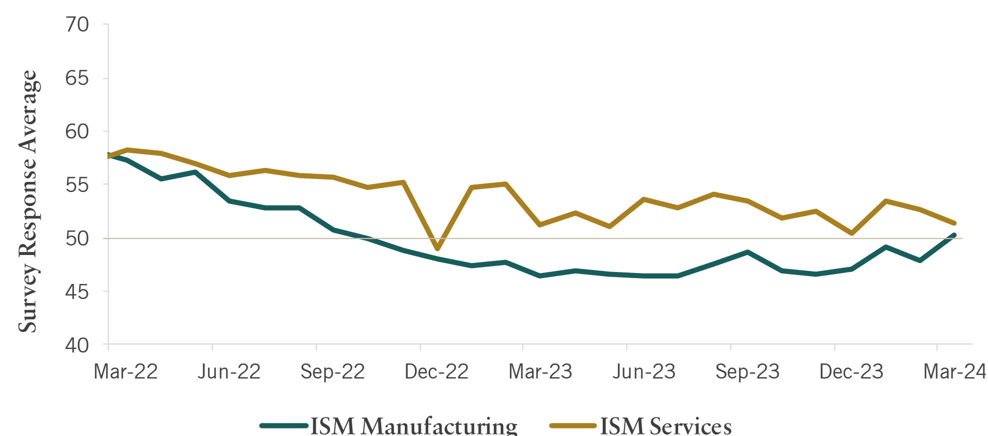
- The labor market remains healthy, with 229k and 275k jobs added in January and February, respectively. The unemployment rate ticked up to 3.9% in February. The often-cited ratio of job openings to unemployed workers is now 1.37 marking the lowest measurement since fall of 2021.
- The University of Michigan Consumer Sentiment Index has been hovering at just below 80 so far in 2024. These are the highest readings since the middle of 2021. While this is still considerably lower than pre-pandemic, and there is a fair amount of monthly variation, the upward trend that is emerging is undeniable.
- Business activity has also started to bounce back, with the ISM Manufacturing PMI improving to 50.3 in March, marking the first expansionary reading since October 2022. The ISM Services PMI has consistently been around 50-55 for the past year, most recently registering 51.4 in March.

REAL GDP GROWTH



Source: Bloomberg

ISM MANUFACTURING AND SERVICES



Source: Bloomberg

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First Quarter 2024

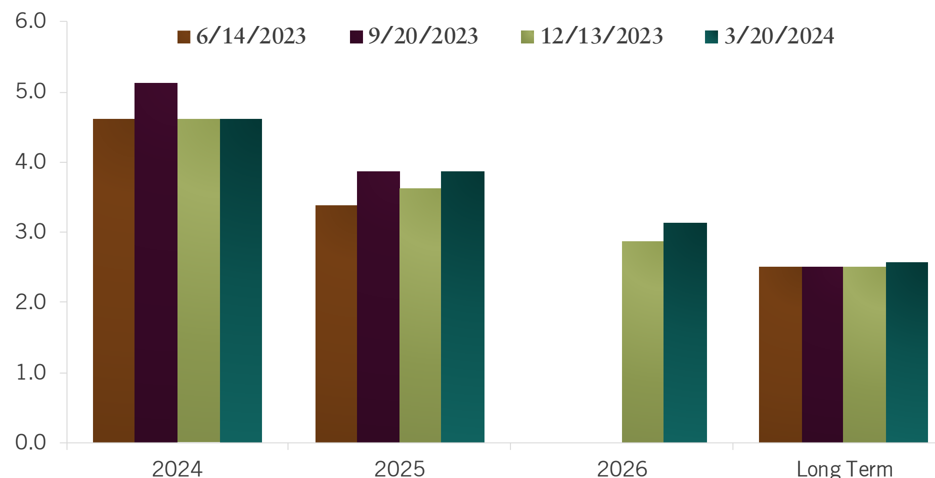
Fed Expects To Cut, Eventually…

- In its final meeting of 2023, the Fed stayed on hold and provided a dovish message indicating interest rate cuts would be forthcoming in 2024. The market had been begging for a dovish "pivot" and with the message finally received, futures priced in a whopping seven policy rate cuts by January 2025, despite the December SEP dot plot suggesting a median of only three cuts in 2024.
- By the time the March meeting rolled around, the market was digesting two months' worth of stubborn inflation numbers and a paring back of interest rate bets, pushing cuts out to mid-summer and reducing expectations to only three or four cuts. The Fed stayed on hold again and reiterated its message of patience.
- The updated SEP showed median year-end 2024 Fed Funds at 4.625%, unchanged from December, suggesting the Fed still anticipates cutting three times this year. Further, it does not believe a recession is on the horizon. For now, market expectations have converged with Fed messaging.

…As Inflation Stalls Out Above 2%

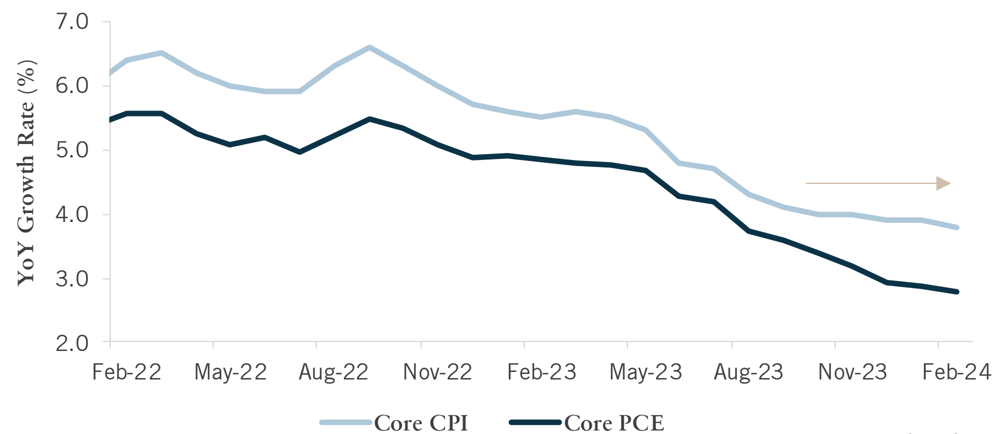
- Progress towards meeting the Fed's 2% inflation target has slowed considerably. Last quarter, we noted some concern about the easing of financial conditions related to rallying interest rates and the run-up in equity prices, and the possibility of this leading to more inflation.
- Headline CPI measured 3.4% y/y, 3.1% y/y, and 3.2% y/y in December, January, and February respectively, while core CPI increased by 3.9% y/y in both December and January, and 3.8% y/y in February. PCE inflation numbers show a similar pattern.
- Inflation expectations have increased as well. 2-year breakeven inflation rates widened by 70 bps to 2.72% and 5-year breakevens drifted up by 29 bps to 2.44%. Meanwhile, 10-year breakeven rates increased by 15 bps to 2.32% and the 5 year, 5 year forward breakeven increased by a smaller amount, to 2.25%.

FOMC MEDIAN FED FUNDS RATE PROJECTIONS (%)



Source: Federal Reserve

CORE CPI VS. CORE PCE



Source: Bloomberg

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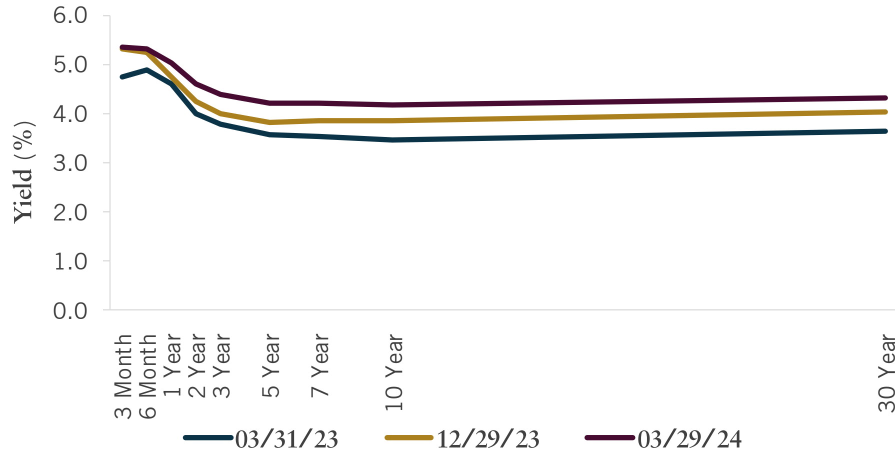
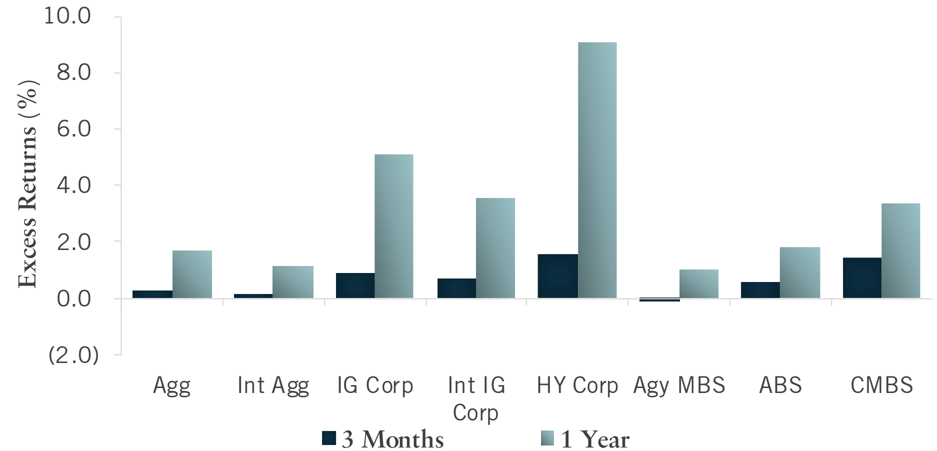
Interest Rates Move Higher With Stubborn Inflation; Spread Sector Excess Returns Mostly Positive

U.S. TREASURY YIELD CURVE



Source: Bloomberg

BLOOMBERG U.S. EXCESS RETURNS VS. TREASURIES



Source: Bloomberg

- Interest rates moved higher across the curve during the quarter. The 2-year Treasury sold off by 37 bps while the 10-year Treasury sold off by 32 bps, leaving the curve inverted by 42 bps. Virtually all the adjustment happened in February when it became apparent that progress on inflation was stalling out.
- Excess returns were modestly positive for the first quarter across major fixed income spread sectors, with the exception of Agency MBS. Excess returns remain positive across major spread sectors over the last one-year period, with Corporates turning in stronger performance relative to securitized assets. Within IG Corporates, longer bonds outperformed short/intermediate maturities, and BBB issuers outperformed higher quality names.
- Corporate spreads moved tighter across the board once again during the quarter. Within subsectors, financials tightened the most; however, industrial spreads remain relatively tighter than both financials and utilities. Investment grade new issue supply picked up significantly to start the year, with record issuance months in January and February. Overall, first quarter investment grade new issuance was approximately $537 billion according to SIFMA, outpacing first quarter 2023 issuance by over $100 billion.
- Agency MBS excess returns ended the first quarter slightly negative. As market sentiment about interest rate cuts reversed, the market sold off in January and February, leading to underperformance of -18 bps and -29 bps, respectively. However, mortgage spreads rallied in March as interest rate volatility fell, leading to excess returns of +34 bps to end the quarter. Mortgage rates, as measured by the Freddie Mac Weekly Survey rate, ended the quarter marginally higher at 6.8% alongside the selloff in Treasury rates.
- ABS posted positive, but muted, excess returns for the quarter. ABS new supply came in at $93 billion, marking the highest quarterly total on record and a whopping 46% more than the same time period last year. Although there are pockets of credit deterioration forming, particularly at the lower-end of the credit spectrum, so far it is not beyond expectations. Ultimately, the unemployment rate will dictate broader consumer and small business credit trends if the economy cools over the coming year.
- Non-Agency CMBS turned in the strongest excess return performance of the securitized sectors for the quarter as credit spreads raced tighter alongside a broader rally in corporate credit spreads. A challenging refinancing environment will continue to drive credit problems in 2024, particularly for office properties. New supply picked up the pace, measuring $17.4 billion for the quarter.

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