Third Quarter 2024

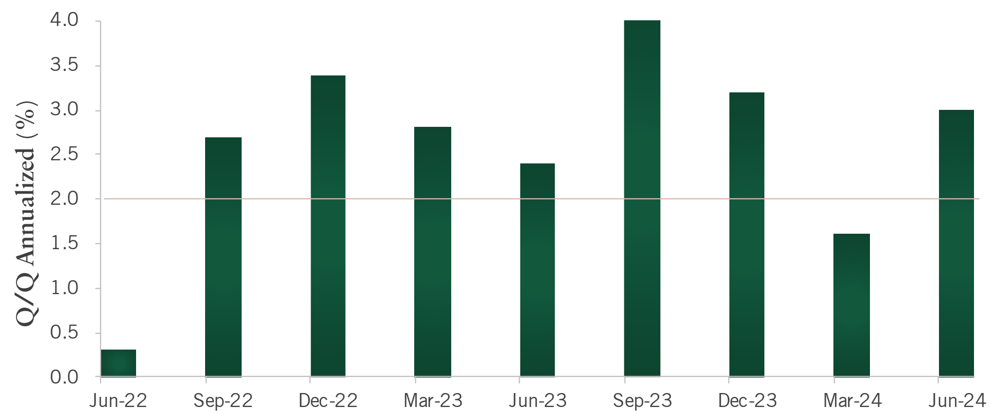
Fed Easing Starts With A Bang…

- After months of debate and deliberation, the Fed's easing cycle finally arrived in September. Following a weak July employment report, market expectations for a 50 basis point (bps) cut proved accurate. As we hurtle toward the end of the year, the market chorus now wonders how accommodative the Fed will ultimately be.
- Despite two years of restrictive monetary policy, market measures of liquidity risk and interest rate volatility have remained low, resulting in financial conditions that are already extremely easy. Naturally, the path forward depends on the trajectory of economic conditions along with the Fed's policy response.
- 2Q GDP growth was revised up to 3.0% q/q annualized after an initial estimate of 2.8%. Personal consumption accelerated to 2.8% q/q annualized from 1.9% in the first quarter. 3Q GDP growth is expected to remain strong at 2.5-2.9% q/q annualized. Full year growth for 2024 is now projected to be 2.5%-2.7%.

…As Economy Slows Gradually

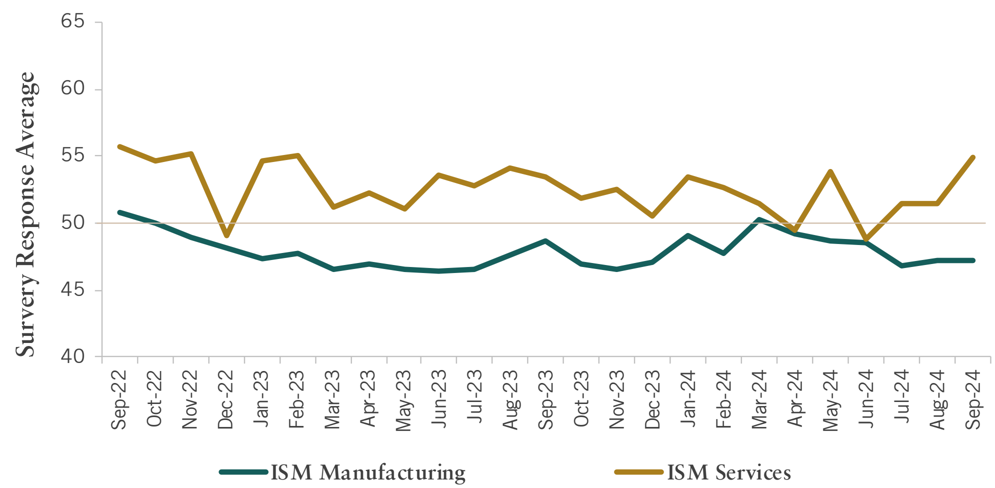
- Non-farm payrolls added 118k, 144k, and 142k jobs in June, July, and August, respectively. Furthermore, measures of job gains have underperformed expectations with prior month revisions often resulting in further reductions.
- Adjusted retail sales measured 1.1% m/m in July and 0.1% m/m in August. Annual revisions to GDI led to upward revisions to personal income and savings, which suggests that consumers have been earning and saving more than previously thought, helping to explain the surprising resilience of consumer spending.
- The ISM Manufacturing PMI remained just below 50 throughout the quarter, landing at 47.2 in September, while the ISM Services PMI regained some momentum, coming in at 51.4 in July and 51.5 in August after briefly dipping below 50 in both April and June.

REAL GDP GROWTH



Source: Bloomberg

ISM MANUFACTURING AND SERVICES



Source: Bloomberg

Third Quarter 2024

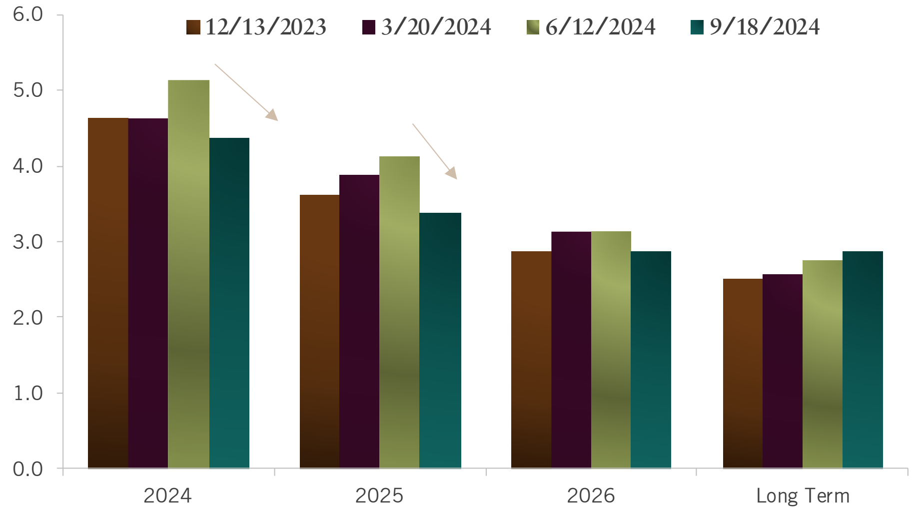
A Hawkish Cut…

- As previously mentioned, the Fed delivered a 50 bps cut at the policy meeting in September. The official FOMC statement indicated that the Fed has "gained greater confidence that inflation is moving sustainably toward 2 percent" and reinforced that the risks to inflation and employment are more balanced.
- Although a 50 bps cut is dovish in tone, the updated Summary of Economic Projections (SEP) and Powell's press conference leaned more hawkish. Within the updated projections, the median indicates the Fed plans on two additional 25 bps cuts between now and year end.
- The 50 bps cut in September can be interpreted as a catch-up for the 25 bps cut that should have happened in July, plus the 25 bps that was widely expected to occur in September, putting the Fed back on track. Alternatively, the 50 bps cut could be considered a reinforcement of the Fed's commitment to strong employment markets.

…As Inflation Trends Downward

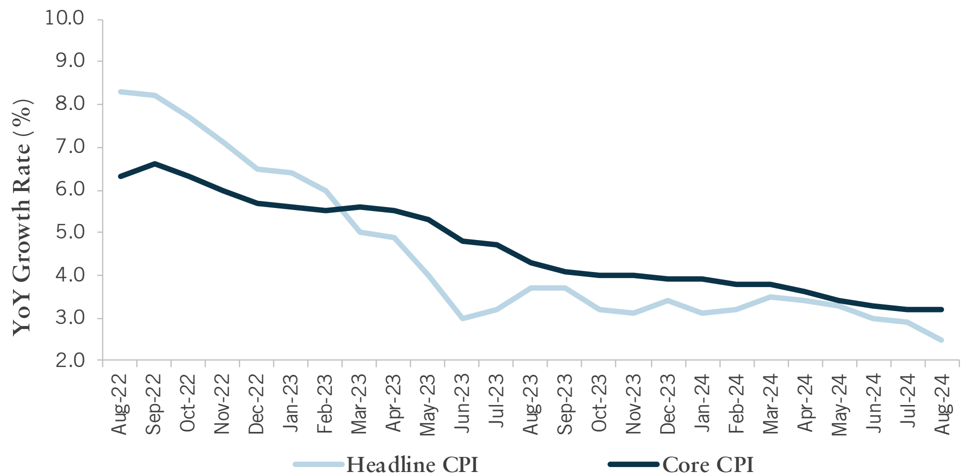
- Inflation measures continue to trend in the right direction despite core inflation numbers bouncing up modestly month-over-month and year-over-year more recently. Headline CPI measured 3.0% y/y, 2.9% y/y, and 2.5% y/y in June, July, and August respectively, while core CPI increased by 3.3% y/y, 3.2% y/y, and 3.2%y/y during the same period. PCE and PPI show a similar pattern.
- On a rolling 3-month basis, headline CPI increased by only 0.1% m/m in August whereas core CPI measured 0.2% m/m. These rolling averages imply an annualized run rate of approximately 1.5% to 2.5%, squarely in the Fed's target range.
- 2-year breakeven inflation rates fell as low as 1.47% in mid-September but climbed back to 1.77% to end the quarter. Long-term inflation expectations, represented by the 5-year breakeven, 10-year breakeven, and 5-year, 5-year forward breakeven rates, are between ~2.10% and 2.25%.

FOMC MEDIAN FED FUNDS RATE PROJECTIONS (%)



Source: Federal Reserve

HEADLINE CPI VS. CORE CPI

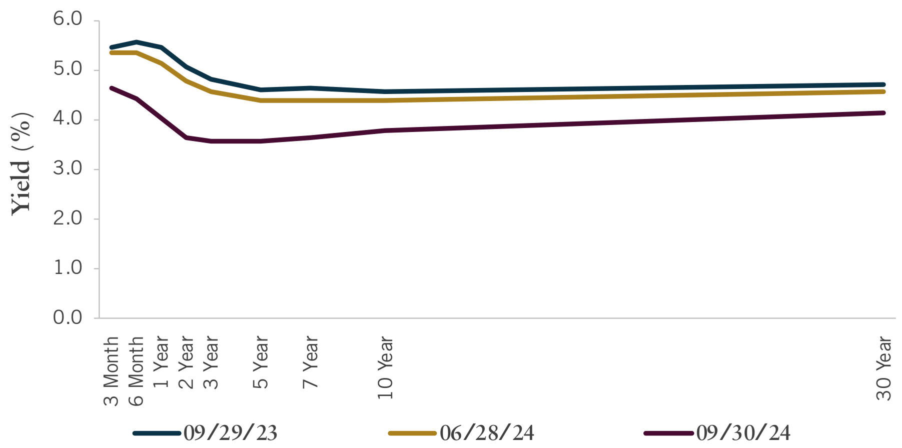


Source: Bloomberg

Third Quarter 2024

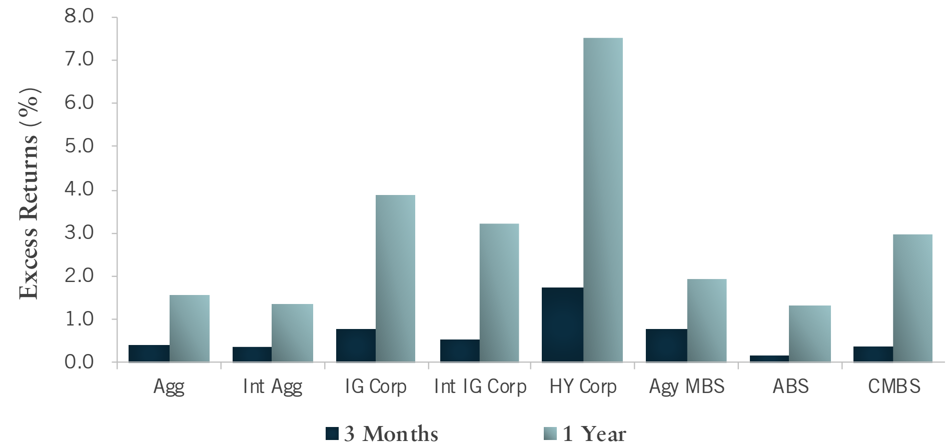
Interest Rates Rally As Fed Starts Easing; Spread Sectors Outperform Across The Board

U.S. TREASURY YIELD CURVE



Source: Bloomberg

BLOOMBERG U.S. EXCESS RETURNS VS. TREASURIES



Source: Bloomberg

- Interest rates continued a rally that began in May, with the 2s-10s curve steepening into upward sloping territory for first time in 26 months. Sniffing out the pending shift in monetary policy, 2-year Treasuries rallied a whopping 111 bps in the third quarter while 10-year Treasuries rallied 61 bps, leading to a 50 bps bull steepener. While at first glance this curve reshaping is considerable, it is perfectly within historical norms set by the months leading up to the beginning of an easing cycle, particularly when a recession is not imminent.
- Excess returns were positive for the third quarter across major fixed income spread sectors. Excess returns remain positive over the last one-year period as well. Within IG Corporates, longer bonds continued to outperform short/intermediate maturities for the quarter and year. BBB issuers outperformed higher quality names over the year but lagged for the quarter.
- Corporate spreads tightened slightly during the quarter. Within subsectors, financials tightened modestly more than industrials and utilities. Longer Corporates narrowed relatively more than shorter and intermediate maturities. Investment grade new issue supply accelerated during the quarter, outpacing the second quarter by ~$75 billion. New issue also eclipsed third quarter 2023 issuance by over $140 billion.
- Agency MBS excess returns were positive for the third quarter following two quarters of underperformance as interest rates rallied considerably with the market anticipating easing monetary policy. Ultimately, the Fed cut its policy rate by 50 bps in September but kept the rate of quantitative tightening unchanged.
- Mortgage rates, as measured by the Freddie Mac Weekly Survey rate, ended the quarter at 6.08%, the lowest rate since fall 2022. Existing home sales fell to only a 3.9 million-unit annualized pace in August while existing home supply remains low at ~4 months. The S&P Case Shiller home price index continued an upward trend with the 20-city composite registering 5.9% y/y in July.
- ABS posted positive, but muted, excess returns for the quarter once again. ABS new supply came in at $82 billion. With unemployment edging higher, continued deterioration in credit performance is expected, particularly at the lower end of the credit spectrum.
- Non-Agency CMBS also turned in positive excess returns for the quarter and there is some optimism that lower interest rates will provide a more favorable refinancing environment. However, some credit challenges will remain particularly for office properties. Between conduit and SASB, total new supply measured $29 billion for the quarter.