First Quarter 2025

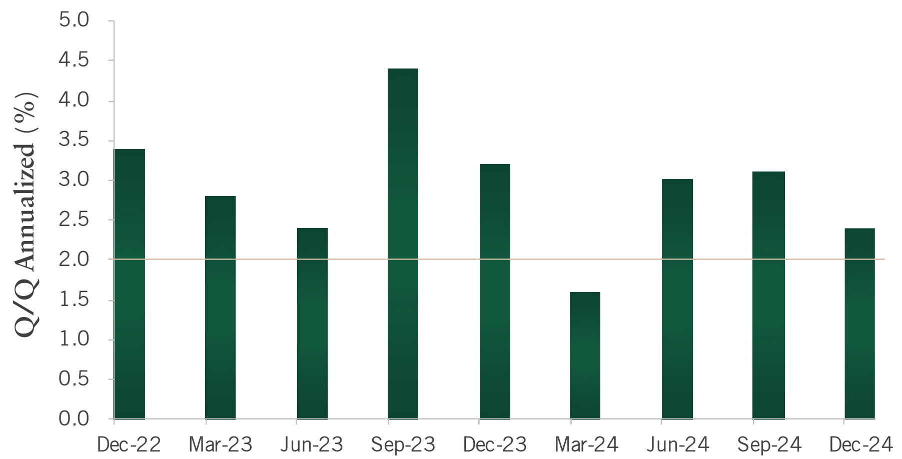
The New Year Brings Uncertainty…

- The first quarter of 2025 can be summarized with one word: uncertainty. With so many moving parts, it is difficult at best to opine on possible outcomes, both short-term and long-term. The Global Economic Policy Uncertainty Index and the Bloomberg Economics Global Trade Policy Uncertainty Index have spiked to the highest levels on record.
- 4Q GDP growth measured 2.4% q/q annualized, bringing 2024 GDP growth to ~2.5% for the year. Personal consumption registered 4.0% q/q annualized, handily beating estimates and signaling consumers remained quite healthy through year-end.
- 1Q GDP growth forecasts vary widely among the estimates we track, ranging from -1.8% to 2.3% q/q annualized. Importers attempting to front-run tariffs by accelerating shipments are distorting the U.S. trade balance, which in turn will distort measures of GDP, but this will likely reverse over the near term. While it is too soon to tease out the ultimate impact that increased tariffs will have on the economy, the heightened level of uncertainty muddies the outlook.

…And Consumer Sentiment and Business Activity Weaken

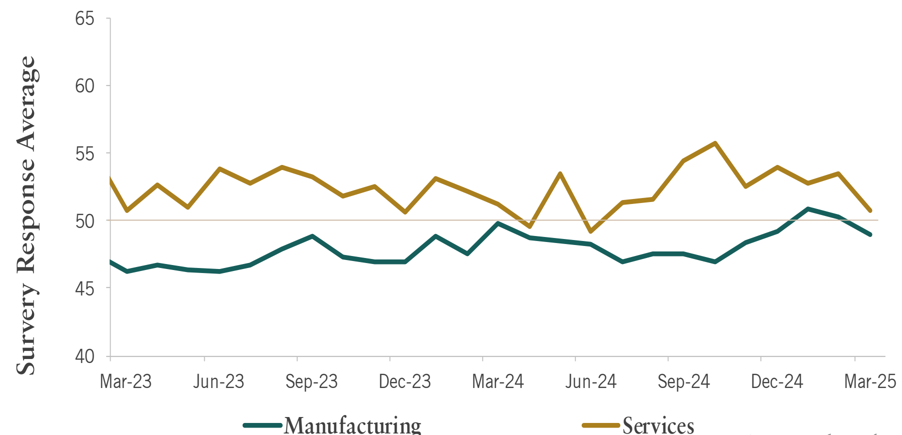
- The labor market remained healthy despite the general tone of market uncertainty during the quarter. While January and February payrolls were more muted with 111k and 117k jobs added, March saw another 228k jobs added in an overall solid employment report.
- Despite income and earnings growth, the University of Michigan Consumer Sentiment Index decreased to 57 in March. While this is the lowest reading since the pandemic, consumer sentiment measures have historically provided a weak signal of consumer spending.
- Manufacturing and business orders weakened following a brief rebound, and services also dipped lower. The ISM Manufacturing PMI turned contractionary once again after breaking above 50 for the first two months of the year. The ISM Services PMI had been strong; however, it dipped to only 50.8 in March marking the lowest reading since last June when it briefly turned contractionary.

REAL GDP GROWTH



Source: Bloomberg

ISM MANUFACTURING VS. SERVICES SECTOR



Source: Bloomberg

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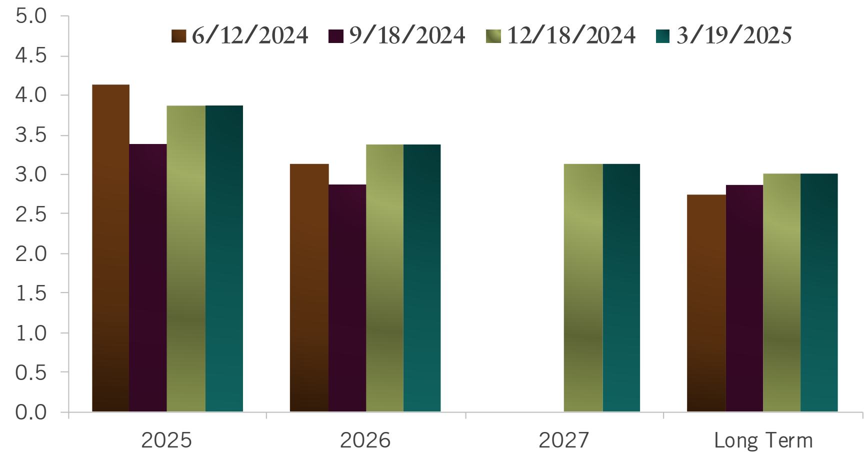
Fed Hits Pause Button…

- As highly anticipated, the FOMC stayed on hold at its meeting in March. Notably, the Fed is slowing the runoff of its balance sheet by reducing the monthly cap on Treasury securities from $25 billion to $5 billion while the Agency MBS monthly cap remains at $35 billion per month.
- The post-meeting statement highlighted patience in the face of uncertainty. For now, the Fed's base case is for transitory price increases from tariffs. With all that is in play, Powell reinforced that the FOMC "will not be in any hurry to move" on policy rate decisions.
- The median dot plot indicates only two cuts in 2025, unchanged from December. Additionally, the median Fed forecasts for 2025 include GDP growth moving down to 1.7% from 2.1%, unemployment moving up to 4.4% from 4.3%, and core inflation moving up to 2.8% from 2.5%. Continued trends of higher unemployment and elevated inflation could conflict with the Fed's dual mandate of price stability and full employment.

…As Inflation Remains Above Target

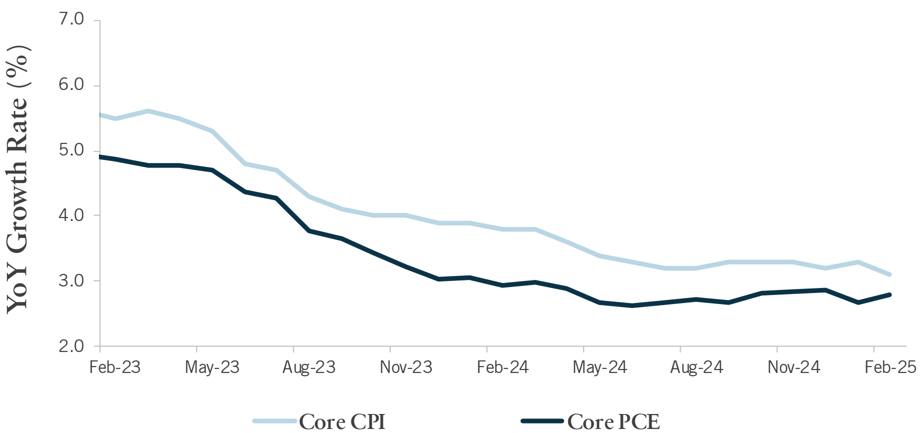
- Inflation remains above the Fed's target, with most measures of inflation bottoming out and perhaps even trending higher since last fall . Headline CPI crept up to 2.9% y/y in December, 3.0% y/y in January, and 2.8% y/y in February. Core CPI increased by 3.2% y/y, 3.3% y/y, and 3.1% y/y in December, January, and February, respectively.
- Headline PCE accelerated to 2.5% y/y in November where it has remained for three of the past four months, while core PCE edged up to 2.9% y/y in December before slipping back slightly to 2.8% y/y by February.
- Short-term inflation expectations, represented by the 2-year breakeven inflation rate, have catapulted to ~3.3%. Meanwhile, long-term inflation expectations have increased only slightly with 5-year breakeven and 10-year breakeven rates registering 2.63% and 2.37%, respectively. Importantly, the 5-year, 5-year forward breakeven rate remains anchored at 2.19%.

FOMC MEDIAN FED FUNDS RATE PROJECTIONS (%)



Source: Federal Reserve

CORE CPI VS. CORE PCE



Source: Bloomberg

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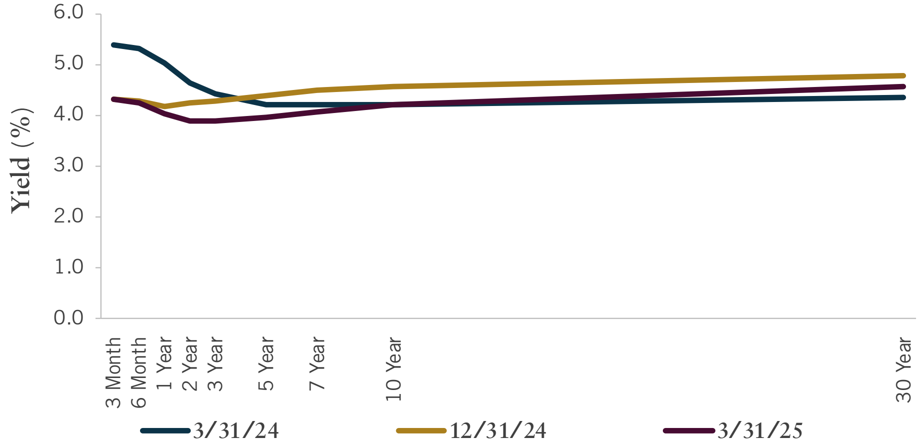
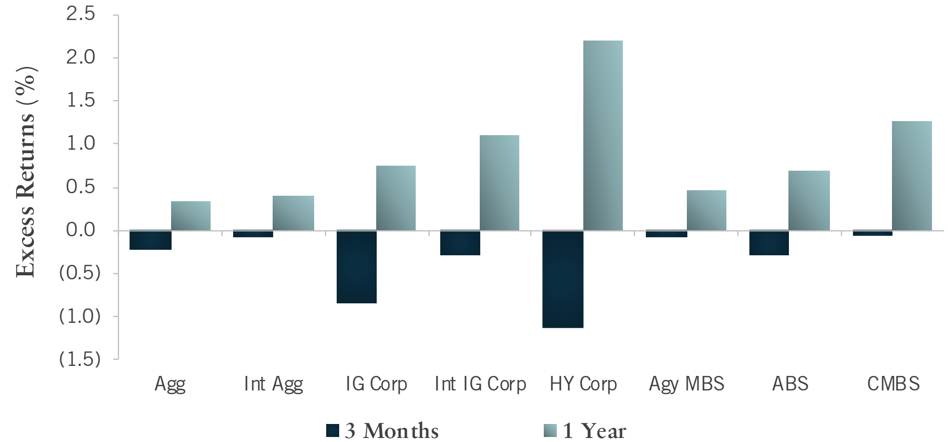
Interest Rates Rally With Economic Uncertainty; Spread Sectors Underperform

U.S. TREASURY YIELD CURVE



Source: Bloomberg

BLOOMBERG U.S. EXCESS RETURNS VS. TREASURIES



Source: Bloomberg

- The yield curve rallied during the first quarter with the 2-year Treasury decreasing by 36 bps and the 10-year Treasury decreasing by 37 bps, resulting in no change to the shape of the curve. The rally in interest rates has primarily come from real rates on the long-end of the curve: 10-year real rates are 39 bps lower whereas 10-year breakeven inflation is only higher by 2-3 bps. The short-end of the curve is a different story, however, with 2-year real yields plummeting by 113 bps and 2-year breakeven inflation higher by 77 bps. We would characterize the rally in rates as a "flight to quality" rally. With increased volatility and equities resetting lower, investors looking for insurance are happy to buy Treasury yields that are still healthy.
- Excess returns were negative to varying degrees for the quarter across major fixed income spread sectors as uncertainty drove spreads wider. Excess returns remain positive over the last one-year period across the board. Within IG Corporates, longer bonds underperformed short/intermediate maturities for the quarter and year.
- Corporate spreads widened during the quarter. Longer and intermediate Corporates widened more than shorter maturities, while utilities underperformed financials and industrials. Investment grade new issue picked up relative to the fourth quarter 2024, coming in at approximately $362 billion.
- Agency MBS turned in negative excess returns for the quarter as interest rates rallied on growing economic uncertainty; however, the shape of the curve beyond two years was unchanged.
- Mortgage rates, as measured by the Freddie Mac Weekly Survey rate ended the quarter approximately 20 bps lower than at the end of 2024. Existing home sales increased slightly to 4.3-million-unit annualized pace in February while existing home supply remains low at ~3 months.
- ABS were the worst performing of the securitized sectors during the first quarter. Economic uncertainty trickled into the ABS market, driving spreads wider. ABS new supply came in at $89 billion on the quarter, approximately 2% lower than the same time one year ago.
- Non-Agency CMBS excess returns were also negative for the quarter. New supply in single asset single borrower (SASB) deals continues to be strong, with $27 billion of gross new issue during the quarter. Total new supply (conduit and SASB) measured $36 billion for the quarter. There continues to be some optimism around commercial real estate fundamentals; however, credit challenges will remain, particularly for office properties.