*June 2024*

# Q3 2024 Economic & Fixed Income Outlook

## Economic Outlook

The U.S. economy remains on solid footing, driven by the mighty U.S. consumer which has benefitted from a strong labor market and an exceptional fiscal thrust. More broadly, increased immigration and innovation have been additional tailwinds.

As we enter the second half of the year, consumer activity is expected to ease. Factors contributing to this include higher interest rates, stricter lending standards, and a softer labor market. These factors are putting the most strain on lower income consumers. Notably, retailers such as Walmart, Target, and McDonald's are resorting to special price promotions to maintain demand.

The strength of the labor market has been a key factor driving consumption. However, the exact strength of employment in the U.S. is being questioned due to the notable disparities in key employment indicators from the Bureau of Labor Statistics (BLS). The establishment survey, which utilizes company payrolls, indicated the creation of 6.9 million jobs over the past two years, while the unemployment rate, based on household surveys, estimates 3.2 million jobs created.

In August, "benchmark revisions" tied to the Quarterly Census of Wages and Employment (QCEW) are expected to address these differences. Many economists anticipate a downward adjustment in payroll numbers, aligning them more closely with household employment figures. This revision could have significant implications

| Region | 2024 Median Economic Growth Forecast |
|---|---|
| U.S. | 2.4% |
| Europe | 0.7% |
| U.K. | 0.7% |
| Japan | 0.4% |
| China | 4.9% |
| Emerging Markets | 4.3% |
| Global | 3.0% |

*Source: Bloomberg, 06/17/2024*

for monetary policy, with Chair Powell highlighting labor market weakness as a factor that could result in early and/or more rate cuts than currently forecasted.

In the first quarter, inflation readings re-accelerated, prompting investors and the Federal Reserve to move out the timing and reduce the magnitude of expected rate cuts in 2024.

However, inflation moderated during the second quarter. April's reading was in line with estimates, and May's data was lower than expected with core CPI (which excludes food and energy prices) posting the smallest year-over-year price increase since April 2021. If inflation data continues its recent pattern, it will give the Fed the 'greater confidence' required to lower its policy rate.

The U.S. economy is forecasted to grow at 2.4% in 2024 before slowing to 1.8% next year. The distribution of outcomes around those forecasts is wide, therefore,

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employing a probabilistic, scenario-based framework for economic forecasting is imperative.

Internationally, the growth outlook appears to be modestly improving. Economic activity in Europe has been better than the modest expectations and Japan is expected to post moderate growth, driven by improving consumer sentiment.

Chinese growth exceeded expectations in the first quarter. However, this will likely be a bounce, not a boom as the Chinese economy still faces challenges from the bursting of a real estate bubble, weak business and consumer confidence, and trade tensions with the U.S. and other developed economies.

Growth is forecasted to remain robust in India, driven by strong domestic consumption. Select emerging market economies stand to benefit from global re-, near-, and friend-shoring.

As ever, we are acutely aware of the risks to our forecast and remain attentive to how shifts in the macro landscape might reverberate across financial markets and impact investment strategies. As we look ahead, the most obvious *known* risk is upcoming elections.

2024 has been dubbed the "year of the election'" – with roughly 60% of the global economy by GDP participating in elections. During the second half of the year, elections are scheduled to occur in several countries including France, the United Kingdom, and notably, the United States.

The outcome of the U.S. election in November could significantly impact markets at both the macro and sector levels. Neither political party seems inclined to address the fiscal deficit or ease the stringent stance towards China. However, the occupant of the White House and the composition of Congress could greatly influence policies on taxes, tariffs/trade, energy, immigration, and regulation.

Globally, election results will determine the amount of fragmentation that occurs within the global economy with many populist parties running on protectionist policies.

Other prominent risk factors include the persistence of inflation, the delayed effects of higher interest rates, and geopolitical conflicts to name but a few.

Given the considerable uncertainties and the potential range of outcomes for global economies and markets, we view the ability of active management to swiftly adjust portfolios as a distinct advantage.

## Monetary Policy

As anticipated, during the May and June meetings, the Federal Open Market Committee (FOMC), also known as the Fed, maintained its policy rate at 5.25%-5.50%. The policy rate has remained unchanged since July 2023.

At the May meeting, the Fed announced plans to slow the pace of quantitative tightening (QT) by reducing the monthly runoff cap on U.S. Treasury securities from $60 billion per month to $25 billion, while maintaining the $35 billion cap on agency mortgage-backed securities (MBS).

The updated Summary of Economic Projections (SEP) – released at the Fed's June meeting – showed a median expectation for only one rate cut in 2024, instead of the

**Summary of Economic Projections**

| | 2024 | 2025 | 2026 | Longer Run |
|---|---|---|---|---|
| Change in real GDP, Q4 to Q4 | **2.1** | **2.0** | **2.0** | **1.8** |
| March Forecast | 2.1 | 2.0 | 2.0 | 1.8 |
| Unemployment Rate, Q4 | **4.0** | **4.2** | **4.1** | **4.2** |
| March Forecast | 4.0 | 4.1 | 4.0 | 4.1 |
| Headline PCE Inflation, Q4 to Q4 | **2.6** | **2.3** | **2.0** | **2.0** |
| March Forecast | 2.4 | 2.2 | 2.0 | 2.0 |
| Core PCE Inflation | **2.8** | **2.3** | **2.0** | |
| March Forecast | 2.6 | 2.2 | 2.0 | |
| Federal Funds Rate, end of year | **5.1** | **4.1** | **3.1** | **2.8** |
| March Forecast | 4.6 | 3.9 | 3.1 | 2.6 |

*Source: Bloomberg, 06/17/2024*

three rate cuts estimated in the previous SEP released in March.

However, Chair Powell noted in his press conference that the committee's confidence level about the timing and magnitude of rate cuts is low. The Chair also reiterated that the Fed is alert to any unexpected weakening in the labor market and is prepared to cut in response.

The median forecast for the longer-run level of the policy rate was also revised higher. This represents the level the Fed believes is the neutral rate – or the rate at which the Fed neither stimulates nor restrains economic growth. Current market pricing suggests that the neutral rate may be closer to mid-to-high 3%.

We expect the Fed to begin easing rates later this year. If inflation remains sticky, then rate cuts will be delayed further. On the other hand, if there is a material weakening in the labor market, the Fed could cut rates sooner and by a greater magnitude.

Globally, some central banks, including the Bank of Canada and the European Central Bank (ECB), have already embarked on cutting their policy rate.

## Fixed Income Outlook

Economic data releases, shifting rhetoric from the Federal Reserve, and market pricing around the timing of rate cuts will continue to produce volatility in bond markets. But investors must not allow the noise to distract them: the outlook for bonds is attractive given the current level of yields.

Today, *where* investors own duration may be even more important than *how much* duration they own. **The intermediate (3-7 years to maturity) portion of the yield-curve remains the sweet spot, providing a strategic balance between attractive yields, the potential for price appreciation, reduced exposure to reinvestment risk, and a hedge against volatility in risk markets.**

While short-term Treasury bills and money market rates are currently attractive, they expose investors to reinvestment risk and the opportunity cost of potentially missing out on price appreciation that intermediate maturity bonds have historically experienced when the Fed cuts its policy rate. Conversely, yields on longer-dated maturities (10+ years-to-maturity) may remain elevated as investors demand a term premium for the uncertainty around inflation as well as the amount of future issuance necessary to support the fiscal deficit.

## Fixed Income Sector Outlook

Investment grade credit spreads remain tight as investor demand for the sector remains strong, driven by attractive yields. Over time, fundamentals will become less supportive of such compressed risk premiums as higher interest expense slowly deteriorates leverage and interest coverage ratios. With valuations (from a credit spread perspective) stretched, a patient approach is warranted with a focus on maintaining liquidity and flexibility.

**We maintain a favorable view on short- and intermediate-maturity BBB-rated bonds, focusing on issuers committed to deleveraging, liquidity management, and maintaining or improving their credit ratings.**

Conversely, we take a cautious view of many highly-rated companies that are currently offering a lower credit premium but may be more inclined to pursue aggressive financial policies, leading to a deterioration of their balance sheet.

While all-in yields are attractive, the risk premium offered by high yield corporate bonds is very compressed, particularly in an environment where default rates may begin to increase. At current valuations, we are more interested in the higher-quality segments of the fixed income markets.

Collateralized loan obligations (CLOs), which are securitized pools of corporate loans, have performed very well over the past 12-18 months. Given the floating rate nature of the complex, they have benefitted from higher short-term interest rates. The sector also produced positive returns during the first half of 2024 despite bond yields rising as investors pushed out the timing of the first rate cut.

Our focus has been on the AAA-rated tranche, which despite experiencing spread compression, remains cheap *relative* to corporate bonds. **AAA CLOs are a valuable addition to core fixed income portfolios because of their diversification benefits, minimal interest rate sensitivity, appealing yield levels, and robust credit profiles and ratings.**

We remain constructive on senior non-Agency mortgage backed securities (MBS) due to the combination of positive credit fundamentals and low new issuance. These securities typically have a lower mortgage rate than the prevailing market rate and have significant underlying equity. New issue volume is expected to remain limited due to low home sales activity and the lock-in effect due to borrowers having locked in low mortgage rates.

Within Preferreds, our focus remains on prominent, high-caliber "national champion" banks in the U.S. and Europe. These entities derive an advantage from more strict regulatory requirements since the financial crisis.

We continue to prefer preferred securities with limited duration. With the timing of rate cuts being pushed out, floating rate preferreds have outperformed and this trend could continue with the path of eventual rate cuts potentially shallower than previously expected.

Our view on coupon structure has evolved. Entering the year, low initial coupon preferreds were trading cheap both in price and on a spread basis relative to preferreds with higher coupons. However, following a sizable price rally in low coupon preferreds during the first half of the year, our preference has shifted to higher coupon securities which will provide better convexity if rate volatility were to increase.

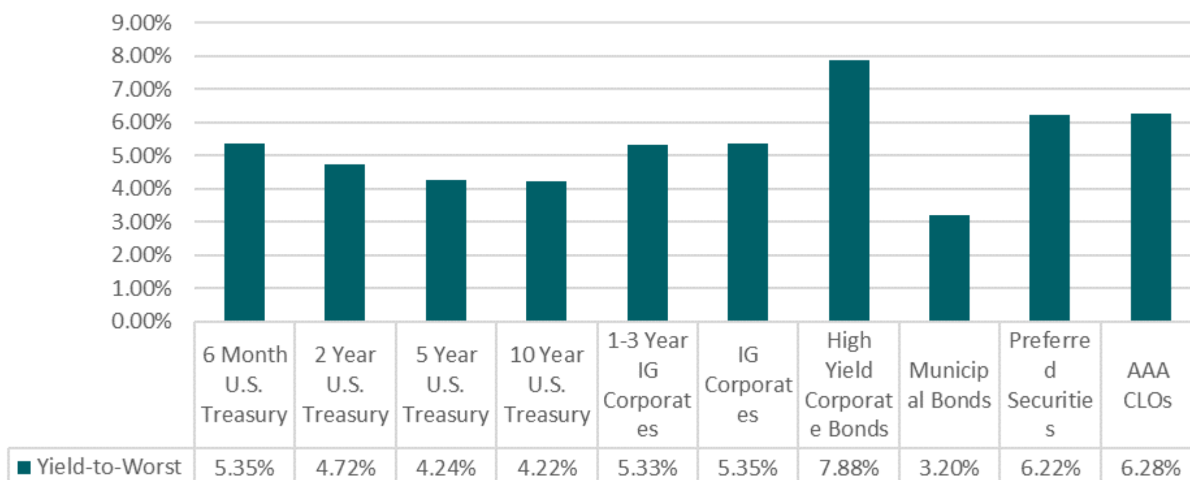
From a valuation perspective, the yield advantage that preferred securities currently offer over corporate bonds is lower than average. However, it is worth noting that many preferred securities pay dividends, which can be taxed at a lower rate than interest payments from corporate bonds.

Within the muni market, fundamentals remain healthy and demand remains strong. Issuance in the second quarter increased slightly from very low levels.

**From a valuation perspective, tax-exempt municipal bonds – at an aggregate level – are expensive relative to taxable bonds.** In many cases, investors can obtain a better *after-tax* return by purchasing a taxable bond even after factoring in taxes. Careful security selection within the municipal market will remain paramount. We maintain our emphasis on high-quality general obligation and essential-service revenue bonds.

**A broad range of fixed income sectors appear well-positioned to produce solid risk-adjusted returns.** The potential for volatility in interest rates and credit risk premiums could create opportunities on top of attractive starting yields. For example, even though the Fed policy rate has been at the same level since last July, there have been opportunities to add to returns by tactically shifting duration exposure, as markets have repriced the future path for the Fed funds rate several times.

<u>This backdrop is a constructive one for actively managed fixed income.</u>




*Source: Bloomberg, 06/19/2024*

Disclosures:

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