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Webcast Summary

3Q24 Market & Strategy Update

Global disinflation continues steadily but unevenly, with US core PCE approaching the Fed's 2% target. Economic growth remains resilient, particularly in the US, though a moderate slowdown is anticipated without triggering a recession. This economic landscape should pave the way for central bank rate cuts later this year. The US election adds uncertainty, but market impacts may be limited unless there is a sweep. Meanwhile, China grapples with challenges stemming from debt, demographics and de-globalization, constraining its growth to around 4%-5% this year. In this environment, we see value in higher-quality high-yield bonds, bank loans, CLOs and structured credit such as agency MBS and CMBS as well as local currency EM debt, particularly Mexican bonds.

US Economic Outlook

- With inflation down and growth moderating, we expect the Federal Reserve (Fed) to begin cutting interest rates in September 2024, with discussion of recalibration likely to start at the July 2024 meeting.
- US core Personal Consumption Expenditures (PCE) inflation has been trending downward, now approaching the Fed's 2% target after peaking above 5% in 2022.
- The labor market is likely to cool gradually, with job growth slowing and the unemployment rate potentially ticking up slightly.
- Fiscal policy is likely to become more restrictive as pandemic-era stimulus measures fully unwind, creating a modest drag on economic growth.
- The deficit remains problematic, with interest costs becoming a significant burden, but it has contradictory economic effects—providing short-term stimulus while potentially sapping long-term growth potential if left unchecked.
- The US economy is expected to experience a moderate slowdown in growth, with GDP likely to expand around 1.5%-2.0% (annualized) in the coming quarters.
- With inflation trending downward and growth moderating, the opportunity set for fixed-income investors appears increasingly attractive, particularly as central banks may begin normalizing interest rates in the coming months.

2024 US Presidential Election Outlook

- The 2024 US election outcome remains difficult to predict, with betting odds showing a recent shift toward higher chances of a Republican sweep.
- A Trump victory could be perceived as inflationary and potentially lead to higher long-term rates, deregulation benefiting small businesses, and continued tariffs, though the overall market impact may be moderated if Congress remains split.

- Trump has historically viewed stock market performance as validation of his presidency, which may constrain disruptive policies.
- A Biden victory would likely let the personal tax cuts from Trump's administration sunset, in contrast to Trump who would of course likely push to extend them.

Global Economic Outlook

- Overall, there is a global trend of central banks pivoting toward easing as inflation recedes and growth moderates, though the pace varies by country.
- Europe is likely to see modest economic expansion, with services sectors showing more resilience than manufacturing.
- The UK economy faces challenges, but hiring intentions and wage growth trends suggest some stabilization ahead.
- China's growth is expected to moderate to around 4%-5% in the coming years, facing headwinds from demographics and shifting global supply chains.
- Japan's rising wages and higher inflation forecasts, along with the Bank of Japan ending negative interest rates, strongly suggest Japanese yields are likely to rise further.
- Emerging markets (EM) have proactively tightened monetary policy before the Fed, resulting in higher interest rates compared to the US, setting the stage for potential outperformance as developed markets begin easing.
- The Fed's sustained high-rate policy and strong US growth have previously limited EM growth, but a shift in US growth and potential Fed easing could enhance EM performance.

Investment Themes

- **Overall risk assets:** The ongoing global disinflation trend and resilient economic growth, especially in the US, create a favorable backdrop for risk assets as central banks may be able to ease policy and normalize rates.
- **Credit sectors:** These broadly outperformed in the first half of 2024, with most sectors generating positive excess returns versus US Treasuries (USTs), driven primarily by income and carry rather than spread compression.
- **Investment-grade credit:** Despite tight spreads, investment-grade credit fundamentals remain supportive, suggesting potential for spread stability and low likelihood of material widening. We particularly like large US banks and select energy companies.
- **High-yield credit:** High-yield credit tends to perform best in slow to moderate growth environments, which aligns with the current economic outlook of slowing but still positive growth. Dispersion or bifurcation in the market supports active approach in high-yield–favoring high-quality, high-yield.
- **Structured products:** Agency mortgage-backed securities (MBS) offer attractive yields with low prepayment risk, given current mortgage rates are significantly higher than most existing borrowers' rates. Commercial MBS (CMBS) spreads have widened significantly compared to corporate credit spreads, potentially offering attractive relative value.
- **EM debt:** Local currency EM bonds, particularly in countries like Mexico, offer attractive yields and potential benefits from trends like nearshoring, while inflation is moving closer to targets.

Q&A Highlights

- The softening economic data seen recently has not led to as much of a rally in government bond markets as might have been expected. This may be due to the large rally in 4Q23 and central banks signaling caution about cutting rates too quickly.
- Regarding central bank easing and yield curves, the expectation is for yield curves to gradually disinvert as central banks recalibrate policy.
- A Trump victory in the US election is likely not fully priced into UST markets. The market impact would depend on whether Republicans also gain control of Congress. Initial reaction may be higher yields on inflation concerns, but longer-term impacts are less clear.
- Investment-grade credit spreads appear tight by historical standards, but fundamentals remain supportive. There is potential for spreads to tighten further if rates decline and money flows from short-duration assets to credit sectors.
- The US dollar is expected to moderately weaken as US economic growth slows relative to other economies. However, should a global recession occur, the dollar may retain its strength as investors seek safe-haven assets.