Webcast Summary

Post-Election Strategy Update: US Core and Core Plus

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Trump's re-election will have a significant impact on US inflation, economic growth and the labor market. While inflation continues to trend downward, potential tariffs and regulatory changes could introduce some volatility. We believe US growth should remain stable or improve slightly, driven by tax cuts and regulatory policies, though immigration policies may tighten the labor supply and increase costs. The Fed will likely continue lowering interest rates, but at a slower pace. Given this backdrop, we favor structured product sectors like agency mortgages but are cautious regarding EM currencies due to potential volatility.

Here are some key takeaways.

Market Review

- The labor market has shown a declining trend in job growth, with expectations of returning to 100,000 to 150,000 jobs added per month as the economy cools.
- Interest-rate volatility has been extremely high over the past few years, driven by economic data and political events, with significant fluctuations in the yield curve.
- Spread sectors have generally performed well this year, with positive excess returns across various sectors, including agency mortgages, investment-grade corporates, high-yield and structured products.
- Emerging market (EM) local rates have been attractively priced, but performance has been negatively impacted by currency volatility, particularly due to political events and policy expectations.

Federal Reserve (Fed) Policy

- The Federal Reserve (Fed) recently shifted its focus from inflation to employment, reducing interest rates by 50 basis points (bps) on September 18.
- There is a general belief that the Fed will maintain its independence and credibility, despite political changes and potential pressures from the Trump administration.
- The market has seen significant fluctuations in expectations for the Fed's terminal fed funds rate, ranging from around 2.75% to 3.85%, influenced by both economic data and political events.
- There is an expectation that the Fed will continue to lower interest rates, but the pace of reductions may slow, especially if economic growth and inflation prove to be stronger than anticipated.

Inflation

- Inflation has come down significantly from its peak in 2022, with core goods prices declining sharply due to improved supply chains and increased exports from Asian countries.
- We expect inflation, as measured by the Fed's preferred gauge, the core Personal Consumption Expenditures (PCE) price index, to be around 2.7% year-over-year in December, with potential further decline into next year. However, we also realize Trump's promised tariffs may be inflationary.
- We believe that a softening in key components like rent, owners' equivalent rent (OER) and insurance costs should contribute to a further decline in inflation into 2025.

Investment Themes

- As always, we are prepared to adjust duration and currency exposures based on the evolving economic and political landscape—particularly in response to potential Trump policies.
- We are actively seeking opportunities to add to spread sectors if significant spread widening occurs, while currently maintaining a moderate level of risk exposure.
- Our strategy includes shifting duration from the back end of the yield curve to the belly and short end, where we expect to find value due to expected Fed policy and fiscal concerns.
- We are maintaining an overweight position in structured product sectors like agency mortgages, which have suffered due to high volatility but now appear to be attractive.
- Investment-grade corporates remain a key holding for us due to their strong fundamentals, despite the tight spreads.
- We are holding positions in below-investment-grade sectors such as high-yield and bank loans, focusing on more liquid, higher-rated securities in Core Plus portfolios.
- While cautious regarding local EM due to currency volatility, we still see value in the rate side of these investments.

Outlook

- Inflation will remain a key focus, and we're closely monitoring potential volatility and stickiness in key components.
- We anticipate a gradual decline in interest-rate volatility, which should benefit positions in structured products.
- We are closely monitoring the economic impact of Trump's policies and making portfolio adjustments to align with any significant shifts in growth and inflation expectations.
- We'll continue to leverage our sector specialists' insights to identify undervalued opportunities and maintain a diversified portfolio that balances yield and risk.

Q & A

- We are cautious about the potential for higher inflation due to Trump's policies, including tariffs and regulatory changes, and will adjust portfolios accordingly.
- The Fed's independence is expected to remain intact despite political changes, with monetary policy decisions continuing to be data-driven.
- We are prepared to take advantage of opportunities in spread sectors if volatility increases, maintaining a balance between yield and risk.

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