2Q 2024: Labor Market Showing Signs of Cooling

- Economic data started to soften in the second quarter across a number of categories, including labor markets. Of note, non-farm payrolls moderated somewhat, though still not at levels that would indicate a looming recession. However, the household survey, a separate measure of employment that is used to determine the unemployment rate, showed 400k jobs lost in May (vs. 272k added per the establishment survey), with an unemployment rate of 4.0%, up more than 0.5% from the cycle lows.

- The divergence in the two measures has made it difficult to get a read on the true strength of the labor market. Though the non-farm payroll report is one of the most commonly referenced measures of employment, it is not without its flaws. It is a survey-based measure, and the response rate for that survey has fallen in recent years from over 60% a few years ago to around 40% today, increasing the risk of subsequent revisions. At the same time, the use of the birth-death model to impute new business creations and closures has historically overstated employment during downward turning points in the cycle (and understated employment at the upward inflection points).

- Away from the non-farm payroll report, other measures of employment more clearly pointed to cooling in the labor market. Most notably, job openings per the Job Openings and Labor Turnover Survey (JOLTS) dipped to the lowest level since February 2021, while the quits rate also continued to fall. This combination helped ease wage inflation, with the median year-over-year increase in annual pay for job switchers now at 7.8% - a far cry from the 16% gain observed in late 2022.

- A slowdown in hiring and decline in job openings drove the level of recurring applications for unemployment benefits to its highest level in nearly three years, with the number of continuing claims rising to over 1.8 million. Meanwhile, the amount of initial benefit claims peaked at 243k in June, bringing the four-week average to its highest level since the third quarter of 2023.

Our View: There is demonstrable evidence that the labor market is weakening, the magnitude of which is likely understated given the flaws of headline non-farm payroll reports. We expect to continue to see further weakness filtering through to the real economy with increased unemployment, lower consumer spending, slowing growth, and ultimately, a recession.

2Q 2024: Consumer Stress Migrating Up the Quality Spectrum

- While lower income consumers bore the initial brunt of the move to a higher rate environment, prime consumers have also felt the bite of higher rates in recent months. Illustratively, data from this cohort indicates that delinquency and default rates have increased on both auto and bank cards, with levels now in line with or worse than that of 2015 to 2019. With stress moving up the quality spectrum, the New York Fed reported that 3.2% of outstanding U.S. consumer debt was in some stage of delinquency.

- Meanwhile, the elevated cost of consumer credit has seen debt service as a percentage of disposable income approach 6% after falling as low as 4.8% in early 2021. Inclusive of mortgage debt, much of which was refinanced in 2020, that number is closer to 10%, and well into double digit levels for those who took out a mortgage at current rates. The pressure of higher debt payments is compounded by a depletion in excess savings, with the personal savings rate down nearly 90% from the peak of the pandemic era to 3.9% today.

- Against this backdrop, consumer spending faltered in the second quarter as retail sales and personal consumption expenditures fell, with discretionary sectors like restaurants, leisure, and home furnishing experiencing the largest pullbacks. With this, several large consumer-facing companies reported lower than expected earnings and negative forward guidance, while the Federal Reserve's beige book saw several mentions of increased consumer frugality from businesses across all districts.

- Unsurprisingly, consumer sentiment faltered, driven by a souring outlook on personal finances and business conditions. Respondents of the University of Michigan Consumer Sentiment survey also indicated that the perceived odds of losing a job over the next five years increased, which comports with the uptick in the unemployment rate and signs of cooling observed in the labor market.

Our View: Growing debt burdens and increased delinquency rates reveal a stretched consumer that will face increasing challenges without the tailwinds of excess savings, stimulus checks and short-term credit utilization. We expect this stress to have an increasingly profound effect on lower income borrowers while also continuing to challenge middle- and higher-income consumers, resulting in an overall slowing of consumer activity.

2Q 2024: Inflation Trending in the Right Direction

- Inflation moved closer to the Fed's long-term target throughout the quarter, with both CPI and PCE reported inflation declining on a year-over-year basis. This continues the general trend observed over the past few quarters, notwithstanding the occasional bumps and upside surprises early in the calendar year from challenges in seasonal adjustments around the holidays.

- Aside from the shelter component of measured inflation, deflationary trends among more cyclical and discretionary sectors have emerged and contributed to lower readings in recent months. Given the sizable impact rents have on the calculations, lower rents will help guide inflation lower over the next twelve months.

- Further, anecdotal evidence suggests consumers are beginning to push back on still high price levels in the economy, meaning corporations are less likely to be able to pass through any cost increases, pressuring margins. Not only could this dynamic potentially slow the pace of inflation, but also may lead to higher unemployment as companies are forced to reduce headcount to maintain margins.

- Despite the favorable trend in CPI and PCE, comments from Federal Reserve officials continued to emphasize patience in monetary policy, with many officials wanting to see the trend progress for longer before loosening policy. This was reflected in the Fed's updated summary of economic projections, where the number of cuts projected for the remainder of the year moved from three at the end of the first quarter to just one.

- Interestingly, the updated projections also indicated that Fed officials expected core PCE, their preferred measure of inflation, to be at 2.8% by year-end. Released on the final trading day of the quarter, core PCE for May came in at 2.6% on a year-over-year basis, already below the Fed's expected value. With most investors and the Fed currently aligned on expectations for a cut this year, the recent PCE data likely gives the Federal Reserve cover to do so, especially if data continues to be weak.

Our View: Given lower inflation and cooling labor markets, we agree that the Fed is likely to cut this year. The exact timing is difficult to predict with certainty and will depend on the strength of the data over the next several months. Regardless, when they cut is less important than the magnitude and pace of the overall cutting cycle. We expect the Fed will eventually be easing not because the can, but because they need to, ultimately necessitating a more immediate and forceful response than what is currently priced in as they move to support the economy and restore liquidity.

2Q 2024: Divergence in Global Economies

- Following a globally synchronized hiking cycle, monetary policy among major economies began diverging in recent months given differing paths of inflation, growth, and labor markets. The Swiss National Bank was the first of the G10 economies to cut rates while the Bank of Canada and European Central Bank soon followed, with expectations for the Bank of England to initiate their easing cycle early in the third quarter. On the other end of the spectrum, stickier inflation in Australia brought renewed potential of an additional hike.

- Emerging Market economies are already well into their cutting cycles after having begun much earlier than their developed counterparts, with growth generally rebounding on improved domestic demand. China, however, has yet to experience the same recovery owing to weak consumption, a struggling property sector, declining consumer confidence, and policy constraints given already high levels of debt and the potential negative currency impact of robust economic stimulus.

- With the Federal Reserve keeping U.S. rates on hold while other central banks began their cutting cycles, the dollar strengthened versus a broad-based basket of currencies. The DXY Dollar Index reached year-to-date highs of over 106 in mid-April before declining later in the period alongside falling Treasury yields to finish around the average level over the past year, where it is expected to remain until U.S. monetary policy eases.

- Meanwhile, a host of presidential, parliamentary, and legislative elections add to the shifting global landscape with over sixty countries scheduled for some type of election over the year. France's snap election late in the quarter caught market participants by surprise, with the potential for an unsustainable fiscal policy leading to underperformance among French banks, higher yields on French government bonds (OATS), and a widening of the spread between 10-year French OATs and German Bunds to multi-year levels.

Our View: Though traditional measures of volatility remain suppressed, the differing paths of global economies towards their long-run sustainable levels create the potential for varying outcomes. Despite global interest rate levels poised to move lower, we anticipate elevated risk premia due to elections and sustained geopolitical risks, which could lead to heightened volatility and potential opportunities.

2Q 2024: Credit Markets Remain Priced to Perfection Despite Imperfect Conditions

- Credit spreads traded in a 9 bps range over the second quarter and reached new cycle lows of 80 bps in May, just 4 bps off the post-GFC tights, before finishing the period at 88 bps. Indicative of how tight these levels are historically, current valuations are in the 11th percentile, meaning only 11% of the time have they been tighter than they are now.

- One of the factors helping to support valuations and keep spreads in such a narrow range is the persistence of yield-based buyers, given the yield on the credit index increased from 5.0% at the start of the year to 5.4% by the end of June. Aside from attractive yields, investors seem to also be comfortable with credit risk as the spread between BBB and A-rated issues narrowed, reaching as low as 33 bps during the quarter to remain near the tighter levels of history.

- Further supporting this notion was the aggregate spread level across high yield credit, which reached as low as 289 bps in early May to mark a two-year low. However, spreads on the CCC component of the index widened nearly 100 bps to finish the quarter over 800 bps, driven wider by idiosyncratic credits facing liability management exercises, cash flow constraints, and business model challenges. Interestingly, spreads for performing CCC credits are closer to 500 bps, indicating strong investor demand for even low-quality credits that aren’t deemed to be in distress.

- After the rate backup in April, the leveraged loan asset class experienced a $2 billion inflow in the first week of May to mark the largest inflow in two years. Increased demand drove spreads tighter by 13 bps on the quarter and resulted in nearly 70% of loans trading above par in June, while also driving outperformance of the risky CCC cohort. Despite this strong performance, recovery outcomes for more distressed borrowers remain near the lowest levels on record due to recent periods of weak covenants and legal wrangling among lenders.

Our View: Credit spreads at current levels represent an asymmetric risk and reward profile, with the likelihood of continued moves tighter much lower than the risk that spreads widen meaningfully, especially in a slowing economy. Meanwhile, leveraged borrowers that require more frequent access to capital markets face the potential of a more discerning lender base and expensive borrowing costs in upcoming periods.

2Q 2024: Opportunities Remain Across Securitized Sectors

- With elevated mortgage rates dampening housing turnover and new origination activity in the agency mortgage sector, organic supply remains low, while demand has proved formidable in part due to increased money manager inflows to the sector. Also offering significant support for the market has been the return of overseas and domestic bank demand, with U.S. banks adding over $35 billion in agency mortgages throughout the second quarter, according to data from the Federal Reserve.

- Non-agency MBS performed well over the quarter, buoyed by strong credit fundamentals given ongoing home price appreciation and declining loan-to-value ratios. Sustained investor demand helped further propel performance, especially among more risky and subordinated tranches. With the government sponsored entities (GSEs) issuing tenders of outstanding credit risk transfer (CRT) bonds, investors looked for similar-yielding opportunities across the sector, spurring demand, while the likelihood of Fed rate cuts drove a bid for duration.

- Issuance in the ABS sector increased markedly from last year's pace as it is presented as an economical form of financing, with new issues across collateral types often multiple times oversubscribed. This has led to broadly positive performance across the sector, though certain subprime consumer issues or those deals backed by unsecured collateral have faced challenges as borrowers are increasingly forced to prioritize their debt obligations.

- CMBS has been one of the strongest performing securitized sectors year-to-date, with over 270 bps of excess returns for private label deals. Difficulties remain under the surface, however, especially among the office sector where bifurcation remains evident. Office vacancy rates reached 20% early in the quarter, pressuring weaker assets and contributing to the first originally AAA-rated single asset single borrower CMBS tranche to take a loss in the post-GFC period, though stronger assets, or those core to sponsor portfolios, continue to perform well.

Our View: Agency MBS continues to be one of the most attractive segments of the fixed income market given favorable liquidity, the government guarantee, and spreads that remain wide both relative to historical standards and other high-quality sectors. Similarly, non-agency MBS offers strong return potential, especially pre-GFC legacy collateral with substantial embedded home equity. Finally, the bifurcation in CMBS presents opportunity among trophy properties that are likely to withstand potential volatility while also providing solid total return potential.

2Q 2024 Core and Core Plus Fixed Income Positioning Summary

Positioning remains defensive given the likelihood of a recession and current market valuations that do not uniformly reflect this risk. This cautious positioning provides ample dry powder as we look to capitalize on opportunities created by a slowing economy and stressed markets.

Characteristic	Positioning	Comments
Duration	Approximately 0.8 years long versus the benchmark	Rates remain above fair value, especially in an economy marked by easing inflation and a softening labor market
Curve	Expectations for a steeper curve	Overweight short and intermediate tenors of the curve given expectations that the Fed will have to ease aggressively to support the economy
Governments	Small underweight, with an emphasis on on-the-run securities	On-the-run Treasury securities provide much greater liquidity
MBS	• Agency MBS – large overweight • Non-Agency MBS – maintain allocation, with bias to add further	• Positioning roughly split between TBAs given favorable liquidity and specified pools offering more favorable collateral characteristics • Favor lower coupon (<3.5%) issues given price upside and middle coupon (4%-4.5%) given attractive spreads and better convexity profile than current coupons • Maintain emphasis on high quality legacy non-agency MBS bonds as well as newer issues, especially those backed by legacy collateral
ABS	Small Overweight	• Prefer AAA and AA rated CLOs due to better liquidity, robust structures, and attractive spreads • Reduce senior FFELP student loan ABS, with a preference for higher yielding subordinates
CMBS	Small Overweight	Cautious overall with targeted exposure via single asset single borrower deal structures
Investment Grade Credit	Large Underweight	• Positioning remains concentrated in high conviction names and defensive sectors like communications and consumer non-cyclicals • Underweight banks given potential for spread widening in a recession • Minimal exposure to cyclical credit sectors and non-corporate credit
High Yield	Small allocation	Prefer defensive credits and select, high conviction idiosyncratic issuers over broad exposure
International	Small allocation	• Reduce Euro denominated corporate exposure given continued spread tightening relative to U.S. markets • Slowing growth presents challenges for EM issuers

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