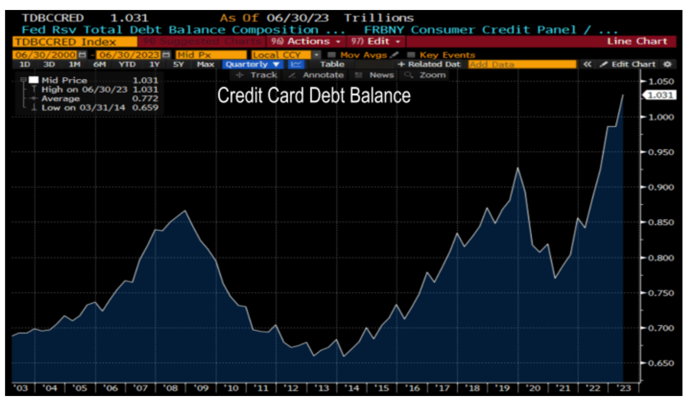
VANDERBILT Ave.
ASSET MANAGEMENT

Third Quarter 2024

Vanderbilt Avenue Asset Management (VAAM) forecasts an **economic slowdown** eventually bordering on a recession. We are looking for annualized real GDP growth of 2.5% for the third quarter down from the 3% level of the second quarter. The labor market has cooled with the unemployment rate rising to 4.1% from 3.5% in July 2023. September showed a strong employment report that points toward a 25 basis point rate cut in November, greatly undermining the potential for a 50 basis point rate cut the market was discounting. In late August, annual employment data was revised down by 800,000 jobs, the largest decline since 2009. Further still, jobs only increased by an average of 140,000 a month during the summer (June through August), which was one third less than the prior 12 month average of 220,000 and half of the August new jobs were in government, healthcare and social assistance all of which are heavily funded by the government as opposed to private sector growth. Consumers have become cautious and price sensitive in their spending. There are a rising number of late payments and delinquencies on auto loans and credit card debt. A recent survey by the New York Fed found that around 9.1% of credit card balances turned delinquent over the past year-the highest rate in more than a decade. The lagged effects from the Fed's restrictive monetary policy will continue for a while. Also, corporations have become more cautious when making their forecasts for sales and earnings guidance.



As we have outlined previously, government deficits and resultant debt levels remain very high with the current fiscal year deficit expected to be $1.9 trillion. Interest expense on the Federal debt now exceeds defense expenditures. This raises the issue of how much additional fiscal stimulus the Federal government will be able to supply to offset future recessions. A long term bi-partisan approach to this issue is required; however, neither presidential candidate has addressed this issue.

The course of **disinflation** continues. The Fed's preferred gauge of inflation, the core PCE, has increased 2.6% over the last 12 months. While this number remains above the Fed's 2% inflation goal, it is down substantially from a peak of more than 7% in 2022. This gap between 2.6% and the Fed's 2% target largely reflects the lagged effects of higher housing prices from a few years ago. Recent easing price pressure from the homeowner's component of the PCE will help inflation further toward the 2% goal as this data has yet to pass through the inflation calculation. Another proxy for inflation is the fixed income market's breakeven rate for inflation adjusted U.S. Treasury securities. The two-year breakeven rate has declined to 1.6% (from 2.95% in April)-below the Fed's 2% goal. In any particular month, inflation has the potential to surprise on the upside. Wage cost pressure could be felt from generous labor agreements such as the UAW, the dock workers and 30% pay increase by Boeing. In addition, exogenous shocks to the economy could result in unforeseen price pressures (such as adverse geo-political impacts on the supply of crude oil or other supply chains).

As inflation approaches the Fed's target level and the labor market show signs of cooling, their focus has shifted from inflation to their full employment mandate to achieve a soft economic landing. The Fed is wary of keeping interest rates too high for too long and hurting the labor market thereby costing people jobs and wage gains. The Fed just changed **monetary policy** from tightening to easing with a 50-basis point reduction in the fed funds rate (from 5.25%-5.5% to 4.75%-5%). In addition, they forecast another 50-basis point reduction before year end, a 100-basis point reduction in 2025 and a further 50 basis point reduction in 2026. The Fed is hoping to eventually achieve a neutral real interest rate that neither encourages nor discourages economic activity. However Powell as he often does, reiterated that policy can be adjusted based upon incoming economic data.

Presidents generally have much less influence on the economy and inflation than the business cycle. Markets may see a bump or decline depending on who wins or loses the upcoming presidential election but it's the business cycle that influences markets the most. However, there will be economic ramifications in the wake of the **election** outcome. The extent of the impact will depend on whether there is a sweep or gridlock from the election results. A sweep of the White House and Congress by one of the parties will result in a much greater ability to enact policies versus the party losing the White House gaining majority control of one of the chambers of Congress. This would limit the White House's ability to promote their policies and would require compromise to enact legislation. Further complicating the outlook is that the 2017 tax cut legislation will expire at the end of 2025 and will have to be addressed or there will be tax increases reverting to tax rates in 2017. Trump vis-à-vis Harris would have a more restrictive immigration policy (with labor market ramifications), higher tariffs, lower taxes and a lighter regulatory policy. Higher tariffs would be passed on to the American consumer. Tariffs are in effect a regressive tax. This could trigger a trade war whereby reciprocal tariffs are placed on American exports.

China, the world's second largest economy, is increasingly a headwind to **global economic growth**. In addition to consequences for global growth, there are also repercussions to global trade policies. Property values, a major asset for China's consumers, have experienced severe price declines amidst over building. The Chinese government has been unable to stabilize the overleveraged property market. The property meltdown is sapping government revenue, holding back investment and retarding consumer spending. Chinese authorities have tried to reorient the economy to less manufacturing and construction and more consumer spending. The Chinese consumer has consistently represented less than 40% of GDP (vs. approximately 70% in the U.S.). The ability of the government to reorient the economy to more consumer spending has been unsuccessful due to the consumer being constrained by the property market and confidence in the economy has declined. The Chinese consumer, who already saves heavily, has now become even more frugal. Beijing is trying to make up for the weakness by significantly stimulating factory output and exports which are state subsidized. However, other countries are restricting Chinese imports and increasing tariffs on these products to protect their own local manufacturing raising the possibility of a global trade war. Recently, the government unveiled a new program of monetary and fiscal stimulus to stabilize the property market, stimulate consumer spending and provide funds to indebted local governments. Past programs have failed partly because they were too small. Whether this new program is large enough to achieve their objectives remains to be seen. In addition, foreign firms that once invested in China to gain access to their consumer market are now retrenching. China is also confronting a demographic issue. Their population has now shrunk two years in a row.

Throughout the third quarter, a decrease in the threat of inflation accompanied by an increase in the threat of a weakening labor market has resulted in a rally within the fixed income markets as investors were preparing for the Federal Reserve to lower interest rates. Within rates, housing stood to be a big gainer as mortgage rates continued to decrease throughout the quarter, dropping to about 6.2%, from a peak of nearly 8% in 2023. Corporate bond fundamentals remained intact even as some maturity walls are coming due in the next year.

U.S. treasury yields decreased throughout the third quarter of 2024 as inflation fears continued to subside and whispers of impending Federal Reserve interest rate cuts to avert a recession grew louder. Most of the decrease occurred in the 2-year treasury, which started the quarter at 4.75% and ended at 3.64%, a decrease of 1.11%. The longer 10-year treasury also decreased, but by a lesser amount, from 4.39% to 3.78%, a drop of 0.61%. As a result of the greater decrease in the shorter part of the curve, the yield curve as measured by the difference between the 2-year and 10-year treasury, ended the third quarter with a normal positive slope of +0.14%, for the first time since it inverted in July 2022.

An inverted yield curve has historically been a harbinger of future recessions to occur only after the curve un-inverts and returns to a positive slope. In the current environment, the yield curve was inverted for over 2 years as the Fed raised short term rates, and investors demanded greater return for short term investments than for long term investments due to the economic uncertainties present in the short term. The recent un-inversion indicates that economic uncertainties are becoming more pronounced in the longer term as investors anticipate an economic slowdown and demand more compensation for longer term investments. The rapid decrease in the 2-year treasury yield demonstrates that investors expect a cut to the Fed Funds rate to spur investment in an economy that was stifled with high borrowing spreads.

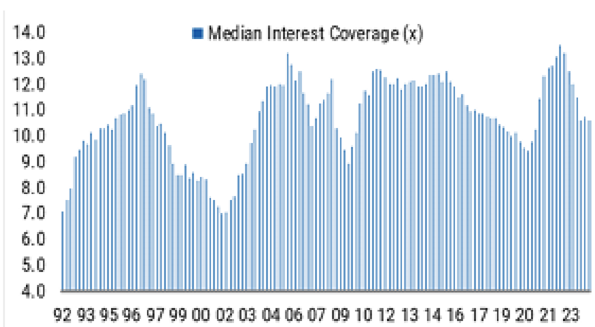
As CPI continues its path down to the Federal Reserve's desired target of 2%, the shelter component continues to lag. Most recently headline year-over-year CPI was 2.5%, while the shelter inflation portion which constitutes 1/3 of the index was 5.2%. On the bright side, this indicates that most of the other components of CPI are under control, but shelter remains the stubborn hold-out. Part of the reason for shelter price stickiness is due to the lack of supply of housing. New housing supply was hampered due to insufficient construction after the financial crisis in 2008 and the supply and labor shortages in 2020-2021. Existing housing supply has been suppressed due to the lock-in effect of homeowners unwilling to sell their homes that carry a low mortgage.

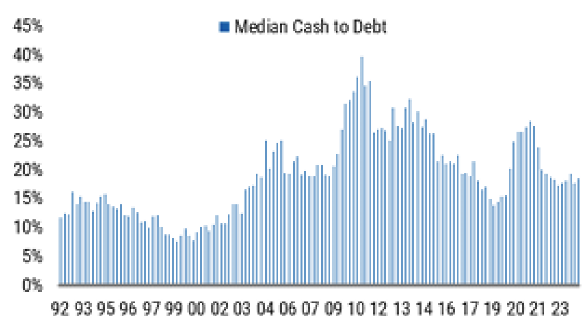
The recent cut in rates by the Federal Reserve and the expectation for continued interest rate cuts should alleviate some of the housing supply shortage both for new and existing homes. Lower rates will facilitate borrowing by builders to increase new housing supply. Lower rates should also entice existing homeowners to sell their homes, knowing that they could buy another home without taking on a high mortgage rate as has been present over the last two years. The caveat to the lowering of mortgage rates however, is that demand for homes will also increase as affordability becomes within reach for many borrowers.

Another reason for the slow decrease in the CPI shelter inflation is due to the way it is calculated. Unlike real-time housing sources like Zillow which calculate rent inflation by looking at current market rent prices, CPI shelter inflation is calculated circuitously via surveys from renters and homeowners. One third of shelter CPI is calculated by asking renters to disclose the amount that they are paying for rent, in spite of the fact that their level of rent may have been determined by a lease that was entered into a year or two prior when rents were higher. The other two thirds of shelter CPI is calculated by asking homeowners the value of their homes if they were to be rented, a possibly misleading figure. As a result, CPI shelter inflation lags real-time shelter inflation such as Zillow which has been showing for some time that market rental prices have slowed their increase. We expect CPI shelter inflation to catch up once leases reset.

Corporate Bond Commentary

Investment grade corporate bond fundamentals remained solid even as economic uncertainties persisted. Net leverage for the sector remained flat at 1.75x, which is the same range as it has been in the time period post-pandemic. Interest coverage has deteriorated modestly since last quarter, but is still above pre-pandemic levels. On a positive note, however, cash-to-debt ratios have improved slightly, and are in line with 20 year averages and well above the levels before the pandemic.





Investment grade corporate bond spreads fluctuated throughout the quarter but ended up slightly tighter than at the start. We continue to have a cautious view towards corporate bonds as we expect an economic slowdown to take form over time. In order to gauge the future health of investment grade corporate bonds, we track the spread differential of high yield bonds, specifically the spread difference between CCC and BB rated bonds. We have found that as their spread differential increases, it also points to credit widening in investment grade corporate bonds. Currently their spread is about one standard deviation above the 5-year low, but still below the average over this time period. We continue to actively monitor this spread for direction on rebalancing the portfolio.

As CPI and expected future inflation ticked lower each month, Treasury Inflation-Protected Securities ("TIPS"), which benefit from and therefore serve as a hedge against inflation, underperformed regular treasury bonds during the third quarter. However, once the Federal Reserve lowered interest rates by 50 basis points, TIPS outperformed other treasuries. The reason rests on risks and expectations. A lowering of borrowing costs is viewed by traders and investors as a potential to spur the economy, thereby reviving inflation. As a result, TIPS which hedge against inflation, outperformed once rates were lowered.