VANDERBILT Ave.
ASSET MANAGEMENT

4th Quarter 2024

VAAM is forecasting **economic growth** to lose momentum and slow to a 1.5% annualized growth rate by the second quarter of 2025. There are several potential headwinds to economic growth. While November payrolls had a healthy gain, the labor force participation rate declined, and the unemployment rate rose to 4.2%. The consumer (66% of GDP) has become overextended. Credit card debt has risen, and delinquencies are up. 60% of credit card debtors have been in debt for over a year. The interest rate on this debt is a very high 20%. Consumers have depleted their reserves from various pandemic programs meant to prop up consumer demand. Another headwind is the continuing weakness in the commercial real estate market. Office vacancies remain high due to companies leasing less space in the wake of workers working remotely and/or on a hybrid schedule. Office building valuations have declined significantly and there is $1.3 trillion of commercial real estate debt coming due in 2025. Another impediment to growth is the small business sector. This is a major part of the U.S. economy that is experiencing tighter credit conditions. The housing sector is expected to be another headwind to growth. Due to rising home prices, stubbornly high interest rates and a shortage of supply, 2024 experienced the slowest housing market in three decades. Even as the Federal Reserve cut short term rates, mortgage borrowing rates, which are tied to the 10-year treasury, remained elevated at close to 7%. As a result, existing homeowners weren't incentivized to sell and forgo their much lower locked-in mortgage rate. Additionally, higher rates precluded developers from building as much housing as was necessary to fill the housing void, which, according to Freddie Mac, is 3.7 million units short. Due to the shortage of new and existing homes for sale, and the growing demand, the median sales price of homes in the U.S. currently stands at $420,000, 32% higher than in 2020. As a result of the elevated price of homes, the majority of homes sold are to repeat, older buyers, with first time buyers having a median age of 38 and only representing 25% of purchasers.

The core (excludes food and energy) PCE **inflation** rate, the Fed's preferred measure, was 2.8% over the last year. Inflation has the potential to be volatile and sticky vis-à-vis attaining the Fed's 2.0% objective. There is a recent trend that inflation's decline has halted or at least stalled. The core Consumer Price Index rose 3.3% the past 12 months which is similar to the pace it has been rising at for several months now. Services inflation is up 4.6% over the last year. Recent labor agreements such as the UAW and Boeing contracts have settlements well above the inflation rate and could serve as a source of wage cost push inflation. Furthermore, several of Trump's proposed economic policies could result in renewed inflationary pressures.

We think the pace of the Federal Reserve's **monetary policy** easing will slow in 2025. The Federal Reserve is now only forecasting two rate reductions, instead of three or four rate reductions. The Fed will be hesitant to keep cutting rates in an environment where new jobs continue to post decent gains, third quarter real GDP grew at a healthy 2.8% and inflation is stuck above the Fed's objective. The potential problem occurs if the Fed continues to reduce interest rates and inflationary pressures resurface. They would then have to change policy and start raising rates, a move that would greatly damage their credibility. The Federal Reserve will have to be mindful of Trump's economic policies. Numerous policy proposals have the potential to be inflationary (tariffs, tax cuts, deportations). Longer term, policy makers will have to be alert to higher inflation, the Fed adopting a tighter monetary policy as a result and slowing growth (if not a recession). This could cause the Trump administration to push the Fed for monetary easing and lower interest rates thereby threatening the Fed's independence. Any threat to reduce the Fed's independence in formulating monetary policy would be viewed very negatively by the investment markets and the bond vigilantes could come into the market and wreak havoc.

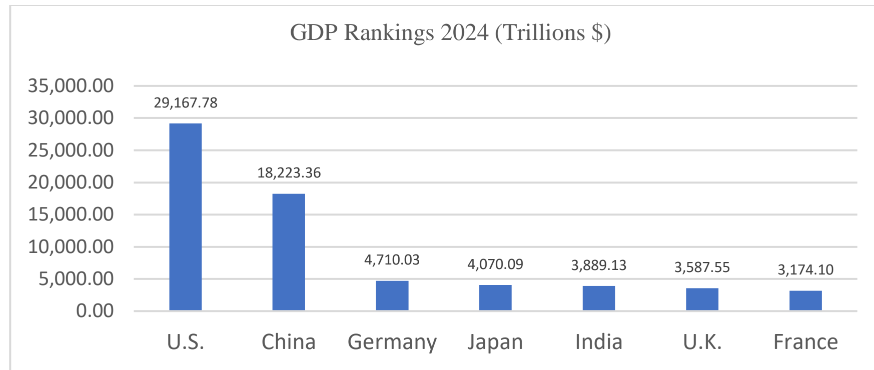
With a new Trump administration, significant **policy changes** are on the way. Assessing these policy ramifications is difficult due to a lack of clarity on some policies. In addition, some of these policies work at cross purposes with other proposed policies. Trump has proposed 60% additional **tariffs** on China and 10% additional tariffs on other countries. We don't know to what extent these proposals will be fully implemented or whether they are a negotiating tool to gain compromises elsewhere. If enacted, this would choke off China's exports to the U.S. Companies would pass on these increased costs to consumers and businesses in the U.S. There would also be retaliatory tariffs implemented by other countries against U.S. imports. It is questionable the extent to which tariffs protect local manufacturing. Tariffs would act as a regressive tax against consumers. The broader impact of these tariffs would be to retard trade, impeded economic growth and stimulate inflation. This sequence of events could potentially lead to a stagflation environment.

Trump has established a commission to cut $2 trillion in **Federal spending**. To put this in perspective, $2 trillion is approximately 30% of the federal budget and 7% of overall GDP. Finding $2 trillion will be difficult without cutting programs that Congress or Trump would want to protect. About 60% of the budget comprises programs difficult to cut including Medicare, Social Security, Defense and interest on the debt (which is now larger than the defense budget). The remaining 40% goes to Cabinet agencies, Medicaid and Veteran's benefits. Significant federal workforce reductions would impact critical functions. More than 60% of federal civilian workers are employed by the Defense department, Veteran affairs and Homeland Security. The federal workforce has not expanded significantly the last several decades while the U.S. population has grown. While there could be some savings from headcount reductions and fewer outside contractors, there is not much savings vis-à-vis the $2 trillion target. Any meaningful reduction in spending would be a headwind to growth.

Fiscal policy could be in for meaningful changes. Tax legislation enacted during Trump's first term in 2017 will expire the end of 2025. Upon expiration, taxes will revert to the higher levels preceding the 2017 changes. Trump has proposed further tax reductions that will necessitate new tax legislation effective in 2026 (e.g. lowering the corporate rate from 21% to 15% and lower personal income taxes). The current budget deficit is $1.8 trillion which is equivalent to 6.4% of GDP-a record deficit when excluding wars, recessions and extraordinary events such as the pandemic. The proposed tax reductions have the potential to further widen the already too large deficit and resultant debt levels. A bi-partisan multiyear approach is required from Congress to address this issue.

The role of the **U.S. Dollar** in global trade is supported by the size and strength of the U.S. economy. Strong traditions in the rule of law, large and liquid financial markets uniquely positioning the Dollar for global markets and global trade. At present, sixty percent of central bank reserves around the world are held in U.S. dollars.

The United States GDP exceeds twenty-nine trillion dollars, exceeding the next largest economy (China) by ten trillion dollars. Education is an important characteristic of the Dollar's economic success. With investment equal to five and a half percent of GDP. The U.S. is a leader in important areas such as NANO technology and Artificial Intelligence. The U.S. holds sixty percent of outstanding patents in these areas. The U.S. spends the equivalent of 3.4% of GDP on the military which has afforded the U.S. a dominant position on land, in air, on the seas and in space. When these characteristics are coupled with a judicial system grounded in the rule of law, the U.S. Dollar will continue to be a relied upon store of value around the globe.



Source: Bloomberg

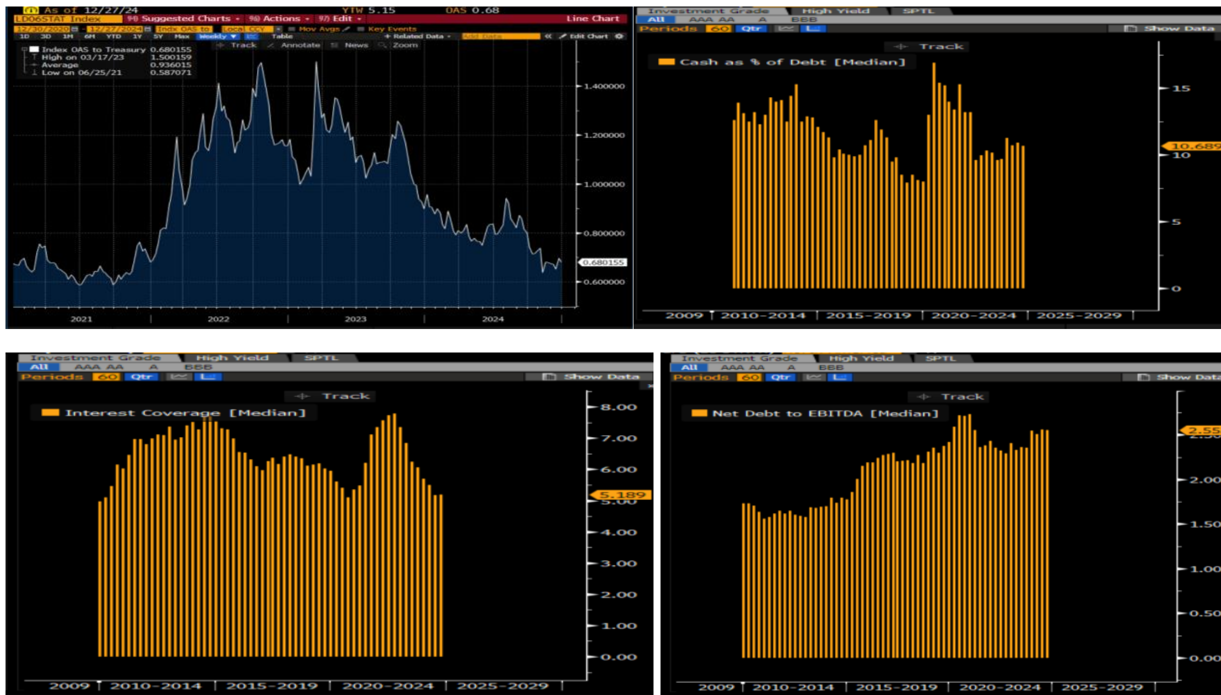
4th Quarter Fixed Income Summary

Interest rates in 2024 traced a volatile path, as they initially fell across the curve following the Federal Reserve's first interest rate cut, before uncertainties led the long end of the curve to increase again. The 2-year treasury yield was virtually unchanged after starting the year at 4.25% and ending at 4.24%. Meanwhile the 10-year treasury yield began the year at 3.88% and bounced around between a high of 4.7% in April, followed by a low of 3.6% in September, before racing back up another 100 basis points to end the year at 4.57%. The greatest downward movement in rates naturally occurred in the very short end of the curve where the Federal Reserve's actions had the most impact: the 3-month treasury bill started the year at 5.33% and dropped over 100 basis points to 4.31%. These uneven movements in treasury rates resulted in a complete reshaping of the treasury curve, whereby the slope went from a negative to a positive shape. At the start of the year, the 10-year to 2-year treasuries slope was -0.37% and 10-year to 3-months treasuries slope was -1.45%. By year-end, these slopes were flipped to +0.33% for the 10-year to 2-year and +0.26% for the 10-year to 3-months.

Historically, an inverted yield curve has been a harbinger of recessions that occurred after the curve resumed a normal upward sloping shape. Throughout 2024, the curve's shape was mostly flat to inverted, but in the fourth quarter it has taken on an upward slope. This is indicative of an eventual slowdown in the economy, as markets begin to place greater uncertainty on, and therefore demand higher returns for, longer-term investments.

Corporate Bonds

Corporate bonds delivered strong returns in 2024, but going forward, their fundamentals appear weak relative to their valuations. Spreads on corporate bonds have compressed to the tight levels which we last witnessed in 2021, a period that coincided with strong fundamentals. For example, interest coverage ratios (EBITDA divided by interest expense) have come down and may continue to decrease due to currently elevated interest rates. Additionally, leverage (debt divided by EBITDA) is higher and companies are carrying less cash. As a result, we are underweighting corporate bonds in your portfolio relative to the benchmark and maintaining a higher average rating.



Treasury Inflation Protected Securities

In conjunction with the last mile of stubborn inflation, the Treasury Inflation Protected Securities (TIPS) that you hold in your portfolio have marginally outperformed regular treasury securities. TIPS returns are based on both actual inflation (CPI) and expected inflation, both of which have been sticky. CPI has been slow to return to the Fed's desired rate of 2% largely due to the price of housing as well as expanding price of healthcare and insurance. Meanwhile, expected inflation remains elevated as a result of the Fed's interest rate cuts which could reignite prices through investment and growth, along with uncertainties surrounding the potential effects of the Trump administration tariff and immigration policies. By instilling an allocation to TIPS in your portfolio, we provided a hedge against these possible circumstances.

Mortgage-Backed Securities

The housing market has been in a standstill over the last two years, as the majority of homeowners are locked in a mortgage rate well below the prevailing rate available in the market. Even after the Federal Reserve cut short term interest rates by 100 basis points, mortgage rates, which are calculated from the 10-year treasury rate have remained elevated near 7%, a level that is unaffordable for many potential buyers, but even more so, a level that discourages existing homeowners from selling their homes. The lack of sales has resulted in a stunted supply of existing homes for sale. Even as builders have increased the supply of new homes for sale, they are a long way from bridging the gap between supply and demand. As a result, despite 2024 being the slowest housing market in three decades, home prices continue to increase. In fact, given the increase in mortgage rates and home prices, the average monthly mortgage payment has more than doubled from $1000 per month before the pandemic to well over $2000 per month currently (see chart below). If mortgage rates remain in the 6%-7% range in 2025 as housing specialist Redfin forecasts, supply of existing homes for sale likely won't increase dramatically, and affordability will remain out of reach for many.