July 3, 2024

Dear Clients and Friends:

Reflecting on last quarter's theme of "Waiting for Godot," it's hard not to feel a sense of déjà vu. It seems we are, collectively, still waiting. The Federal Reserve's pivot toward rate cuts remains elusive, ever receding into the horizon as we approach. Whenever the rate cuts do occur, and however many there might be, most market participants seem to expect these cuts to be "manna from heaven," an unalloyed positive that will usher in the next wave of euphoria. However, we caution against such one-sided optimism, as the true impact may be far more complex.

The Fed began hiking rates more than two years ago, and the yield curve, as measured by the 2Y-10Y segment, has been continuously inverted for nearly as long. Despite these significant (and extended) tightening measures, equity valuations are elevated, and a wide variety of risk premia are near record lows. It has become fashionable to dismiss these indicators as antiquated, believing they no longer hold relevance in today's economic environment. However, the prolonged inversion of the yield curve and a string of negative leading economic indicators – not to mention the fact that monetary policy has been tight for over two years – suggest that a healthy amount of prudence is warranted at this juncture.

People have been predicting a recession since the Fed began hiking rates, of course, but it hasn't occurred…yet, at least. While a recession may not be inevitable, the yellow caution flag is certainly out. We embrace flexibility and adaptability, recognizing the value of modern insights. Models and theories should absolutely evolve over time. That said, we also maintain respect for economic indicators and valuation metrics that have served investors well for decades, and skepticism towards the notion that "this time is different."

In terms of portfolio positioning, we continue to maintain an above-neutral duration stance to take advantage of real interest rates that remain attractive on a long-term basis. Within this strategic duration positioning, we have been tactically managing duration to capitalize on short-term movements tied to the market's vacillating views on the timing and magnitude of Fed rate cuts. We have an underweight position in corporate credit, including zero exposure to high yield. Notwithstanding our cautionary comments above, this shift away from corporate credit risk is not based on the expectation of an impending recession, or fundamental deterioration in corporate balance sheets, but rather on spread levels that have become relatively unattractive on a risk-adjusted basis. Concurrent with our rotation out of corporates, we continue to maintain significant exposure to securitized products such as agency MBS, non-agency MBS, and ABS. This sector bias is similarly driven by spreads and valuations that remain attractive, albeit less so than they were in late Q3/early Q4 2023.

While we await the elusive and all-important change in Fed policy with bated breath, we will continue to focus on strategic portfolio positioning that will allow our clients to achieve long-term success. Understanding the warning signs present today and maintaining a balanced perspective will help us navigate the potential challenges ahead. The cycle lives, and history has shown us time and again the value of being prepared for its inevitable turns and the folly of failing to do so.

Sincerely,

Mark M. Egan, CFA
Managing Director