Vanderbilt Ave. Asset Management

1st Quarter 2024

The path of **inflation** will determine the course of the Federal Reserve's monetary policy. While progress has been made towards the Fed's 2% inflation target (CPI is down from a high of 9.1%), we believe the path of inflation will be sticky, volatile, and not a straight line down. In addition, we believe the Fed's 2% objective will not be achieved until the second half of this year. The March CPI came in above expectations, other measures exceeded expectations. CPI y-o-y was 3.5% and core CPI y-o-y was 3.8%. Costs for housing and gasoline were up with these categories contributing over 60% of the overall month-to-month increase. The CPI inflation pace has recently increased with the last three months (annualized) at a higher rate than for the last 12 months.

We are going to take a closer look at housing which is a major component of the CPI index (shelter costs make up 36% of the CPI). Owner occupied housing represents 28% of CPI and renter occupied housing represents 8% of CPI. There are two problematic areas that impact the accuracy and timing of shelter data. Owner occupied housing measures an estimated implicit rent an owner would receive if they were renting their house. Owner equivalent rent (OER) is a significant weighting but one based on subjectivity and hypotheticals that may or may not reflect current housing conditions. The CPI for shelter tends to lag home price changes by approximately four quarters. This lag effect occurs because it takes time for rental leases to roll into new contracts. As a result, shelter costs could continue to exert upward pressure on overall inflation data even after housing prices have changed. We could see OER inflation fall by half over the next six to twelve months. A slowdown in rental costs is one source of disinflation that has yet to show up fully in the data. OER accelerated in January but moderated somewhat in February and March. Other uncertainties which muddy the inflation outlook include geopolitical events that could cause energy prices and other commodity prices to rise. In addition, the recently negotiated UAW contract for workers could cause broader wage cost pressures.

VAAM forecasts that there will be one interest rate reduction by the **Federal Reserve** in the second half of this year. It should be noted that the Fed's preferred inflation gauge is the core PCE which was up 2.8% in February versus a year ago. The Federal Reserve is looking for sustainable signs that inflation is slowing down (i.e. disinflation) before it cuts rates. The CPI data we outlined earlier does not provide that sustainability with several of the metrics coming in above expectations. The Fed's pivot to lower rates will be a slow and cautious process given economic growth that has held up in the face of rising rates and a continued strong labor market (although there have been recent signs of a cooling in the labor market).

VAAM is looking for a significant **economic slowdown** bordering on recession the second half of this year. Headwinds to growth include a consumer sector (approx. 70% of GDP) that has drawn down savings and has rising debt levels. While consumer spending is still supported by a relatively strong labor market there have been signs of slowing. Although the labor market added 275,000 jobs in February, unemployment ticked up to 3.9% (higher than expected). In addition, jobs added in January were revised sharply lower. However, the March jobs number exceeded expectations. Slowing growth will impact on business spending with pressure on revenues and cash flows that will have an adverse effect on capex. Small business optimism last month suffered the biggest drop in more than a year, hurt by deteriorating profits and diminishing sales expectations. The lagged effects from monetary tightening could also be an uncertainty to economic growth. The commercial real estate market, in particular office buildings, have relatively large vacancy rates and significantly lower values. Banks will have to deal with delinquent loan workouts-especially regional banks which could constrain loan availability. China is attempting to jump start their economy with an all-out manufacturing push and then exporting these products at subsidized low prices. Advanced economies are placing restrictions on these imports to protect their local manufacturing infrastructure. This could result in a tariff war and restrict international trade. On a more optimistic note, productivity has recently increased and there is the possibility that artificial intelligence has the potential to provide a sustained boost to this important metric.

The current path of U.S. **fiscal policy**, larger deficits and debt levels, is unsustainable in the long term. Deficits have averaged 3.3% of GDP the past half century and have now expanded to 6% of GDP. Higher debt levels are being financed at higher interest rates. Interest expense on the debt is on a pace to surpass defense expenditures this year. A third of the current deficit is going to pay interest. This could be an impediment to economic growth. Higher deficits will also constrain the ability to provide increased fiscal stimulus to the economy to offset future recessions. In addition, a sustained reduction in the deficit (through increased tax revenues and/or lower spending) could lead to slower growth and a higher likelihood of a recession. A bi-partisan effort will be required to find a long-term solution. However, given the polarized situation in Washington, this does not look promising anytime soon.

We want to provide brief comments on two other asset classes that have been in the news recently-**gold** and **crypto currency**. Gold prices have increased in recent weeks-up 9% from a month ago and up 14% over the past year. Gains have been driven by central bank purchases, geopolitical tensions, expectations of Federal Reserve rate cuts (which reduces the opportunity cost of owning gold), and a spike in quant driven momentum trading. Longer term gold prices could be supported by safe haven buying amid geopolitical uncertainty and the U.S. election.

Crypto currencies, specifically bitcoin, have soared to a record driven by supply and demand. Bitcoin demand has surged since January after the launch of spot ETFs that hold units of the digital currency. Unlike other commodities, bitcoin supply is tightly constrained. There is a hard limit on the ultimate supply of bitcoin-more than 90% of the limit has already been created. The rate of newly created bitcoins will drop in half on April 20th-an internal protocol mining event called halving which occurs every four years. As supply becomes constrained, a rise in the value of bitcoin has typically occurred. The supply of bitcoin is set to stop growing when the final coin is mined around the year 2140. Bitcoin has proven to be a volatile asset class. For example, after the last peak in November 2021, bitcoin dropped more than 70% over the next year. Since the start of this year, bitcoin is up approximately 59%.

Fixed Income Commentary

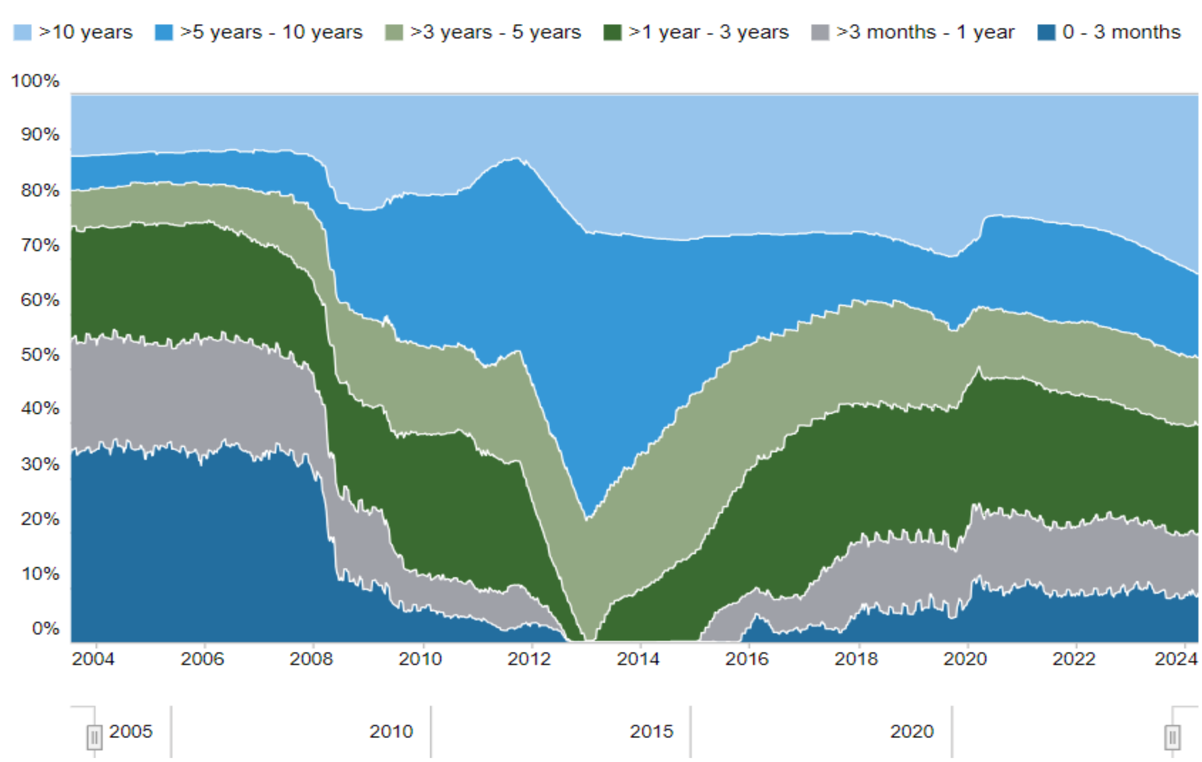
On the heels of a sizable treasury rally at the end of 2023, the first quarter of 2024 has begun with a backup in interest rates, with the 2-year finishing at 4.62% and the 10 year at 4.20% at the end of the quarter. Most of the backup occurred in February as market participants became less confident about the number of times that the Federal Reserve would cut interest rates, and if the cuts would occur as early in the year as they had been anticipating. Since the Federal Open Market Committee ("FOMC") left the overnight rate unchanged at their March meeting, the rate backup appeared to be justified. However, the FOMC offered an indication that there would likely be three cuts this year, and that the pace of quantitative tightening ("QT") would soon be tapered.

The manner by which the Federal Reserve executes QT is it allows a portion of securities that it holds on its balance sheet to mature and not be replaced with new purchases (i.e. taper the balance sheet), which in turn decreases the reserves in the banking system and the money supply, an effect that is, to a degree, comparable to raising interest rates. At his March press conference, Chairman Powell stated that the Fed will "soon" begin the process of slowing down the taper.

In June 2022 the Fed's balance sheet reached nearly $9 trillion in assets, due in part to the massive quantity of treasury and mortgage-backed securities that the Fed bought during the pandemic to prop up the economy by increasing the money supply. In the time since June 2022, each month the Fed replaced all but $95 billion of the bonds that matured on its balance sheet, decreasing the balance sheet by about $1.5 trillion. This tapering of the balance sheet, known as quantitative tightening or QT, has permitted its balance sheet to shrink to the current level of about $7.5 trillion. Chairman Powell stated that the Fed will continue to exercise QT, but soon it will slow down the pace of the taper, meaning that when bonds mature, the amount that they will not repurchase will be a quantity that is less than $95 billion per month. Since the Fed will not be stopping QT, but slowing it down, reserves and money supply should continue to decrease each month, but at a slower pace.

As for the securities that the Fed repurchases when bonds on its balance sheet mature, Chairman Powell stated that the Fed would like to target an all-treasury portfolio in the future, instead of holding treasuries and mortgage-backed securities. Additionally, the mix of securities that the Fed has been purchasing has slanted towards longer maturities, and this has perpetuated the inverted yield curve, as the Fed has been providing a stronger bid for the long end of the curve. Prior to the Great Financial Crisis, one third of the Fed's treasury balance sheet consisted of short maturity securities, as opposed to less than 10% currently. The chart below from the Federal Reserve Bank of New York outlines the percentage breakdown of the Fed's treasury holdings by maturity. One of the Federal Reserve governors, Christopher Waller, has stated that the Fed should consider increasing the short maturity versus long maturity holdings on its balance sheet. An increase in short maturity purchases by the Fed would facilitate decreasing short-term rates versus long-term rates and could help lead to an upward sloping yield curve where banks could pay lower rates on deposits and receive higher long-term rates on borrowings.

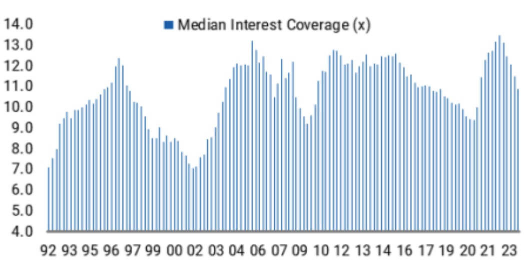
Percentage Breakdown of Fed Treasury Holdings by Maturity

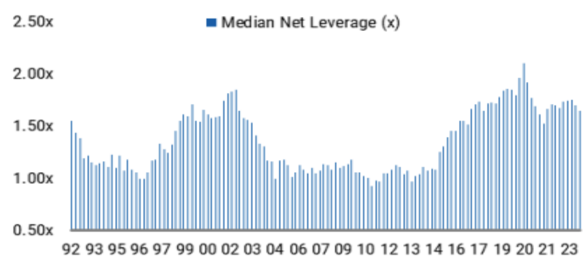


Historically, over the last 70 years, an inverted yield curve has been a precursor to recessions, where a recession followed two months after the curve reverted to an upward slope. Today's economy, however, is in disequilibrium with regards to the historical relationship between CPI, housing prices, and the yield curve as measured by the difference between the 10 year and 2-year treasuries.

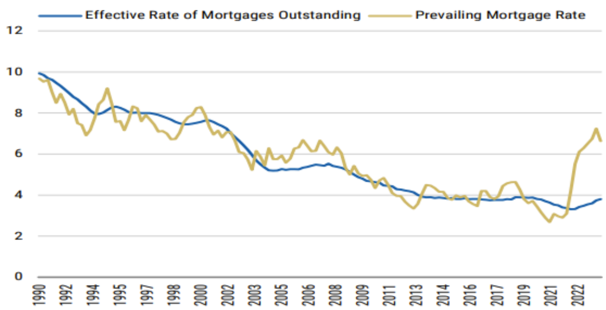
When the yield curve is upward sloping short-term bank borrowing is at lower rates than long-term lending, making it profitable for banks to lend. When the curve is inverted, banks lose profitability. Higher short-term rates have not had an impact on banks yet because banks are flush with deposits due to cash inflows during the pandemic, so the inversion has not impacted most banks. The relative decline in long-term rates at the end of 2023 has led to a surge in corporate bond issuance along with a tightening in spreads without causing market concern. Despite regional bank stress in early 2023, banks have loosened their standards, continuing to lend, so the yield curve has remained inverted. This yield curve inversion will eventually unwind, as it always has when the economy slows down and recession follows. At that point the Fed will start cutting rates, giving banks additional options for lending.

Even though corporate bond issuance has been increasing, the fundamentals for corporates have remained mixed. While net leverage which measures debt over EBITDA (earnings before interest taxes depreciation and amortization) continues to remain at a stable level, interest coverage ratios, that measure a company's ability to utilize EBITDA to cover interest payments on debt, have continued to decrease because of the high interest rates carried on their debt.

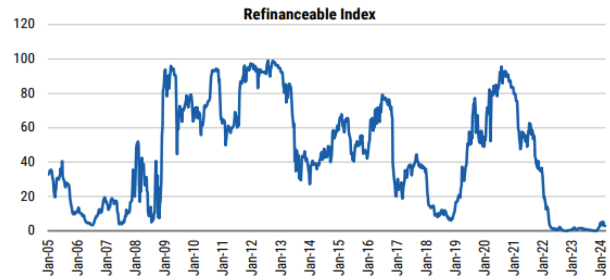




The residential housing market is still out of alignment. Even as the decrease in rates brought down the mortgage rate from nearly 8% in 2023 to below 7% currently, it is still significantly above the average effective rate on outstanding mortgage loans. Because rates were at historically low levels for an extended period since the financial crisis, the vast majority of homeowners locked in low borrowing fixed rates. The rapid increase in rates by the Federal Reserve drove up the prevailing mortgage rate and created a disincentive to existing homeowners to sell their homes. The charts below illustrate the magnitude of the difference between the prevailing rate for new loans and the effective rate of existing loans, resulting in what amounts to a negligible number of loans that are currently re-financeable. This differential between the prevailing and effective mortgage rates is suppressing the supply of existing homes for sale to such a great extent that the prices of homes continue to increase despite higher rates and lower affordability. This has caused CPI to remain elevated, as the shelter component represents 36% of CPI, despite the Fed's efforts to tamp down inflation.



Effective Rate of Mortgages Outstanding
Prevailing Mortgage Rate



Refinanceable Index