April 2, 2024

Dear Clients and Friends:

The first quarter of 2024 was punctuated by the bond market's ongoing gyrations around Federal Reserve (Fed) policy expectations. Back in September 2023, the Fed's messaging centered on the need for "higher for longer" interest rates to temper economic activity and inflation, pushing nominal Treasury rates (and real rates) up to high levels. In mid-October 2023, however, this narrative took a sharp turn, and the market began to price in not only an end to the rate-hiking campaign, but a decidedly dovish pivot by the Fed. By the end of 2023, the market was projecting upwards of six rate cuts in 2024, including the first rate cut in March. This shift appeared too aggressive at the time and was out of step with the Fed's own "dot plot" median projection of three rate cuts in 2024.

By the end of March, market expectations had tempered to align with the Fed's median projection of three rate cuts, which remained unchanged between the March and December 2023 Fed meetings. In addition, the much-anticipated first rate cut kept getting pushed out. At the time of writing, Fed funds futures point to June as the first rate cut, but the probability is hovering just north of 50%. Interest rate volatility and policy uncertainty are to be expected at this point in the cycle, and for our brand of active management, they are in fact welcomed. The key takeaway is that the market-implied policy shift – certainly the dovish scenario from late 2023, but even the more moderate projection of three rate cuts in 2024 – is not yet fully supported by the underlying economic data.

The current situation is reminiscent of "Waiting for Godot," a seminal existentialist play penned by Samuel Beckett in the late 1940s. In the play, two characters (Estragon and Vladimir) wait endlessly and in vain for the arrival of someone named Godot, who ultimately never comes. Much like the characters in Beckett's play, both the Federal Reserve and market participants find themselves in a state of perpetual anticipation, awaiting signs of an economic slowdown that will justify a pivot towards easing monetary policy – a pivot that, as of now, remains as elusive as Godot himself.

Running (too far?) with the existential theme, this waiting game is compounded and confounded by the Fed's somewhat Kafkaesque decision-making process. Just as the protagonists of Franz Kafka's work grapple with bewildering bureaucracies that defy straightforward logic, market participants confront a Fed whose actions and rationales can seem inscrutable, at times. The Fed is currently espousing a misguided and largely aspirational monetary policy framework built on a foundation of gossamer, one that is more rooted in hopes for economic moderation than in the concrete evidence of such. The Fed, in its quest for a pretext to dial back its hawkish stance, and the markets, in their eagerness for rate relief, are now struggling to navigate a landscape where expectations and reality have fundamentally diverged.

In this environment of unrequited anticipation and surreal policymaking, our strategy can be best described by the British mantra "Keep Calm and 'Carry' On." Yes, I am also rolling my eyes as I write this phrase. Originally conceived by the distinctly Orwellian-sounding Ministry of Information in the summer of 1939, the wartime slogan was never actually used during WWII. Although posters were printed in 1940, they were pulped and recycled before ever being publicly displayed. It was only after an original poster was discovered in a Northumberland bookshop in 2000, and reproductions were subsequently made, that the phrase achieved a level of ubiquity that eventually turned it into nearly meaningless pablum.

Notwithstanding the trite patina that the phrase has now acquired, it is still an apt way to describe our current overall approach. Superficially speaking, we are striving to adopt a posture of resilience and resolve in the face of heightened uncertainty…as we always do.

More specifically, we continue to prioritize positions that offer favorable “carry” opportunities along with a measure of stability. A focus on positive carry, i.e., income, may sound anathema to many of our long-time clients, or perhaps an April Fools’ joke. Fair point, although we never said that positive carry should be avoided at all costs. We are bond managers, after all. What should be avoided is a blind, structural focus on embedding excess yield/income in your portfolio, regardless of the amount of risk that this entails.

There are points in the cycle when low-risk carry is on offer, and now is one of those times. Although valuations within the corporate sector have edged into relatively unattractive territory over the past several months, mortgage-backed securities remain a high-quality source of excess carry that is largely devoid of credit risk. Similarly, real rates remain high and reasonably attractive compared to recent history. The current landscape is therefore providing the ability to construct a portfolio that should participate in the vast majority of upside price return (within fixed income, of course) while maintaining a largely defensive posture. In short, uncertainty is high but the cost of insurance – against a sell-off in risk assets or unforeseen macroeconomic developments – is manageable, if not outright low, at the moment.

Beckett closes “Waiting for Godot” with an impeccable punchline: “ESTRAGON: Well, shall we go? VLADIMIR: Yes, let's go. (They do not move.)” Although we, like Beckett’s characters, may find ourselves in a state of anticipation for a policy shift that may never arrive, we will not succumb to their inertia. Our mission is to navigate these uncertainties with a proactive, disciplined approach, ensuring that our clients’ portfolios are poised to capture value, irrespective of the vagaries of the Fed's next move.

Sincerely,

Mark M. Egan, CFA
Managing Director

This letter is provided for informational purposes only and contains no investment, tax, legal or accounting advice or recommendations to buy or sell any specific securities. Statements in this letter are based on the opinions of the author and the information available at the time this letter was written. The opinions expressed do not necessarily reflect the views of the firm, its clients or any of its or their respective affiliates. All opinions are subject to change without notice. All investments involve risk, including the possible loss of principal. Past performance does not guarantee future results. Reams Asset Management is a division of Scout Investments, Inc., a registered investment adviser that offers investment management services for both managed accounts and mutual funds. Scout Investments is a wholly owned subsidiary of Raymond James Investment Management, a registered investment adviser and a wholly owned subsidiary of Raymond James Financial, Inc. Additional information is available at www.reamsasset.com or www.scoutinv.com.

NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE

M-520458 Exp. 07/31/24