

# Webcast Summary



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## The Fed and Liquidity Markets: Maintaining Balance

*In the latest quarterly webcast, Matt Jones, alongside portfolio managers Mark Lindbloom and Kevin Kennedy, discussed the impact of Federal Reserve policy on liquidity and fixed-income investments in light of recent stubborn inflation data and resilient economic indicators. Mark Lindbloom provided an overview of market sentiment changes, attributing them to stronger-than-expected economic performance and persistent inflation, while maintaining a base case scenario of moderating growth and inflation for the remainder of the year. Kevin Kennedy discussed the effects of Treasury issuance and the reduction of the Fed's reverse repo program on money markets, emphasizing a cautious approach due to Fed policy uncertainty and new SEC regulations that increase liquidity requirements for money market funds. The webcast concluded with a discussion on the potential impact of the upcoming election year on federal policy, with Mark Lindbloom generally unconcerned about significant changes to the Fed's approach under a new administration.*

### Shift in Market Sentiment Regarding Interest Rates

- As the year began, the market expected six to seven cuts in the federal funds overnight target rate over the course of 2024, but recent data suggests expectations have shifted to one or two.
- We believe the shift was due to economic resiliency with growth expectations at 1.5% to 2.0%; strong payroll and higher than expected consumer spending.
- Our base case continues to be a moderation in inflation and growth

### Effect of Shift on Expectations on Money Markets

- The short end of the money market has closely followed the Federal Reserve (Fed) rate expectations.
- There continues to be extremely strong demand for bills from both US and offshore investors.
- Attractive Treasury bill yields have led to a decrease in the use of the Fed's reverse repo program (RRP), a key tool the Fed uses to maintain stability in the money markets.
- There's a consensus that the Fed may have finished raising rates, though with data continuing to reflect stubborn stickiness in inflation, some speculate about a resumption of tightening.
- Any increase in yields is seen as a chance to extend fund maturities, with current levels for short-term investors remaining attractive.

### Thoughts on the Likelihood of the Fed Raising Rates in 2024

- Western Asset's investment process considers a base case scenario as well as alternative outcomes.
- Our Base Case Scenario assumes slower growth in 2024 without a recession and inflation falling to around 2% by the end of the year.
- Alternative Scenarios include a left-hand tail with a significant economic slowdown or recession, and a right-hand tail with stronger-than-expected growth—which is closer to what we're seeing lately.
- Western Asset's positioning strategy is conservative in the stronger growth scenario, adjusting duration and yield curve positioning in portfolios.
- Our base case remains moderate growth and inflation, but we remain vigilant and ready to adjust strategies if necessary.

### Changes in Money Markets

- Western Asset has no immediate concerns regarding the current dynamics in the liquidity markets and their impact on fund portfolio management despite money market investors having largely moved away from the RRP into Treasury bills due to the very large quantities of bills issued by the Treasury department as well as because of the expectations for strong collections this tax season. The RRP is now less than \$500 billion from its height of well-above \$2 trillion in 2022.
- The Fed is keen to avoid a repeat of the 2019 disruptions in the repo markets caused by reserve imbalances, and is taking a number of measures to mitigate this risk, including slowing down the roll-off of Treasuries and mortgage-backed securities from the Fed's balance sheet.
- Overall, the Firm has confidence in the current state of liquidity markets, with no significant concerns, and emphasizes the importance of the Fed's role in maintaining market stability.

### Long-Term Positioning

- Western Asset's investment process is built on valuations, conviction in market pricing, and diversification. These principles have guided the Firm for 50 years.
- We see opportunities in actively managing fixed-income sectors to attractive yields, which range from 5.5% to 7%, depending on duration.
- We believe that bonds will return to their traditional role as a stabilizer in portfolios, offsetting volatility in other asset classes.
- While recent optimism has prevailed in the economy and equity markets, there is a need for caution. Valuations in non-sovereign paper are okay, but spreads over Treasury are less compelling, especially in the investment-grade market.
- Western Asset is shifting toward higher quality structured sectors such as mortgages and asset-backed securities, balancing the portfolio for all-weather conditions.
- The Firm is positive on specific emerging markets, particularly local markets and currencies, where valuations remain attractive.
- We emphasize diversification and consider rates to be attractive, and we advocate a balanced, conservative approach in light of current concerns.

### Money Market Funds and New SEC Regulations on Liquidity

- The SEC has mandated new liquidity requirements for US money market funds, increasing daily liquidity to 25% and weekly liquidity to 50%, up from 10% overnight and 30% weekly.
- Western Asset believes the amended liquidity regulations could lead to somewhat less attractive returns for MMF investors in the future, especially those favoring prime money market funds for their higher yields compared to government funds.
- Other changes, including Mandatory Liquidity Fees for prime MMFs, may contribute to the growth of government funds which will continue to be represent an important demand source for Treasury issuance. In turn, this increased demand may, potentially lead to lower Treasury bill yields over time.
- Despite the new rules, we continue to manage our funds with a high level of liquidity due to Fed uncertainty, and this conservative approach will persist.

### Election Impact on Fed Policy

- There are debates about the fiscal policies of a potential Biden or Trump administration, with concerns about how each might address the deficit—Biden possibly through tax increases and Trump potentially leading to even higher deficits.
- Tariffs are another point of discussion, especially under a Trump administration, which could impose tariffs on China and other countries, affecting budget deficits, economic growth and inflation. However, campaign rhetoric often does not translate into drastic policy changes.
- Speculation about the future of Fed Chair Powell and the Fed's independence is a topic of conversation. We dismiss concerns about the Fed's compliance with presidential wishes, citing institutional memory and regulations that safeguard its independence. Even if Powell were replaced, some potential candidates are considered more hawkish.

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