

# Webcast Summary



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## The Fed and Liquidity Markets: Edging Toward Steady Progress

*We expect slowing but steady US economic growth, with inflation moderating toward the Fed's 2% target. Key inflation indicators show progress, particularly in housing costs and consumer spending. Markets anticipate a September rate cut. While new regulations have impacted money market funds, short-term funding markets remain stable. Fiscal deficits and potential post-election changes are ongoing concerns. In our investment strategies, we favor longer-duration portfolios, intermediate maturities and select emerging market opportunities. Diversification remains crucial in the current environment.*

*Here are some key takeaways.*

### Liquidity Markets Outlook

- Money market fund yields are attractive, with government funds offering well above a 5% yield on the institutional side and close to 5% on the retail side.
- There has been significant Treasury bill issuance, but demand from growing government money market funds has largely absorbed this supply.
- The Federal Reserve's (Fed) reverse repo program (RRP) usage has decreased but remains a stabilizing factor in the market.
- Short-term rates like the Secured Overnight Financing Rate (SOFR) have seen some volatility, especially at quarter-end, but this is not indicative of broader liquidity issues.
- There's value in longer-dated money market paper, with one-year commercial paper and CDs offering yields of 5.10%-5.20% from top financial institutions.
- Investors might want to consider extending duration slightly, as the market is pricing in Fed rate cuts beginning in September.
- New SEC regulations for money market funds (effective October 2023) include increased liquidity requirements and mandatory fees for large redemptions in institutional prime and tax-exempt funds, but these are not expected to significantly impact the commercial paper market.

### Inflation

- Inflation is expected to moderate to around 2.5% for the personal consumption expenditures (PCE) price index by year-end, showing progress toward the Fed's 2% target.
- Recent months have shown improvement in inflation data, particularly in the second quarter, after higher-than-expected readings in the first quarter.

- Housing costs, particularly owners' equivalent rent (OER), are beginning to show signs of moderation, which is expected to contribute to lower overall inflation.
- Progress on inflation is seen as a key factor in the Fed's data-dependent approach to monetary policy.

### Growth

- Our base-case scenario anticipates a slowdown in economic growth, but not a collapse or recession.
- Recent economic data has shown some signs of moderation, with indicators like the Citi Surprise Index suggesting data is coming in below expectations.
- Consumer spending is showing signs of moderation, though not dramatically, with continued good income levels and strong capital markets performance supporting consumers.
- The labor market is exhibiting some softening, with a slight increase in the unemployment rate and a decline in the quit rate from previous highs.
- There are concerns about potential impacts on growth from various factors, including political events, geopolitical tensions and fiscal policies.

### Fed Policy

- The Fed is expected to begin easing interest rates, with the first cut anticipated in September 2024.
- The market is now pricing in two to three rate cuts by the end of 2024 (down from six to seven at the start of the year), with further easing expected through 2025.
- The Fed is closely monitoring various liquidity metrics, including the SOFR and bank reserves, to ensure stability in financial markets.
- The Fed maintains tools like the Standing Repo Facility to address potential liquidity issues in the market, providing a safety net for financial stability.

### New Money Market Fund Regulations

- We anticipate limited overall impact, especially for Prime Funds, which have already decreased in number as many converted to Government Funds.
- Surprisingly, there has not been a significant widening of spreads in the commercial paper market because of the new regulations. Spreads remain tight, only about 10-15 bps over T-bills for high-quality commercial paper.
- The limited impact on commercial paper pricing is attributed to strong demand for high-quality short-term paper from non-money market fund investors globally.
- Overall, the regulations have not dramatically altered the short-term funding markets as some may have expected, with pricing levels for commercial paper remaining in line with or even tighter than historical norms.

### Portfolio Positioning

- Western Asset is maintaining longer duration relative to benchmarks in broad market portfolios, with about 110% duration compared to benchmarks, due to adequate valuations and as a diversifier against risk assets.
- The Firm has been shifting from overweight positions in long-term maturities (20+ years) to more intermediate and short maturities in recent months, expecting yield-curve steepening as the economic cycle progresses.

- We have reduced somewhat but are still overweight in spread sectors like investment-grade credit, high-yield credit and bank loans, while rotating more into structured products—including agency mortgages, specifically commercial mortgage-backed securities (CMBS), non-agency mortgages and asset-backed securities (ABS)—for higher quality and liquidity without sacrificing much yield.
- The Firm is finding attractive opportunities in select EM countries, particularly those offering double-digit nominal yields in both USD-denominated external debt and local currency debt.
- For our money market funds, we are shortening duration in prime funds due to upcoming regulations, while maintaining a longer duration in non-2a-7 money market funds and short portfolios.

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