Western Asset
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Webcast Summary

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The Fed and Liquidity Markets: Past the Turning Point

The Fed's recent rate cut has significant implications for growth, inflation and employment. Growth remains positive but moderate, with inflation nearing the Fed's 2% target and employment showing signs of softening. This has impacted liquidity markets, particularly money market and ultra-short bond funds, emphasizing the importance of higher quality investments. We see the potential for further rate cuts, but risks from geopolitical factors and fiscal deficits remain. Our overall outlook for liquidity investors suggests a cautious yet optimistic approach to investment opportunities. Given today's backdrop, we currently favor agency mortgages and AAA rated structured products.

Here are some key takeaways.

Liquidity Markets Outlook

- The Federal Reserve's (Fed) pivot to begin an easing cycle with an initial 50-basis-point (bp) rate cut brings us "past the turning point."
- Ongoing Fed policy changes are expected to influence liquidity markets, particularly in the short-term funding space.
- Overnight funding markets, represented by SOFR and Treasury repo rates, have experienced some volatility, especially during quarter-end periods.
- Money market funds continue to maintain high balances, with total assets around $6.5 trillion, indicating strong demand for short-term cash-like instruments.
- While prime money market funds face regulatory changes, the impact on commercial paper funding has been minimal, as other investors absorb demand.
- The ultra-short bond fund space is becoming increasingly attractive as investors look to extend maturities and lock in higher yields amid expectations of future rate cuts.

Fed Policy

- The Fed has been paying close attention to the labor market, noting that the pace of job growth has decelerated and wage growth has moderated, which are key factors in its policy decisions.
- Changes in Fed policy have significant implications for liquidity markets, particularly affecting overnight funding rates and the repo market.
- The market and the Fed are closely aligned in their expectations for future rate cuts, with the market anticipating about 50 bps of additional cuts in 2024 and 100 bps in 2025.
- The Fed has been monitoring funding pressures and may adjust its quantitative tightening (QT) program if necessary to maintain stability.

Inflation

- Inflation data has shown significant progress toward the Fed's 2% target, with core Personal Consumption Expenditures (PCE) running just above 2% on a three-month annualized basis.
- The services component of inflation, which has been stickier than goods, is finally starting to adjust, contributing to the overall moderation in inflation.
- Supply and demand imbalances following the pandemic have been alleviated, and labor market softening is helping to control wage growth, further aiding the inflation outlook.
- Owner-equivalent rents, a significant component of inflation metrics, are improving—currently running at about 4% annualized, down from higher post-Covid levels.
- Lending activity in commercial, residential, construction and industrial loans is down, which should contribute to continued progress toward the Fed's inflation target.

Growth

- Economic growth remains positive but has moderated from the high levels seen a year ago, with annualized GDP growth at 1.6% in Q1 and in the high 2% range for Q2. Q3 annualized GDP growth is projected to be about 3%.
- The current growth environment is characterized by low but positive trend-like levels, which are more sustainable than the above-trend growth experienced in the second half of 2023.
- The overall economic outlook is relatively constructive, with expectations of continued favorable macroeconomic conditions to support growth.

Portfolio Positioning

- Broad market portfolios are being positioned toward higher quality segments such as agency mortgages and AAA structured products to capture yield while managing risk.
- Our liquidity strategy emphasizes aiming for a yield advantage through safer portions of the market, given the current tight spread levels.
- We are shifting much of our long-end exposure to shorter-dated exposures to mitigate uncertainty and volatility in long-term rates, particularly due to fiscal concerns and potential geopolitical risks.
- Treasury duration is being used to offset higher-beta positions in spread products, providing a hedge against potential risk-off events.
- Our primary focus is on capturing yield where prudent, with a modest duration overweight concentrated at the front end of the yield curve, as front-end yields are expected to react more favorably than long-end yields in a fundamentally driven risk-off scenario.