SKY HARBOR
CAPITAL MANAGEMENT
Responsible Investing for a Sustainable Future

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February 5, 2024

SKY Harbor Weekly Briefing

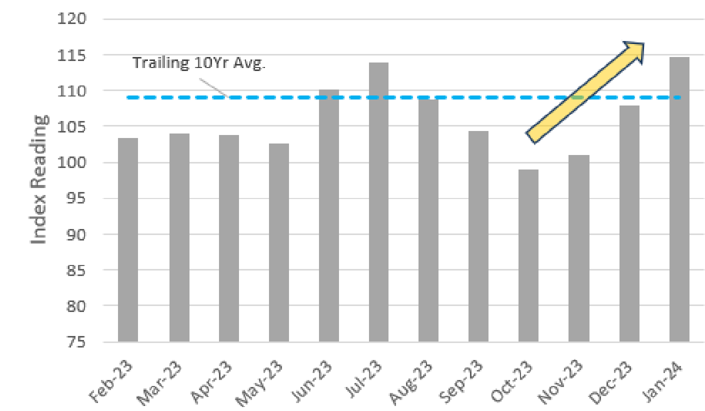
No March Cut?

Apparent cooling of labor market conditions in the lead-up to the January FOMC meeting gave investors hope that Jerome Powell would telegraph rate cuts in the near term. This enthusiasm proved unfounded, with the Fed Chair stating that we have not yet seen enough disinflation data to merit such action by March. Nevertheless, investors continue to anticipate nearly 150 bps of cuts in 2024, albeit somewhat delayed relative to expectations earlier this month. In this *Weekly Briefing*, we review recent economic data releases and the FOMC statement, finding reason to remain comfortable with high yield market risk but with limited inclination to extend duration.

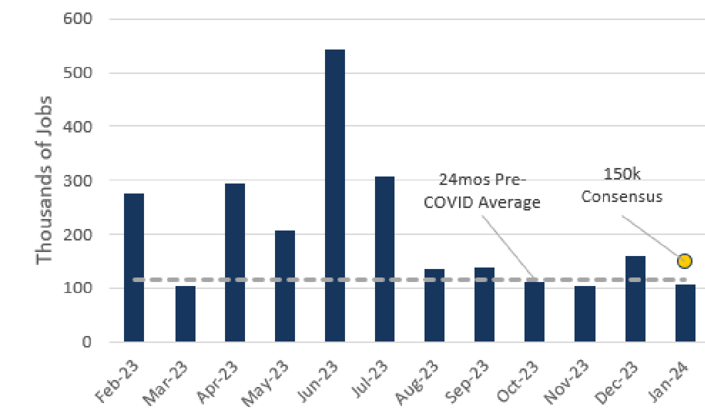
Economic Resilience

Buoyed by increased confidence that inflation would slow, rates would subside, and employment conditions would remain favorable, the Conference Board Consumer Confidence Index increased to 114.8 this month, the third consecutive increase and the highest reading since December '21. Shortly thereafter, ADP data showed that **US companies added 107k jobs in January, falling short of the 150k expected, but at levels that still implied a healthy labor market, albeit one moving into better balance**. In conjunction with stronger output growth and cooler inflation datapoints highlighted earlier in January (see our *Weekly Briefing* entitled "A Goldilocks Scenario?"), markets continued to price in rate cuts both sooner and of a higher magnitude than prior Fed guidance.

Consumer Confidence Up On Lower Inflation Expectations
data released Jan 30, 2024



ADP Employment Change Signals Cooling Labor Markets
data released Jan 31, 2024



Source: SKY Harbor, Conference Board, Automatic Data Processing, Inc.

"I Don't Think It's Likely…"

As expected, rates were kept unchanged at the January FOMC meeting, a decision that was once again unanimous among voters. Notably absent from the Chairman's statement was language leaving the door open for further rate hikes, largely as risks to reaching employment and inflation targets move into "better balance." Furthermore, Powell noted the "solid pace" at which the economy was expanding, though he refused to declare it a "soft landing" just yet. Perhaps the most notable update from the Chairman's press conference was that **he did not think it likely that the committee would "reach a level of confidence" to begin cutting rates in March**, much to the dismay of numerous investors and strategists that have been predicting a Q1 move.

Fed Keeps Rates Unchanged; Dampens March Cut Enthusiasm
select commentary from FOMC statement on January 31, 2024

Highlights from Fed Chairman Powell

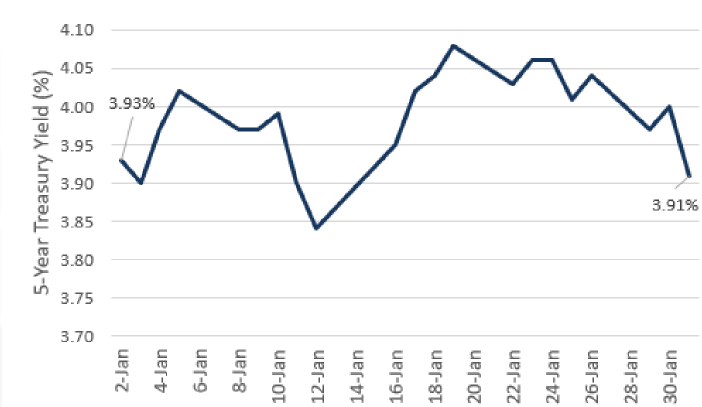
"Recent indicators suggest that **economic activity has been expanding at a solid pace.**" (prior statement read that the economy has "slowed from its strong pace in the third quarter")

"The Committee judges that the risks to achieving its employment and inflation goals are **moving into better balance.**

"The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent." (removed language around potential for "additional policy firming")

"...the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities..." (unchanged from Dec FOMC)

Treasury Yields Essentially Unchanged in January, But Volatile
daily data

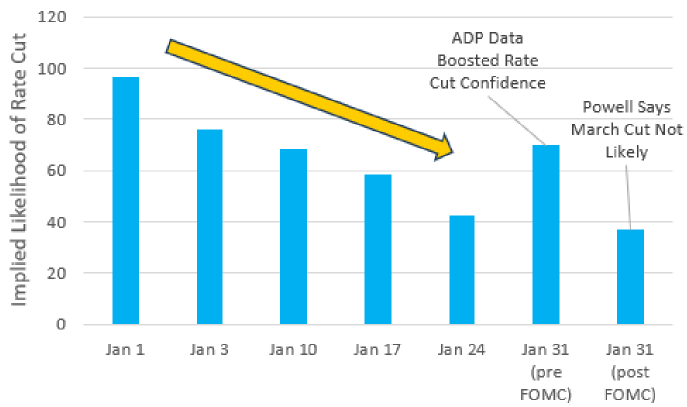


Source: SKY Harbor, Federal Reserve, Bloomberg

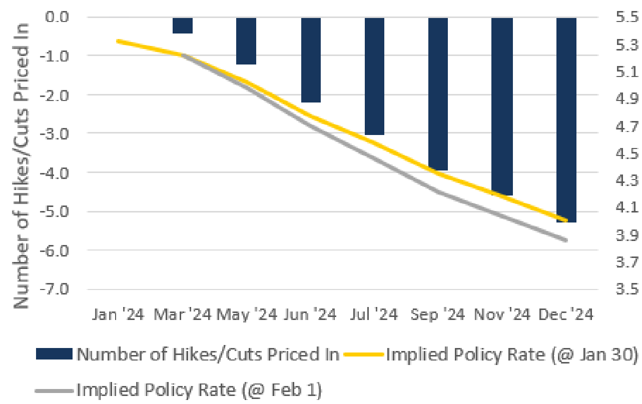
Tempered Enthusiasm

In our view, the key takeaway from Chairman Powell's press conference was temperance. Though pleased with the trend of inflation over the last six months, he was adamant that **additional data pointing to normalization in the 2% range was needed, particularly since most of the progress thus far has come from the goods side**. We highlight below that anticipation for a March rate cut has been on the decline throughout this month – notwithstanding a brief surge immediately following the January ADP data – and Powell's commentary later that afternoon merely brought the outlook back toward the same trend.

Powell Cools Enthusiasm for March Cut
based on Fed Funds Futures



Market Still Anticipates ~ 6 Cuts; Timing Delayed
based on Fed Funds Futures

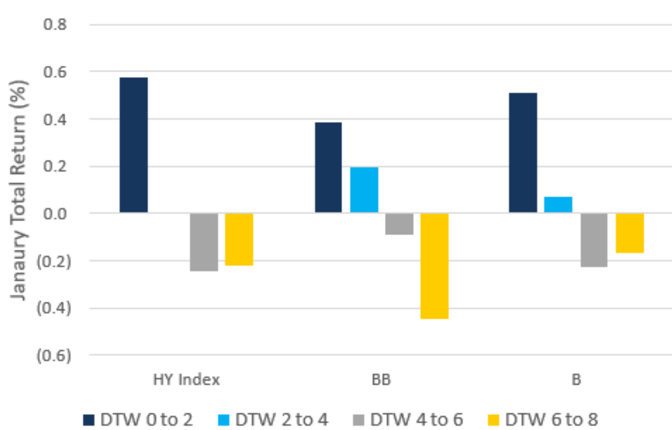


Source: SKY Harbor, Bloomberg

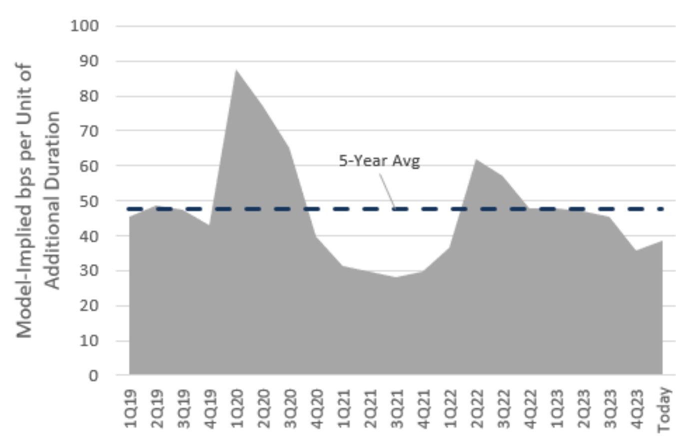
Relative Value

Through January, high yield returns (using the ICE BofA US High Yield Index as our proxy) largely favored lower-duration credits, a reversal from trends observed in the final quarter of 2023. Following this move, are investors being appropriately compensated to add duration? Recall from past *Weekly Briefings* that we aim to generate, on a monthly basis, a regression-derived estimation of compensation per unit risk factor, with differences in credit quality (via weighted average rating factor), tenor (via duration), and liquidity (via bond issue size) constituting ~ 90% of index option-adjusted spread variability, in our view. As demonstrated below, **term risk compensation remains below the trailing 5-year average**. As such, and given uncertainty between the Fed dot plot and market-implied expectations (a differences of ~ 3 cuts), we see little justification to be overweight duration at present.

Duration Not Rewarded in January
data through Jan 31, 2024



Term Risk Compensation Up Sequentially But Below 5yr Average
quarterly data; most recent data point is Jan 31, 2024



Source: SKY Harbor, ICE Data Indices

Patience is a Virtue

Though the market may have gotten ahead of itself, economic resilience persists while inflation continues to trend in the right direction. Cuts will eventually come, but investors may need to exercise a greater degree of patience. In the meantime, the case to meaningfully extend duration is weak, in our view, until either greater conviction on the magnitude of cuts develops, or compensation to take on term risk returns to more normalized levels.

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