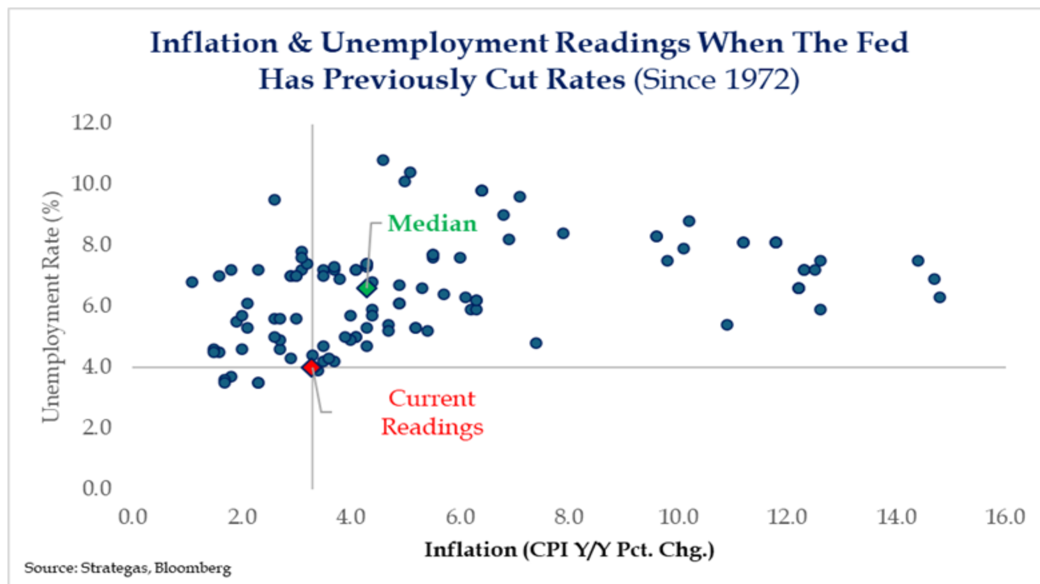
Birch Run
INVESTMENTS

2Q 2024 – Quarterly Commentary

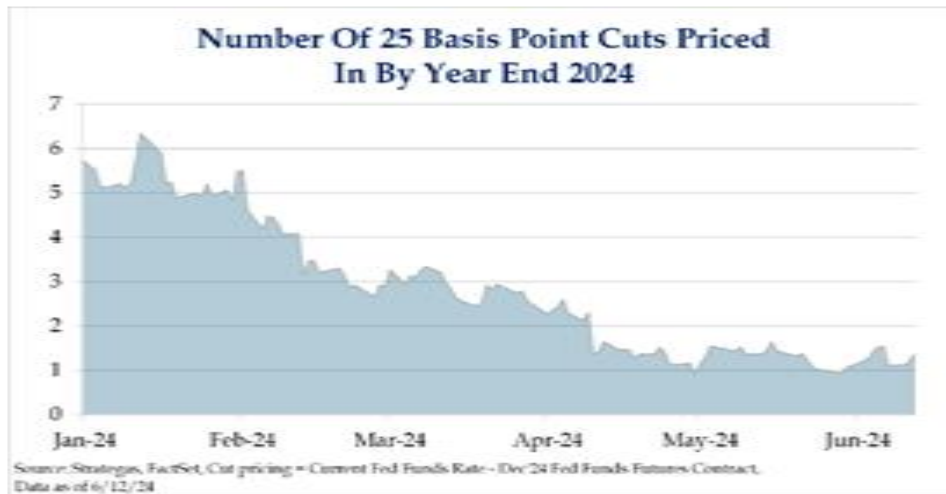
As discussed previously, stubbornly high inflation readings earlier this year led to the Federal Reserve delaying interest rate cuts, electing to hold short term interest rates unchanged to further combat inflation. By maintaining this restrictive policy stance, recent readings on inflation have continued to improve and appear close to reaching a sustainable path towards the Fed's stated objective of 2.0%. The additional gains achieved in tamping down inflation over the second quarter have come at the expense of a softening in economic data which raises the risk of an economic contraction. GDP has moderated and a growing number of economic indicators are reflecting the negative effects of a prolonged period of restrictive monetary policy. One of the more troublesome areas of weakness has been in the labor market. While still historically low, the unemployment rate has risen over the past several months to 4.1%, a key level that has preceded all but six rate cuts by the Federal Reserve since 1972 (See Chart 1).

Chart 1



In addition to a softening in the labor market, home sales are also reflecting the effects of high interest rates as are rising delinquencies on credit cards and auto loans. The recent slowdown in economic activity, while necessary to achieve the Fed's inflation goal, highlights the risk policymakers now face in balancing their dual mandate of price stability and full employment. The Fed is widely expected to acknowledge the more uncertain economic outlook by reducing the federal funds rate at the September FOMC meeting and in doing so join seven other Global Central Banks that have already begun the process of lowering interest rates. Market pricing suggests this one rate cut by year end will be the only one this year. However, given the softening economic backdrop there remains an increasing likelihood that the Fed moves more aggressively and cuts rates more than expected (See Chart 2).

Chart 2



The bond market reacted to the weakening economic data as expected with yields steadily declining throughout the quarter. Declines were most pronounced on intermediate maturities with the Ten-Year U.S Treasury yield ending the period at 4.20%. While the yield curve has remained modestly inverted as the Fed has remained on hold, we expect short term interest rates to react more swiftly when the rate cuts do occur which should normalize the curve in the months ahead. We expect portfolio yield curve positioning to be an important driver of relative returns in the coming year and will be adjusting portfolio maturity exposure accordingly.

Despite mixed economic data, with the exception of bonds in the lowest high yield ratings category, corporate bond credit spreads remained mostly unchanged during the quarter. Rich valuations will continue to pose a headwind for further price appreciation with additional outperformance more likely to come from the sectors yield advantage. Given the increasingly uncertain outlook, we continue to emphasize issuers of higher credit quality which are less susceptible to underperformance during a period of economic contraction.

As we look to the future, we will continue to monitor Fed policy; however, the upcoming elections and their possible impact on the economy and the business environment will see an increasing role.

Birch Run Investments, LLC
June, 2024