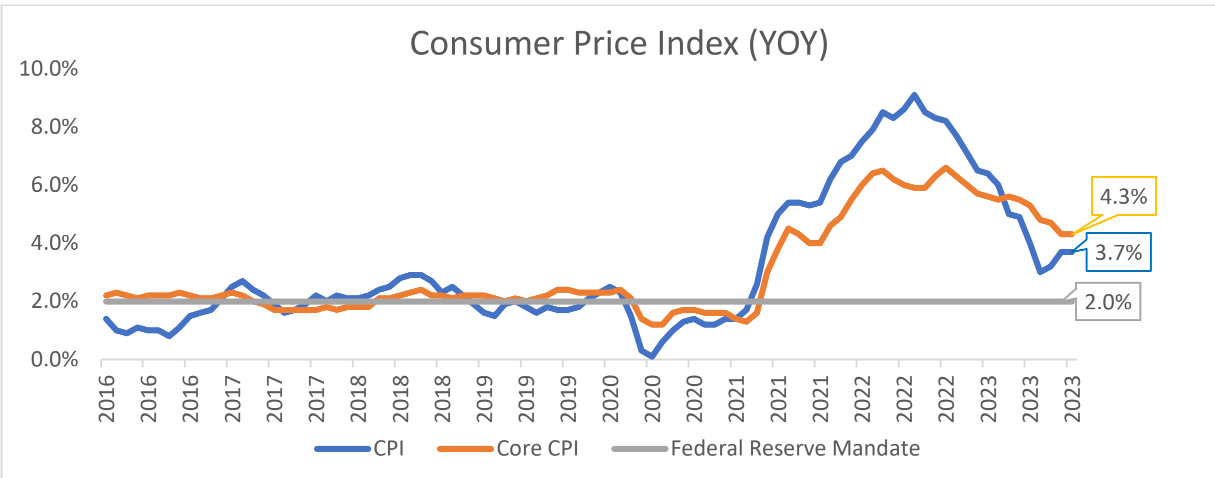
Q3 2023 Commentary and Investment Outlook

As we enter the final quarter of 2023, a hawkish Federal Reserve will likely continue to keep yields at the highest levels in almost two decades. Markets may have to adjust to one more hike of the Federal Funds O/N rate for 25 basis points, but the message has been received that rates will remain "higher for longer".

The Federal Reserve has aggressively raised the Federal Funds O/N Target rate over the past 18 months, to a range of 5.25% - 5.50%, (a 22-year high). During the last FOMC meeting, Chairman Powell indicated that rates would remain 'higher for longer" because "the process of getting inflation sustainably down to 2% has a long way to go." Inflation, as measured by Core CPI, continues to trend disinflationary at 4.3% down from a 6.6% peak[1], however **well above the 2% target**.



Source: Bureau of Labor Statistics as of 9/30/2023

The current restrictive monetary policy will likely continue as data on the economy and jobs continue to remain resilient. Federal Reserve GDP estimates were revised upward from 1.0% to 2.1% for 2023[2]. An unemployment rate below 4.0%.[3], which is indicative of full employment, will continue to allow the Fed to remain vigilant. Economists, in both the public and private sectors, have pushed out their rate forecasts delaying rate cuts for 2024, with the Federal Reserve Implied Fed Funds Target Rate Dots chart showing a target rate at 5.125% at the end of 2024.

As of 9/20/2023	2023	2024	2025	2026	Longer Term
FOMC Implied Fed Funds Rate	5.625%	5.125%	3.875%	2.875%	2.500%

[1] US CPI Ex Food and Energy YoY – Bureau of Labor Statistics
[2] Federal Reserve Board as of 9/20/2023
[3] Bureau of Labor Statistics

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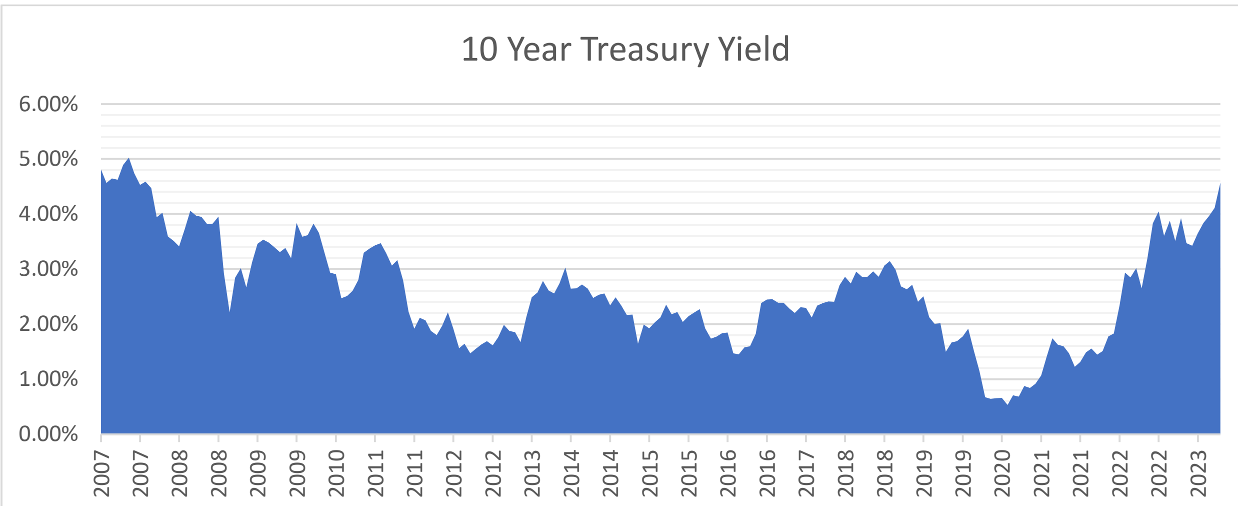
An astute SWS analyst pointed out during a recent research meeting, “predictions and forecasts work until they don’t”. Fed speak, the current data on the economy, inflation, and unemployment bolster the ‘higher for longer” rates environment. However, unknown events, or a possible recession will change forecasts and dot plots. The probability of a recession in the U.S. in a year is approximately 60% as per the Federal Reserve Bank of New York.[4] This is not a Federal Reserve forecast, but merely a measure of probability using the yield curve as a leading indicator. The probability is based on the shape of the current inverted yield curve. Easing inflation and a slightly cooling labor market have improved the forecasts for a “soft landing”. In our opinion, using the yield curve as a predictor versus resilient economic growth coupled with strong jobs data put the recession odds at 50/50.

The current yield curve is steepening (becoming less inverted) as longer-term yields continue to rise, and a shift upward is occurring in maturities greater than one year. The yield on the 10-year US Treasury surpassed 4.5% for the first time since the 2007-2008 financial crisis[5]. Long-term interest rates are not directly influenced by the Federal Reserve interest rate policy. Long-term rates are influenced by market expectations for how growth and inflation will evolve over time, as well as future expectations of Treasury supply.



Source: Bloomberg as of 9/30/2023

SWS Capital Management’s portfolios and strategies are constructed to take advantage of the current interest rate environment and are well positioned for the “higher-for-longer” narrative that the Federal Reserve is telegraphing.

In the current cycle, we are using yield curve positioning, asset mix optimization and duration management to position our strategies to improve portfolio yield while striving to increase total return to respective benchmarks.

Over the next quarter, SWSCM will continue to favor US Treasury Bills and Commercial Paper for our Ultra Short Strategies. For our longer duration strategies, we will continue to increase corporate credit exposure. Moreover, we will continue to increase duration in all strategies to benchmark neutral, as we get closer to the end of the current rising interest rate cycle.

SWS Capital Management’s philosophy is based on a value-oriented, active management style which emphasizes liquidity and risk management. This philosophy is woven into all our strategies. Security selection, sector allocation, and yield curve positioning are based upon interest rate anticipation as well as our fundamental economic outlook.

[4] NY Fed Probability of Recession in US Twelve Months Ahead predicted by Treasury Spread as of 8/31/2023
[5] US 10 Year Yield as of 9/29/2023, 4.57% as per Bloomberg Data Services

If you have any questions or if there is any additional information I can provide about our strategies or the fixed income markets in general, I welcome the opportunity to discuss these subjects.

Thank you for your business,

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