Satish Mansukhani
Investment Stategist
smansukhani@rithmcap.com

2025 Marked by Divergence, Dispersion, Bifurcation

ECONOMIC

1 Broadening Employment Composition, Surging Optimism

Three sectors — health care, government, and leisure & hospitality — have driven employment gains post-pandemic. Surging animal spirits post-election, most notably evidenced in the NFIB (National Federation of Independent Businesses) survey, could broaden employment gains ahead. Any risk of immigrant deportations could shrink the labor force and raise wage inflation.

Signs of a slowing in the labor market have been cited as a reason for the onset of Federal Reserve easing since September. The December payroll report and optimism turning into reality could force a pause and considerations for a reversal in the policy stance cannot be fully ruled out.

2 Rising Inflation Expectations from Consumers and Markets

Consumer and market inflation expectations are reversing recent declines. The University of Michigan 5-10 year Inflation Expectations are on the high end of the post-pandemic levels. Bond market inflation expectations are also at the high end of the post-2022 range. The breadth of CPI components rising, at 43%, is the highest since February 2023, compared to 60% recorded in 2022.

The 10-year nominal yield has risen, breaking from the trend of past Federal Reserve easing cycles. The consensus has tabled a 5% level as forcing a correction in equity valuations. We see a 2.6% level on market-implied 10-year inflation expectations as critical for risk asset valuations. The market would be signaling a loss of confidence in the Fed's ability to lower inflation to the 2% target.

TECHNICALS

3 Treasury Refundings: How to Fund the Deficit?

February 3rd and 5th will bring the Treasury's Quarterly Refunding Announcement (QRA), including forecasts on the 3rd and issuance details on the 5th. This will be the first QRA under the new Trump Administration. Under former Treasury Secretary Yellen, issuance of T-Bills rose to command 20% and more of the share of total debt issued. It may be too soon to have the just confirmed Treasury Secretary Bessent remap the issuance mix. It is debatable if issuance shifts to past trends. T-Bills commanded just 10-15% for much of the post-GFC era, until moving higher through and after the pandemic. The November QRA is when the funding mix could change as the deficit picture firms for FY 26 and 27.

Rising interest outlays paid by the US Government on its Treasury debt is a part of the rising deficit. This stands to interplay with an outlook for spending plans under the new Administration. If the 10-year Treasury yield is a true market barometer to President Trump, these developments remain front and center.

4 Debt Ceiling, Treasury General Account (TGA) and Bank Regs

Failures in raising the debt ceiling will lead to a drawdown from the Treasury General Account (TGA). This has the ability to boost market liquidity supporting risk assets, a possible replay of 2023. However, once the X-Date arrives, estimated to be mid-August, a liquidity gap could emerge, forcing a correction in risk asset valuations.

Easing of proposed Basel 3 Endgame rules is broadly expected, but timing is contingent on nominations and confirmation of a new Federal Reserve Chair for Supervision, making this a 2H'25 event.

Irrespective of the regulatory capital requirements, asset-liability mismatches are what triggered the 2023 regional banking crisis. A "higher for longer" rate environment only stands to further drive deposit competition and shorten deposit liabilities, pushing banks to shorten asset durations too. Banks continue sitting on unrealized losses on their long duration securities books, primarily Treasuries and agency MBS purchased during the pandemic; the magnitude of this has declined, however any move higher in rates could bring this back in focus.

Optimism on a pickup in bank M&A is a catalyst for portfolio rebalancing and shifting the asset mix. Smaller bank exposure to commercial real estate and also credit cards on balance sheets with far higher delinquencies than at the larger banks, speaks to the appeal of balance sheet restructuring opportunities.

5

Asset-Based Finance: Time for Specialization and Customization

Bank balance sheet restructuring over the last two years has been central to driving the growth of the asset-based finance (ABF) sector. As banks right-size their balance sheets to focus on origination and financing roles, they require stronger partnerships with asset managers to fill the gap. These asset managers are perhaps even better equipped to manage ABF assets, as they bring specialized skills suited to realize the investment economics presented.

Investor demand is also shifting from public to private markets. Pure play exposure to specific assets and sectors, in scale and in specialized hands, is expected to shape the space through 2025. This will open up the realm of opportunity for customization and specialization at the product, structure and platform level.

Public markets, equities and credit are increasingly seen as crowded, priced to perfection and sentiment driven. The structural demand for cash flowing assets that offer liquidity is high as investors seek to rebalance from the private equity and venture capital allocations post-GFC, under a zero lower bound for interest rates. A strong supply pipeline, growing demand and a structural need is expected to grow the ABF sector even further in 2025.

6

Bifurcation, Compounded by Wealth Effects and High Rate Burdens

No sector of the economy and markets is as bifurcated as the US consumer. The accumulated home equity wealth and stock market gains have enabled spending from the compounded "wealth effect," with household wealth now at a 5.7 multiple of nominal GDP and a 7.8 multiple of disposable personal income. Concentration of stock market gains in the Magnificent Seven, or even in crypto currencies, poses a risk to sentiment and perhaps spending too. Any sharp reversals could eventually show up in the valuations of consumer discretionary versus staples stocks and getting reported into weaker trends in retail sales and cooling down in services inflation.

The consumer picture is broadly normalizing, where rising delinquencies are grabbing headlines, but mostly getting back to pre-pandemic trends. The impact of high rates is hampering the performance of debt laden consumers, driving up delinquencies. Factors like FICO inflation, wherein stimulus payments boosted borrower credit scores, and rising insurance premiums are clearly weighing across certain pockets of consumer spectrum. Geography is also a consideration as a proxy for climate risks, be that in hurricane prone Florida or wildfire prone Southern California.

Ability and willingness to pay vary across secured to unsecured, collateralized to uncollateralized loans. This interplays with shifts in debt prioritization across credit lines which change over time. These factors and the tail of weak performance are where added focus is merited as the consumer picture evolves through 2025.

7

Diverging Trends, Inventory, Insurance Costs

Diverging trends based on inventory and supply are taking hold. Housing supply remains constrained at the national level. Borrowers locked into pandemic-era low mortgage rates are disincentivized to list their homes for sale, further compounding the shortage of housing. However, the picture is turning into a more regionally divergent trend taking hold.

Inventory is rising, led by hurricane ravaged regions of Florida and overbuilt parts of Texas. In contrast, the Midwest and Northeast remain undersupplied and underbuilt. Home price trends reflect this fluid supply picture, with home price gains leading in the supply constrained markets.

Geography will play a determining factor when speaking about home prices. Regional dispersion in supply and home price trends will unravel even further in 2025. The spring housing market will likely be key to these trends unfolding.

8

Single Asset or Single Borrower, Legacy or New

Bifurcation has also not spared the CMBS and CRE markets. In the office sector, high-end assets are in demand as return-to-work is taking hold across the Government and corporations, providing strong tail winds. Legacy, dated offices, in smaller, poorly connected areas may continue to lack the sponsorship and enthusiasm to repurpose or equitize.

In CMBS, "Single Asset" SASB is also separating from "Single Borrower," with trophy properties in "Single Asset" gaining investor support. On the other hand, "Single Borrower" backing is enabling CMBS deals across property types as investors focus on sponsor quality and backing.

The spread differential on legacy CMBS, comprising the 0-3 year portion of the ICE CMBS Index, versus new issue, comprising the 7-10 year portion of the ICE CMBS Index has narrowed on improved risk appetite, perhaps mostly driven as "extend and pretend" modifications have taken hold imparting greater confidence in rate driven bailouts. How a "higher for longer" regime plays out remains to be seen.

ASSETS CONTINUED

9

Strong Demarcations Between Fixed-Versus-Floating

Notable bifurcation exists in the corporate sector as well. Spreads are at multi-year tights on investment grade and high yield credits and well as leveraged credits.

Default rates have been running at or close to historical low levels but have fundamentally been trending up over recent years when taking into account various forms of restructuring, many of which with the expectation that short term rates would have substantially declined by now. Special Mention and Classified loans have also been trending up at regulated lenders.

This points to a dividing line between the larger, rated entities with access to the public markets, those comprising the investment-grade and high yield sectors, that are able to issue long term fixed rate debt and secure financing versus the smaller entities or weaker credits, those in the middle markets and leveraged loan sectors, beholden to floating rate debt with limited ability or appetite to implement long term interest rate hedges. In addition, stronger and larger issuers tend to hold more liquidity in cash or equivalent than most floating rate issuers.

Stronger and larger fixed rate issuers have been less exposed to the rise of interest rates and have benefited from carry from earning high rates on cash on hand. Floating-rate borrowers, on the other hand, have been exposed to rising rates, interest costs and weakening their debt service coverage. Evidence of stress has come through in "amend and extend," liability management exercises (LME) and lender-on-lender violence, with an increasing number of issuers that will gradually exhaust these options to avoid plain credit default.

This activity is showing up in spread dispersion in HY markets and leverage loan markets, and the loan issuance mix, with refinancings, extensions and re-pricings in the loan market commanding growing share of the primary market. Kicking the can down the road hinges on some reprieve coming in the form of lower rates or entities earning their way out by outpacing rise in debt burdens with growth in earnings.

The segment of issuers that have bought time through restructuring or various forms of extensions of maturities are now even more exposed to "higher for longer" rates and the overall health of the economy and many may have exhausted balance sheet management flexibility.

GEOPOLITICAL

10

Geopolitics and Policy Goes Into Overdrive

The new Administration has turbo charged the geopolitical picture. Tariffs, borders, immigration, conflicts, intelligence wars, cyber threats, chips, rare earth metals, all are complicated by the starting point of a negotiating stance. The terminal ending point looks markedly different.

American exceptionalism and resilience are bifurcating assets too, with sharp dividing lines manifesting in US dollar supremacy also filtering into demand for US assets, relative to the rest of the world. Yield differentials between US Treasury and German Bund yields symbolize the US-Europe divide, while similar differentials between Japanese and Chinese yields reflect the divergent state of those economies.

The Rithm Take

Stay tuned as 2025 is a year that in looking back will be rocked and rolled as these factors and trends unfold. Volatility is what presents opportunities. Cracks in fundamentals present opportunities to reprice risk. High event risk episodes will recur (DeepSeek is just one such event risk to the mix of factors that stand to bring surprises through the year)! Evolving fundamentals, fiscal and monetary policy responses, geopolitical positioning will test American resilience in ways new and unknown.

Separating signal from noise is our objective.