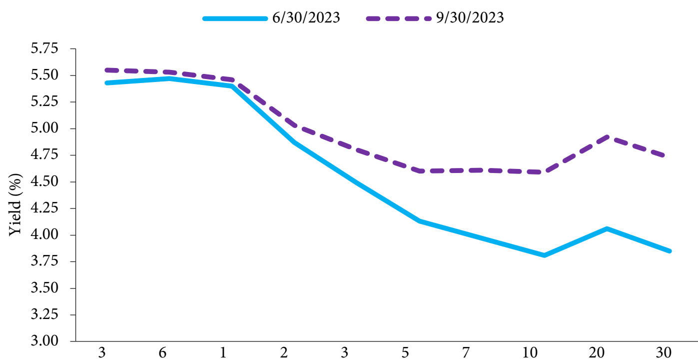
KEY TAKEAWAYS:

1. **Fixed income investments present a ripe opportunity for those seeking a stable source of investment income.**
2. **Inflation appears to be past its peak, but we expect the Fed to continue to use monetary policy to fight inflation and do not find additional rate hikes to be out of the question.**
3. **Credit spreads softened slightly over the third quarter. While markets seem unconcerned of growing expenses, we maintain a cautious view and would expect credit spreads to be wider.**

The long end of the U.S. Treasury yield curve rose over the third quarter while short-term rates remained relatively stationary. Markets are searching for the end of the interest rate cycle, for the Federal Reserve Board ("the Fed") to end its pattern of interest rate hikes. Equity markets have softened slightly since the mid-year mark, while bond yields seem to become ever more attractive as they rise. Fixed income investments have taken a new shine as higher yields are now a ripe opportunity for those seeking a stable source of investment income.

Figure 1 US Treasury Yield Curve at June 30, 2023 & September 30, 2023

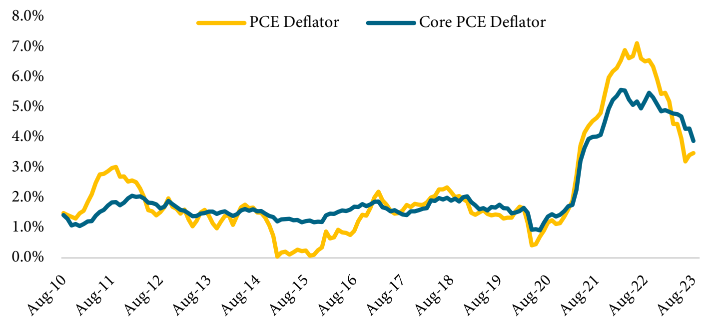


Source: FactSet

Inflation appears to be past its peak as we review economic data points. Yet, the momentum has been persistently pedestrian and frustrating for both Fed officials and consumers alike. The slow change has pushed the Fed into a "wait and watch" mode with regard to future rate hikes. They fear that additional hikes could not just accelerate the pace of change, but also speed the economy into an unwanted recession. As for consumers, we still feel the bite most sharply at the gas pump and at the food market even as other, non-core goods prices have likewise risen. Happy memories of cheaper goods and services are repeatedly and rudely interrupted by the reality of more expensive everyday purchases.

The Fed hiked 25 bps in July but made no move during its September meeting. Their last move in July brings the total number of hikes to 11 actions in this cycle, for a total of 525 basis points. Current market-based expectations suggest another potential 25 basis point hike close to year end and then, more loosely, a series of interest rate cuts to follow in 2024/2025. While these expectations can frequently change, they signal how investors feel the Fed is faring in their fight against inflation.

Figure 2 Personal Consumption Expenditures Price Indices (YoY)

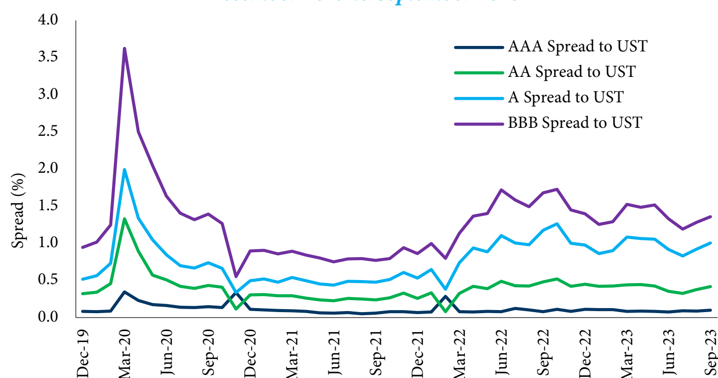


Source: FactSet

We expect the Fed to continue to use monetary policy to fight inflation and do not find additional rate hikes to be out of the question. Given the time it takes for previous hikes to be fully integrated into the economy, we are now starting to see the impacts of those earlier actions. They are evident so far in higher mortgage costs, higher financing costs for short term loans, and softer home prices. But further impacts, particularly in slower GDP growth or slowing employment rates, have yet to materialize. There is a fair amount of data dependency weighing on future Fed policy.

Credit spreads, or the additional yield required by investors to compensate for default risk, grew slightly over the third quarter. Markets are brushing aside growing expenses for businesses, such as rising input costs, higher labor costs, and volatile fuel/energy costs. At some point these costs could strain profitability or, worse, negatively impact their ability to make timely interest payments or to issue debt to fund their operations. We maintain a cautious, but not cynical, view on the profitability and ability of investment grade corporate debt issuers to make good on their coupon and principal payments. Overall, we would expect credit spreads to be wider as the economy has yet to feel the full impact of all of the Fed's policy moves.

Figure 3 Intermediate Investment Grade Credit Spreads (OAS) by Rating Cohort December 2019 to September 2023



Source: Bloomberg

Performance for bonds was slightly negative for the Intermediate Government/Credit area of the bond universe. Higher yields meant lower prices, which then pushed total returns just below zero for the quarter. Year-to-date returns are still positive for the group. Credit issues and U.S. Treasury issues both had similar returns for the quarter, where rising rates overcame the benefit from the additional spread of corporate bonds. On a year-to-date basis, Credit issues maintain a strong lead over U.S. Treasury issues in terms of total returns.

With today's higher yields, investment grade bonds present a rather attractive opportunity for investors. As the Fed nears the end of its policy tightening cycle, there is no serious likelihood of a repeat of the rash of interest rate hikes we have witnessed over the last 18 months. With that risk behind us, high quality bonds represent an appealing alternative to riskier assets. More certainly, fixed income is now a much more welcome part of a balanced strategy when paired with high quality growth stocks.

We seek to build portfolios for our clients with safety, liquidity, and quality as their primary attributes. Our thoughtful and measured portfolio construction process has been part of our strategy for many years. With today's better yields, higher coupons, and portfolio stability, now is the time to review opportunities in fixed income investments. We remain committed to our long-term strategy of purchasing liquid, high-quality bonds for our client's portfolios.

This material is for information purposes only. Any forecasts, figures, opinions, statements of financial market trends or investment techniques and strategies expressed are, unless otherwise stated, Congress Asset Management's own at the date of this document. They are considered to be reliable at the time of writing, may not necessarily be all-inclusive and are not guaranteed as to accuracy. They may be subject to change without reference or notification to you. The value of investments and the income from them can fall as well as rise and investors may not get back the full amount invested. Past performance is not a guide to the future.

2023_Q3_FIXED_COMM_01

Congress Asset Management
2 Seaport Lane Boston, MA 02210
800.234.4516
www.congressasset.com