CONGRESS
ASSET MANAGEMENT COMPANY

Fixed Income Outlook

| 1Q25

KEY TAKEAWAYS:

1. The Treasury yield curve began to normalize over the quarter as the Fed continued to cut short term rates while firmer inflation readings led longer term rates higher. We expect the threat of inflation in 2025 will temper the Fed's ability to substantially cut rates going forward.

2. A positive, upward sloping yield curve signals that the market no longer expects a recession and is a boon to bond holders as additional yield can be found by extending maturities.

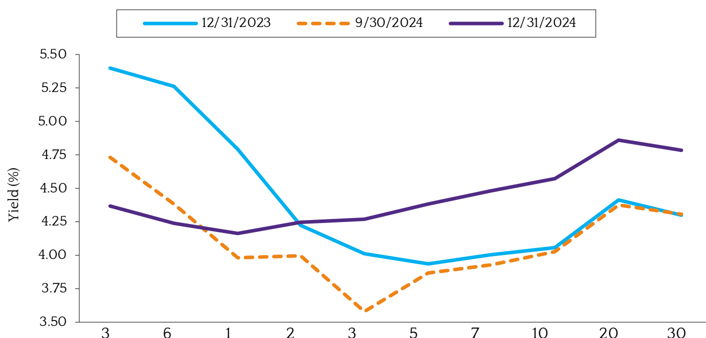
3. Credit spreads remain historically tight and we believe markets are too willing to lend without sufficient credit protection.

4. Given the steepening yield curve, narrow credit spreads, and a diminished slate of Fed actions, our measured and thoughtful portfolio construction should benefit our clients.

Economic data continues to guide and shape bond market participants' expectations for 2025. Investors' viewpoints on inflation shifted as recent reports showed increasing core prices for consumers even though prior predictions had anticipated slowing costs. The Federal Reserve Open Market Committee (the Fed) is now contemplating a slower pace of future rate cuts based on this developing information. In response, the U.S. Treasury yield curve shifted higher and has become upward sloping for maturities longer than one year.

Most of the U.S. Treasury curve is now upward sloping, which is a welcome departure from the inverted curve that we had grown overly familiar with. From a predictive standpoint, this shift is a sign that market makers no longer expect the economy to slip into a recession. For bond investors, this means additional yield can be found by extending maturities, allowing them to move away from the front end of the curve and gain greater diversification across their holdings.

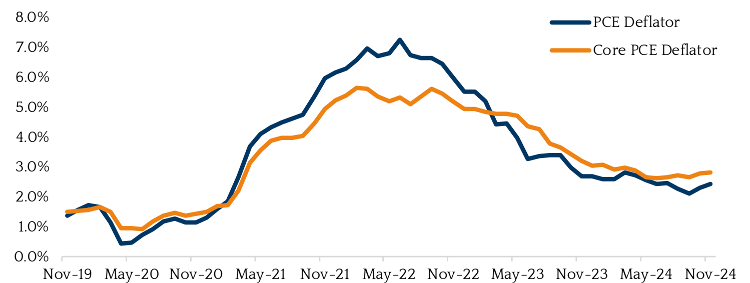
Figure 1 U.S. Treasury Yield Curve on December 31, 2023, September 30, 2024 and December 31, 2024



Source: Bloomberg

Our largest concern for the economy and the bond market is the inflation outlook. Core measurements remain elevated and above the Fed's soft target of 2%. The recent inflection upward is troubling as the Fed has just begun an easing cycle. The impacts of the initial rate cuts in September have yet to be fully absorbed into the economy, which normally take six months to manifest. Despite inflation being above target and trending in an adverse direction, the Fed appears ready to plow ahead with further rate cuts.

Figure 2 YoY Personal Consumption Expenditures Price Indices 2019-2024



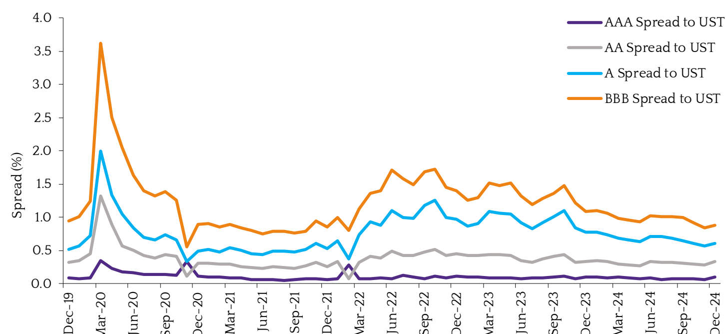
Source: Bloomberg

To be fair, the Fed's dual mandate of price stability and maximum employment puts them in a difficult position. Employment has remained robust since the recovery from the COVID-19 pandemic and currently rests just above 4%, a low reading in historical context. The long-term trend, however, has been a grind upward that began in early 2022. Altering the trajectory of employment is slow and time consuming, leaving the Fed to walk a narrow path with no clear roadmap.

As for recent changes in monetary policy, the Fed cut rates by a total of 100 bps in 2024, including two 25 bps cuts in the fourth quarter. Expectations for actions in 2025 have been tempered in the last few weeks, but in September they featured an aggressive slate of seven cuts of 25 bps (totaling 1.75%). Subsequent forecasts now call for a more realistic one or two cuts, which seems timid in contrast. This change, in just three months' time, highlights the market's sensitivity to changes in inflation data.

Credit spreads, or the additional yield required by investors to compensate for default risk, are still narrow with few signs of widening given the overall environment. Economic growth and corporate profits continue to be strong, buttressing cash flows for coupon and principal payments. An upward sloping yield curve is a positive for financial institutions, improving their net interest margin and profits. Further, the incoming administration has been loudly broadcasting plans to introduce business-friendly legislation early in the first term.

Figure 3 **Intermediate Investment Grade Credit Spreads (OAS) by Rating Cohort Dec 2019 to Dec 2024**



Source: Bloomberg

Corporate bond performance for both the last quarter and the full calendar year easily outpaced performance for both U.S. Treasury bonds and U.S. Agency bonds. Corporate issues were supported by a narrowing of credit spreads and a voracious investor appetite for risky assets. Over the course of 2024, investment grade credit issuers brought to market over $1.7 trillion in bonds, an increase of over 20% from the previous year.

Looking ahead to 2025, we expect the Fed will be eager to cut interest rates multiple times in the year to support employment but will be stymied by the threat of price increases. Inflation typically accompanies growth and forecasts predict existing economic productivity trends will continue or increase. This may relegate the Fed to a position of "watch and wait" for each incremental data release, tempering the number of cuts they can perform. Price increases also suggest a steeper U.S. Treasury yield curve over time, further diminishing the remaining areas of inversion.

Portfolio positioning for the start of 2025 shows a conservative approach to Corporate exposure. Spreads on Corporate bonds have persistently been too narrow for our comfort, causing us to be more selective when adjusting positions. Given the accommodative Fed stance and the overall positive trajectory of the economy, we see little impetus for spreads to move dramatically. Overall, we maintain that spreads are generally too tight and that the markets are too willing to lend without sufficient credit protection.

Given the steepening yield curve, narrow credit spreads, and a diminished slate of Fed actions, our measured and thoughtful portfolio construction should benefit our clients. Higher interest rates, particularly on the long end of the curve, should provide an incentive for investors to review and expand their fixed income allocation. We reaffirm our strategic goals of purchasing liquid, high-quality bonds for our clients' portfolios.

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