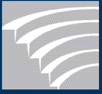


CONGRESS ASSET
MANAGEMENT COMPANY

FIXED INCOME OUTLOOK | 3Q24

John Beaver, CFA | Portfolio Manager

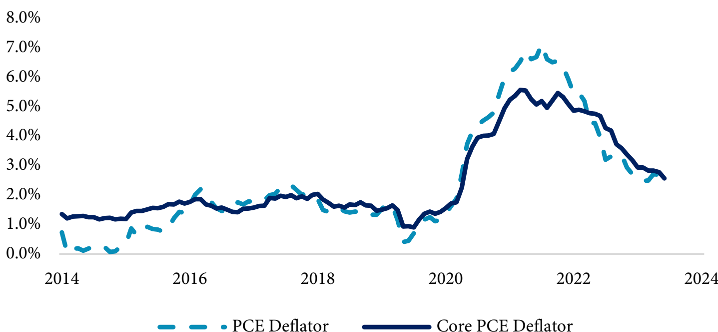
KEY TAKEAWAYS:

1. **Yields rose over the quarter, particularly in the long end, as inflation and economic data remained strong enough to dash market hopes of significant rate cuts this year.**
2. **Demand for higher yields is still very competitive. Though credit spreads widened marginally during the quarter, they continue to be historically tight and we think they should be higher given macro uncertainty.**
3. **We believe short-end rates will remain anchored to expectations of Fed cuts while long-end volatility remains as the market wrestles with the outlook for inflation.**
4. **The current environment of higher rates makes investment grade bonds an excellent opportunity, especially within a multi-asset class strategy.**

The Federal Reserve Board (the Fed) has held short-term rates steady since July of 2023. Since then, inflation concerns have been at the forefront for fixed income investors. Unchecked, inflation could move interest rates higher and push total returns into the red. Investors have been raptly watching economic data for signs pointing towards relief, but with few strong results. This has led to volatile yields at the long end of the yield curve as market makers watch and prepare for the Fed's potential next steps.

Recall that at the beginning of the year, market makers were expecting a series of six interest rate cuts this year. That number has since dwindled to one cut, or to a slighter probability two cuts, before the new year begins. Inflation data has simply not softened enough for the Fed to take any action. Consumers have borne the brunt as prices of goods and services have both risen, with housing and shelter related costs standing out as a prime example of painful price increases.

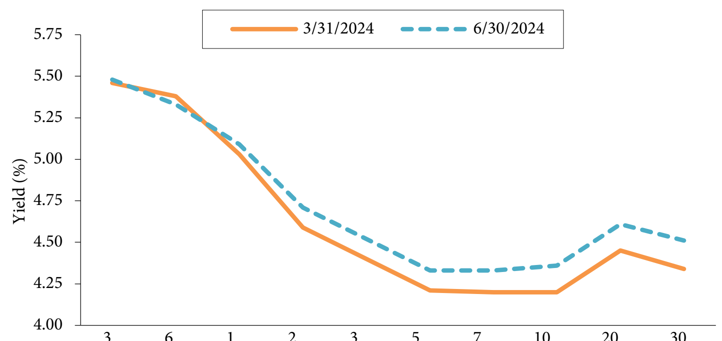
Figure 1 Personal Consumption Expenditures Price Indices (YoY)



Source: Bloomberg

The U.S. Treasury yield curve rose over the second quarter with longer-dated yields rising more than shorter maturity yields. Interest rates have been volatile and have had periods of rapid ups and downs within the quarter. The quick movements have not appeared irrational, thankfully, and instead reflect the changing hopes and fears of investors. Overall, the market sentiment has been leaning towards hopes of cuts, occasionally dashed by noncomplimentary economic data, leading to short periods of doubt.

Figure 2 U.S. Treasury Yield Curve on March 31, 2024 and June 30, 2024

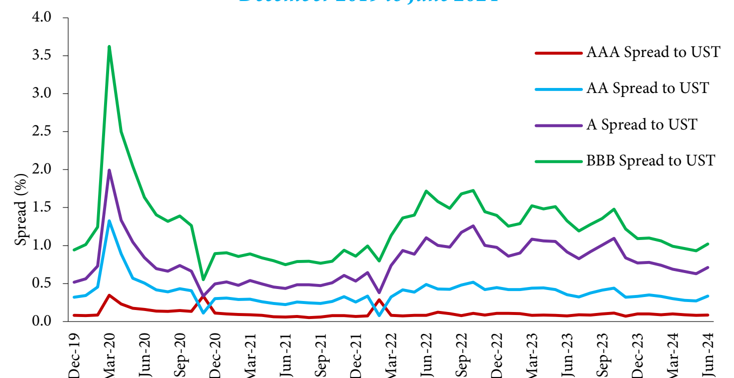


Source: FactSet

The economy has been doing reasonably well, despite the elevated inflation figures. GDP reports have been positive and consumer behavior has been strong, as witnessed by consumption measures. Housing has been a sore spot as inventories are down for both new and existing homes. Home buyers have exacerbated the inventory issue with all-cash purchases and short times on market. Some consumer relief has been felt with recent moderation in both food and energy prices as their advances have been tempered of late.

Credit spreads, or the additional yield required by investors to compensate for default risk, rose slightly during the second quarter. The changes, while minimal, still reflect a very tight market. Demand for higher yields is still very competitive and has kept spreads from moving higher. We continue to believe that the market is underpricing risk and that spreads should be larger than they are today.

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



Source: Bloomberg, FactSet

Total returns for the second quarter were positive, despite the increase in interest rates. Corporate bonds outperformed U.S. Government guaranteed debt yet again, although the margin of victory was slim. On a year-to-date basis, however, corporate bond returns were demonstrably ahead of U.S. Government guaranteed issue returns. The year-to-date outperformance by corporate bonds best embodies the long-standing trend between these two segments of the marketplace in the post-COVID environment.

Our outlook for the fixed income markets is unchanged. Volatility, particularly at the long end of the yield curve, will remain in place as the market wrestles with the inflation question. The short end should remain anchored until the Fed opts to move rates lower as we approach the year end. It is difficult to envision the Fed enacting multiple cuts given the lack of a strong trend in economic data reports around inflation. We see one cut being more likely in the fourth quarter or even the first quarter of next year as the Fed has been very slow to change their stance up to this point.

The current environment of higher interest rates makes bonds a good choice for investors, especially those employing them within a multi-asset class strategy. Our process and people are important factors within our fixed income investment strategy. We are steadfast in our commitment to building high quality, investment grade portfolios for our clients. It bears repeating that it is a good time to review possible opportunities in fixed income as either a stand-alone investment or as part of a larger investment strategy.

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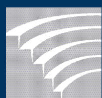

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