Fixed Income Outlook

| 4Q24

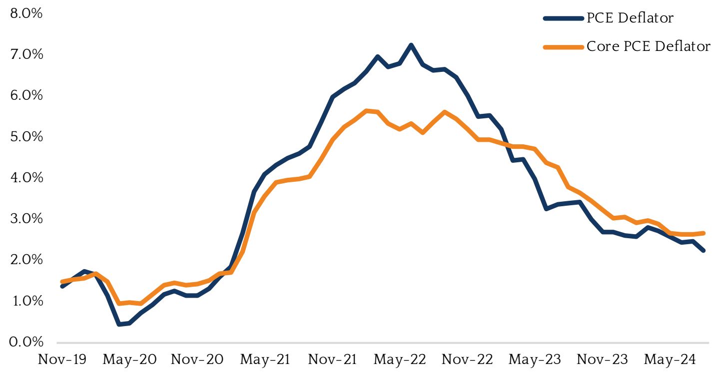
KEY TAKEAWAYS:

1. Yields fell across the curve as fixed income markets reacted to the Fed's rate cut and anticipated beginning of a new easing cycle.
2. The economy continues to perform well, but persistent inflation, slowing employment growth, and limited housing turnover complicates the picture.
3. Investor demand for yield led credit spreads lower. We continue to believe markets underappreciate credit risk and feel that spreads should be higher.
4. While the Fed has embarked on a rate cutting cyle, longer term yields remain near historical averages and investment grade bonds continue to provide an attractive opportunity as part of a broader investment strategy.

Yields fell over the past quarter as the fixed income markets reacted to the first monetary policy change since July 2023. The Federal Reserve Open Market Committee (the Fed) cut short-term borrowing rates by 50 basis points or one half of one percent. This decision was prompted by slowing economic growth measures mixed with expectations of slowing inflation. Overall, the markets reacted positively, anticipating the beginning of a new easing cycle from the Fed.

The majority of the market had been waiting on the Fed to cut short term rates as they watched job growth slow and inflation ebb. At the same time, other participants had expected the Fed to wait until their formal inflation target of 2% had been achieved. Ultimately, the Fed made its change, citing labor concerns and saying that "progress" towards its inflation goal was sufficient. This move raises questions about the future significance of the Fed's inflation target and may weaken confidence in its adherence to its own guidelines.

Figure 1 YoY Personal Consumption Expenditures Price Indices 2019-2024

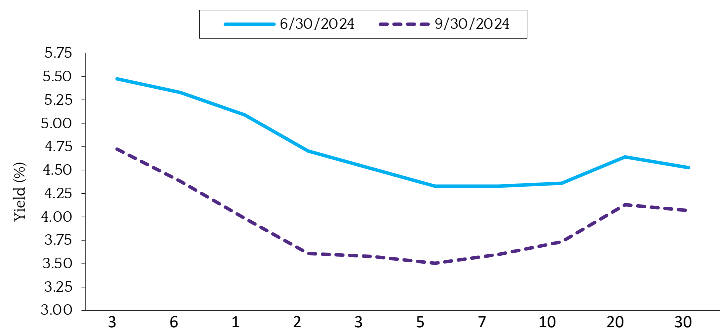


Source: Bloomberg

Inflation remains a stubborn sticking point for the U.S. economy. Since peaking in mid-2022, inflation has decreased sharply, but the rate of decline has slowed recently. What once was a clear downward trajectory has stalled. One could make the case that momentum has slowed so much that the next beat would be an inflection point upwards. The Fed appears to have interpreted this data trend differently.

Overall, the U.S. economy is doing well on a number of counts such as GDP growth, good wage increases, as well as resilient consumer spending. However, persistent inflation, slowing employment growth, and limited housing turnover due to inventory shortages complicate the picture. Therefore, it is premature to designate the current economic state as a "safe landing" as the plane is so obviously still in flight and circling the runway.

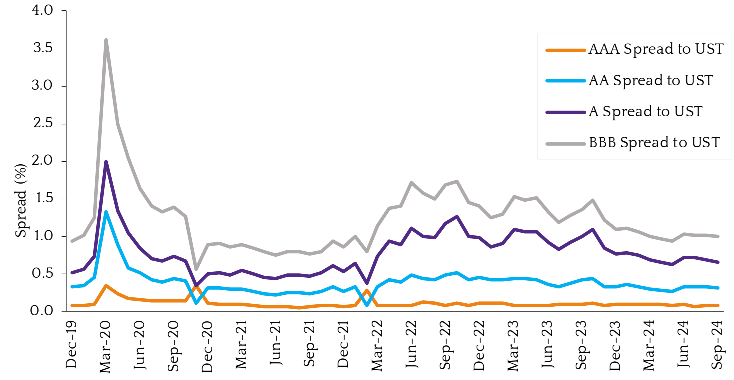
Figure 2 U.S. Treasury Yield Curve on June 30, 2024 and September 30, 2024



Source: Bloomberg

Yields fell over the quarter, reflecting the change in monetary policy and the market's outlook for future cuts. Now that the Fed has started moving, there is a strong expectation that they will continue to cut rates over the next two years. Some forecasts ranged as high as eight more cuts, or about 2.00% in yield. While future policy changes may not play out to this magnitude, it does indicate the depth of market expectations anchored on a series of future cuts.

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



Source: Bloomberg

Investor risk appetite has not abated as the year has progressed. Credit spreads, or the additional yield required by investors to compensate for default risk, continued to narrow through the quarter. Despite higher risk-free rates offered by U.S. Treasury issues, investors have been indefatigable in seeking the incrementally higher yields offered by Corporate bonds. In our estimation, the market underappreciates credit risk and we assert that credit spreads should be wider.

Corporate bonds outperformed U.S. Government-backed issues for yet another quarter. We attribute this trend to investors' enduring risk seeking behavior, favoring Corporate over Government bonds. Despite the recent memory of the Silicon Valley Bank bankruptcy in March 2023, the markets have favored risker securities despite dwindling protection. This underscores our belief that Credit spreads are too narrow and should be wider.

In our previous outlook, we expected a 25 basis point cut from the Fed in the fourth quarter. Instead, they delivered a 50 basis point cut in the third quarter. The timing and magnitude of the cut were somewhat unexpected, given the overall state of the economy and concerns around policy changes close to national elections. Now that the "game is on," the Fed seems poised to implement 25 basis point cuts during both their November and December meetings.

Our overall portfolio positioning remains unchanged, as we are selective about the pace and size of Corporate bond purchases. Should credit spreads move wider, we may reconsider our approach in this area. Meanwhile, the higher rate environment should evolve as the Fed continues to cut short term interest rates. This could finally mark the end of the inverted yield curve as shorter rates fall and longer rates rise. Given the extent of the inversion, this would take some time to be realized.

Our thoughtful and measured portfolio construction process has been a cornerstone of our strategy for many years. It favors building our clients' portfolios with safety, liquidity, and quality as their primary attributes. As the Fed embarks on a new rate cutting cycle, now is an excellent time to examine opportunities in fixed income investments as part of a broader investment strategy. We remain committed to our long-term strategy of purchasing liquid, high-quality bonds for our client's portfolios.

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