

Opportunities will persist

Investors may benefit, regardless of the pace of the Federal Reserve’s easing cycle.

While the sharp rise in the federal funds rate, beginning in March of 2022 and extending to July of 2023, led to difficult times across fixed income, the silver lining has been higher yields—income is back in play. Additionally, as the rate cut cycle that began with 50 basis points in September progresses, existing bonds with longer maturities will increase in price value more than bonds with shorter maturities.

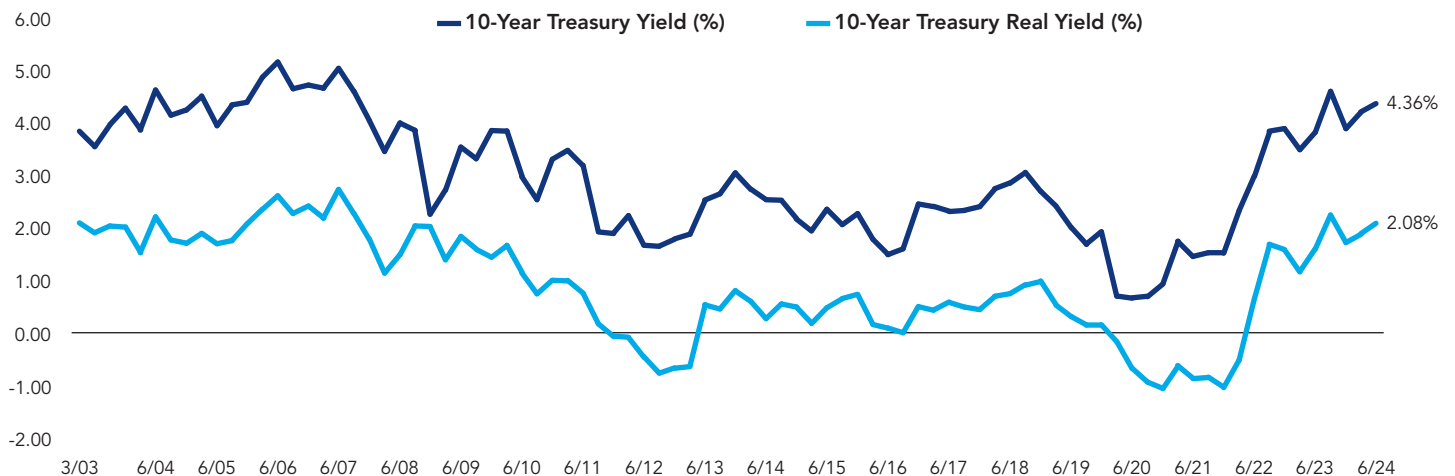
From the Global Financial Crisis through the Fed’s most recent tightening, investors have become trained to monitor price changes closely, as income from bonds was extremely low during the extended zero interest policy era.

As even newer habits die hard, investors may continue looking for the quick gains associated with price movements, having been trained to expect rapid and deep rate cuts in response to severe economic and market events since 2000. The good news? Thus far, a soft landing seems more likely than a recession, suggesting the current rate cut cycle will likely be more measured and lengthy, ending with yields closer to historically normal levels rather than the zero range.

With yields poised to remain higher relative to the levels investors have experienced over most of the past decade, the balance of risk and return opportunity for fixed income investors appears favorable.

The 10-year Treasury real yield is at a 17-year high

In the era of historically low yields post the financial crisis, investors earned very low real interest rates—the value of the income received after adjusting for inflation. We believe this phenomenon encouraged risk-taking as investors sought higher real returns in stocks and other risk assets. With the sharp rise in yields over the past few years, bonds appear poised to provide much more competitive real returns going forward.



Source: Bloomberg as of 9/25/24. **Past performance is no guarantee of future results.**
For illustrative purposes only and not indicative of any specific investment.

Macro outlook

The hard vs. soft landing debate resurged with third quarter market volatility. Investor focus has turned from inflation concerns to indications of slowing growth with weakening in the US labor market and falling oil prices suggesting diminishing global demand. The initial 50 basis point cut in September suggests the Fed is confident in its ability to maintain the soft landing and is also, at least for now, more aligned with already priced-in market expectations on rates.

The US economy remains key to the global outlook, with the expectation that growth will moderate through the rest of 2024 before perhaps leveling to trend in 2025. Recession expectations have risen somewhat, and contrarily, reacceleration due to the Fed’s generous initial rate cut is a possibility as well.

Regardless of fluctuations in the economy, individual bond sectors do not move in lockstep. Investing in a specific sector or taking a multi-sector approach requires considering likely economic and market scenarios unique to each sector. Positives for one may not be positives for another.

US macro fundamentals

- The Fed has pivoted to cutting rates amid signs of moderating inflation and a cooling job market.
- The US election cycle and resultant political tensions may create market volatility.
- The headline labor market remains strong, but layoffs are starting to rise.
- Corporate credit quality appears to be holding up well in the slowing inflationary environment.
- Firms appear to be conservatively managing their balance sheets and shareholder returns as a percentage of cash flows are in a declining trend.
- Earnings expectations for full year 2024 are positive low double digits.
- Tight bank lending standards are not consistent with a soft landing.
- Credit card delinquencies are rising, especially among lower-income consumers.
- Geopolitical risks remain high.

Credit scenarios

With the Fed having jump-started its easing cycle and the US currently experiencing a soft landing, corporate bonds are potentially the most sensitive to fluctuations in the economic outlook. We have been neutral or underweight to investment grade credit in our multi-sector portfolios for some time, and underweight high yield. We currently favor higher quality credit like US Treasury bonds for their defensive characteristics in periods of equity volatility, and Agency Mortgage-Backed Securities, which are also high quality and have historically attractive valuations exiting a period of historic rate hikes.

US corporate spreads have settled into a historically tight range post pandemic, making them less attractive currently in our view as downside price risk outweighs the higher income generation and potential price improvement relative to high quality assets.

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector. Material has been prepared using sources of information generally believed to be reliable, but its accuracy is not guaranteed.

Credit ratings of A or better are considered to be high credit quality; credit ratings of BBB are good credit quality, and the lowest category of investment grade; credit ratings BB and below are lower-rated securities ("junk bonds"); and credit ratings of CCC or below have high default risk.

Yield to Worst (YTW): On a bond, the yield to worst is the lowest yield that a buyer can expect among the reasonable alternatives, such as yield to maturity, yield to call, and yield to refunding.

Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

Past performance is no guarantee of future results.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

Real yield is the nominal interest rate stated for an investment minus the current inflation rate.

Not FDIC Insured • May Lose Value • No Bank Guarantee

Duration

In prior periods where the Fed paused its hiking cycle and ultimately began cutting, longer duration portfolios generally outperformed shorter duration portfolios. Investors who may have been reluctant to move further out the yield curve during the Fed pause now face less of a conundrum. While overall bond market yields have declined from their peak, and 2s/10s Treasuries have disinverted after a historically long inversion, parts of the yield curve remain flat/inverted, with short maturities yielding more or a similar level relative to longer maturities. As the cutting cycle continues, we expect the full curve to normalize - i.e., resume its upward slope.

Bonds have outperformed during rate cuts

Federated Hermes recently analyzed how 50 commonly used equity and fixed-income benchmark indexes performed during past federal funds rate cut cycles. We ranked the top 10 indexes based on median annualized return during the five periods since 1989 when the Fed cut rates. All were fixed-income indexes. Specifically, out of 50 equity and fixed-income indexes, the top performers were bonds and mortgage-backed securities.

Looking forward

With the Fed having jump-started its easing cycle and the US currently experiencing a soft landing, bond investors are now in a potentially unique position to benefit from higher current rates and also from price appreciation should the Fed continue to cut interest rates as expected.