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## Fed Easing Changes the Game for Fixed Income Investors

### Key Takeaways

- The days of “5% yield for naught risk” are over. With the Fed beginning an easing cycle with a decisive 50 basis point rate cut, US Treasury 2-year note yields have fallen from a peak of 5.2% to 3.6% currently. The Fed expects its policy rate to fall to 3.4% at the end of 2025 and 2.9% for a long-run average.
- The Fed does not condition its rate forecasts on recession, but rather on a view that real GDP growth and inflation will both be trending near 2%. A “standard recession” – with US employment falling by several million – would send yields even lower, with policy rates falling perhaps toward 2.0%.
- Could markets be exaggerating how far and fast the Fed will cut interest rates? We see a somewhat stronger US growth and inflation outlook than the Fed does even as the labor market cools. With corporate profits rising to new record highs, we’ve maintained overweights in global equities after lifting allocations last month (please see our September [Quadrant](#) for full details). Most non-US investment grade bond yields are even lower than the US, leaving much of the global fixed income universe unattractive.

### Potential Portfolio Implications

- The Fed maintained its peak policy rate for 15 months, but we have long warned that short-term yields were unsustainably high. Therefore, we believe investors should consider an extended duration in order to lock in higher yields for longer.
- The Fed’s decisive rate cut and strong market expectations for further action has pushed up the price of most safer bonds and altered the “yield scape.” Simply adding more duration with so much Fed easing expected is unlikely to add great value.
- Fixed income investors need to shift their focus to wisely managing credit risks. There are standout yields still available across the risk spectrum ranging from government-backed mortgage securities to high yield loans. We believe diversified portfolios should not exclude US Treasuries even as yields have moved decisively lower. But Treasury Bills in isolation are not a portfolio.

# Adapting to the New Rate Reality

The Fed chose to end the monumental suspense over “25 or 50” basis points for its first rate cut of the easing cycle with the more decisive action. Wisely, it chose not to make us wait all year for a “meager 25.”

Whatever the Fed’s decision, further declines in US policy rates have always been just a matter of time. Is the Fed uncertainty all out of the way now? The Fed’s decisiveness actually left markets less clear in some respects. Short-term fixed income markets are now roughly split 50/50 on the chance of 25 or 50 basis point rate cuts at both the November and December FOMC meetings. The “25 or 50” agony will continue.

By the end of next year, fixed income markets now price cuts in the Fed funds rate from a peak of 5.5% all the way down to 3.0% (this represents the “top end” of the Fed’s target range).

Of course, the more important question for most investors is what the Fed will achieve. As **FIGURE 1** shows, the Fed’s growth and inflation forecasts are steady and have barely changed. In line with updates to data since June, the unemployment rate forecast is a tad higher. But the Fed has roughly doubled the speed of its expected rate cuts. This is far closer to bond market pricing than the Fed’s previous forecast and closer to historic experience.

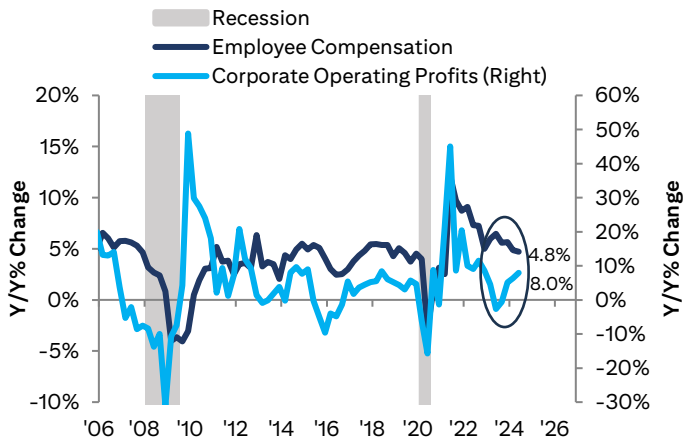
While we indeed expect the US labor market to continue slowing, it’s most notable that output data continue to remain firm. On a year/year basis, US real GDP growth exceeded 3% in 1H 2024 and tracking data suggest a roughly 2.5% pace this quarter. Strong labor markets didn’t mean strong corporate profits in 2023. Similarly, a slower labor market hasn’t inhibited a broadening profits recovery in 2024 (see **FIGURE 2-3**).

**FIGURE 1: Fed Forecasts from Summary of Economic Projections (SEP) – June vs September**

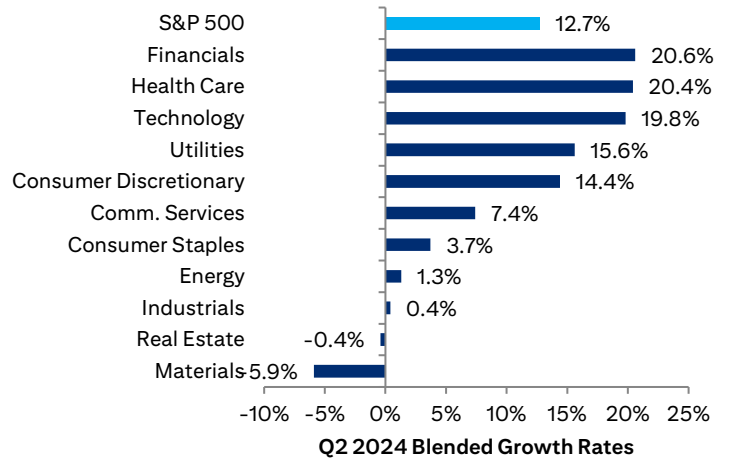
Fed September 2024 Summary of Economic Projections (%)				
	2024	2025	2026	2027
<b>Federal Funds Rate</b>	4.4	3.4	2.9	2.9
<b>GDP</b>	2.0	2.0	2.0	2
<b>Inflation (PCE)</b>	2.3	2.1	2.0	2.0
<b>Unemployment</b>	4.4	4.4	4.3	4.2
<b>(June Projections)</b>				
<b>Federal Funds Rate</b>	5.1	4.1	3.1	
<b>GDP</b>	2.1	2.0	2.0	
<b>Inflation (PCE)</b>	2.6	2.3	2.0	
<b>Unemployment</b>	4.0	4.2	4.1	

Source: Federal Reserve as of September 18, 2024. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is no guarantee of future results. Real results may vary.

**FIGURE 2: US corporate profits and employee compensation**



**FIGURE 3: S&P 500 EPS by sector through 2Q 2024**



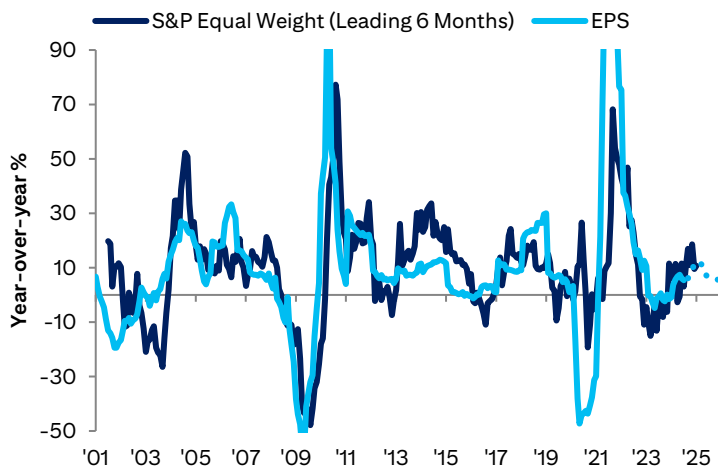
Source: Haver Analytics and Bloomberg as of September 18, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

## Us equity outperformance: here now, an uncertain future

US corporate profits reached a record high level in 2Q 2024. As we discussed in our August 31<sup>st</sup> [CIO Bulletin](#), we’ve raised estimates for S&P 500 EPS for both 2024-2025, anticipating new record highs for profits in the coming year.

There’s a chance investors and analysts will extrapolate the good news too far. However, the rise in the “average stock” hasn’t been profound since the market bottom of late 2023. Barring some new shock, our conservative estimates imply further, if more moderate, gains in 2025 after this year’s rally (see **FIGURE 4**).

**FIGURE 4: S&P 500 Equal Weight index vs EPS Y/Y% with CGWI EPS forecasts**



Source: Factset and CGWI as of September 18, 2024. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Meanwhile, US policy is a critical question for the world. As this past week showed, the Fed has moved decisively in a more friendly direction for global asset prices (please see our August 24<sup>th</sup> [CIO Bulletin](#)). Foreign policy, US fiscal policy, and tariff policy could be a different story. There, the question is “how disruptive might US policy be?”

These questions weighed on our Global Investment Committee as we held our allocations steady this week. We maintained overweights in equities centered in US “broadening strategies” aimed at softening tech concentration risk. In the long run, we will need to carefully assess any changes in the drivers of US outperformance, which has been profound in the past 15 years. Potential policies of the upcoming US administration could potentially shock, strengthen, or weaken that trend.

We’ve also maintained overweights in US bonds while underweighting global bonds given the US yield advantage. Even so, the declines in US Treasury yields across all maturities represents a new investor challenge. It requires us to focus on segments of the bond market where yields have remained high on a risk-adjusted basis.

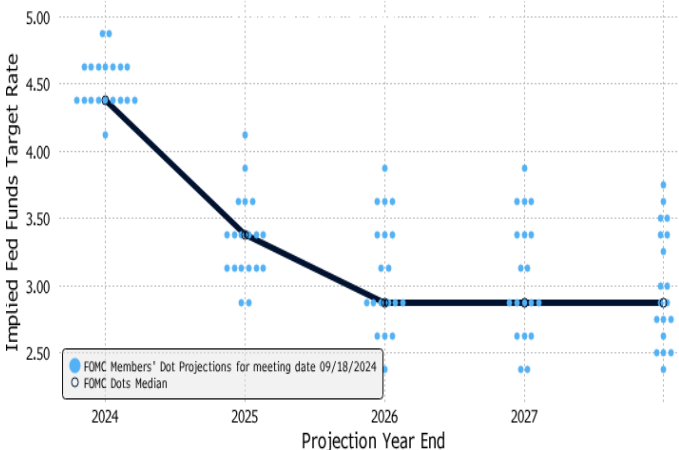
With cuts in cash deposit rates and plunging T-bill yields, investors now know the days of 5% for “naught risk” are over. As the US Treasury yield curve steepens – as it has in every Fed easing cycle in history – we believe fixed income strategies need to move beyond merely “extending duration” to taking wise credit risks.

## Fed easing changes the landscape for fixed income investors

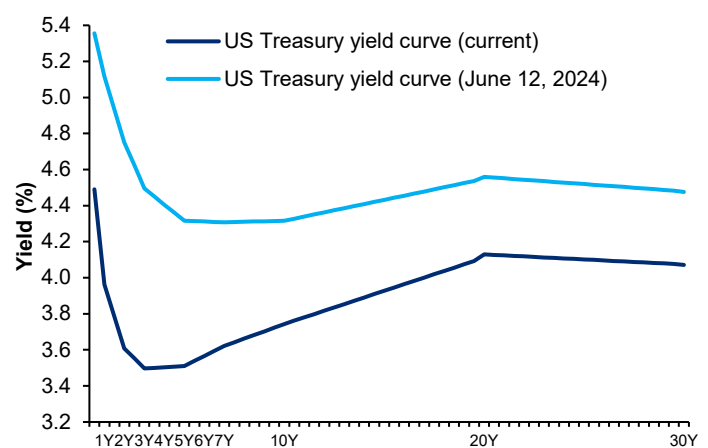
As it seeks to engineer a full normalization and “soft landing” of the US economy, this past Wednesday the FOMC cut the Fed Funds rate by 50bps, taking the rate down to 5%. This was the first rate cut since the pandemic shock of 2020. The FOMC also published its “dot plot,” an estimate of where the Fed thinks the Fed Funds rate might be in the next few years (see **FIGURE 5**). While this dot plot often proves inaccurate, it does provide a window into the Fed’s current expectations. For now, the Fed is indicating the possibility of six more 25bps rate cuts through the end of 2025, down to a top Fed Funds rate of 3.50%. In 2026, the Fed indicates the possibility of another few cuts, down to about 3%. Futures markets are slightly more aggressive on the pace of Fed rate cuts but not really the depth. The market currently prices nearly 2% of cuts down to 3% in 2025, with perhaps one more cut after that to 2.75% in 2026.

When looking at both the Fed’s dot plot and the futures market, they both coalesce around an ultimate “neutral rate” of about 2.75–3% for Fed Funds at some point in late 2025 or early 2026. The US Treasury market has already priced in much of this potential shift in yields lower, so since the time of the Fed’s previous dot plot back in mid-June, the yield curve has declined considerably (see **FIGURE 6**). Most of the decline has occurred in the “intermediate” portion of the yield curve (2–7 years), an area we have long favored for investors. The 2y yield, for example, has declined by more than 100bps, while 5y yields have declined almost 80bps and the 10y has dropped by about 50bps.

**FIGURE 5: Fed participants’ projections for midpoint of target range of Federal Funds rate**



**FIGURE 6: US Treasury yield curve**

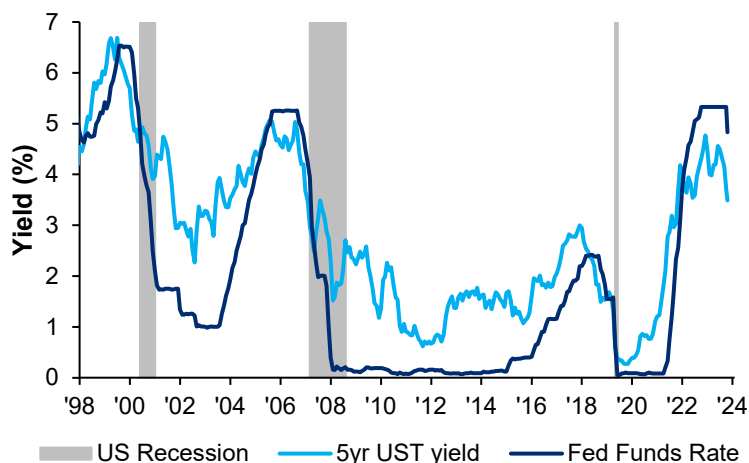


Source: Bloomberg as of September 18, 2024. Past performance is no guarantee of future results. Real results may vary.

While this rally in Treasury prices has been welcome for investors who owned fixed income, it does present a quandary as to what to do next for those still sitting in cash. We do not think that the Fed will lower rates much below 3% in the next year or two.

However, the issue for investors is that generally one wants to receive a premium to invest in longer maturities. For the 5-year Treasury for example, one might want to earn at least 50bps over the Fed Funds rate, and similarly for the 10y Treasury one might want to earn 75-100bps over the Fed Funds rate. As **FIGURE 7** shows, except when the Fed is raising rates or drastically cutting them during times of recession, the 5y has traded with some premium to the Fed Funds rate. Currently the 5-year Treasury yield is about 3.5% and the 10-year Treasury yield is about 3.75%, both at levels we would consider near or slightly below long-term “fair value” (assuming a neutral rate near 3.00%).

**FIGURE 7: 5yr US Treasury yield vs Fed Funds rate**



Source: Bloomberg as September 19, 2024. Past performance is no guarantee of future results. Real results may vary.

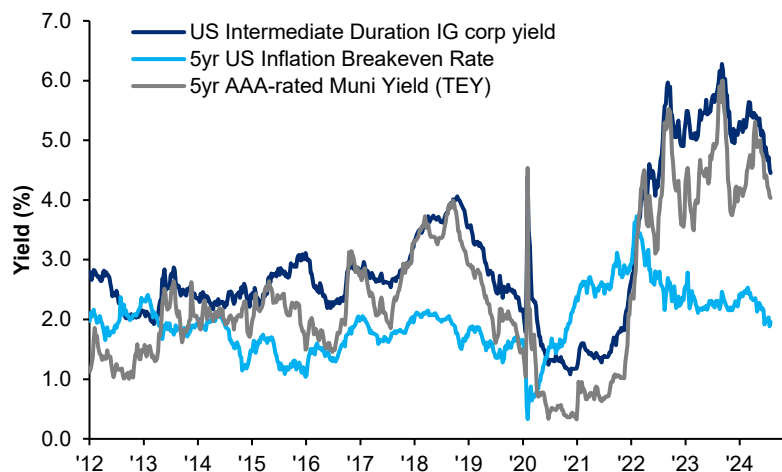
Of course, Treasury yields could still move lower, particularly when equities and credit markets weaken. This is why we believe investors should consider allocating at least a portion of their investment portfolio to Treasury securities as a core holding to provide some “ballast” should the economy unexpectedly weaken.

In addition, Treasury Inflation Protected Securities (“TIPS”) offer a relatively high “real yield” compared to the last decade, as well as have discounted due to declining inflation expectations. Should inflation remain higher than expected, TIPS might offer a higher return than Treasuries and so provide some hedge for the overall portfolio.

But we think investors may benefit from differentiated types of credit in the core fixed income portion of their investment portfolio (depending on their knowledge of the products, their risk tolerance, and other suitability factors). Based on our view that real GDP growth this year and next will be around 2.4%, we estimate that credit spreads – the return one can earn over Treasury yields – will remain relatively range-bound.

We believe investors should therefore consider intermediate maturity investment grade corporate bonds as a core fixed income holding. Credit spreads remain very tight, declining from about 150bps a year ago to about 80bps currently. While this spread is not particularly high relative to historical levels, it is still incremental yield in addition to Treasury yields and should provide some additional income. For US-based investors who can maximize the tax benefits, selected investment grade rated municipal bonds have the potential to provide additional yield benefit over Treasury yields (heavy recent supply has also discounted municipals recently relative to Treasury yields). In addition, both intermediate investment grade corporate bonds and tax-adjusted municipal credit still offer a much higher yield than breakeven inflation rates (as priced by TIPS), which have moved lower recently (see **FIGURE 8**).

**FIGURE 8:** 5yr breakeven inflation rates vs intermediate credit



Source: Bloomberg as September 19, 2024. Indices used as proxy are Bloomberg Intermediate Corporate Total Return index and the BVAL Muni Benchmark 5Y index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

## With rates lower, investors will need to focus on taking the right credit risks

We also believe that clients comfortable with and knowledgeable about the risk profile could consider low BBB-rated and BB (high yield) corporate bonds, where one can potentially earn additional spread over the intermediate IG corporate index (A-/BBB+ average rating). BBs currently represent increased substantial yield over IG-rated bonds, though of course there is additional credit risk.

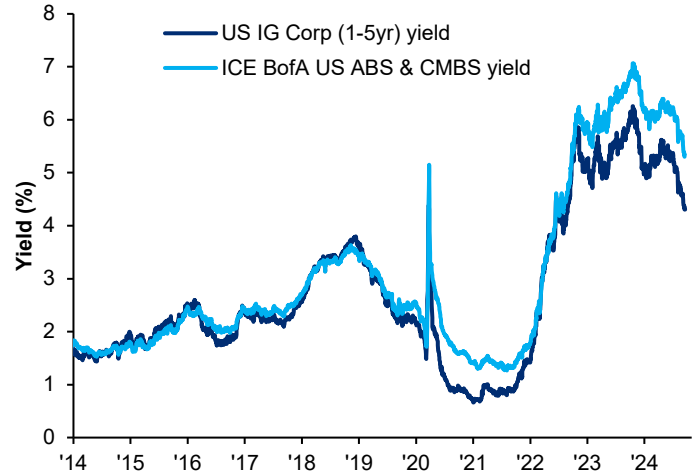
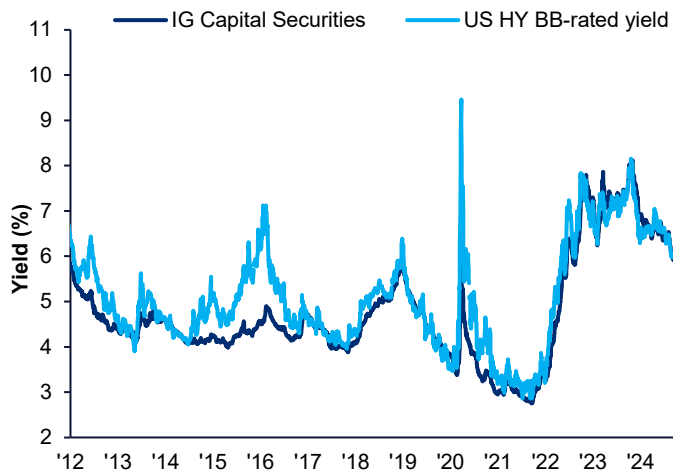
Investors comfortable with the risk may also want to consider an allocation to IG preferred securities. Yields for these IG securities are currently slightly higher than the BB-rated HY index (see **FIGURE 9**). Moreover, in the current environment where the yield curve will likely further “steepen” (short term rates drop more than longer term rates), many of these securities may move closer to being called by their issuers, which could result in gains beyond just the interest income as prices rise. Additionally, depending on structure, many of the US-based preferred issues’ interest distributions are taxed as dividend income, which can have a preferential tax rate for certain US taxpayers<sup>1</sup>, and so effectively increases the pre-tax equivalent yield.

Another type of credit that suitable and qualified investors might consider is called “structured credit.” This includes Agency AA-rated mortgage-backed securities (MBS), which are currently offering yields in excess of the corporate IG index (see **FIGURE 10**). Diversified structured credit funds often own MBS as a large portion of their overall portfolio, as well as other types of structured credit such as highly rated Collateralized Loan Obligations (CLO) and Commercial Mortgage-Backed Securities (CMBS) tranches, student loan securitizations, etc. MBS in particular may also benefit from a steeper yield curve due to its longer intermediate duration (about 5.5 years).

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**FIGURE 9: US IG preferreds vs BB-rated corporate bond yields**

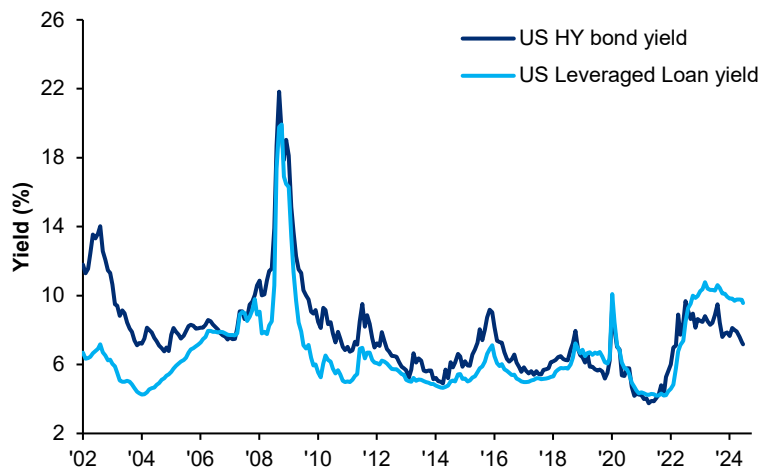
**FIGURE 10: Structured credit yields**



Source: Bloomberg as September 19, 2024. Indices used in the left chart are ICE BofA US Investment Grade Institutional Capital Securities Index and Bloomberg US Ba High Yield Total Return index. Indices used in the right chart are Bloomberg US Corporate Bond 1-5 Year Index and ICE BofA US ABS & CMBS Index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Finally, investors comfortable with and knowledgeable about the risk profile could consider funds that own high yield syndicated bank loans. These assets typically have yields far in excess of most other types of credit due to their low average credit rating of single B (see **FIGURE 11**). These loans are typically floating-rate, so coupons will decrease as the Fed continues cutting rates, but the current yield differential with other types of credit provides ample room for rates to be cut and still offer additional yield.

**FIGURE 11: US bank loan yields**



Source: Bloomberg as September 19, 2024. Indices used as proxies are Bloomberg US Corporate High Yield Total Return index and Morningstar/LSTA US Leveraged Loan index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

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	Moody's <sup>1</sup>	Standard and Poor's <sup>2</sup>	Fitch Rating <sup>2</sup>
<b>Credit risk</b>			
<b>Investment Grade</b>			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
<b>Not Investment Grade</b>			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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2 The rating from AA to CC by Standard and Poor's and Fitch Ratings may be modified by the addition of a plus or a minus to show relative standings within the category.

(MLP's) - Energy Related MLPs May Exhibit High Volatility. While not historically very volatile, in certain market environments Energy Related MLPS may exhibit high volatility.

Changes in Regulatory or Tax Treatment of Energy Related MLPs. If the IRS changes the current tax treatment of the master limited partnerships included in the Basket of Energy Related MLPs thereby subjecting them to higher rates of taxation, or if other regulatory authorities enact regulations which negatively affect the ability of the master limited partnerships to generate income or distribute dividends to holders of common units, the return on the Notes, if any, could be dramatically reduced. Investment in a basket of Energy Related MLPs may expose the investor to concentration risk due to industry, geographical, political, and regulatory concentration.

Mortgage-backed securities ("MBS"), which include collateralized mortgage obligations ("CMOs"), also referred to as real estate mortgage investment conduits ("REMICs"), may not be suitable for all investors. There is the possibility of early return of principal due to mortgage prepayments, which can reduce expected yield and result in reinvestment risk. Conversely, return of principal may be slower than initial prepayment speed assumptions, extending the average life of the security up to its listed maturity date (also referred to as extension risk).

Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

An investment in alternative investments can be highly illiquid, is speculative and not suitable for all investors. Investing in alternative investments is for experienced and sophisticated investors who are willing to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks may include:

- loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices;

- lack of liquidity in that there may be no secondary market for the fund and none is expected to develop;
- volatility of returns;
- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
- manager risk.

Individual funds will have specific risks related to their investment programs that will vary from fund to fund.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

Diversification does not guarantee a profit or protect against loss. Different asset classes present different risks.

The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

Past performance is no guarantee of future results.

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