Fixed Income Quarterly

Confluence Investment Management

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Trust But Verify

- The bond market is continually evaluating Fed policy, and in recent months, the Fed verified its own policy guidance by lowering rates as expected.
- A flat curve has replaced the inverted curve and we expect a normal shape to form as the Fed continues to lower short-term rates.
- The corporate sector should remain relatively stable, although given tighter spreads we suggest an underweight exposure.
- The MBS sector has constructive fundamentals, while spreads remain attractive, and we suggest an overweight exposure.
- We suggest a slightly shorter duration posture with an underweight allocation to Treasurys.

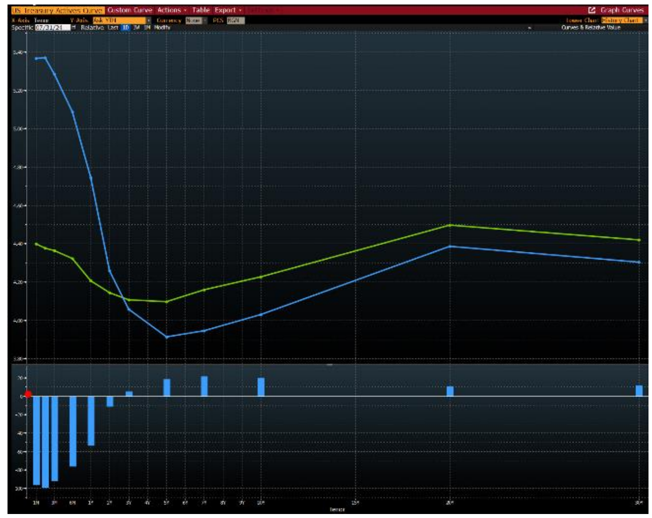
"Trust but verify" was a phrase used by President Ronald Reagan in the 1980s as the thaw in the Cold War advanced. Reagan was taught the phrase as a reference to a Russian proverb, one that could help two enormous nuclear powerhouses move forward with disarmament. Today, we reference the saying, which has utility across a multitude of conditions, not in the context of geopolitical events but instead with regard to the Federal Reserve and the bond market. These two powerhouses certainly aren't trying to disarm one another; however, there is a constant give and take between the parties as the Fed projects, implements, and adjusts its policies, and the bond market responds with market rates that may agree or disagree with the Fed pronouncements.

Near the end of the third quarter, at the September FOMC meeting, the Fed began easing monetary policy with a reduction in the overnight interest target rate. Prior to the meeting, the Fed had telegraphed its intention to lower rates so the bond market had been expecting the move. However, interest rates have changed significantly across the entire spectrum of maturities after this initial rate cut, which we have illustrated in our first graph with Treasury yield curves. The green line shows Treasury yields from mid-December, ranging from one month bills to the 30-year bond. The blue line shows yields for the same maturities from the end of July prior to the Fed's initial rate cut. The blue bars on the bottom show how much yields have changed over the period. So, while there was a measure of trust that the Fed would lower rates, there was a strong response once the bond market had verification of lower rate policy.

Yield Curves

Yield curves are funny things, but they are important for several reasons. Perhaps most important is that they provide a clear illustration of market expectations for growth, inflation, and Fed policy. A lot has been written about the inverted curve in recent quarters, where short-term rates were higher than longer-term ones. The shape gathered attention because inverted curves have historically been a harbinger for recessions. Yet even as the broad expectation for a recession dissipated throughout this year, the curve remained inverted. Why? A big part of the explanation is that as bond maturities become shorter, they increasingly reflect actual Fed policy as opposed to expectations of future Fed policy, which manifests in greater magnitude in longer maturities. Therefore, the steep inversion at the front of the curve has dissipated as the Fed lowered its target rate in recent months.

Treasury Yield Curves, *7/31/24 and 12/11/24*



(Source: Bloomberg)

The curve is now very flat and the longer-maturity yields are actually near or even above those of short-term bills. On our chart, we include a red circle at 3.5% to illustrate where the Fed anticipates its overnight target interest rate to be at the end of 2025. Our own view is that this may be a bit on the low side as we expect inflation to generally be a bit higher than the Fed's preferred level of 2%. We also expect inflation to be more volatile. Regardless, as the front end of the curve declines with easier Fed policy, there is a pathway toward a normally shaped yield curve in 2025, which would be consistent with moderate economic growth and inflation that is well below the peak levels experienced after the pandemic. So, at least for now, it appears there is not just trust and verification, but also a bit of agreement between the Fed and bond markets.

Treasury Sector

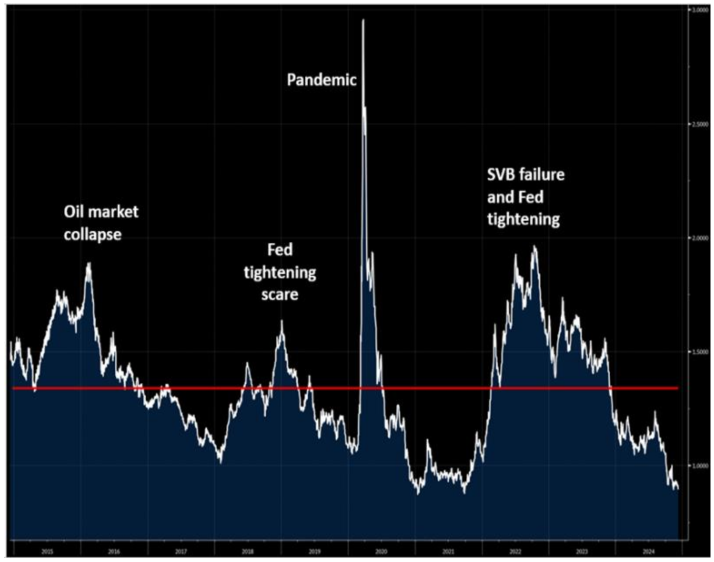
With the Fed now well into the easing part of its monetary cycle, Treasury yields have become similar across a wide range of maturities, meaning the inverted yield curve has been replaced with a flat one. As noted in the commentary above, we expect that as the Fed continues to ease, short-term yields will decline, creating a normally shaped yield curve. However, for now, we have a curve that is flatter than what we have experienced for quite some time.

With a flat yield curve, there is an absence of term premia, where investors can capture incremental yield by accepting incremental interest rate risk. Therefore, we favor a posture where investors can capture market yields, while avoiding risks from long-term bonds. At the same time, with our expectation of incremental Fed easing, we prefer to avoid large exposures to shorter maturities, which harbor significant reinvestment risk. *Combining these concepts, we suggest a focus on intermediate maturities, with an underweight exposure to Treasurys and a duration profile that is shorter than common bond market benchmarks.*

Bonds provide investors a variety of investment utilities, with yield being perhaps the most visible. But bonds also have a lower volatility profile relative to most other asset classes, along with low correlations. Also, in the case of long-term bonds, particularly long maturity Treasurys, the correlation often turns negative during times of broad financial market stress or when geopolitical conflicts erupt. In this regard, long-maturity Treasurys can be quite useful in addressing overall portfolio risk. And with the disappearance of the inverted yield curve, investors no longer have to sacrifice yield when including these bonds. So, while we prefer to avoid longer maturities right now in traditional bond allocations, we recognize that long-maturity Treasurys can still play an important role when considering broader asset allocation postures.

Corporate Sector

Corporate Investment-Grade Spreads, 10 years ending Dec. 2024



(Source: Bloomberg)

In some ways, credit market cycles are comparable to that of a forest. When conditions are favorable for extended periods of time, the environment fosters a wide range of growth, not all of which is useful. In a forest, when vast underbrush flourishes, it creates a large volume of kindling. When ignited, this kindling can feed conflagrations that can burn down the entire system, setting the stage for a cycle of rebirth. A corollary, taken from Austrian economics, is labeled "creative destruction," where the status quo is eliminated and replaced by new, improved systems. Although creative destruction is considered a natural progression in market-based systems, it can be nonetheless quite unpleasant and painful for investors.

When credit markets move through extended periods without problems, the tendency is to extend credit with declining standards. The absence of problems creates a sort of forgetfulness among lenders, leading them to tolerate increasing amounts of risk. It manifests in the form of low underwriting standards, higher proportions of leverage, and tight credit spreads. Borrowers who normally wouldn't qualify for loans gain credit, and those who already have access are given even more. In time, this kind of lending sets the stage for a destructive cycle, one that punishes lenders with widespread losses.

It's been quite some time since we've had a major "forest fire" in the credit markets. A measure of caution is therefore prudent, especially against the backdrop of tight corporate bond spreads, which are shown in the chart with the red line depicting the 10-year average. However, we can see that there have also been several minor fires in the credit markets over the past decade, including the shock caused by rapidly declining oil prices, the Fed tightening scare in 2018, the pandemic, the failure of SVB, and the recent Fed tightening cycle. These events all pressured corporate spreads wider and in many ways reset the terms and conditions of corporate lending.

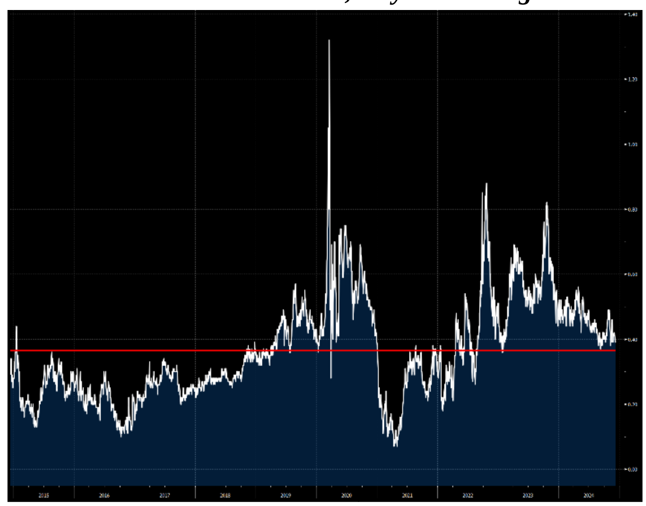
Our view is that although we haven't had a major downturn in the credit markets for quite some time, the smaller downturns have been frequent and significant enough to limit excessive undergrowth problems. With the Fed now easing, it appears defaults are likely to remain low as the economy avoids a recession. Therefore, we expect conditions in the corporate sector to remain relatively stable. *Nevertheless, with corporate spreads much tighter than the longer-term average, we don't find the value particularly compelling and suggest an underweight exposure to the corporate sector*.

Mortgage-Backed Securities (MBS) Sector

The MBS corner of the bond market is one of the most complex sectors due to the embedded options that homeowners have. If rates decline, homeowners can refinance their mortgages, which has the effect of calling bonds away from MBS investors, who then face reinvestment in a lower rate environment. On the other hand, if rates rise, refinancing activity declines, which has the effect of extending MBS maturities and forcing investors to remain in lower coupon bonds, even as rates are higher. The condition creates a "losing" posture for MBS if rates rise or fall, while "winning" takes place only when rates are generally stable.

In our view, conditions in the MBS market today are much different than what have been in place for the last few decades. When the Fed tightened in 2022, the market responded with higher rates, including mortgages. MBS prices declined sharply, along with refinancing volume. These circumstances have created an environment today where refinancing volume is unlikely to decline, given the already low levels. On the other hand, if refinancing activity rises, MBS investors could actually benefit if they are focused on MBS trading at significant discounts to par (higher refinancing calls MBS principal at par).

30-Year Fixed Rate MBS OAS, 10 years ending Dec. 2024



(Source: Bloomberg)

Taken all together, we believe the historical challenges of investing in MBS are less pronounced today and may even benefit investors. Furthermore, with MBS option-adjusted spreads (OAS) a bit wider than the 10-year average (in red on the chart), we find this sector quite attractive. *We suggest an overweight exposure to the MBS sector*.

Municipal Bond Sector

The municipal segment of the bond market is heavily influenced not only by the term structure of the Treasury market, but also by supply and demand of municipal bonds, the fiscal health of state and local governments and revenue issuers, and federal individual tax policy.

Although the flat yield curve has dampened the advantages of refunding, new issuance of municipal bonds — both general obligations (GO) and revenue — has occurred at a brisk pace thus far in 2024, buoyed by infrastructure projects supported by federally funded projects under the CHIPS and IRA legislation. These new issues have found favorable demand by investors as evidenced by nearly $50 billion in net new flows into municipal bond funds. While there remains a lack of clarity about the details of tax policy under the incoming presidential administration, the broad outlines, especially related to SALT provisions and the extension of the 2017 TCJA, suggest lessening demand from tax-sensitive investors. Reciprocally, the fiscal health of municipalities, a growing economy, and a more accommodative Fed offer a favorable environment for municipal investors. When viewed in the aggregate, *we expect a supportive environment for municipal bonds, yet with elevated volatility surrounding legislative announcements.*

Confluence Fixed Income Strategy Committee

Mark Keller, CFA	David Miyazaki, CFA	Bill O'Grady
Greg Ellston	Kaisa Stucke, CFA	Patrick Fearon-Hernandez, CFA

Confluence Investment Management LLC

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