Fixed Income Quarterly

September 2024

Fed Policy Adjustment

- The recent 0.50% cut to the fed funds rate by the US Federal Reserve is indicative, we believe, of the beginning of a period of sequential rate reductions.
- Over the past year, savers have been rewarded by short-term rates in excess of inflation for the first time since the Great Financial Crisis (GFC).
- A normalization of the yield curve is unlikely in the near term.
- Focusing on intermediate-maturity bonds can help address the attendant risks in short- and long-term bonds.
- We continue to advocate for a slightly shorter-duration posture, with overweight exposures in Treasurys and MBS along with an underweight exposure to corporates.

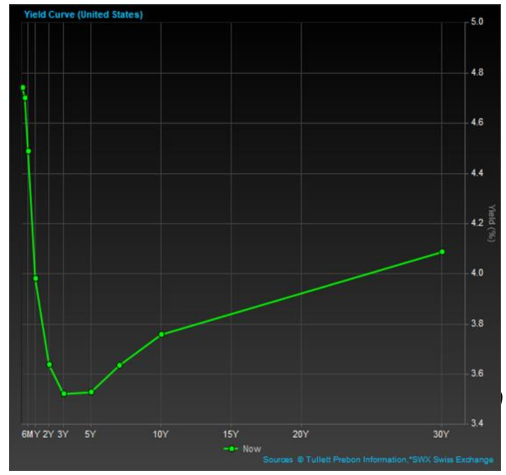
The US Federal Reserve reduced its fed funds rate by 0.50% on September 18th, representing the first rate reduction in four years. Our belief is that the size of the reduction reflects more of a correction from a missed opportunity in July, rather than an aggressive easing in response to economic concerns. This is based upon the release of the minutes of the Federal Open Market Committee (FOMC) from the end of the July meeting highlighting a shift in its attention from inflation to employment. Recent employment data has shown signs of easing and the Fed noted an optimistic outlook regarding the downward trajectory of inflation. Moreover, in his speech following the annual Fed meeting in Jackson Hole at the end of August, Federal Reserve Chair Jerome Powell stated the following:

> The time has come for policy to adjust. The direction of travel is clear, and the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks.
>
> We will do everything we can to support a strong labor market as we make further progress toward price stability. With an appropriate dialing back of policy restraint, there is good reason to think that the economy will get back to 2% inflation while maintaining a strong labor market.
>
> – Federal Reserve Chair Jerome Powell, Speech at Jackson Hole, 8/23/24

While both Powell's speech and the subsequent cut to the fed funds rate were welcomed by maket participants, the front-end of the yield curve remains steeply inverted, with short-maturity yields higher than longer maturities. The following chart indicates that the Fed would need to implement four additional cuts of 25 basis points each in order for the fed funds rate to yield less than the 10-

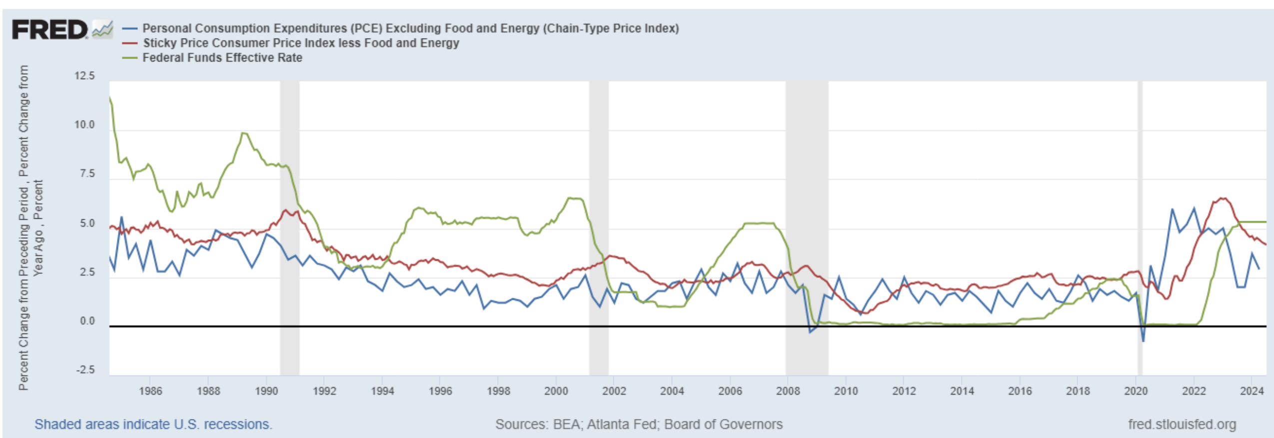
year Treasury, all else being equal. As a consequence, absent a sizable move higher in long rates or a drastic cut to fed funds, yield curve normalization is likely to occur well beyond this year.

Treasury Yield Curve, *9/20/2024*



Inflation and Rates

When viewed across the past 40 years, the fed funds rate has traditionally been in excess of both core CPI and the Fed's preferred inflation measure of core PCE, with the notable exception of the period of post-GFC through COVID. This is logical not only in the context of providing a real return to savers in excess of inflation, but also as the Fed's primary instrument in its attempt to maintain price stability. Although many market participants would hail a return to a normally sloped yield curve, the Fed's intransigence in cutting rates is consistent with its dual mandate of stable prices and promoting maximum employment. Therefore, the current inversion of the yield curve is likely to persist for an extended period of time as the Fed attempts to engineer a soft landing for the economy, obviously absent an exogenous shock or a sudden economic contraction.



Spreads on agency and corporate debt have been trading in tight relative ranges thus far this year, which is consistent with an economy in expansion. Should the Fed successfully introduce a modestly accommodative policy and avoid an economic contraction, these ranges could tighten further to historically narrow levels.

Although in modern history an inverted yield curve has served as a precursor to a recession, each business cycle is unique, and arguably so in the aftermath of a global pandemic. Accordingly, our expectations are for short rates to gradually decline as the Fed engages in a series of easing over an extended period of time. We note that longer maturities will remain risk exposed as that is the nature of long-duration instruments. Consequently, we find an intermediate-maturity posture to be preferable, with a duration slightly shorter than the benchmark.

Treasury Sector

Most bond investors are well aware of a time-tested way to lose money in the bond market: reach for yield. This approach, where an investor pursues yields in excess of what is generally available in the market, usually involves one of three maneuvers, or a combination of them: 1) accept high levels of credit risk; 2) accept high levels of interest rate risk; 3) accept high levels of structuring risk. Although the tradeoff of higher yields in exchange for these risks has probably existed since the dawn of modern bond markets, the incentive to reach for yield has been a common tack in recent decades, given the long-term, multi-decade disinflationary environment. Bond investors have often looked at what yields were available, only to yearn for the halcyon yields of yesteryear. Accordingly, reaching for yield has persisted, despite so often being part of unfortunate outcomes.

But in today's bond market, the circumstances are much different than in recent decades. The Fed began raising its overnight interest rate in response to inflation back in 2022 but maintained a tight posture, even as inflation declined. Because Treasury bills and money market yields tend to mirror the Fed's overnight rate, their real yield — the nominal yield minus inflation — is unusually high. This chart illustrates the real fed funds rate (fed funds upper bound minus CPI), with the light blue line at the zero level. Through most of this time frame, real short-term yields have been negative (below the blue line).

Fed Funds Rate Minus CPI, January 2000 to September 2024

(Source: Bloomberg)

Real short-term yields have not been at the current level since around 2007. Happily, investors have been able to partake in attractive yields without having to reach at all! But, conditions are changing and yield-seeking investors heavily allocated to the front end of the yield curve may now be exposed to a less-obvious risk: reinvestment risk. While this risk isn't as destructive as most other financial market risks, short-term yields will decline as the Fed eases and investors in the front end of the curve will have to reinvest into incrementally lower yields. Thus, in today's market, over-allocating to the front end of the curve is, in fact, another form of reaching for yield.

Fortunately, a relatively straightforward solution is available by allocating into intermediate maturities. Of course, the tradeoff is a lower yield caused by the inverted yield curve. But even with lower yields, bond investors can still capture attractive yields while limiting exposure to reinvestment risk as the Fed eases. This option is available without having to take on excessive credit, interest rate, or structuring risk. This opportunity hasn't been available very often in recent decades, but sometimes great solutions are the simple ones. We think that's the case today.

Corporate Sector

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

(Source: Bloomberg)

It hasn't happened very often, but it appears the Fed is likely to successfully achieve an economic "soft landing," where tighter policy slows growth enough to cool inflation, while avoiding a recession. Such a soft landing would be constructive for corporate bond investors in that the sector now offers attractive yields, yet the absence of a recession should help keep credit problems at a relatively low level. For these reasons, we think it makes sense right now for investors to include the corporate sector in their bond allocations.

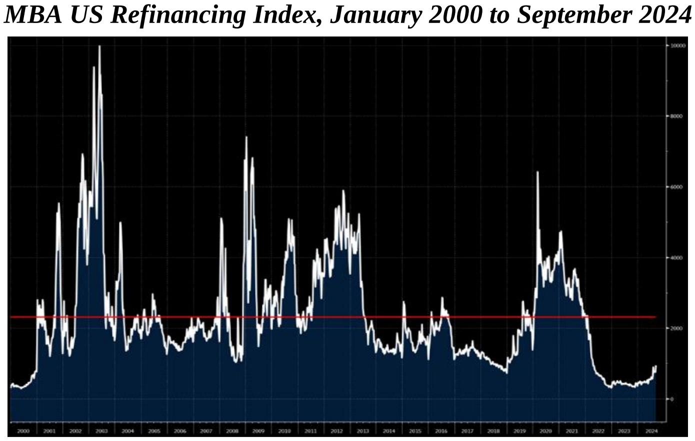
Still, much of the benefits of a soft landing are already priced into many corporates. In the chart above, we illustrate corporate bond spreads over the past 10 years, with the red line indicating the average level. Spreads are tighter than average and, for this reason, we believe a modestly underweight allocation is appropriate.

Mortgage-Backed Securities (MBS) Sector

Because of the embedded interest rate risk, mortgages are often considered the squirreliest of the major bond sectors. MBS holders are simultaneously short both a call option and a put option to mortgage borrowers. If interest rates decline, mortgage borrowers tend to refinance, which has the effect of calling higher coupon MBS and forcing investors to reinvest into lower yields; on the other hand, if interest rates rise, mortgage borrowers tend to hold onto their low-rate mortgages, which has the effect of extending MBS duration and putting lower coupons (and MBS prices) on investors. In bond parlance, this condition is broadly described as "negative convexity" and creates an impression where there are more ways to lose than to win.

In today's mortgage market, we see a rather unusual condition, one that hasn't manifested since the creation of modern MBS in the 1980s. When the Fed pulled out all the stops on easy monetary policy during the pandemic, mortgage rates reached unusually low levels. Many homeowners were able to take advantage of these low rates, with many locking in 30-year mortgages with rates in the 3-5% range. Then, as the Fed dramatically began to tighten in 2022, interest rates rose rapidly and mortgage rates rose in tandem. Homeowners fortunate to have low-rate rates recognized their good circumstance and oftentimes opted to not sell their homes in order to keep their mortgages. The normal cadence of

MBA US Refinancing Index, January 2000 to September 2024



(Source: Bloomberg)

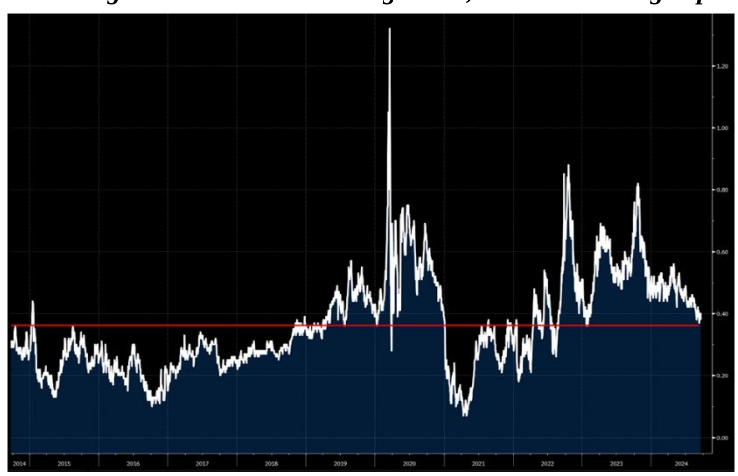
mortgage refinancing and MBS principal amortization slowed to historic levels as homeowners exercised a put of low rates on MBS investors. This effect is illustrated in the next chart showing the Mortgage Bankers Association (MBA) US Refinancing Index, going all the way back to the turn of the century, with the red line indicating the average level of refinancing volume.

With the massive decline in refinancing activity, MBS durations extended, which amplified the negative price effects of higher rates. Prices fell dramatically, particularly low coupon, fixed rate 30-year MBS, with many trading down to dollar prices in the 80s. Although this section of the journey wasn't enjoyable for MBS investors, we believe it's created a unique opportunity going forward.

With most existing mortgages well below new mortgage rates, refinancing volume remains historically low, even as it has increased a bit recently. This circumstance indicates incremental duration extension would be mild and unlikely. At the same time, fixed rate 30-year MBS prices remain well below par. From our perspective, these conditions combine to nearly eliminate the negative convexity that typically characterizes MBS. Specifically, if rates were to rise, MBS duration has already extended, thereby limiting or eliminating that phenomenon. On the other hand, if rates were to decline enough to create a rise in refinancing, investors would benefit because MBS prices are so deeply discounted to par (MBS principal amortization, including early repayments from refinancing, is repaid at par).

With limited duration extension risk, and potential refinancing upside caused by prices well below par, we find fixed rate 30-year Agency MBS particularly attractive. In many ways, their profile today is similar to Treasurys, even as incremental spread yield is currently available. This chart illustrates fixed rate 30-year MBS option-adjusted spreads (OAS) over the last 10 years. Despite low levels of negative convexity, spreads remain slightly above the long-term level (this may be caused, in part, by the overhang of the Fed allowing its MBS portfolio to amortize).

Bloomberg Fixed Rate MBS Average OAS, 10 Years Ending Sept. 2024



(Source: Bloomberg)

Because seasoned fixed rate 30-year Agency MBS pools have characteristics similar to Treasurys, we suggest an overweight allocation to MBS. Note that our favorable view toward MBS is not necessarily directed to current production MBS. These pools currently have wider spreads, but also have a convexity profile that is more typical of the MBS sector history.

Municipal Bond Sector

Following a decline in new issues last year, owing to the higher-rate environment, municipalities have thus far this year issued bonds at an accelerated rate. Year-to-date, municipal bond issuance increased 33% compared to 2023, with ample issuance ahead of the November US elections. While the increased supply of $37 billion in new issuance this year has largely been met with healthy demand from retail municipal bond investors, as evidenced by the net new flows to municipal bond funds and ETFs of over $21 billion year-to-date, the sheer size of the issuance has dampened returns of municipal bonds relative to Treasurys of the same maturity.

On a fundamental level, state and local governments remain sound as growth in tax receipts is 25% higher than before COVID and rainy day fund balances continue to notch record-high levels. Similarly, revenue bonds, especially in the essential services sectors, have had stable and growing receipts. Revenue bonds were further supported by an appellate court ruling regarding liens on revenue continuing even after bankruptcy filing of a borrower.

The municipal yield curve remains slightly inverted within 10 years of maturity. The muni curve has a technical uniqueness to it — owing to the 10-year call provision it is extremely unlikely that the longer end of the yield curve would invert, thus the inversion affects the front end of the curve. We continue to favor the intermediate segment of the curve, thereby avoiding reinvestment risk associated with short-term bonds and the more consequent price risk of longer-duration bonds.

Although municipal bond fundamentals are strong and yields remain attractive, several concerns tied to the November elections could have an outsized effect on municipal bond pricing, including the State and Local Tax (SALT) deduction, the level of the Alternative Minimum Tax (AMT) exemption, and the continuation of federally funded projects under the CHIPS and IRA legislation. Taken together, we approach the municipal bond segment with a degree of caution, encouraging a slight overweight to general obligation bonds (GOs) relative to municipal revenue bonds, with a slightly shorter duration posture through a laddered maturity structure.

Confluence Fixed Income Strategy Committee

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