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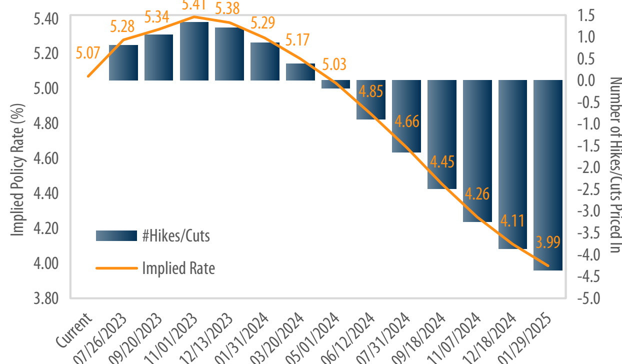
At the Federal Reserve's (the "Fed") June meeting, the committee held its target terminal Federal Funds rate steady at 5.00-5.25%, despite inflation remaining above its 2.00% target. While this may have seemed like reason to celebrate, the current target rate is still a whopping 500 basis points (bps) higher than it was in March 2022 when the Fed embarked on its tightening expedition. At the June meeting, Chairman Powell was clear in saying that "inflation pressures continue to run high, and the process of getting inflation back down to 2.00% has a long way to go," suggesting that future rate hikes remain under consideration.

Last quarter, we wrote about the bond market mispricing the Fed's willingness to win its battle with inflation. After all, back in March, the market not only expected that the Fed would stop raising rates, but that it would have to cut rates 3-4 times by January 2024. As such, we expected rates would snap back to the reality of higher for longer, perhaps again reaching a terminal range of 5.50-5.75%, where the market predicted rates were headed just before the emergence of the regional banking crisis. Today, forecasts for the Federal Funds rate are much more reasonable, in our view, with the peak terminal rate hovering near 5.50%, and holding above 5.00% through June 2024 (see Chart 1). As market expectations have changed, so too have interest rates across the treasury curve as yields continue to move higher particularly on the front-end of the curve where rates are most sensitive to Fed policy.

There is seemingly little debate today about whether the economy will soft land (in other words, no imminent recession). After all, the S&P 500 Index hovers near 4,500, almost 1,000 points higher than its bottom on October 13, 2022. Notably, however, the 2-year/10-year U.S. Treasury yield curve, which inverted last July and remains inverted by 106 bps today resides at its steepest inversion since the 1980's (see Chart 2). As we assess historical inversions alongside the ultimate timing of a recession, Milton Friedman's words about "long and variable lags" seem timely. In fact, when looking at prior recessions dating back to 1978 (excluding the government induced shutdown of the economy in 2020, given yield curves could not possibly predict such behavior), we find that, on average, after the 2-year/10-year yield curve inverts, a recession begins 453 days later. The median time frame is 503 days. By our count, the 2-year/10-year yield curve inverted 360 days ago. Furthermore, a recession typically begins, on average, 352 days after the 3-month/10-year yield curve inverts. The 3-month/10-year yield curve inverted last November and remains 148 bps inverted today. The median is 383 days. For reference, the 3-month/10-year yield curve inverted 234 days ago (see Chart 3). Consequently, we do not believe we are out of the proverbial hard landing (recession) woods despite the exuberant animal spirits in the equity market.

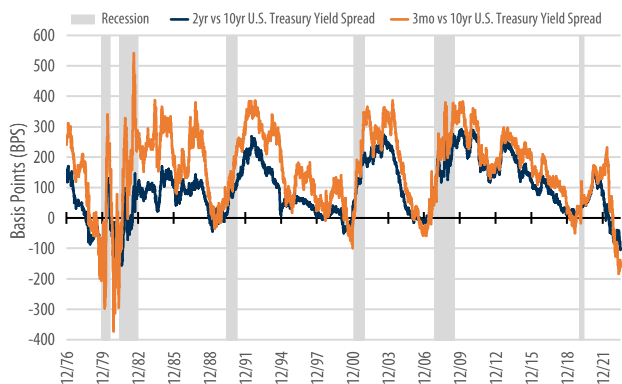
We expect the Fed to "leak" additional rate hikes into the market, albeit at a slower pace, and to hold rates higher until they are either (1) confident they have achieved their 2.00% inflation target or (2) believe they have weakened the labor market enough to spur a recession. However, today's fixed income markets are much more balanced when it comes to income and interest rate risk. While the Fed may still leak additional rate hikes into the market, we believe we are much closer to this hiking cycle's finish line than we are to its beginning. Consequently, the reinvestment risk inherent in owning short-term securities likely poses a greater risk than owning more duration, in our view. **As such, for the first time since the hiking cycle began, we have moved our duration target to 100% of the Bloomberg US Aggregate Bond Index's duration.** We continue to closely monitor the health of the labor market to gauge the timing of further duration extension. Finally, we continue to favor more defensive areas of fixed income (investment grade) over higher risk bond allocations.

### Chart 1: Implied Federal Funds Rate & Number of Hikes/Cuts as of June 30, 2023




Source: Bloomberg, as of 6/30/2023. The assumed rate movement for one rate hike or cut is equivalent to +/- 0.25%. There is no assurance forecasts will be achieved.

### 2-Yr/10-Yr U.S. Yield Curve & 3-Mo/10-Yr U.S. Yield Curve




Source: Bloomberg, as of 6/30/2023. Past performance is no guarantee of future results. The yield spread is the difference between yields on the varying Treasury maturities. A basis point is a common unit of measure for interest rates and is equal to 1/100th of 1% or 0.01%. A 1% change is equal to 100 basis points.

### Chart 3: Recession Indicators

| 2-yr/10-yr US Yield Curve Inversion Date | 3-mo/10-yr US Yield Curve Inversion Date | Recession Following Inversion | Days Since 2-yr/10-yr US Yield Curve Inversion | Days Since 3-mo/10-yr US Yield Curve Inversion |
|---|---|---|---|---|
| 8/17/1978 | 12/15/1978 | Jan 1980 - Jul 1980 | 503 | 383 |
| 9/11/1980 | 10/27/1980 | Jul 1981 - Nov 1982 | 293 | 247 |
| 1/5/1989 | 5/24/1989 | Jul 1990 - Mar 1991 | 543 | 404 |
| 2/11/2000 | 7/18/2000 | Mar 2001 - Nov 2001 | 384 | 226 |
| 6/8/2006 | 7/19/2006 | Dec 2007 - Jun 2009 | 543 | 502 |
| **7/5/2022** | **11/8/2022** | **TBD** | **360*** | **234*** |
| | | **Mean** | **453** | **352** |
| | | **Median** | **503** | **383** |

*Measures the time since inversion.

Source: Bloomberg. Data from 12/1/1967-6/30/2023. Past performance is no guarantee of future results. The yield spread is the difference between yields on the varying Treasury maturities. Inversion date was determined based on 30 successive days of the 2-Year US Treasury Yield and 3-Month US Treasury Yield being greater than the 10-Year US Treasury Yield.

## SECTOR POSITIONING

### Ultra-Short Maturity

The Fed has significantly increased short-term interest rates, benefitting the income potential from ultra-short securities, including commercial paper and short term corporate notes. While we anticipate further hiking from the Fed benefitting ultra-short securities, we're now far less concerned with interest rate risk. Instead, we believe reinvestment risk is likely the greater threat over the next year.

### Mortgage-Backed Securities

We hold a favorable view on mortgage-backed securities for two reasons. First, in the event of a hard landing or recession, we anticipate this asset class will outperform broader fixed income with exposure to credit risk. Additionally, valuations for mortgage-backed securities are currently significantly cheaper compared to their longer-term averages. The housing market is expected to be more durable, primarily due to constrained available inventory which resulted from homeowners locking in such low rates during the pandemic, which has supported prices. Given the continued volatility, we recommend maintaining hedged structures and defensive positions.

### U.S. Treasury Securities

We find investments in U.S. Treasury securities appealing to mitigate credit risk and extend duration, especially considering our belief that risk is increasing due to the economic impact of the Fed's tighter financial conditions. We anticipate relatively limited upside in U.S. Treasury yields in the intermediate and long part of the yield curve, as we believe the Fed is approaching the end of the tightening cycle. However, yields are likely to remain elevated as the Fed continues to combat persistent inflation in a robust labor market. Given our expectations of moderating interest rate risk, especially further out on the yield curve, and rising economic risk in the upcoming quarters, longer duration U.S. Treasuries appear attractive as part of an overall neutral benchmark duration strategy.

### High-Yield Bonds

We maintain a cautious stance on high-yield bonds due to elevated recession risk, deteriorating fundamentals, and declining corporate profits. Moreover, the headline default rate, although starting from low levels, is increasing and is expected to continue rising throughout this year and into 2024. This presents challenges in a market where we believe cracks are beginning to appear. While the average yield is near 8.5% and the average dollar price is below 90 in the high-yield market, offering relatively attractive carry and a potentially strong total return opportunity, we believe it prudent to be patient with respect to increases in below investment grade (IG) credit exposure, especially within safe fixed income mandates.

### Senior Loans

Bank loan valuations are currently favorable compared to long-term averages, and the yield advantage of loans over high-yield bonds has reached historically high levels. However, we believe it is important to note that weaker companies are facing increasing challenges due to tighter financial conditions. Of particular concern is the interest burden that higher leveraged companies face after such a rapid increase in interest rates. This has served to erode cash flow at a time when we're also anticipating worsening economic conditions and heightened recession risks. In light of these factors, we continue to have a higher quality bias within our loan allocations and will continue to exercise patience with respect to opportunities to increase exposure at appropriate valuations.

### Investment Grade Corporate Bonds

The IG credit market has held up better than expectations. We foresee modestly positive near-term returns as all-in-yields have increased to the point where income can offset the impact of spread volatility. In addition, we believe the Fed is closer to the end of their tightening cycle, which causes us to now view a neutral duration position as appropriate. Finally, we believe IG rated corporates have many available options to defend the balance sheet, such as reducing or pausing share buybacks, cutting capital expenditures, and/or selling non-core assets. Within the sector, we have a more favorable view on short and intermediate duration, since long duration corporate bonds are at greater risk of negative returns due to their higher price sensitivity to increased credit spreads. Thus, while we expect economic uncertainty to push spreads wider, we remain confident in the strength of the market and would view such an event as a buying opportunity.

### Preferred Securities

Preferred securities remain at compelling long-term valuations on both a yield-to-worst (7.78%)[1] and percent of par (88%)[2] basis, despite significant tightening since the March lows. However, the considerable volatility experienced in the first quarter of 2023 has reduced inflows into the space, limiting potential for near-term gains, in our opinion. U.S. regional banks, which remain a very small percentage of the overall preferred and hybrid securities market, have seen stabilized deposit flows, but continue to face challenges, including margin pressures and commercial real estate and recession risks. In contrast, European banks have been reporting robust results.

### Emerging Market Bonds

Emerging Market bonds currently offer attractive valuations and provide competitive levels of income, in our opinion. As we approach the end of the Fed's cycle of interest rate hikes, there is the potential for this to benefit holders of Emerging Market bonds, as it may exert downward pressure on the U.S. dollar. We believe fundamentals of Emerging Market economies are considered neutral, with several countries showing signs of continued moderate expansion, as indicated by their Purchasing Managers' Indices (PMIs) being above 50. Notably, central banks in Emerging Markets have shifted from hiking interest rates to pausing, reflecting a belief that inflation has peaked in a majority of countries in Latin America and Asia. However, it's important to consider the potential impact of a global risk-off event that triggers a flight to safe-haven assets, such as the U.S. dollar, as this could exert pressure on Emerging Market debt.

### Municipal Fixed Income

Fund flows and U.S. Treasury rate movements will be key drivers of municipal bond performance over the coming quarters, in our view. Despite negative flows of $7.7 billion[3] so far this year, strong demand from separately managed accounts and individual bond buyers have softened the impact, along with reduced new issuance. Municipal bonds are expected to deliver positive total returns across maturities, especially as longer-term rates are anticipated to decrease in the second half of the year. While credit fundamentals have remained relatively stable, we expect a gradual deterioration due to a weakening U.S. economy, subdued revenues, and a rising unemployment rate. We believe federal funding will support municipal credit this year, but the funds are depleting and will not be replenished. Although there have been more ratings upgrades than downgrades, municipal bonds are experiencing a higher number of negative outlook changes, which we believe will continue.

[1]Source: Stonebridge Advisors LLC, Bloomberg LP. As of 5/31/23.

[2]Source: ICE Data Services. As of 5/31/23 using monthly data.

[3]Source: Barclays and Investment Company Institute. As of 6/1/23.

**Definitions:**

The **Federal Funds Rate** is the interbank overnight lending rate for commercial banks' excess reserves. The **Implied Federal Funds Rate** for the U.S. is the estimated forward rate for the United States and is derived from Federal Funds Futures contracts to determine the probability of the Federal Reserve changing monetary policy at a particular meeting.

The **Bloomberg US Aggregate Bond Index** measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS, ABS and CMBS. Indexes are unmanaged and investors cannot invest directly in an index.

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