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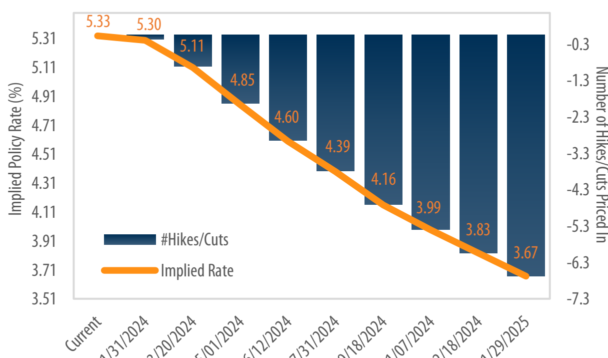
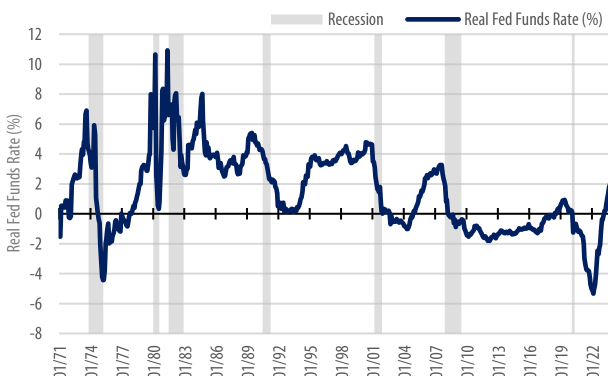
Chart 1: Implied Federal Funds Rate & Number of Hikes/Cuts



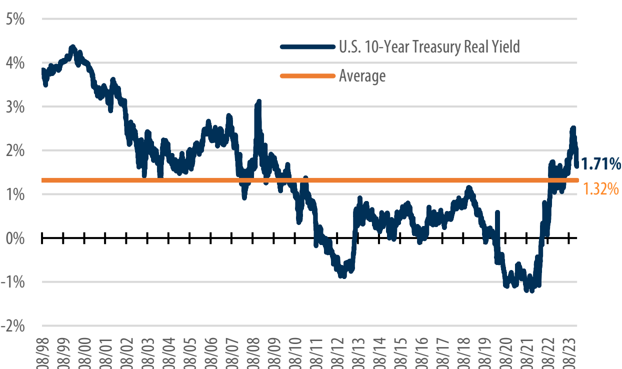
Source: Bloomberg, as of 1/2/2024. The assumed rate movement for one rate hike or cut is equivalent to +/- 0.25%. There is no assurance forecasts will be achieved.

Chart 2: Real Federal Funds Rate



Source: Bloomberg, FRED.12/31/1970-12/31/2023.

Chart 3: U.S. 10-Year Treasury Real Yield



Source: Bloomberg. Data from 8/3/1998 to 12/29/2023. Past Performance is no guarantee of future results. Real Yield is an interest rate that has been adjusted to remove the effects of inflation. Real Yield is calculated as the difference in yields between U.S Treasury bonds and Treasury Inflation-Protected Securities (TIPS).

A hawkish Federal Reserve ("Fed") meeting in September, strong third quarter GDP growth, and growing concern over the U.S. government's budget deficit whipsawed the U.S. Treasury market in the fourth quarter. As interest rates surged in October, Fed officials attempted to guide markets through public rhetoric; first, Lori Logan of the Dallas Fed explicitly noted the restrictive implications of higher interest rates with respect to financial conditions. Then, at the Fed's December policy meeting, Chairman Powell's public discourse around monetary policy decidedly shifted as he abandoned the "higher for longer" rate regime in favor of a "peak rate" regime, indicating the unlikelihood of future rate hikes. Moreover, the Fed's 2024 dot plot forecasted a 75 basis points (bps) decrease in the median Federal Funds rate by year-end.

Powell's shift was both overt and abrupt, marked by rallying equity markets and plummeting interest rates, forcing one to wonder if the market reaction to Powell's reversal was a little too much too soon. After all, the bond market is now pricing in approximately 150 bps of rate cuts in 2024 (Chart 1). In some respects, this may be Powell's "Treaty of Versailles." While the Treaty of Versailles marked the official end of World War I, it also contributed to the start of WWII as heavy reparations on the Germans led to social unrest. By abandoning rate hikes prior to achieving 2% inflation, while also signaling three interest rate cuts in 2024, we believe Powell signed his own metaphorical Treaty of Versailles, resulting in a substantial easing of financial conditions. Loose financial conditions now pose the risk of further interest rate volatility as well as a prolonged path to the Fed's 2% inflation objective, in our opinion.

Despite the significant drop in interest rates from the peak in October to today, we believe rates remain at attractive levels for two reasons. First, real rates appear adequate for the current inflation environment. The real Federal Funds rate is 2.35%, meaning the current Federal Funds rate is well above the Core PCE inflation rate (Chart 2). The real Federal Funds yield has not been this high since 2007. Furthermore, the real interest rate of the 10-year US Treasury is 1.71%, above the long-term average of 1.32% dating back to 1998 (Chart 3). Second, even after the sizable decrease in interest rates from the peak in October to today, the asymmetrical return available to bond investors given a 100 bps increase or decrease in interest rates remains favorable. (Chart 4). Said differently, we believe the yield ("carry") of today's market, coupled with the convexity (non-linear relationship between interest rates and bond prices) of today's market offers potential protection to investors.

Despite the risk of near-term interest rate volatility, driven by either a non-linear path to the Fed's 2% inflation target, or simply a reversal of the recent stark move in interest rates, our duration target remains 100% of the Bloomberg U.S. Aggregate Bond Index's duration for core fixed income. We suggest using any near-term elevation in Treasury yields (into the low 4% area on the 10-year U.S. Treasury) as a tactical opportunity to add duration. Finally, we continue to favor more defensive fixed income (investment grade) over higher risk bond allocations.

Chart 4: Bond Convexity is Back: Asymmetrical Return Profile

Treasury Maturity	Current Yield	12-month Total Return if Rates Increase +100bps	12-month Total Return if Rates Decrease -100bps
Two-Year	4.26%	2.42%	6.19%
Five-Year	3.85%	-0.56%	8.17%
10-Year	3.89%	-4.17%	11.67%
30-Year	4.05%	-12.91%	20.25%

Source: Bloomberg, as of 12/31/2023. Past performance is no guarantee of future results. Two-Year treasuries are represented by the ICE BofA Current 2-Year US Treasury Index. Five-Year treasuries are represented by the ICE BofA Current 5-Year US Treasury Index. 10-Year treasuries are represented by the ICE BofA Current 10-Year US Treasury Index. 30-Year treasuries are represented by the ICE BofA Current 30-Year US Treasury Index. Total return profiles in the above illustration assume an investor purchases the specified treasury maturity on December 31, 2023 and sells the investment 12-months later. 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. Yield for ICE BofA Current 2-Year US Treasury Index was 4.26% on 12/31/2023. Yield for ICE BofA Current Five-Year US Treasury Index was 3.85% on 12/31/2023. Yield for ICE BofA Current 10-Year US Treasury Index was 3.89% on 12/31/2023. Yield for ICE BofA Current 30-Year US Treasury Index was 4.05% on 12/31/2023.

SECTOR POSITIONING

Ultra-Short Maturity

The ultra-short space currently offers front-end investors the highest yields since 2007. Because of its defensive nature, this has been an attractive asset class during the rate hiking cycle. We expect yields to remain elevated in the near term even as the Fed's hiking cycle has most likely concluded, and the market anticipates a shift to the next cycle of rate cuts. Because yields on ultra-short securities, like commercial paper and short-term corporate bonds, are very responsive to rate moves by the Fed, we expect yields to trend lower in 2024.

Mortgage-Backed Securities

We hold a favorable view on the agency mortgage-backed securities market as valuations are more attractive than historical averages and we would expect them to outperform broader credit markets during both corrections in risk assets or a recession. Given elevated interest rate volatility, we favor agency mortgage-backed exposure in securities with more stable cash flow profiles. We are selectively seeking yield enhancement opportunities in commercial and non-agency sectors to complement a portfolio of more defensive agency-backed securities.

U.S. Treasury Securities

We believe U.S. Treasuries offer a ballast alongside the credit risk in our models given our expectations of lower economic growth or a recession. There is a fair amount of easing priced in, but if the economy slows, we expect Treasuries to benefit and would also view higher yields as more attractive entry points to add duration.

High-Yield Bonds

We expect positive total returns for high-yield bonds in 2024, but the path is dependent on the timing and scale of an anticipated economic slowdown. We believe tight credit spreads compared to recent averages suggest expectations of a soft landing, and if successful, could lead to attractive total returns due to robust income and discounted prices. However, default rates and bankruptcies are rising, and even though we do not believe they will materially exceed long- term averages, economic stress would likely result in a repricing of credit spreads partially offsetting attractive income characteristics. Therefore, we anticipate positive total returns in both scenarios within the next 12 months, but we will seek opportunities to increase exposure at more favorable valuations.

Senior Loans

Bank loan spreads are near the long-term average and the yield advantage over high-yield bonds is the highest on record, principally driven by the floating-rate component of bank loan yields. We expect positive total returns for senior loans, though will not increase exposure at this stage in the monetary cycle given the Fed's shift to a peak rate regime and the potential for lower rates in 2024. We believe the bank loan market has a weaker credit quality than the high-yield market and we favor exposure in credits that exhibit lower cyclicality to navigate economic weakness.

Emerging Market Bonds

We believe Emerging Market debt provides relatively attractive levels of income and potential for capital appreciation given our expectation for a weaker U.S. dollar as interest rates peak in the U.S. While a global risk-off event could increase Emerging Market volatility and pressure returns, we believe the attractive valuations of the asset class and the overvalued U.S. dollar could help mitigate its impact.

Investment Grade Corporate Bonds

We believe investment grade corporate bond yields are attractive on a historical basis, although they currently have lower credit spreads than long-term averages. We anticipate modest credit spread widening in a weaker economic environment with a bifurcation in performance between cyclical and non-cyclical sectors. We expect positive total returns as both income and lower expected interest rates would likely mitigate the impact of modest spread widening.

Preferred Securities

Strong returns have driven a turnaround of flows into preferred securities funds which we anticipate will continue as investors re-assess their allocations. Although recession risk appears to be delayed, we believe a cautious approach to credit risk is warranted given typical lagged effects of prior central bank tightening. Fundamentals remain robust for the highest quality banks, although we anticipate an increase in loan deterioration in some segments next year. In addition, European bank earnings have exceeded expectations. Meanwhile, we believe valuations remain attractive and elevated credit spreads suggest that significant risk is still being priced into the market. Overall, we anticipate positive returns driven by both income and capital appreciation.

Municipal Fixed Income

We have a positive outlook on total returns for municipal bonds. Muni-Treasury ratios, particularly in the shorter maturities, are on the richer side compared with the 3-year historical average. Additionally, we find high-yield new issues to be attractive. We do not anticipate any major tax or spending initiatives impacting municipal securities in 2024. Supply and demand technicals appear favorable in the first quarter of 2024 given expectations for negative net supply resulting from more cash in the form of bond calls, maturities and coupon payments than bond issuance. While the U.S. Treasury rally appears overextended, we moved to neutral effective duration.

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 **Real Federal Funds Rate** is the effective Federal Funds Rate minus 12-month core PCE inflation. The **Effective Federal Funds Rate** is the interest rate banks charge each other for overnight lending.

The **Bloomberg U.S. 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. The **ICE BofA Current 2-Year U.S. Treasury Index** is a one-security index comprised of the most recently issued 2-year U.S. Treasury note. The **ICE BofA Current 5-Year U.S. Treasury Index** is a one-security index comprised of the most recently issued 5-year U.S. Treasury note. The **ICE BofA Current 10-Year U.S. Treasury Index** is a one-security index comprised of the most recently issued 10-year U.S. Treasury note. The **ICE BofA Current 30-Year U.S. Treasury Index** is a one-security index comprised of the most recently issued 30-year U.S. Treasury note. Indexes are unmanaged and investors cannot invest directly in an index.

There can be no assurance that any of the trends and projections cited herein will continue or come to fruition.

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