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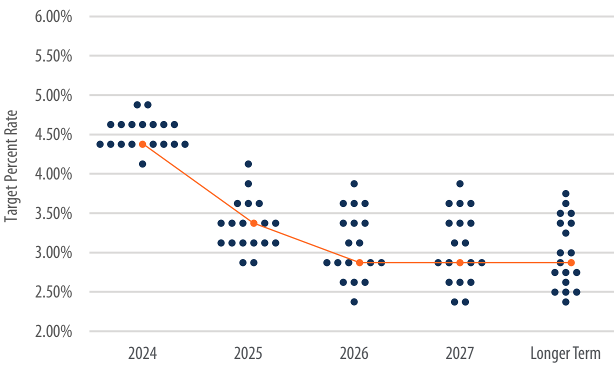
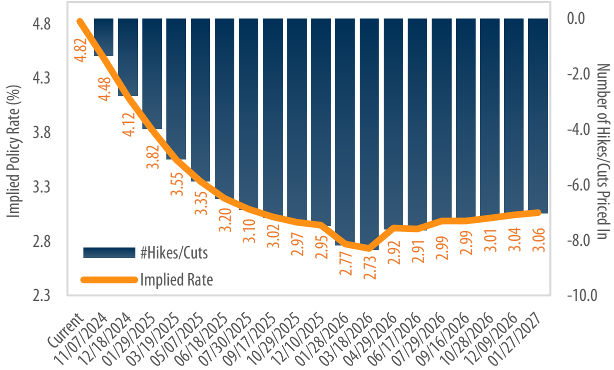
## Chart 1: Fed Dot Plot



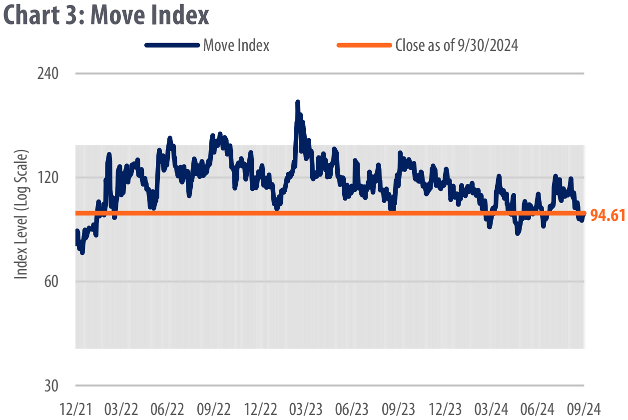

Source: Bloomberg. Data as of 9/30/2024. Orange dots are the FOMC Dots Median.

## Chart 2: Implied Federal Funds Rate & Number of Hikes/Cuts




Source: Bloomberg, as of 9/30/2024. The assumed rate movement for one rate hike or cut is equivalent to +/- 0.25%. There is no assurance forecasts will be achieved.

## Chart 3: Move Index




Source: Bloomberg. Data from 12/31/2021 to 9/30/2024. **Past performance is no guarantee of future results.** The ICE BofA MOVE Index is shown above. The area shaded in gray represents 2 standard deviations above and below the mean of the MOVE Index from 12/31/2021 to 9/30/2024.

After two years, six months and the equivalent of twenty-one 25 basis point ("bps") rate hikes, the Federal Reserve ("Fed") finally reversed course in September with a 50 bps interest rate cut, bringing the effective federal funds rate to 4.83%. The larger than expected move (most were looking for a 25 bps initial cut) was an intentionally bold start to the rate cutting cycle. The Fed hopes that beginning to remove some of the restrictiveness in monetary policy while growth and employment are still strong will act as an insurance policy against a hard landing of the U.S. economy. This, in the Fed's view, is made possible by inflation returning toward their 2% target. Downplaying fears that ongoing growth risks rekindling inflationary pressures, the Fed anticipates several additional interest rate cuts, with the median expectation seeing a return to a 3.375% federal funds rate by year-end 2025 (Chart 1).

The Fed is aware of the empirical difficulties involved with engineering a soft landing, either during or after a traditional rate hiking cycle. The challenge for the Fed is that history has shown that a well-intended tightening policy implemented to fight inflation (higher rates) can often result in unintended, deleterious consequences. To illustrate this point, economist Horst Siebert identified the phenomenon he coined the "Cobra Effect." In the early 1900's, when India was under British colonial rule, Delhi had a problem. It was infested with venomous cobras. As such, the British Government began offering a bounty for dead cobras. The program proved successful, at first. However, after a short while, the enterprising entrepreneurs of India began breeding cobras to make a profit. Once the British government realized what was occurring, they cancelled the bounty payments. Ultimately the bounty payments led to a greater population of cobras than when the program began! For the Fed, whether it is raising rates to fight inflation or cutting rates to protect the economy, it is working with imperfect information and therefore, exposed to a myriad of potentially harmful, unintended consequences.

As of the end of September, with two interest rate cuts in the books, the bond market is pricing in approximately 8 additional interest rate cuts (each cut represents 25 bps) by the end of 2025, with three of those rate cuts anticipated by the end of 2024. The bond market expects the federal funds rate to eventually land near 3.00% (Chart 2). We believe a terminal federal funds rate of 3.00% makes intuitive sense, especially with a backdrop of inflation returning to 2.00%. However, the path the bond market believes we'll take is far too sanguine in our view. We think there are too many rate cuts priced into the yield curve given the current state of the U.S. economy. As additional economic data is released, the timing and the quantity of rate cuts forecasted by the bond market are likely to adjust, removing some of the anticipated rate reduction from the yield curve. We expect two additional interest rate cuts in 2024, with one in November, the day after the presidential election, and another in December. In addition, our base case is that there will be four cuts in 2025, bringing the total to 6; approximately two fewer cuts than what the market believes today. As such, this will likely lead to modest upward pressure on interest rates across the curve, with the order of magnitude for higher rates in the tens of basis points, not hundreds of basis points.

The Fed, having cut 50 bps, brought us into a new phase of interest rate policy. While we expect interest rate volatility (Chart 3) to lift interest rates modestly as the bond market recalibrates its expectations for the timing and the quantity of interest rate cuts, we believe there now exists a structural tailwind to interest rates and the bond market broadly given that the Fed has entered the cutting phase of its policy. On a retracement higher in interest rates, if the 10-year U.S. Treasury yield crosses above 4.07%, we expect the move to peak at approximately 4.34%. In addition, the yield ("carry") of today's bond market, coupled with the convexity (non-linear relationship between interest rates and bond prices) may offer both additional protection and an attractive total return potential opportunity to investors. As such, our duration target is 100% of the Bloomberg Aggregate Index's duration for core fixed income.

## SECTOR POSITIONING

### Ultra-Short Maturity

Even as the Fed begins to cut interest rates, yields within the ultra-short category remain elevated compared to the last 15 years. We expect ultra-short assets to continue providing principal preservation and a real yield that is attractive and beneficial within an investment strategy.

### Mortgage-Backed Securities

We expect mortgage-backed securities to provide a ballast relative to broader credit markets during a potential correction in risk assets or a recession. Index agency mortgage-backed securities are concentrated in low coupon securities which results in lower levels of income while spreads are near historic averages. As volatility remains elevated, we continue to prefer defensive positions and would selectively look to enhance yield in commercial and non-agency sectors.

### U.S. Treasury Securities

U.S. Treasuries are pricing in significant easing from the Fed. While we expect rates to decline over time, we believe it will be slower than what is currently priced in the market as inflation remains above the Fed's target despite trending lower. We expect that U.S. Treasuries would provide a ballast against sectors exposed to credit risk if economic conditions were to deteriorate faster than expected.

### High-Yield Bonds

We believe high yield bonds offer compelling yields and discounted prices, despite tighter than average credit spreads as risk assets continue to price in a soft-landing scenario. Under these conditions, we expect high yield bonds to provide attractive returns driven by interest income and the potential for price appreciation as the relatively short duration of the asset class leads to heavier refinancing and a pull to par for discounted bonds. Should economic conditions deteriorate, our analysis indicates that current yield levels and the potential impact from falling interest rates could provide a substantial buffer against spread widening. Moreover, we believe active management and a bias towards higher quality issuers in less cyclical industries should also prove more durable than an index-based approach through time.

### Senior Loans

Senior loans continue to offer a high level of income with their floating rate structure and balanced credit risk as the default rate remains very low in the asset class. As the Fed continues to reduce interest rates in this cutting cycle, we would expect income from senior loans to gradually decline. As such, we believe investors will be seeking more fixed rate coupon options in an attempt to lock-in current yields while they are available, which may result in outflows from retail funds.

### Emerging Market Bonds

We view the Fed beginning its rate cutting cycle this month as a catalyst for positive returns in local currency emerging markets debt and provides policy flexibility for central banks that have already paused their easing cycles such as Mexico, Brazil and Indonesia. Our medium-term view is for the U.S. dollar to continue to weaken, however the outcome of the U.S. elections provides some uncertainty. We believe emerging market currencies remain attractively valued, and paired with expectations for a weakening U.S. dollar, provide an opportunity in local currency emerging markets debt even as yields have fallen over the quarter.

### Investment Grade Corporate Bonds

We believe investment grade corporate bond yields are attractive and supportive of demand for the sector despite credit spreads that remain below historical averages. Fundamentals remain relatively healthy. However, we expect a bifurcation in valuations between cyclical and non-cyclical sectors over time and, as such, careful credit selection is imperative. We also expect more risk associated with longer term securities given more exposure to spread duration.

### Preferred Securities

The preferred and hybrid securities market has outperformed other fixed income asset classes this year driven by high levels of income and spread compression. We believe credit fundamentals across major segments of the preferred market (banks, insurance, utilities, and energy) remain solid with pockets of weakness in lower quality consumer finance portfolios of some North American banks. We maintain a cautious approach to REITs, riskier regional banks and consumer finance banks and favor moving up in quality in European banks and increasing exposure to regulated utilities.

### Municipal Fixed Income

We expect positive total returns in the short and ultra-short strategies while intermediate and longer duration performance is expected to be highly dependent on the direction of interest rates, especially after the election. Historically, September and October are months of elevated supply, a headwind followed by negative net supply in November and December which could potentially lead to a year-end rally. The outcome of the U.S. elections and potential tax implications of divergent policy proposals are significant for the municipals market, as higher tax rates benefit the taxable equivalent yield of municipal bonds. Moreover, the scheduled expiration of various components of individual tax rates within the Tax Cuts and Jobs Act may have various implications for municipals such as tax brackets, various deductions and the number of taxpayers subject to Alternative Minimum Tax (AMT); all of which can affect demand for municipal bonds. While we believe most municipal debt is fairly valued, there is some value in select lower investment grade and high yield Munis in the 11–21 year portion of the yield curve.

**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 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 MOVE Index** is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options. It is the weighted average of volatilities on the CT2, CT5, CT10, and CT30 (weighted average of 1m2y, 1m5y, 1m10y, 1m30y Treasury implied vols with weights 0.2/0.2/0.4/0.2, respectively). Indexes are unmanaged and investors cannot invest directly in an index.