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After the Federal Reserve's ("Fed") December 2023 meeting, the bond market priced in six interest rate cuts of 25 basis points ("bps") each in 2024, driving interest rates lower into year-end. The market's premature and overzealous assessment stood in stark contrast to the Fed's very own forecast of just three interest rate cuts of 25 bps each in 2024. However, at the Fed's March 2024 meeting, as the committee reiterated its expectation for three rate cuts in 2024 after strong economic growth and sticky inflation colored the first quarter, bond investors reduced their expectation for additional cuts, ultimately aligning the market's expectations with those of the Fed (Chart 1).

As bond investors adjusted their assumptions regarding future rate cuts, the 10-year U.S. Treasury yield increased from 3.88% at 2023 year-end to 4.20% as of March 29, 2024, while the 2-year U.S. Treasury yield increased from 4.25% to 4.62% over the same period. Following the interest rate reset in the first quarter, investors may wonder if we are still traversing the "River of Doubt," the famous 470 miles of perilous and uncharted waters that nearly cost Teddy Roosevelt his life in the early 1900s. However, we believe that interest rates are fairly valued for three reasons.

First, our base case is that the Fed will cut rates two times in 2024 based on current economic data and inflation. Thus, our expectation is that short-term rates finish the year slightly higher than the market's forecast. However, yields are unlikely to run significantly higher from today's levels, in our view. We expect a 10-Year U.S. Treasury yield of approximately 4.50% to 4.60% to be the extent of an upward move. In addition, pushing one rate cut from the current year into 2025 would likely result in only modest upward pressure on the front end of the yield curve, in our opinion.

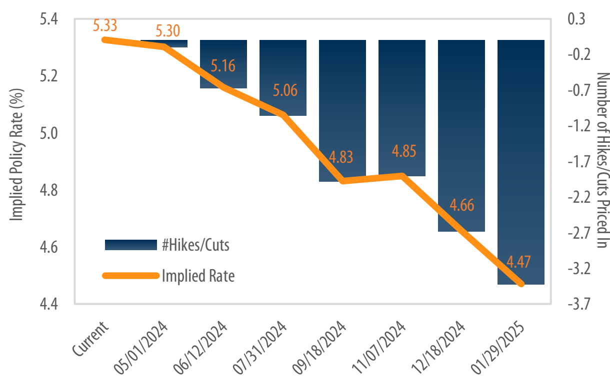
Second, we believe **real rates**, or, inflation adjusted interest rates, are the **real reason** the Fed will trim interest rates prior to achieving their ultimate target of 2% inflation (Chart 2). While the Fed has not increased interest rates this year, the current real Federal Funds rate of 2.72% is higher than the 2.56% real rate at 2023 year-end. In addition, the real 10-year U.S. Treasury yield is nearly 2% as the market prices in an inflation rate of approximately 2.30% over the next decade. We believe a real 10-year U.S. Treasury yield of 2% offers adequate cushion against a stickier than expected inflation rate. Moreover, the Fed has acknowledged that current rates are sufficiently restrictive; in other words, the Fed is not inclined to support a significant increase in real interest rates from current levels for fear of spurring a significant economic slowdown.

Finally, two years have passed since the Fed's first interest rate hike of this cycle, and roughly eight months have passed since the Fed's last rate hike. While interest rates have indeed remained higher for longer, interest rate volatility has declined as the Fed has shifted from an "increasing rate regime" to a "peak rate regime" (Chart 3). Importantly, we believe lower interest rate volatility should result in calmer water for bond investors.

In summary, as it pertains to interest rates, we are no longer forced to traverse the River of Doubt. The market's interest rate expectations now appear reasonable, real rates are sufficient for the current inflation environment, and interest rate volatility is declining. Further, we believe the yield ("carry") of today's bond market, coupled with the convexity (non-linear relationship between interest rates and bond prices) offer additional protection to investors.

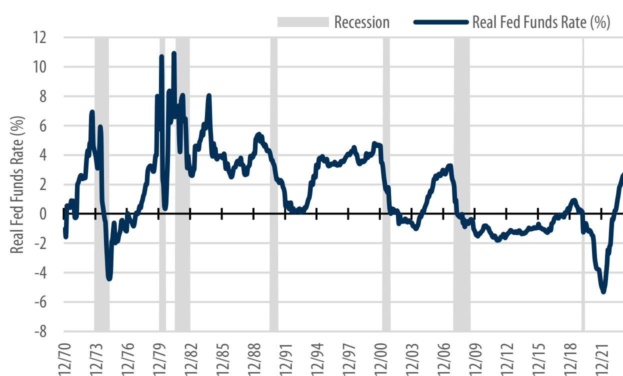
Our duration target has extended to approximately 105% of the Bloomberg U.S. Aggregate Bond Index's duration for core fixed income. Finally, we continue to favor more defensive fixed income (investment grade) over higher risk bond allocations.

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



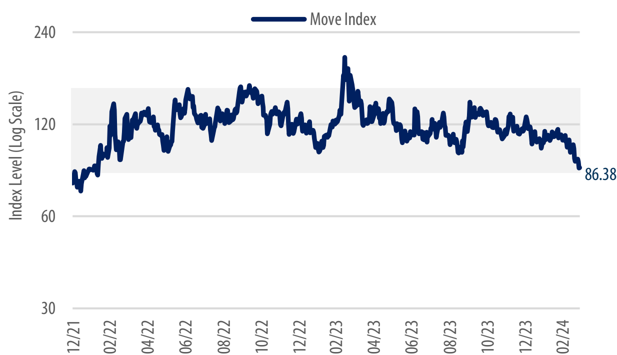
Source: Bloomberg, as of 3/29/2024. The assumed rate movement for one rate hike or cut is equivalent to +/- 0.25%. There is no assurance forecasts will be achieved.

Chart 2: Real Federal Funds Rate



Source: Bloomberg, FRED.12/31/1970-3/31/2024.

Chart 3: Move Index



Source: Bloomberg. Data from 12/31/2021 to 3/28/2024. Past performance is no guarantee of future results. The ICE BofA MOVE Index is shown above. The area shaded in gray represents two standard deviations above and below the mean of the MOVE Index from 12/31/2021 to 3/28/2024.

SECTOR POSITIONING

Ultra-Short Maturity

With yields around 5%, the ultra-short space provides investors a relatively attractive level of absolute and risk adjusted return. However, we expect yields will move lower later this year as economic momentum slows and the Fed adjusts monetary policy. As a result, we expect the positive impact on bond prices from falling interest rates will have a greater impact on longer duration asset classes compared to ultra-short duration asset classes.

Mortgage-Backed Securities

We have a favorable view of mortgage-backed securities where valuations are attractive relative to longer term averages on elevated volatility. We look to mortgage-backed securities to provide a ballast relative to broader credit markets during a correction in risk assets or a recession. 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

We believe Treasuries offer a fairly priced ballast alongside credit risk in the models after the market has taken out the aggressive easing that was priced in the market towards the end of 2023. Accordingly, we would view higher rates as attractive entry points to add U.S. Treasury duration and would expect Treasuries to offset weakness in risk assets if economic conditions sour.

High-Yield Bonds

We expect positive total returns for high-yield bonds this year as we believe high levels of income, paired with discounted prices should largely mitigate credit spread widening if default rates increase in an economic slowdown. Moreover, should the economy experience a soft landing we would expect an attractive total return. Given credit spreads are tight relative to longer term averages and appear to be pricing in a soft-landing scenario, we would look to add exposure at more attractive valuations.

Senior Loans

Bank loan spreads are near long term averages and continue to provide the greatest yield advantage over high-yield bonds on record driven by the floating rate component of bank loan yields. We expect high levels of income to be the principal driver of positive total returns this year. The Fed's shift in monetary policy is likely to result in lower interest rates, however the significant yield advantage of senior loans relative to other fixed-income asset classes may provide an opportunity to enhance income as a satellite position in more diversified portfolios. As the bank loan market is composed of companies with weaker credit quality, we emphasize the importance of active management into sectors with less cyclical exposure.

Emerging Market Bonds

The market has repriced the U.S. easing cycle to later this summer, and the U.S. dollar has traded in lockstep, though it has not reached the highs seen in the third quarter of 2023. Fed easing later this year could weigh on the U.S. dollar, where valuations are at a historically high level, which would support emerging market debt. Emerging Market central banks continue to engage in easing cycles in countries where real rates are high and domestic inflation has fallen. China's growth uncertainty continues to be a challenge, but high commodity prices point to an unlikely collapse in growth. Emerging Market fundamentals are showing strength as purchasing manager indexes (PMIs) are mostly above 50 and, on aggregate, higher than Developed Markets.

Investment Grade Corporate Bonds

Like many pockets of fixed-income, corporate bond valuations are expensive relative to longer-term averages. However, corporate bonds have been supported by strong credit fundamentals and attractive all-in yields. As such, we expect positive total returns as falling yields and attractive carry mitigate the impact of wider spreads. We believe a disciplined approach to credit selection will be paramount as we move through the remainder of this business cycle as we expect more economically sensitive sectors to underperform.

Preferred Securities

Year-to-date through February, preferred and hybrid securities have outperformed other fixed-income asset classes, driven by spread tightening. Looking forward, we expect that most of the return will be in the form of coupon payments until we see rates move lower from their current range. Yields and discounts are still attractive, with yields at around 7% and discounted prices near 94% of par. Credit fundamentals have remained resilient, with some pockets of deterioration in commercial real estate and consumer finance. Market technicals are strong, with new issuance garnering large order books and investment-grade corporate buyers participating in the higher quality parts of the preferred and hybrid securities market to lock in incrementally higher yields.

Municipal Fixed Income

We expect positive total returns for short and long-term municipal bonds for the full 2024 calendar year, predicated on our base case calling for lower Treasury yields as the Fed begins to ease around mid-year. However, spring (March-April) is historically a weak technical period for the municipal bond market, as heavy amounts of new issue supply and fund outflows around Federal income tax deadlines as investors sell municipals to cover tax liabilities result in a temporary supply-demand imbalance. Muni-Treasury ratios remain rich compared to 3-year averages especially in the 5 and 10-year portion of the municipal yield curve, while credit fundamentals remain relatively healthy. By the end of the year, we expect longer duration strategies with a high yield component to produce the highest total returns in the sector.

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 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.

There can be no assurance that any of the trends and projections cited herein will continue or come to fruition. References to specific securities should not be construed as a recommendation to buy or sell and should not be assumed profitable.

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