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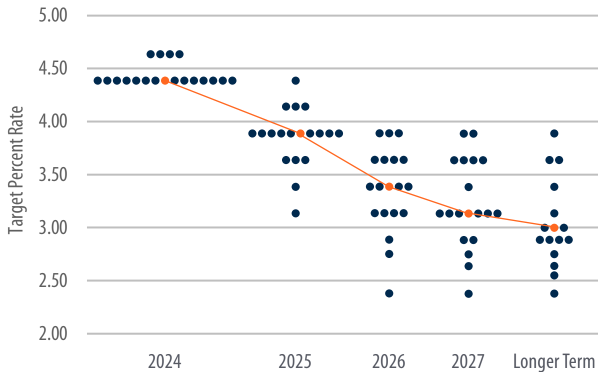
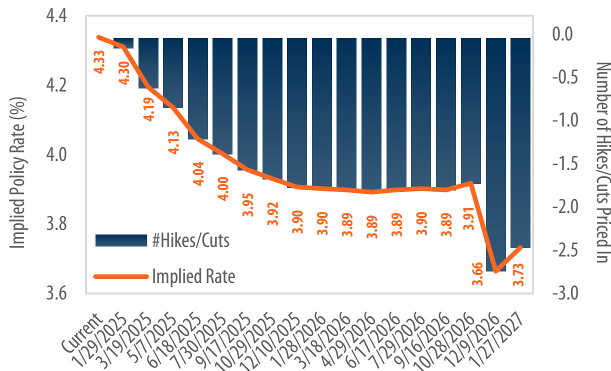
Chart 1: Fed Dot Plot



Source: Bloomberg. Data as of 12/31/2024. Orange dots are the Federal Open Market Committee Dots Median.

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



Source: Bloomberg, as of 12/31/2024. The assumed rate movement for one rate hike or cut is equivalent to +/- 0.25%. There is no assurance forecasts will be achieved.

In a twist that defies conventional wisdom, the Federal Reserve ("Fed") has cut interest rates by 100 basis points ("bps") over the course of its last three meetings, and yet U.S. Treasury yields moved markedly higher. Since the day before the September Fed meeting, the 2-year U.S. Treasury yield has climbed by 64 bps, the 5-year yield by 94 bps, and the 10-year yield by 92 bps. While the Fed's recalibration of monetary policy aimed to remove some of its restrictiveness, its effects have been mixed. Mortgage rates have pushed higher, even as financial conditions—viewed through the lens of rising equity prices—have eased. Reflecting its less certain outlook, the Fed adjusted its 2025 forecast, removing two anticipated rate cuts compared to its September projections. By year-end 2025, the Fed now projects a median Federal Funds Rate of 3.875%, highlighting ongoing uncertainty about growth and inflation trajectories. (Chart 1)

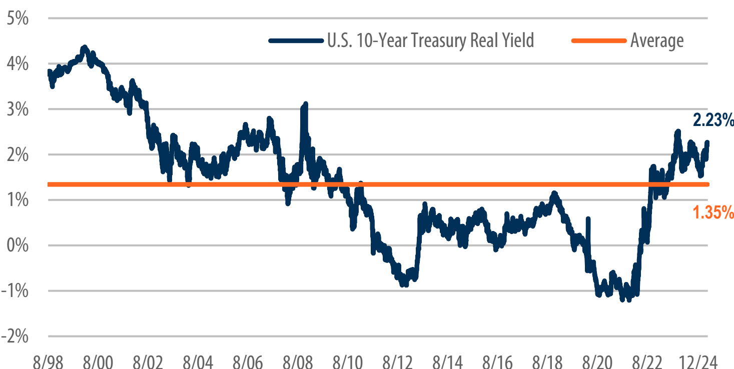
This unwind of previously expected interest rate cuts has been a significant driver of the recent increase in Treasury yields. In September, the yield curve priced in a more aggressive rate-cutting cycle, which has since been revised as economic data demonstrated resilience. This shift in market expectations has contributed to the sharp upward adjustments in yields across maturities, reflecting a rebalancing of assumptions about the Fed's path.

However, the pendulum may have swung too far. With only two rate cuts now priced in for 2025 (Chart 2), the bond market may offer an attractive entry point for investors. Real yields—adjusted for inflation—are at appealing levels (Chart 3), especially when assessed against current and anticipated inflation rates, providing a compelling case for intermediate duration bonds. This suggests that the market may have overreacted to the Fed's more conservative stance, creating opportunities for those who may have thought they missed the opportunity to lock in higher yields.

Meanwhile, the policies of the new administration introduce significant uncertainty into the bond market, casting a shadow reminiscent of the Sword of Damocles. While concerns about ballooning budget deficits or surging inflation persist, we believe the reality is likely to be more nuanced. Proposals such as tariffs, extending existing tax rates, potential additional tax cuts, and deregulation are set to interact in intricate and unpredictable ways with the broader economy. Adding to this complexity, the U.S. dollar strengthened approximately 8% during the fourth quarter of 2024 (Chart 4), creating a potential headwind for multinational corporate earnings and exerting downward pressure on hard commodity prices, including oil—factors that could temper inflationary pressures. Although this uncertainty looms over the bond market, we believe it does not necessarily signal a dire outcome. On the contrary, when viewed holistically, these policy shifts are unlikely to result in dramatic increases in deficits or inflation, ultimately mitigating extreme concerns and offering a degree of stability and reassurance for fixed income markets, in our opinion.

In this dynamic landscape, where prevailing narratives often dominate until challenged by new data, investors are advised to stay both vigilant and opportunistic. We believe the bond market, shaped by attractive real yields and adjusted policy expectations, presents compelling opportunities for those prepared to capitalize on its potential for strong returns.

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



Source: Bloomberg. Data from 8/3/1998 to 12/31/2024. **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).

Chart 4: Weekly U.S. Dollar Index (DXY)

Source: Bloomberg. Data as of 12/31/2010-12/27/2024. **Past performance is no guarantee of future results.** U.S Dollar Index is represented by DXY Index.

SECTOR POSITIONING

Ultra-Short Maturity

Fed rate cut expectations have moderated since the end of last quarter and the Fed has signaled that they expect to reduce interest rates at a slower pace next year, as yields within the ultra-short category remain elevated compared to the last 15 years. We believe ultra-short assets will continue to provide principal preservation and a real yield that is attractive and beneficial within an investment strategy.

Mortgage-Backed Securities

We believe mortgage-backed securities provide a ballast relative to broader credit markets during a potential correction in risk assets or a recession. Mortgage valuations appear to be 'fair' value and are in-line with the historical average. With continued volatility, we prefer defensive exposure and selectively positioning for yield enhancement opportunities in the commercial and non-agency securitized sectors.

U.S. Treasury Securities

Given recent changes in the Fed's outlook, U.S. Treasury market participants are pricing in about 100 bps fewer cuts by the end of 2025 than they were at the end of September. Over time, we believe further yield curve steepening, which could come in the form of further pressure on the long-end of the yield curve from funding large deficits with greater U.S. Treasury issuance and/or the Fed slowly cutting interest rates back to neutral. We believe that U.S. Treasuries would provide a ballast against sectors exposed to credit risk in case of either a market correction or deteriorating economic conditions.

High-Yield Bonds

We believe high yield bond valuations are attractive relative to yields and prices, however, in our view, credit spreads are expensive as risk markets continue to price in a soft landing economic outcome. Should these conditions persist, we believe high yield bonds will provide attractive returns driven by income and the potential for price appreciation as their relatively short duration 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 would provide a substantial buffer against spread widening, especially considering that the high yield market now has a greater composition of BB rated (higher quality) credit relative to history. We believe actively managing towards higher quality issuers would prove more durable should conditions worsen.

Senior Loans

Senior loans continue to offer a high level of income because of their floating rate structure and balanced credit risk as the default rate remains very low in the asset class. The slow pace of anticipated interests rate cuts is likely to support the yield advantage of the senior loan asset class relative to other areas of the market. In our view, valuations between high yield bonds and senior loans favor loans, however, the strong demand for senior loans is driving substantial refinancing in loans to lower spreads, suggesting this relationship may compress.

Emerging Market Bonds

The U.S. dollar has been very strong over the last quarter as U.S. interest rates have recalibrated to fewer interest rate cuts over the next year, while Emerging Market central banks continue to ease. Moreover, U.S. trade policy uncertainty clouds the outlook for the beginning of 2025. We believe Emerging Market currencies remain attractively valued, however momentum in the sector has turned negative as U.S. administration uncertainty has replaced U.S. Federal Reserve policy uncertainty.

Investment Grade Corporate Bonds

Investment grade corporate bond yields remain just below their highs in 2009, which we believe provides support to credit spreads that are below historical averages. Fundamentals remain sound though we believe a bifurcation in valuations between cyclical and non-cyclical sectors over time and for credit selection to be critical. We believe more risk to be associated with longer term securities given more exposure to spread duration.

Preferred Securities

We believe that the combination of strong market technicals, high income potential and the high quality issuer base may provide insulation against a weaker economic environment, characterized by lower rates and wider spreads. Credit fundamentals across the major sectors in the preferred securities market (banks, insurance, utilities, energy) have progressed through 2024 largely as expected, with generally stable credit profiles. We believe more defensive positioning into utilities with significant underweights (or no exposure at all) to real estate investment trusts (REITs), riskier regional banks and consumer finance banks is appropriate along with an increase in quality allocation across European banks.

Municipal Fixed Income

We believe 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. For the first quarter of 2025, we believe that projected net-negative municipal supply coupled with continued strong fund flows and stable to improving credit quality will support solid performance for municipals, especially relative to other fixed income asset classes. We view valuations to be slightly rich, but that nominal and tax equivalent yields are attractive to long term averages. Tax policy will take center stage in 2025 as Congress works to extend the Tax Cuts and Jobs Act of 2017. As in 2017, we believe that initial tax proposals could contain several changes for municipals that are later modified or dropped as the legislation is negotiated.

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 **U.S. Dollar Index (DXY)** indicates the general international value of the U.S. Dollar (USD). The index calculates this by averaging the exchange rates between the USD and major world currencies.

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