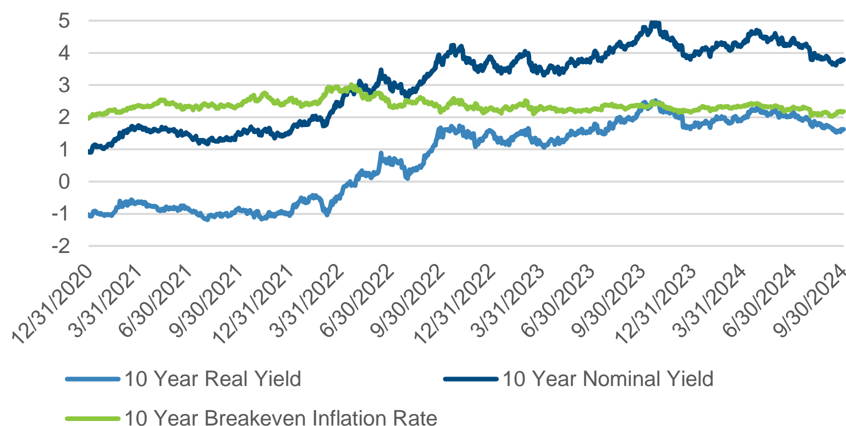
Fixed Income Shines Amid Fed Rate Cuts and Economic Shifts

Julia Zhu
Senior Vice President, Market and Security Research

Market Recap

After a relatively challenging first half of the year, fixed income investments saw an encouraging turnaround in the third quarter, with the U.S. Aggregate Bond ETF index climbing 5.2%. The robust fixed income performance was boosted by the Fed's 50 basis points interest rate cuts as a response to moderating inflation and signs of a softening labor market. The 10-year U.S. Treasury yields declined substantially during the quarter, contributing to the impressive performance in the fixed income assets. The nominal 10-year yield ended the quarter at 3.78%, compared with 4.40% at the end of the previous quarter. The decrease in real yield contributed primarily to the shift, with real yield down by 45 basis points for the quarter, while inflation expectations, measured by the 10-year inflation breakeven rate, saw a marginal decrease from 2.28% at the end of the second quarter to 2.18% (Exhibit 1).

Exhibit 1: Treasury Yields Declined in the Third Quarter of 2024



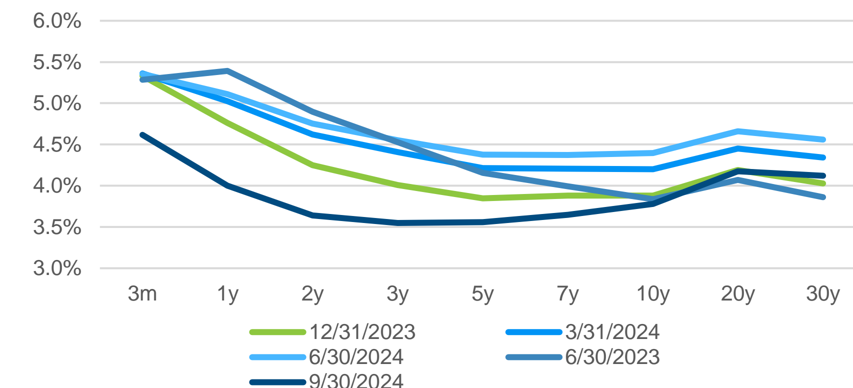
Source: Bloomberg.

In the third quarter, Treasury yields across all maturities decreased significantly and the yield curve went through a notable change, with a shift from a prolonged inverted state to a more normal curve. This normalization occurred when the spread between the 10-year yield and the 2-year yield inched to positive territory in September, marking an end to the inverted yield curve that had persisted since June 2022 (Exhibit 2). However, other segments of the yield curve, such as the closely watched 3-month to 10-year spread, remained inverted (Exhibit 3).

Exhibit 2: U.S. Treasury 10-year Minus 2-year Yield

Source: Bloomberg.

Exhibit 3: U.S. Treasury Yield Curve



Source: Bloomberg.

Macro Landscape

Growth Slowdown: Recent economic data showed some resilience in the U.S. economy, but there remain expectations of a gradual slowdown. The July payroll reports showed a weaker-than-consensus job creation, with payroll employment rising by only 114,000 in July. At the same time, an increase in the unemployment rate to 4.3% from 4.1% triggered the threshold of a recession indicator, the "Sahm rule," sparking recession fears in the market in August. August payroll data slightly improved, rising to 142,000, still weaker than expected. Moreover, the previous two months' job growth figures were revised down significantly by 86,000 combined.

Also, the manufacturing sector is contracting, as evidenced by the ISM Manufacturing Index remaining below the 50 neutral level at 47.2. The housing market continued to struggle despite slightly lower mortgage rates, with existing home sales falling in August by 2.5% to a seasonally adjusted annual rate of 3.86 million. On the positive side, U.S. consumers continued to demonstrate resilience. Consumer spending (in real terms) remains robust, with its third straight month of healthy growth of 0.4%, but the savings rate dipped to 2.9%, raising concerns about sustainability. Although retail sales only grew by 0.1% in August, a noticeable slowdown from July, total sales year-over-year increased by 2.1%, slightly higher than expected.

Moderating inflation: After an uptick in price pressures in the first quarter of the year, inflation moderated again in the third quarter, with the headline CPI increasing 0.2% in August, resulting in a decrease in the year-over-year inflation rate from 2.9% to 2.5%, the lowest level since March 2021. Core CPI (excluding food and energy) rose 0.3% in August, with year-over-year growth remaining at 3.2%. The modest upside surprise in core CPI was primarily driven by an acceleration in shelter inflation (a 0.5% rise), though the owners' equivalent rent (OER) metric does not reflect actual costs households incur. Other major components of CPI, including food inflation, new vehicles, and used vehicles, remained subdued. Moreover, the Fed's preferred measure of inflation, the core Personal Consumption Expenditures (PCE) index, rose 0.1% in August, in line with expectations, with the annual rate ticking up from 2.6% in July to 2.7% in August.

We project inflation will continue to fall, with core PCE reaching the Fed's 2% target by the end of next year. According to the Fed's latest projections released during its September meeting, the median forecast for core PCE stood at 2.2% in late 2025. Although shelter inflation is currently driving most of the core CPI growth, housing inflation has further room to fall, as indicated by leading indicators of newly signed rent leases, contributing to overall inflation cooling. Also, the potential further interest rate cuts from the Fed later this year may lead to lower inflation expectations.

Easing Fed policy: For the first time since the COVID-19 pandemic, the Fed cut its policy rate by 50 basis points at its September 2024 meeting, lowering the Fed funds rate to a range between 4.75% and 5%. This decision was primarily driven by signs of moderating inflation and recent weakening payroll data. As to the concerns about whether the Fed was “behind the curve,” Chairman Powell addressed that the FOMC believes that the U.S. economy “is strong overall,” and he does not see “anything in the economy right now that suggests that the likelihood of a downturn is elevated.” We now project 25bps cuts at the Fed’s November and December meetings, thus leading to a 1% lower Fed funds rate by the end of this year.

Market expectations have adapted accordingly. During the third quarter, market expectations about the Fed’s schedule for policy easing changed significantly. As of 09/30/2024, the Fed funds futures market forecasted a Fed funds rate of 3.9% by January 2025, compared with 4.8% forecasted at the end of the second quarter.

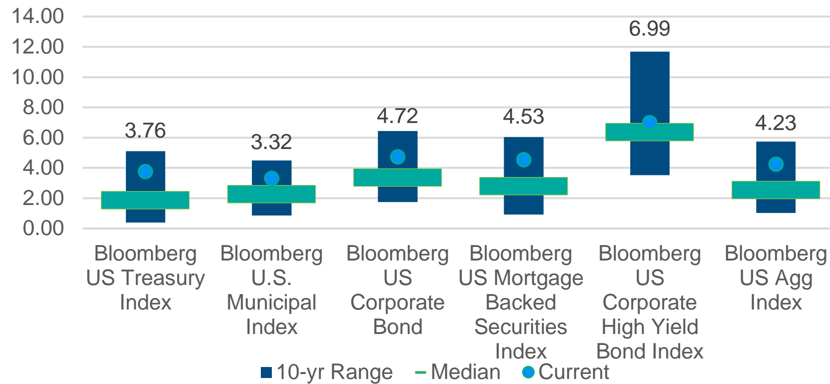
Fixed Income Outlook

Given today’s high yields, a moderating inflation outlook, and the Fed’s easing policy, we view fixed income investments as remarkably appealing to provide attractive income, capital gain potential, downside protection, and diversification through reduced correlation with equity markets. In the following discussion, we will focus on the following three main themes:

1. Yields still look attractive
2. Fixed income investments following the Fed’s easing cycle
3. Additional benefits of investing in global bond markets

First, despite the recent Fed interest rate cuts, yields remain at the highest levels in over a decade and significantly above the ultra-low levels in the post-2008 era. For example, the Bloomberg US Aggregate Bond Index yield currently stands at 4.2%, compared to the medium level of 2.5% over the last ten years (Exhibit 4). Also, with moderating inflation, current bond yields offer decent real returns after being adjusted for inflation. The current high yields create an advantage for investors who can secure these higher yields now, potentially insulating themselves from reinvestment risk if rates decrease in the future. Therefore, we feel strongly that now is the time to lock in the historically elevated yields and take advantage of the higher income potential.

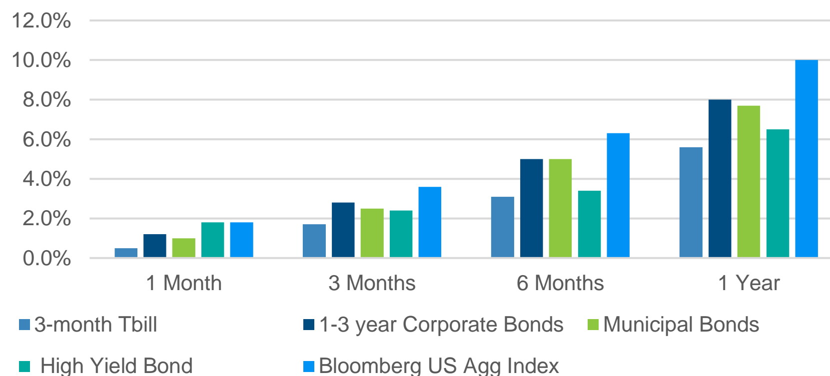
Exhibit 4: Yields Across Fixed Income Assets



Source: Bloomberg.

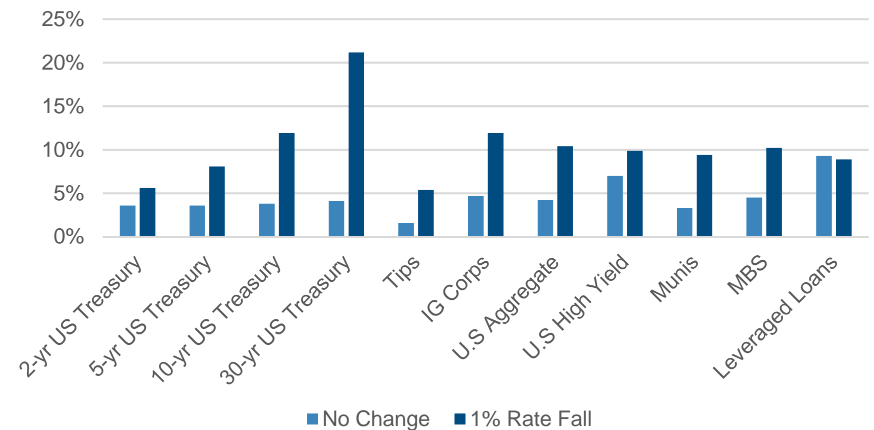
Second, bonds historically outperformed cash after rate cuts begin. While cash can feel like a safe haven and has provided high yields with Fed interest hikes, history shows that cash underperforms other fixed income assets once the rate cutting cycle begins. In the last seven cutting cycles, cash returned on average 3.1% in the six months post-cut, compared to 6.3% from the Bloomberg U.S. Aggregate index (Exhibit 5). Fixed income total return can be boosted significantly from capital gains when interest rates decrease in the future, especially for longer-duration bonds, which are more sensitive to rate changes. Exhibit 6 illustrates the impact a 1% interest rate fall could have on different assets of fixed income investment, assuming a parallel shift along the yield curve.

Exhibit 5: Fixed Income Asset Class Performance After First Fed Rate Cuts



Source: Bloomberg.

Exhibit 6: Fixed Income Asset Class Performance With 1% Rate Fall, Assuming a Parallel Shift of the Yield Curve



Source: Bloomberg.

Third, investing in global bonds becomes particularly attractive with the Fed cutting interest rates and the dollar is likely to depreciate. This offers several benefits: 1) currency diversification as the value of foreign currency-denominated bonds will benefit from a weaker dollar when they convert back to the US dollar; 2) yield enhancement as some foreign markets offer higher yields; 3) portfolio diversification effect by exposure to varied economic conditions. At the same time, however, investors should be cautious of any additional risks, such as currency volatility and geopolitical factors.

Investment Implications

Against the backdrop of a moderating economic outlook, cooling inflation, and the beginning of the Fed's easing cycle, we found today's fixed income market remarkably attractive. While we still favor high-quality bonds, we emphasize the importance of active management as each sub-sector of fixed income has unique characteristics and risks, especially in the current changing interest rate environment. We are neutral in duration in our more static portfolios and slightly overweight duration in our more dynamic portfolios. For YTD as of September 30, 2024, our Dynamic Income strategy returned 4.6% net of fees, outperforming the Global Aggregated Bond Index and U.S. Aggregate Bond Index by 1.0% and 0.2%, respectively. In the third quarter, we focused on several key themes in our strategies, outlined below:

- **Slightly extended duration:** While current cash yields are still high, we expect cash yields to decline and duration likely to outperform with the Fed's easing cycle. Therefore, we moved out along the yield curve and have trimmed SHY (iShares 1-3 Year Treasury Bond ETF) and slightly added our exposure to IEF (iShares 7-10 Year Treasury Bond ETF) and TLT (iShares 20+ Year Treasury Bond ETF) during the quarter.

- **Trimmed bank loan exposure:** With the Fed beginning to ease, we expect BKLN's (the Invesco Senior Loan ETF) attractiveness of variable interest rates to diminish due to its lack of duration. In our portfolio, we have trimmed our exposure to BKLN from 7% to 3%, and BKLN has underperformed the Bloomberg U.S. Aggregate Bond Index by 3.0% during the third quarter.

- **Interest rate hedged vs. unhedged corporate bonds:** We divested our position in IGBH (iShares Interest Rate Hedged Long-Term Corporate Bond ETF) and increased our allocation to IGLB (iShares 10+ Year Investment Grade Corporate Bond ETF) at the beginning of third quarter. In a Federal Reserve easing environment, the interest rate hedging strategy becomes less effective and potentially detrimental to performance as rates fall. At the same time, given moderate economic growth, the fundamentals of the investment-grade credit sector remain relatively steady. IGLB has outperformed IGBH significantly by 6.5% during the third quarter.

Important Disclosure Information

The information contained herein has been prepared by NorthCoast Asset Management ("NorthCoast") on the basis of publicly available information, internally developed data and other third-party sources believed to be reliable. NorthCoast has not sought to independently verify information obtained from public and third-party sources and makes no representations or warranties as to accuracy, completeness or reliability of such information. All opinions and views constitute judgments as of the date of writing without regard to the date on which the reader may receive or access the information and are subject to change at any time without notice and with no obligation to update. This material is for informational and illustrative purposes only and is intended solely for the information of those to whom it is distributed by NorthCoast. No part of this material may be reproduced or retransmitted in any manner without the prior written permission of NorthCoast. NorthCoast does not represent, warrant or guarantee that this information is suitable for any investment purpose, and it should not be used as a basis for investment decisions. ©2024 NorthCoast Asset Management.

NorthCoast Asset Management is a d/b/a of, and investment advisory services are offered through, Kovitz Investment Group Partners, LLC (Kovitz), an investment adviser registered with the United States Securities and Exchange Commission (SEC). Registration with the SEC or any state securities authority does not imply a certain level of skill or training. More information about Kovitz can be found at www.kovitz.com.

PAST PERFORMANCE DOES NOT GUARANTEE OR INDICATE FUTURE RESULTS.

This material should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any securities or investment products or to adopt any investment strategy. The reader should not assume that any investments in companies, securities, sectors, strategies and/or markets identified or described herein were or will be profitable and no representation is made that any investor will or is likely to achieve results comparable to those shown or will make any profit or will be able to avoid incurring substantial losses. Performance differences for certain investors may occur due to various factors, including timing of investment. Investment return will fluctuate and may be volatile, especially over short time horizons.

INVESTING ENTAILS RISKS, INCLUDING POSSIBLE LOSS OF SOME OR ALL OF AN INVESTMENT.

The investment views and market opinions/analyses expressed herein may not reflect those of NorthCoast as a whole and different views may be expressed based on different investment styles, objectives, views or philosophies. To the extent that these materials contain statements about the future, such statements are forward-looking and subject to a number of risks and uncertainties.