NorthCoast Fixed Income Outlook Q4 2024 | December 31, 2024

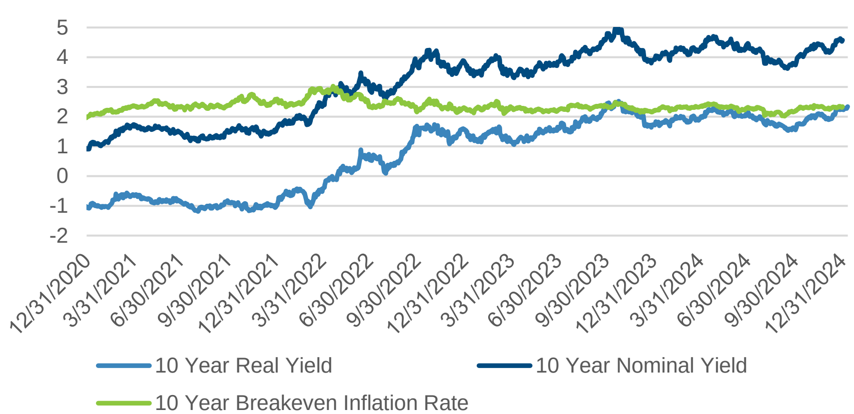
Fixed Income Perspectives: Navigating Volatility and Opportunities in 2025

Julia Zhu
Senior Vice President, Market and Security Research

Market Recap

Fixed income investments have seen some significant volatility in the fourth quarter. While the Bloomberg U.S. Aggregate Index (AGG) returned 5.20% in Q3, posting its second-highest quarterly performance since 1996, the index has since underperformed, returning -3.1% in the fourth quarter. The underperformance can be attributed to reduced expectations of aggressive rate cuts. These expectation changes were due to upside economic data surprises and renewed inflation concerns, particularly in light of proposed policies by President-elect Trump and the Fed's hawkish-looking interest rate projections for 2025. The 10-year U.S. Treasury yields climbed during the quarter, with the nominal 10-year yield ending the quarter at 4.57%, compared with 3.78% at the end of the previous quarter. The increase in real yield contributed primarily to the shift, with real yield up by 61 basis points for the quarter, while inflation expectations, measured by the 10-year inflation breakeven rate, saw a moderate increase from 2.18% at the end of the third quarter to 2.34% (see Exhibit 1).

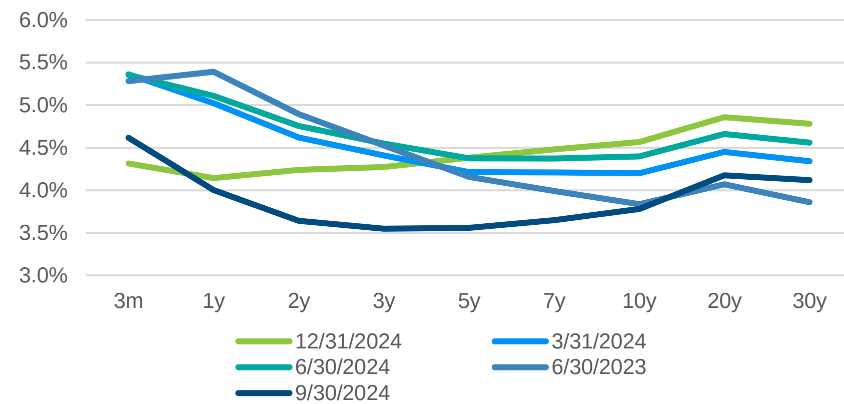
Exhibit 1: Treasury Yields Declined in the Fourth Quarter of 2024



Source: Bloomberg.

In the fourth quarter of 2024, Treasury yields across all maturities increased significantly except the three-month yield, leading to further normalization of the yield curve. At the end of September, the yield curve turned positive after a prolonged period of inversion, with the 10-year and 2-year Treasury yield spread at 0.14%. In the fourth quarter, the steepening trend of the yield curve continued, with the spread of 10-year and 2-year yield increasing to 33bps, which might suggest increased investor optimism about economic growth prospects (see Exhibit 2).

Exhibit 2: U.S. Treasury Yield Curve



Source: Bloomberg.

Macro Landscape

Resilient economy: The U.S. economy demonstrated some resilience recently, with Q3 GDP growth coming in at 3.1%. The most significant contributor to the growth has been consumer spending, which accounted for about 70% of real GDP growth in the last three quarters. Retail sales grew at a healthy pace for three consecutive months in the third quarter, with total sales rising by 0.7% in November after rising by an upwardly revised 0.5% in October. Also, business investment has been robust, with accelerating AI investment trends presenting significant upside growth potential. At the same time, housing market sentiment seems to improve with the NAHB

Housing Market Index continuing to rise, largely driven by the Fed's easing monetary policy.

We see the U.S. economy likely to achieve a soft landing – moderating growth and inflation without a recession. The main risks are slowing activity and labor market growth. Labor markets are cooling but remain relatively healthy at this stage, with the three-month average of payroll numbers ending in November at 173k, more in line with expectations. However, other measures, such as quit rates, have continued to decline. In the coming year, we see consumption is likely to contribute less to economic growth as the pent-up savings has largely faded. The household savings rate has recently dropped to 4.4%, below the historical average. Also, the manufacturing sector, facing sluggish global demand, has seen weak job growth and volatile new order activity. Other risks include potential policy changes of tariffs, immigration, fiscal policy and its implication of inflation and economic growth.

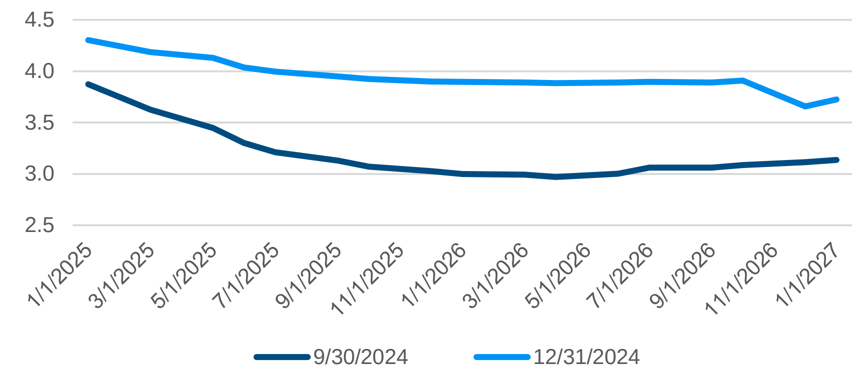
Inflation concerns: The fourth quarter inflation came in a bit stickier than expected but remains on a general trajectory of moderation. Both the November headline CPI and core CPI (excluding food and energy) increased by 0.3% from October. On a year-over-year basis, headline CPI edged up from 2.6% to 2.7%, while core CPI held steady at 3.3% for three consecutive months. The encouraging news is that shelter inflation, a key component of CPI, slowed significantly in November, with owners' equivalent rent rising only 0.2%, its smallest increase since early 2021. Meanwhile, producer prices increased more than anticipated, with PPI for final demand rising 0.4%, pushing the annual rate up from 2.6% to 3%, the highest level in about two years. The higher-than-expected PPI number may lead to potential upward pressure on consumer prices in the near future. Additionally, core PCE inflation, a key inflation measure, remained at 2.8% in November, higher than six months earlier, prompting the Fed to revise its 2025 inflation forecast upward to 2.5%.

We project inflation will continue to moderate in the coming year, though the trajectory remains uncertain. While shelter and services prices showed signs of slowing, their cooling is essential for broader inflation improvement. Base effects from early 2024 price increases will likely contribute to the ease of annual PCE inflation rates by early 2025. However, uncertainty surrounding potential tariffs and the incoming administration's policies could drive goods inflation higher.

A more cautious Fed: Following the substantial 50 basis rate cut in September, the FOMC cut its policy rate by 25 basis points at both its November and December meeting, bringing the Fed funds rate to a range of 4.25% to 4.5%. While the cut was largely expected, the FOMC's latest Summary of Economic Projections indicated a more cautious approach to policy easing in the coming year. The median committee member now expects only 50 basis points in rate cuts for 2025, down from the 100 basis points projected in its September meeting. At the same time, with the recent inflation proving to be stickier, FOMC's inflation projections have been revised upward: the median forecast for the PCE deflator by the end of 2025 increased from 2.1% to 2.5%.

Market expectations have adapted accordingly. During the fourth quarter, market expectations about the Fed's schedule for policy easing have changed significantly. As of 12/31/2024, the Fed funds futures market forecasted a fed fund rate of 3.9% by December 2025, compared with 3.0% forecasted at the end of the third quarter (see Exhibit 3). We now pared back the pace of the Fed's easing cycle, expecting the Fed to lower its policy by 50 basis points in the coming year.

Exhibit 3: Fed Fund Rate Implied by the Futures Market



Source: Bloomberg.

Fixed Income Outlook

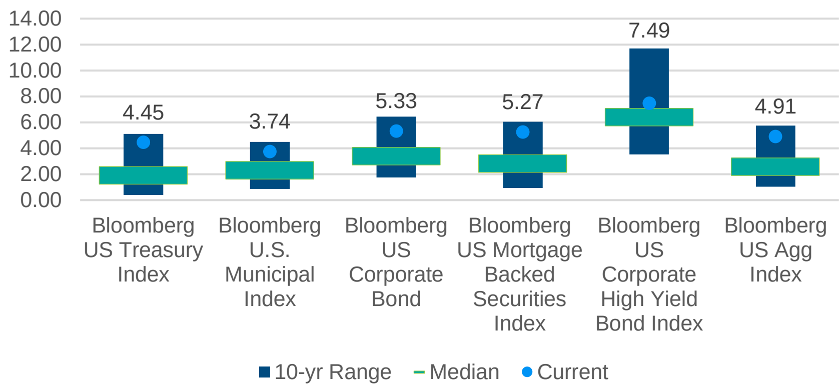
We believe that asset allocation decisions to invest in fixed income will prove rewarding in 2025, though we also anticipate some market volatility. The combination of high yields, moderating inflation, sound corporate fundamentals and the Fed's easing policy could provide investors with attractive income, capital gain potential and downside protection. In this commentary, we would like to highlight the following three main themes:

1. Yields are still attractive in both nominal and inflation-adjusted terms
2. Policy uncertainty could influence the Fed's easing cycle

3. Dynamic investment strategies are the keys to navigating uncertainty

First, current yields are still near the highest levels in more than 15 years. The Bloomberg US Aggregate Bond Index (AGG) yield currently stands at 4.9%, compared to the medium level of 2.6% over the last ten years (see Exhibit 4). Higher starting yields have significantly enhanced income potential and are strongly correlated with the future total return of fixed income investments. For example, historical data demonstrated that for the AGG Index, the yield-to-worst (YTW) explained more than 90% of the five-year forward return.

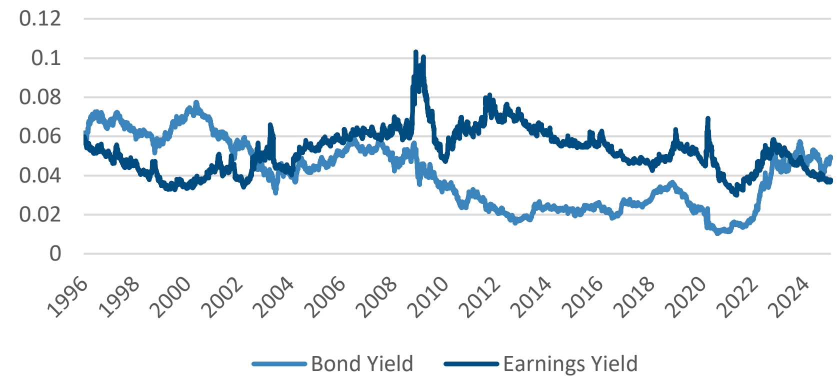
Exhibit 4: Yields Across Fixed Income Assets



Source: Bloomberg.

Also, current bond valuations are attractive relative to equity. As shown by Exhibit 5, the yield on the Bloomberg U.S. Aggregate Index has surpassed the earnings yield of the S&P 500 Index earnings yield. We feel strongly that now is the time to lock in the historically elevated yields and take advantage of the higher income potential while helping reduce overall risk in a portfolio.

Exhibit 5: Bond Yields vs. S&P 500 Earnings Yield



Source: Bloomberg.

Second, The Trump administration is expected to introduce a set of policy changes, including higher tariffs, lower taxes, and immigration reforms. The Trump economic agenda emphasizes imposing tariffs on US imports, including a 10% blanket tariff and a 60% tariff on Chinese imports. While full implementation is unlikely and the impact is not anticipated until late 2025, tariffs could have a stagflationary impact. On tax policy, the Trump Administration plans to extend all expiring tax cuts from the Tax Cuts and Jobs Act (TCJA) as well as additional cuts for domestic manufacturers, which could add significant deficits over the next decade. The impact of immigration may be less inflationary as the current supply and demand for labor are more balanced.

Overall, the combination of tariff policies, fiscal spending, and tax cuts is likely to heighten inflationary pressures, which could push up the Fed's terminal interest rate and influence the pace of rate cuts. For fixed-income investors, these expectations are reflected in the yield curve, which has shifted higher due to increased inflation expectations and rising term premia linked to the growing federal deficit. While Chair Powell has emphasized the Fed's independence, the potential policy changes could complicate the Fed's policy decisions.

Third, in the current environment characterized by policy uncertainty, inflation concerns, and shifting Federal Reserve policy, active management and dynamic investment strategies are becoming more critical in fixed income investments. In our base case of soft landing – moderating growth and inflation without a recession, high-quality duration asset-backed securities and corporate credit, including investment grade, high yields, and convertibles, will benefit. If risks such as renewed inflation or geopolitical shocks lead to recession, fixed income investments, especially sovereign bonds, will still perform well.

As we enter a period of potential policy changes, active managers can dynamically adjust their portfolios to navigate the complexities under different economic scenarios, especially as the Fed continues its easing cycle while maintaining the balance between inflation pressures and growth risks. In today's fast-changing markets, we believe portfolio managers' ability to make dynamic decisions on duration and sector allocation is especially rewarding. In addition, we constantly explore opportunities beyond traditional fixed income sectors to achieve higher risk-adjusted returns.

Investment Implications

A moderating economic outlook, uncertainty around interest rates and potential policy shifts together with potential market volatility create a supportive environment for active fixed income investors, especially with an additional boost from falling interest rates. Historically, bonds have demonstrated strong performance during soft landings and even better in more challenging landing scenarios. 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 2024, our Dynamic Income strategy returned 3.6% net of fees, outperforming the Global Aggregated Bond Index and U.S. Aggregate Bond Index by 5.2% and 2.3%, respectively. In the fourth quarter, we focused on several key themes in our strategies, outlined below:

- **Investment grade credit:** We believe investment grade bonds can enhance portfolio returns in the current environment and the coming year. Tight credit spreads are supported by solid credit fundamentals and investors seeking yield. Also, potential policy changes such as corporate tax cuts and fewer regulations could bolster corporate earnings, further supporting high-quality corporate credit.

- **Mortgage-backed securities:** We kept a significant allocation to U.S. agency mortgage-backed securities through investing in MBB (iShares MBS ETF), as the MBS sector appears attractively valued and was supported by solid fundamentals.

- **Inflation-linked bonds:** Adding to an allocation of inflation-linked bonds is appealing, with recent higher expected inflation and inflation proving to be more persistent than anticipated. Also, the proposed policy changes from the Trump administration, such as tariffs and tax cuts, could potentially be inflationary, making TIPS an attractive investment. We recently added modest exposure (2%) to iShares TIPS Bond ETF (TIP).

- **Convertible bonds:** Convertible bonds offer a unique combination of equity upside potential and downside protection. Convertible's exposure to growth-oriented sectors allows them to outperform other fixed income investments during equity market rallies while offering downside protection when equities decline. Also, the convertible bond market provides access to some companies that do not issue traditional corporate debt. We have a modest exposure (2%) to SPDR Bloomberg Convertible Securities ETF (CWB).

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.

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.

NorthCoast
Asset Management