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SUMMARY

- Fed has kicked off an aggressive rate cutting cycle.
- We believe this should be good for the economy and stocks...
- ...but we think most of the decline in bond yields has likely already occurred.

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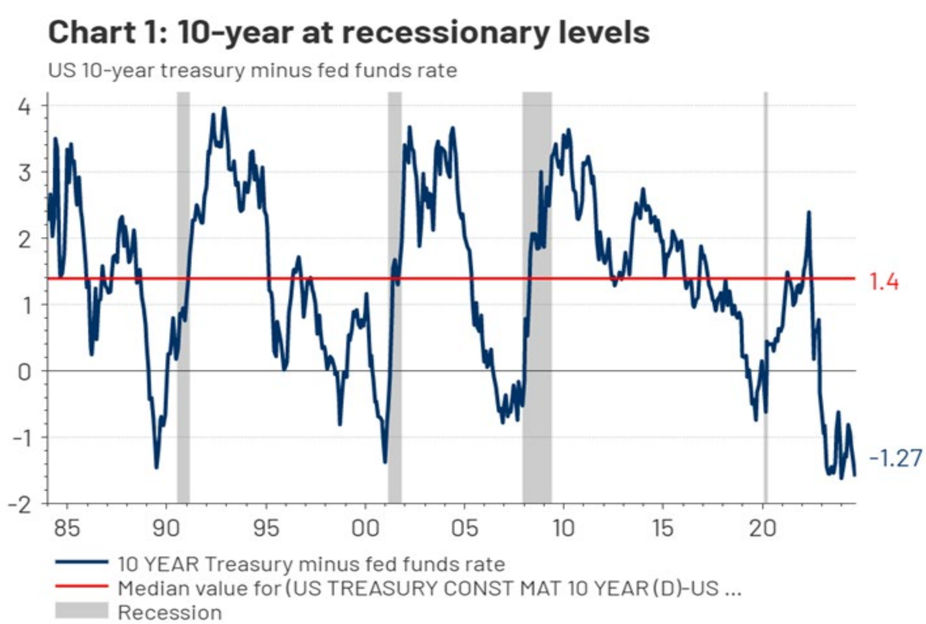
Fed Rate Cutting Cycle Begins with a Bang

Bond Market Is Overextrapolating Recession Risk

The highly expected interest rate cut by the Federal Reserve (Fed) came last week, 13 months after the last rate hike that took the fed funds rate to 5.33%. While we did not believe that a 50-basis point cut was necessary, the Fed has a bias towards cutting and thus has turned the rate cutting machine on, which will stimulate the economy and likely the equity markets. Bond yields have already fallen in anticipation of this cut with 10-year yields down from 5.0% to 3.7%. **We believe that bonds are fully priced and returns will be close to current yields from here. Thus, fixed income investors expecting significant price appreciation from here stand to be disappointed.**

Using the Fed's own forecast for interest rates, we get some insight into the possible timing and magnitude of future rate cuts. The Fed expects an additional 50 basis points of cuts through the rest of the year, with an additional 100 basis points of cuts coming in 2025. Inflation is falling (core CPE is 2.5%) and the unemployment rate is now above 4, both of which suggest further room to cut and so if their forecast is correct, investors would expect the fed funds rate to reach 3.375% by the end of 2025, which we believe is close to the new 'neutral' rate (the interest rate that neither stimulates nor depresses economic growth). If the neutral rate is roughly 3%, this leaves limited upside potential in treasuries, mortgages, and corporate bonds, in our view.



Source: LSEG Datastream, RiverFront. Data weekly as of Sept 20, 2024; gray bars indicate recession. Chart shown for illustrative purposes only. Past performance is no indication of future results.

Treasuries: Short yields fall and long yields stall - Likely to underperform without a recession. We believe that the Treasury market will experience a 'bifurcated' reaction to the rate cutting cycle, with short-term rates falling and longer-term rates rising. If history is a guide for what financial markets should expect over the next year, we should see two-year Treasury yields fall slightly from current levels assuming the neutral rate for fed funds is 3%. Why so little? The answer is that history has shown that yields tend to fall more in anticipation of the first rate cut. Hence, in most cases the bond market's reaction function to actual rate cuts are muted. We think this time will be similar. Absent a recession, we see little further downside for longer term yields and only modest declines for shorter term ones.

The combination of maturities that make up the Treasury yield curve from one-month Treasury bills to the 30-year Treasury bond have been 'inverted' (shorter maturity yields higher than longer maturity yields) since the pandemic. We think this dynamic is set to change as the Fed normalizes yields and the yield curve returns to upward-sloping. An upward-sloping yield curve highlights the additional compensation required by investors to lend the US government money for longer periods of time. Given our investment thesis is that the US will avoid recession, and that the yield curve will return to upward sloping, we expect the 10-year Treasury yield to be higher over the next year than it is today.

Chart 1 on the previous page shows that the 10-year Treasury historically out yielded the fed funds rate by a median of 1.4% percentage points over the last forty years. Hence, this would imply that the 10-year should yield over 4% instead of its current 3.69% if our assumption of 3% is the correct neutral rate on fed funds. Thus, we conclude that the bond market is pricing in a recession based on the yield of the 10-year Treasury currently. If yields revert to their median relationship with fed funds (the red line in the chart), the fed funds rate would need to be around 2.5% to justify current yields.

Mortgages: Prepayments to pick up as newer mortgages are refinanced, but limited upside from here. Over the last two years, potential homebuyers were dissuaded from purchasing a home due to the higher interest rate environment. Many first-time homebuyers opted to rent instead of buying, while many existing homeowners decided to remain in their current homes to preserve their current below market mortgage rate. The lack of existing homeowners selling their homes reduced prepayments of mortgages, and thus extended the payment schedules of mortgage-backed securities (MBS). However, now that the Fed has begun cutting interest rates the fortunes of MBS will change, in our opinion. We expect prepayments to pick up some as homebuyers who bought within the last year will likely opt to refinance as rates have come down from a high on a Freddie Mac 30-year Fixed Mortgage of 7.79% in October 2023 to as low as 6.20% recently. This should help to stabilize the MBS market, but we believe we will likely see limited spread tightening relative to Treasuries. The Fed's rate cutting cycle may not go low enough to fully unlock the mortgage market's potential, given that nearly 60% of homeowners have mortgage rates lower than 4%. Additionally, much like the Treasury market the MBS market has front run rate cuts.

Corporate Bonds: Not getting paid to extend: We favor maturities inside of 10 years. The corporate bond market was resilient during the Fed's rate hiking cycle and now that the Fed has begun to cut rates, we believe the trend will continue. Corporate bonds will likely remain stable as we do not expect the economy to enter recession, and thus access to credit for the issuers should remain readily available, in our view. Given that borrowing costs will be lower due to the Fed cutting rates, corporate bonds may see a slight improvement in overall credit worthiness. However, we believe there is very little room for additional spread tightening relative to Treasuries. Since spreads are tight and the yield curve is relatively flat for maturities shorter than 10 years, we do not see a need to extend out on the yield curve as the additional risk is not justified by the incremental return.

Conclusion: Rate cuts are good for the economy but mixed for the fixed income investor. We believe that the major sectors of the Bloomberg US Aggregate are fully priced and thus we will continue to underweight fixed income across our portfolios, since we think that the Fed rate cutting cycle will be better for the economy and for stocks. For the pure fixed income investor, we believe the results will be mixed - they will benefit from falling rates on their short maturing bonds, while longer maturing bonds may not have the desired outcome that bond bulls are anticipating. That said, for investors looking for income, we think locking in current rates via longer-maturity bonds is still a better strategy than remaining in cash.

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All charts shown for illustrative purposes only. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Index Definitions:

The Bloomberg Aggregate Bond Index, or "the Agg," is a broad-based fixed-income index used by bond traders and managers of mutual funds and exchange-traded funds (ETFs) as a benchmark to measure their relative performance.

Bloomberg U.S. Treasury Bills 1-3 Month Index is a component of the Short Treasury index. The Bloomberg Short Treasury Index includes aged US Treasury bills, notes and bonds with a remaining maturity from 1 up to (but not including) 12 months. It excludes zero coupon strips.

Treasury Bonds is represented by the Bloomberg US Treasury Index which measures the performance of the US Treasury bond market.

10 year treasury note: The 10-year Treasury Note is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.

Definitions:

Inflation is a gradual loss of purchasing power, reflected in a broad rise in prices for goods and services over time.

A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security. (bps = 1/100th of 1%)

In a rising interest rate environment, the value of fixed-income securities generally declines.

When referring to being "overweight" or "underweight" relative to a market or asset class, RiverFront is referring to our current portfolios' weightings compared to the composite benchmarks for each portfolio.

The yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity.

A recession is a significant, widespread, and prolonged downturn in economic activity. A common rule of thumb is that two consecutive quarters of negative gross domestic product (GDP) growth indicate a recession. However, more complex formulas are also used to determine recessions.

US Equities include stocks listed in the United States. Stocks represent partial ownership of a corporation. If the corporation does well, its value can increase, and investors can share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Small/mid-cap equities, MLPs, REITS and alternatives equities are types of US Equities and assume further risks described below.

Interest rate sensitivity is a measure of how much the price of a fixed-income asset will fluctuate as a result of changes in the interest rate environment. Securities that are more sensitive have greater price fluctuations than those with less sensitivity. This type of sensitivity must be taken into account when selecting a bond or other fixed-income instrument the investor may sell in the secondary market. Interest rate sensitivity affects buying as well as selling.

Mortgage-backed securities (MBS) are investments like bonds. Each MBS is a share in of a bundle of home loans and other real estate debt bought from the banks or government entities that issued them. Investors in mortgage-backed securities receive periodic payments like bond coupon payments.

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