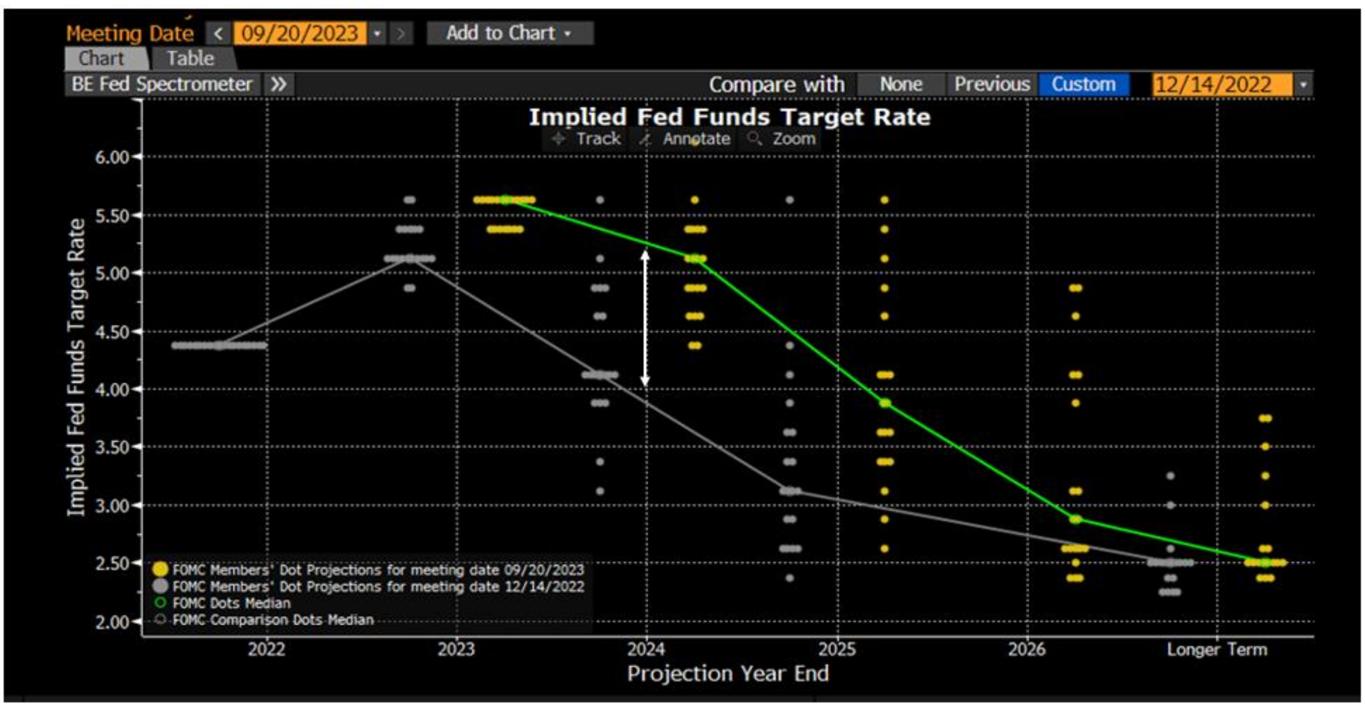
The Fed Makes Waves

The third quarter of 2023 was back loaded with volatility. The S&P 500 had traded sideways from July through mid-September, even as the Treasury yield curve continued to move higher, increasing borrowing costs for consumers and businesses. The yield on the 10-year Treasury bond had risen around 50 basis points prior to the Federal Reserve meeting that concluded on September 20th. That day, the Fed released their Summary of Economic Projections, which includes what is known as the "Dot Plot" chart. This chart is re1leased quarterly, and illustrates the expectations of future Federal Funds interest rate levels, as estimated by the members of the rate-setting Federal Open Market Committee (FOMC).

The Dot Plot released on September 20th revealed a much more pronounced "Higher for Longer" expectation from the Fed, with the terminal rate above prior levels, and the Fed Funds rate declining more gradually than in prior expectations released.

Fed has convinced the market of Higher for Longer

Pushing 2024 dot plot 100 bps higher YTD



Source: Bloomberg Finance L.P.

This shock pushed the 10-year Treasury bond higher by an additional 20 basis points to end Q3, and caused the S&P 500 to go from a roughly flat return in the quarter to ending over 3% in red, with the Mid-Cap and Small-Cap indices down slightly more. International equity (EAFE), and emerging markets (EM), posted similar declines.

The negative momentum created by the Dot Plot chart release did not end just because the quarter came to a close. Interest rates continued to trend higher and equity markets lower through October.

S&P 500 vs. U.S. 10YR Yield

Source: Bloomberg Finance L.P.

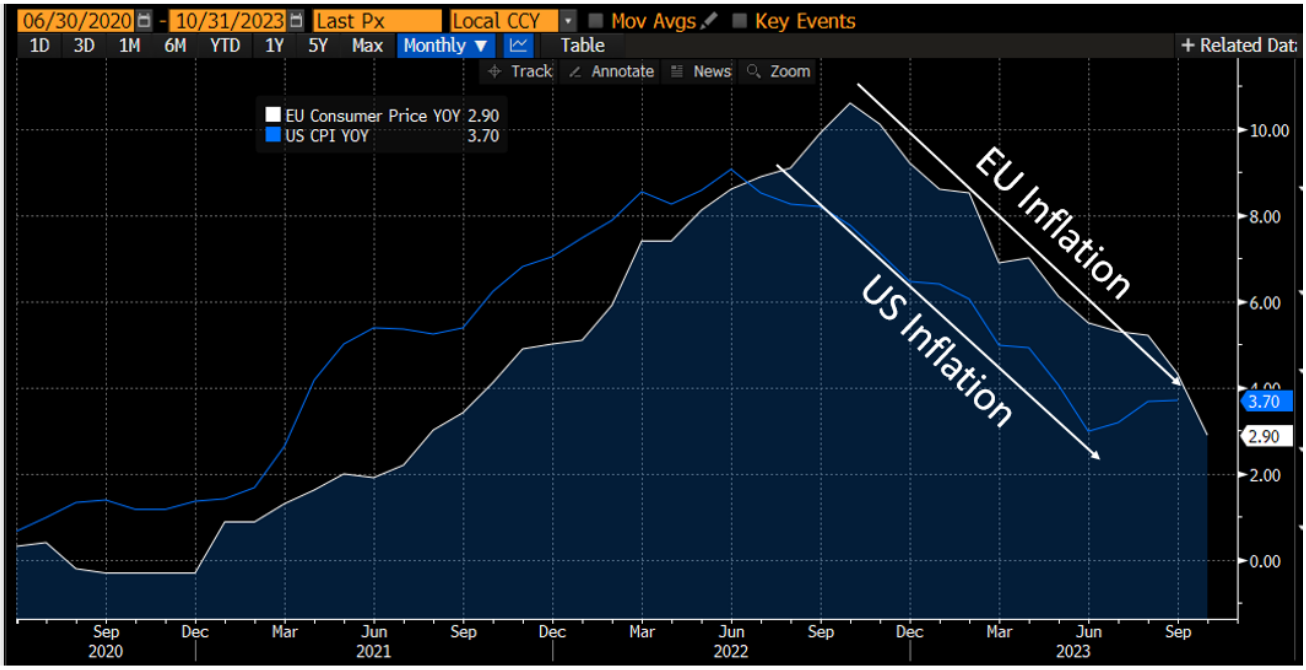
Global central banks continue to find themselves preoccupied by their battle with inflation. The Federal Reserve has made significant progress, as has the European Central Bank (ECB). Both institutions saw inflation approach or breach double digits, spurring them to take aggressive actions intended to bring inflation back down to their target levels of roughly 2%. Both the US and the EU have seen significant success in reducing inflation readings.

Lagarde's Battle with Inflation

Source: Burkhard Mohr; 30 July 2023; 'Two-front battle;' cartoonmovement.com

Christine Lagarde, President of the European Central Bank (ECB), recently stated, "We are determined to bring inflation down to 2%...According to our projections we will get there in 2025." Jerome Powell, Chairperson of the Federal Reserve, has also expressed strong resolve in the fight against inflation, vowing to keep interest rates elevated until this goal is achieved.

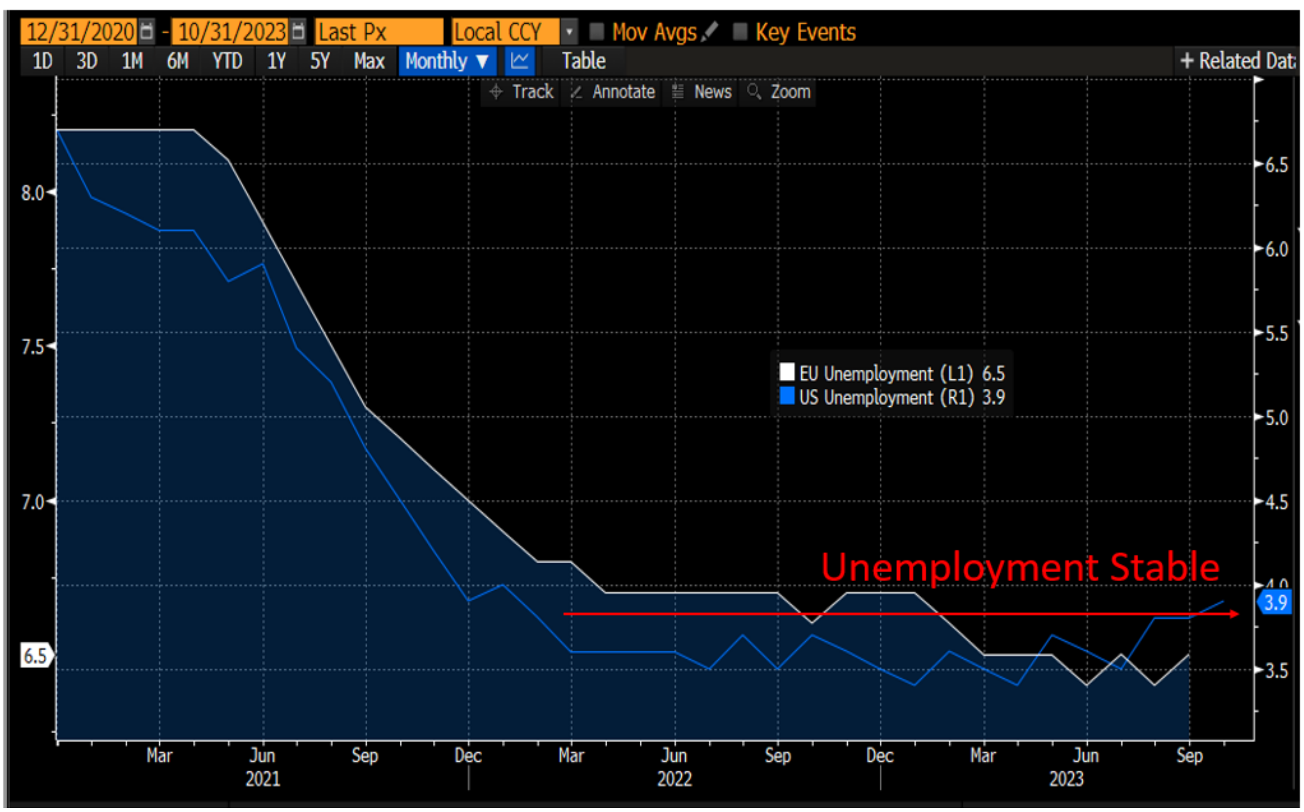
Inflation Declining in U.S. and Europe



Source: Bloomberg Finance L.P.

The declining levels of inflation are a victory for consumers who have been pinched by rising prices, and so far, this victory seems to have been costless in terms of the economic pain that is often required to moderate inflation. To this point, neither the U.S. nor the Eurozone have experienced a signifcant rise in unemployment.

Little Effect on Employment

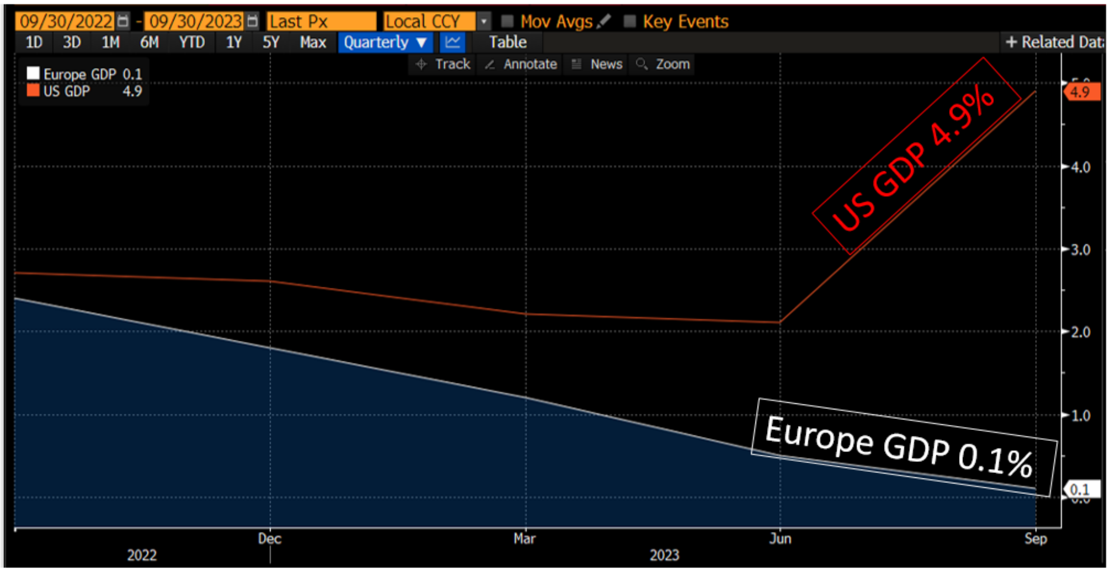


Source: Bloomberg Finance L.P.

Risks Building in Europe

The same cannot be said for European economic activity. While the United States economy has continued to expand and even accelerate, fueled by an extremely strong consumer (thus far), the European economy has stagnated, and appears to be approaching stall speed.

Tighter Policy and Geopolitics Hurting Growth in Europe



Source: Bloomberg Finance L.P.

European economic concerns are being reflected in the corporate bond market. CCC rated bonds offer very high yields due to their elevated leverage and potential for default. This additional yield spread above credit risk-free government bond yields had been fairly consistent between European and U.S. companies. Recently, as European economic growth began to falter, the additional yield that investors require to invest in European CCC bonds has diverged, moving significantly higher than what is required by investors in U.S. bonds of equal credit quality. This can be interpreted as a reflection of the rising default risk created by Europe's abysmal economic growth, teetering on the brink of recession.

Risky European Companies Pay Highest Borrowing Premium Since 2006

Index Spreads (Percentage Points)

Ice BofA indices: CCC & Lower Euro High Yield Index versus CCC & Lower US High Yield Index (option-adjusted spreads)
Source: Ice Data Services; © FT

The risk of owning low quality bonds has risen in the U.S., illustrated by the rising defaults and falling recovery rates noted in the chart below. Typically, these outcomes would push credit spreads wider as investors demand higher yields to compensate for these growing risks. The market has bucked that historic trend, and instead has begun offering less compensation (tighter spreads) on higher risk bonds. This divergence should reconcile itself in time, with defaults rates declining, or yield spreads rising, which could create a compelling opportunity.

U.S. High Yield Bonds

Default rate and spread-to-worst (%)

Source: J.P. Morgan Global Economic Research, J.P. Morgan Asset Management.
Long-run average is based on monthly historical data beginning in January 1990. Default rates are defined as the par value percentage of the total market trading at or below 50% of par value and include any Chapter 11 filing, prepackaged filing or missed interest payments. The default rate is an LTM figure (last 12 months) and tracks the % of defaults over the period. Recovery rates are based on the price of the defaulted bonds or loans 30 days post the default date. Default and recovery rates are as of most recent month-end. Spread-to-worst indicated are the difference between the yield-to-worst of a bond and yield-to-worst of a U.S. Treasury security with a similar duration. High yield is represented by the J.P. Morgan Domestic High Yield Index.
Guide to the Markets – U.S. Data are as of October 9, 2023.

In the higher quality portion of the bond market, some historically appealing valuations have begun to present themselves. Treasury Inflation-Protected Securities (TIPS) are Treasury bonds that offer investors a return that rises along with inflation. This "real yield," has recently offered a return of 2%+ above the rate of inflation. Today's real yields are among the highest that we have seen in the past 20 years, and at a time when future inflation is perhaps the least predictable that it has been in that same time period. The inflation hedge component of TIPS appears to be very reasonably priced.

Opportunity to hedge inflation at historically attractive level, while potential for inflation volatility remains high

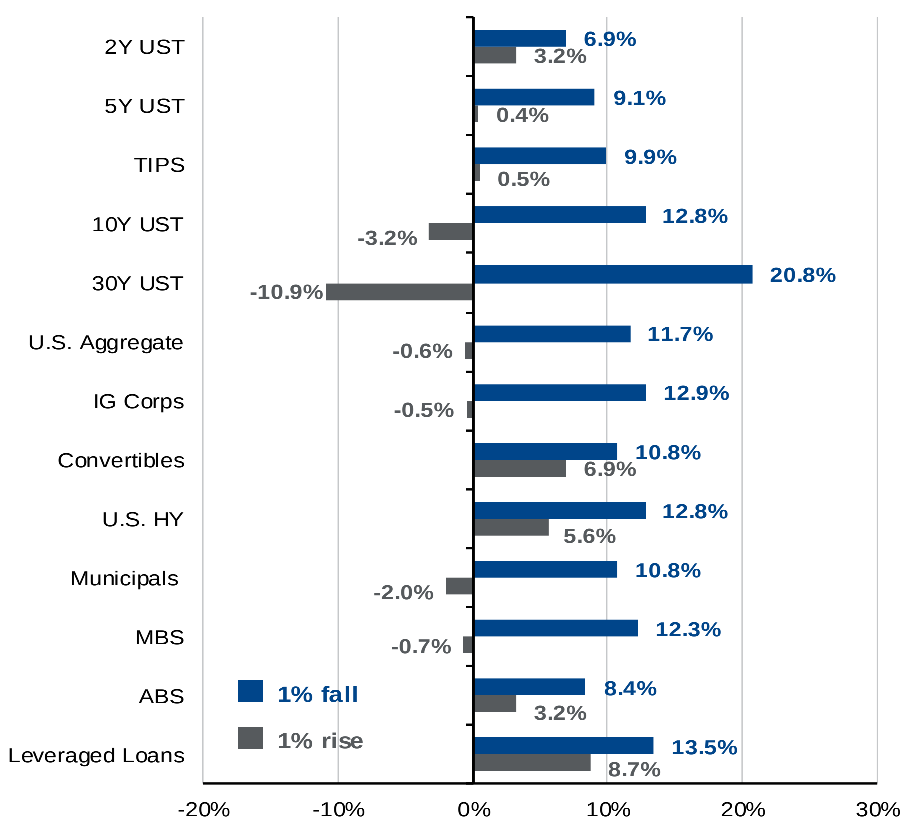
10-yr TIPS yield

Source: FHN Financial; Bloomberg

The broad increase in yields has made much of fixed income very attractive. Interest rates have risen so much that a portfolio of bonds provides some self-insurance against future price declines. This insurance is provided by the cash-flow generated by the higher coupon payments that it is now possible to receive. Without going too deep into the bond math, the chart below illustrates how current bond exposures would hold up to another 100 basis point increase in interest rates.

Fixed Income Market Dynamics

Impact of a 1% rise or fall in interest rates - Total return, assumes a parallel shift in the yield curve



Source: Bloomberg, FactSet, Standard & Poor's, U.S. Treasury, J.P. Morgan Asset Management. Sectors shown above are provided by Bloomberg unless otherwise noted and are represented by – U.S. Aggregate; MBS: U.S. Aggregate Securitized - MBS; ABS: J.P. Morgan ABS Index; Corporates: U.S. Corporates; Municipals: Muni Bond; High Yield: Corporate High Yield; Leveraged Loans: J.P. Morgan Leveraged Loan Index; TIPS: Treasury Inflation-Protected Securities; Convertibles: U.S. Convertibles Composite. Convertibles yield is as of most recent month-end and is based on U.S. portion of Bloomberg Global Convertibles Index. Yield and return information based on bellwethers for Treasury securities. Sector yields reflect yield-to-worst. Convertibles yield is based on U.S. portion of Bloomberg Global Convertibles. Correlations are based on 15-years of monthly returns for all sectors. Past performance is not

While returns would be dampened by rates moving up further, only the longest maturity exposure (30 Year Treasury) would face a significantly negative 12-month return. Many of the exposures would be near breakeven or even produce significantly positive 12-month returns in the face of rising rates. This illustrates the new found strength within the fixed income markets. The *income* is back, and doing its job protecting capital. Now is a great time to be putting money to work in the bond market, and locking in the income producing opportunities that have presented themselves over the past 18 months.

We are happy to discuss these opportunities and the markets more deeply. Please reach out with any questions.

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