NOTTINGHAM ADVISORS
ASSET MANAGEMENT

No Cuts Yet - The Extended Pause

The first quarter of 2024 saw global equity performance fueled by expectations of looser monetary policy just over the horizon, as the scourge of inflation died a slow but assured death in the very near future. Chairperson Powell's dovish pivot towards the end of 2023 was based on this premise.

Q1 RETURNS FOR DOMESTIC EQUITY
Strong positive returns, with only Small-Cap lagging

NAME	Q1 YTD
S&P 500 Index	10.55
S&P 400 Mid-Cap Index	9.94
S&P 600 Small-Cap Index	2.45
S&P 500/Citi Growth Index	12.75
S&P 500/Citi Value Index	8.05

Source: Bloomberg

Q1 RETURNS FOR INTERNATIONAL EQUITY
Strong positive returns, with only EM lagging

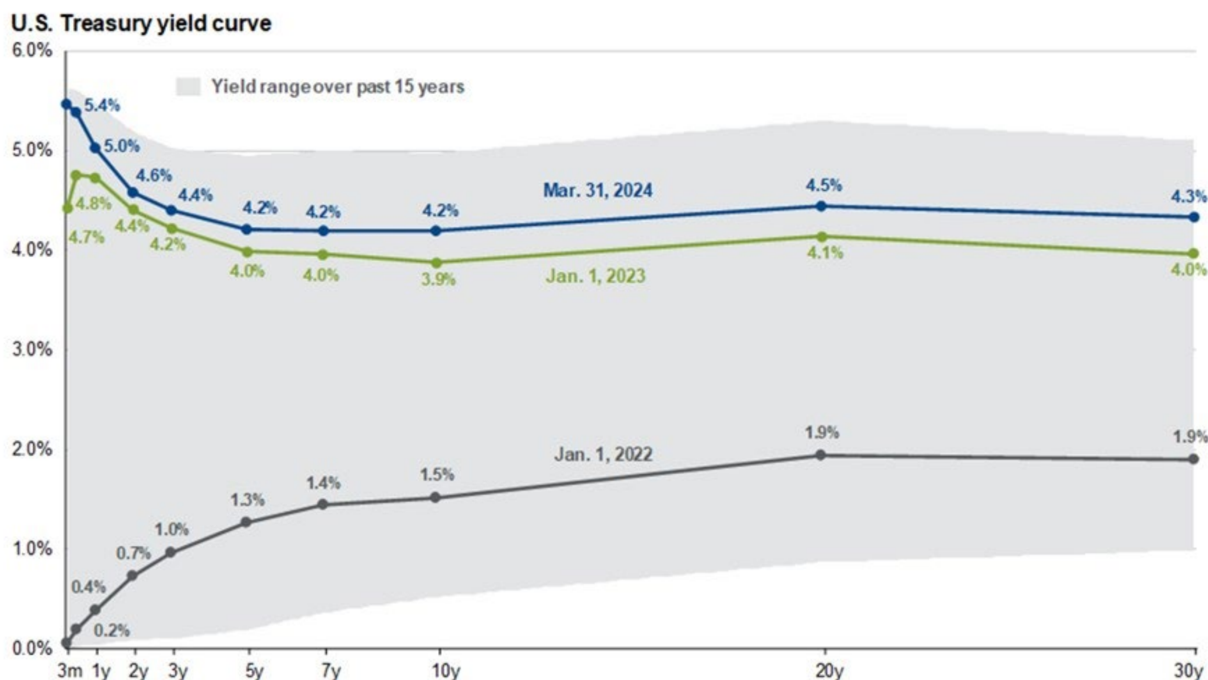
NAME	Q1 YTD
MSCI ACWI Index (USD)	8.32
MSCI EAFE Index (USD)	5.94
MSCI EM Index (USD)	2.41
FTSE 100 Index (GBP)	3.98
Nikkei 225 Index (JPY)	21.43

The risk markets were overjoyed by the "Dot Plot" chart provided by the Fed in December, showing committee members expectations for future interest rate levels. While this data did show expectations of Fed easing (lowering rates) during 2024, the markets took the three cuts expected, and began to price in up to three or four additional rate cuts on top of those forecasted (7-8 total cuts).

Stocks moved broadly higher given the change of stance and the market's belief that rates would come down even faster than the Fed was predicting.

This expectation was quickly challenged as strong GDP growth, good employment numbers, and hotter than predicted inflation data consistently printed during Q1.

The number of rate cuts priced into the market gradually declined to equal the Feds expectation of three, and eventually fell to roughly one. In April, as interest rates rose to reflect the likelihood of a, "higher for longer," scenario, the equity markets gave back some, though not all, of their gains.



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. Guide to the Markets – U.S. Data are as of March 31, 2024.

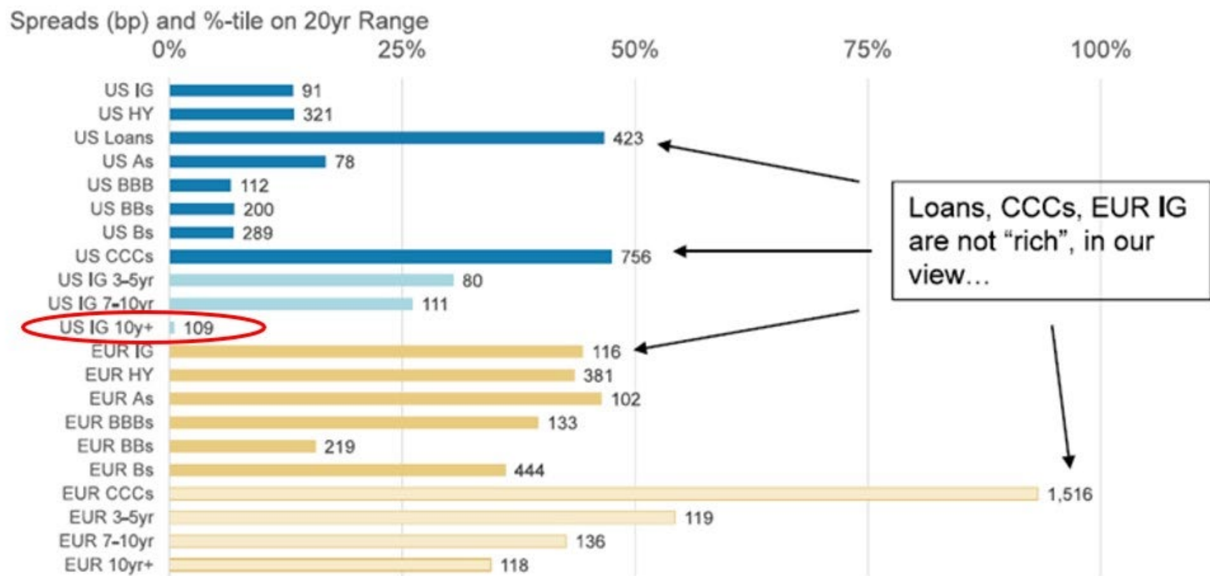
This adjustment higher in rates has pressured bond prices, leading to negative year-to-date returns in most categories during Q1. This pressure did not let up in April, further impairing 2024 bond returns. The upside to these less than stellar returns is that for the first time in over a decade, the yields offered by these fixed income investments are larger than the price drawdown that has been experienced. That means that if interest rates stabilize, and the bonds simply earn their yield going forward, the negative price impact will be erased in less than a year, and in some cases, after just a few months. This ability to quickly recover from reasonable increases in interest rates, a "self-healing" process, highlights how fixed income as an asset class has largely de-risked itself to a significant degree over the past few years as rates approached 20-year highs.

Q1 RETURNS FOR FIXED INCOME
Rising interest rates pushing returns into the red

NAME	Q1 YTD
Bloomberg Barclays US Government Index	-0.93
Bloomberg Barclays US Agg Index	-0.78
Bloomberg Barclays US Corporate Index	-0.40
Bloomberg Barclays US Corporate High Yield Index	1.47
Bloomberg Barclays EM USD Agg Index	1.53
Bloomberg Barclays Global Agg Treasuries USD Index	-0.01
Bloomberg Barclays Municipal Index	-0.39

Source: Bloomberg

While absolute yield levels are attractive across the bond markets, there are some areas which look slightly expensive on some measures. The spread, or additional yield above Treasury bond interest rates, that is offered by corporate bonds (Investment Grade and High Yield), looks a little rich. While corporate bonds



Source: Bloomberg, Morgan Stanley Research

have performed very well recently, the value offered by owning them at today's valuation levels has diminished. This is particularly true when looking at investment grade corporate bonds beyond 10 years to maturity. The valuation is being pushed to an extreme level by significant demand for bonds with these characteristics. The rise in interest rates has reduced the present value of pension plan liabilities, while the gains in the equity markets have increased the value of pension plan assets. This has spurred many pension plans to de-risk their portfolios, implementing Liability Driven Investing (LDI) strategies which entail selling stocks and buying long dated bonds, particularly investment grade corporates.

Source(s): Bloomberg, Guggenheim Investments. This information is provided for informational purposes only and is intended to reflect the general characteristics of certain fixed income sectors in the recent market environment. The characteristics shown herein do not represent characteristics of any client portfolios and there is no guarantee that assets with similar characteristics will be available in the future. Corporate bond index data is based on the yield to worst (YTW) and maturities of the AA-, A-, BBB-, BB-, and B-rated sleeves of the Bloomberg U.S. Corporate Bond Index as of 1/31/2024. Collateralized loan obligation (CLO) data is based on the YTW and weighted average life (WAL) of the Palmer Square CLO Senior Debt Index (AAA and AA or equivalent) and Palmer Square CLO Debt Index (A, BBB, and B or equivalent) as of 1/31/2024. CLO index yields assume that forward benchmark rates are realized. "Esoteric" ABS information is derived from the aircraft, equipment, railcars, utility, and franchise subsectors of the ICE BofA AA-BBB U.S. Fixed Rate Asset Backed Index as of 1/31/2024, and does not include auto, consumer, student loans, single family rentals, collateralized mortgage obligations, manufactured housing, credit cards, home equity, payment rights, and non-performing loans subsectors. Weighting for the selected Esoteric ABS universe is based on the current face value in index for the WAL and market value in index for YTW. The subsectors included in "Esoteric" ABS are generally issued less frequently, backed by less familiar assets, and potentially higher yielding than those subsectors that are excluded. Because they are less common, they may be more susceptible to liquidity and valuation risk than other ABS subsectors.

Other parts of the fixed income market offer more potential. Structured credit (CLOs), Asset Backed Securities (ABS), and Mortgage Backed Securities (MBS) all offer historically attractive return opportunities. These are under owned parts of the fixed income market, perhaps due to the additional complexity and historically limited venues of access for investors. This has evolved more recently, and accessing these assets has become fairly straightforward.

Average Returns After Fed Stopped Tightening

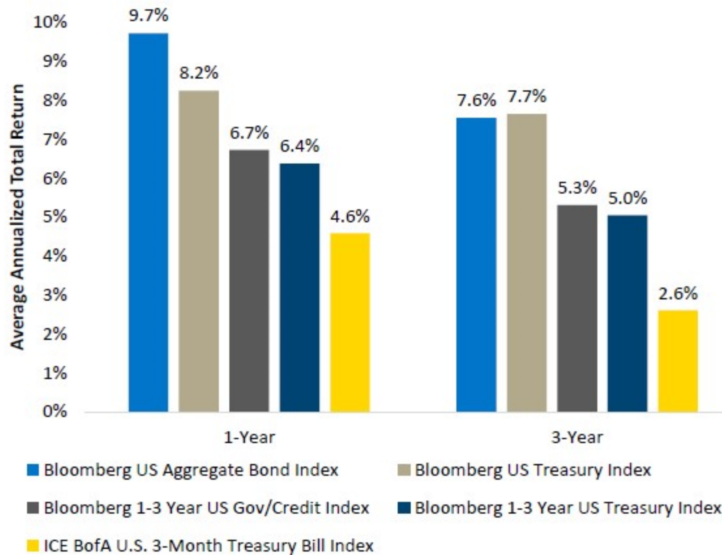
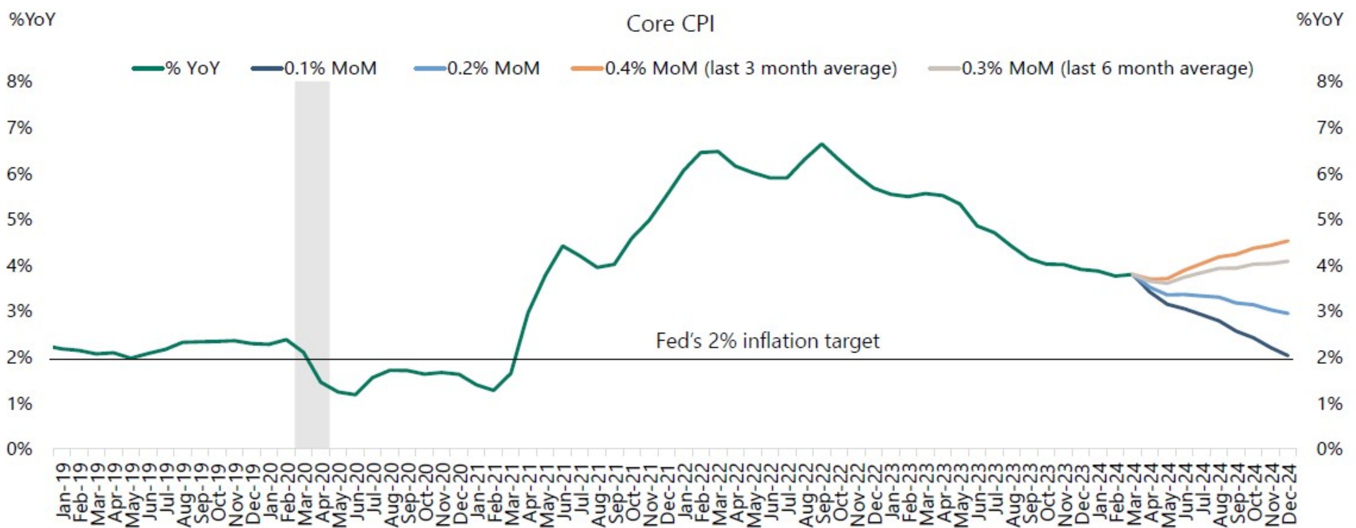


Figure 2
Source: DoubleLine, Bloomberg. A pause is the period between the last Fed rate hike and the first rate cut. Time periods used for analysis were: Dot.com pause: May 16, 2000, until Jan. 3, 2001 (eight months). Global Financial Crisis pause: June 29, 2006, to Sept. 18, 2007 (15 months). COVID-19 pause: Dec. 20, 2018, to Aug. 1, 2019 (nine months). Time period returns greater than one year are annualized. You cannot invest directly in an index.

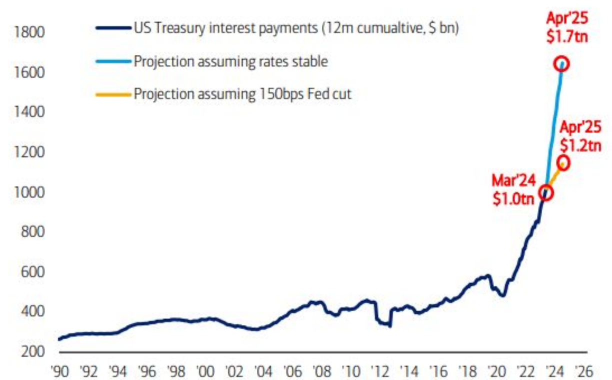
More broadly, with equity markets hovering near all-time highs, there is also a compelling opportunity for non-pension investment accounts to rebalance towards or transition to fixed income, while interest rates are at very attractive levels. Yields are high enough that bonds may be able to produce equity like returns in the next few years, with less volatility.

Limiting the duration of bond portfolios has been accretive to returns as rates have moved higher the past few years. Historically, when the Fed has finished hiking rates, longer Duration bonds have offered better returns than money market funds (MMF) and other short-term bond exposures. Not only does extending the average maturity of a bond portfolio allow the investor to lock in today's attractive yields for a longer period of time, but it also offers the potential of price upside if rates decline in the future.

Inflation will likely be above the Fed's 2% inflation target for the rest of 2024



Source: BLS, Haver Analytics, Apollo Chief Economist



FED RARELY PAUSES FOR LONG

Last Interest Rate Hike	First Cut Of Next Cycle	Number Of Months
Jun-06	Sep-07	15
Jul-23	**???**	**10+**
May-00	Jan-01	8
Dec-18	Jul-19	8
Feb-95	Jul-95	5
Feb-89	Jun-89	4
Aug-84	Oct-84	2
May-74	Jul-74	2
May-81	Jun-81	1
Mar-80	Apr-80	1

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The Fed suggested that they would cut this year, and they really do not want to be wrong. The data moved against them in the first quarter of the year. More recently, GDP growth slowed, and employment data cooled. These are the types of economic releases the Fed needs to see to justify a reduction in interest rates. Chairperson Powell still needs inflation to confirm the trend by resuming last year's trend lower before relief from rate cuts can be recognized. Consumers looking to take out a mortgage would benefit from lower borrowing rates, as would the U.S. Treasury, which is currently on pace to pay $1 Trillion in interest on the national debt, rising to almost $2 Trillion in 2025 if rate cuts do not materialize.

The current pause in monetary policy that we are in the midst of is already one of the longest on record, only exceeded by the pause preceding the Great Financial Crisis (GFC).

The size of the current deficit spending (stimulus) is a likely explanation for the length of the pause. Restrictive monetary policy has been offset to some degree (if not to a significant degree) by this stimulus, fueling the continued strong economic growth.

Whoever wins the White House in November's election will be facing a large budget deficit and rising financing costs. Chairperson Powell will need to steel himself to avoid being influenced by the coming political pressures for monetary policy relief.

We encourage you to reach out with any questions on the markets or our current positioning.

Timothy D. Calkins, CFA
Co-Chief Investment Officer
May 2024

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