The economic data reported at the end of the third quarter remained robust. The U.S. economy added 254,000 jobs in September versus a consensus expectation of 150,000 jobs, the unemployment rate fell from 4.2% to 4.1%, wage growth was solid, job openings are going up, and the Institute for Supply Management (ISM) services reading was also strong.

Why is the economy still strong? A number of reasons: lower sensitivity to higher interest rates for consumers and firms which previously locked-in at lower rates, strong AI spending, along with strong fiscal and defense spending. These tailwinds are countering the long and variable lags of monetary policy. As stated in their September 18th meeting, the Fed is now cutting interest rates to preserve the currently strong labor market, rather than a sign of concern about a worsening economy. The U.S. economy is still growing and the Fed is willing and ready to cut to keep it that way.

## The "Neutral" Rate and the Yield Curve

The "neutral" interest rate also called at times the natural rate or equilibrium rate is the federal funds rate that neither stimulates nor restricts economic activity. It would be the prevailing rate when the economy is growing precisely at potential, ~2%, with inflation also at target, ~2%. Employment/unemployment is not included in the definition. However, one can surmise that if the economy is growing at potential and inflation is stable at target, the unemployment rate must be neutral and not accelerating.

The neutral interest rate was estimated to be 2.90% by the Fed as recently as September. What does that mean for the rest of the yield curve when inflation reaches its 2% target?

Theoretically, U.S. Treasury yield should equal the average federal funds rate over the maturity under consideration plus a term premium. If an investor believes the Fed's neutral estimate of 2.90% and acknowledges that term premium has been negative for some time, an investor could surmise that the 10-year Treasury yield would be approximately 3.00%. It is our belief that the neutral rate is actually higher than the Fed's current estimate and closer to 3.50% or maybe slightly higher. As domestic growth has been above the Fed's long-term goal of 2% for an extended period, with third quarter GDP estimated to be 3.2% by the Atlanta Fed, this suggests that the 10-year Treasury yield should be closer to 4.0%.

What does all this mean for the 30-year Treasury yield all else remaining the same? Recently, the 10-30 year yield spread has been approximately 33 basis points (bps). As a result, the 30-year Treasury yield should be in the area of 4.33%. If the term premium rises, because the Fed has not reached the stated target of 2% inflation rate, the yield curve would subsequently steepen further.

## Bond and Equity Market Correlation

In 1952, Harry Markowitz introduced the world to Modern Portfolio Theory which described how investors could maximize returns per unit of risk through the combination of uncorrelated assets. Markowitz later earned the 1990 Nobel Prize in Economic Sciences for this insight. The application of this theory to practice has led to the tremendous growth seen in alternative asset classes, such as hedge funds and private credit, over the past several decades. The negative correlation between two of the largest and most important asset classes, fixed income and equities, has provided the foundation for efficient portfolio construction in the modern age. However, after the seismic disruption of the COVID-19 pandemic, the negative equity-bond correlation broke down. Correlation turned positive. The hedge that fixed income provided against equity losses disappeared. In 2022, the S&P 500 lost -18.12% while the Bloomberg Aggregate Bond Index declined -13.01%, there was no place to hide. In contrast, in 2008, the S&P 500 lost -37.0% while the Bloomberg Aggregate Bond Index generated a positive total return of +5.24%. What changed? Inflation. Since the early 1990s, until the supply shocks of COVID-19 giving rise to the inflation spike in 2021, inflation had remained solidly below 3% and much of the time even below 2%. Over this period, macroeconomic growth, rather than inflation, was the predominant concern and driver of financial asset prices. In such an environment, low economic growth depresses expectations for earnings growth, weighing on stock prices while at the same time encourages expectations for monetary stimulus, in the form of lower real rates, and higher bond prices. In high growth, low inflation environments, high earnings growth expectations more than offset the higher discount rates from monetary policy tightening. However, in times of high and volatile inflation, monetary policy will be restrictive with high real interest rates, regardless of the growth outlook, plus an elevated inflation premium built into interest rates. Stocks and bonds will be positively correlated. This is the environment U.S. investors have endured from early 2021 through mid-2024.

The Federal Reserve Chairman will often use the Jackson Hole Economic Symposium, held each year during late August, to announce significant policy shifts. In 2024, after two years of fighting a stubborn inflation problem, Fed Chairman Jerome Powell announced, "My confidence has grown that inflation is on a sustainable path back to 2 percent." And "the cooling in labor market conditions is unmistakable." Market participants correctly interpreted his comments as a signal that rate cuts would be following soon. It was around this time that stock-bond correlation flipped back to negative.

Inflation may not yet be quite back to the 2% target, but the steady improvement to a level below 3% has given investors' confidence that the Fed is competent. Absent something like a once in a hundred-year pandemic, we expect inflation expectations to remain low and steady and the negative stock-bond correlation to persist. We believe fixed income will again be an essential ingredient for diversification and maximizing risk adjusted returns in investors' portfolios. Fortunately, yields are still relatively high. This remains an excellent time to establish or enhance a long-term allocation to fixed income, in our view.

**Monetary Policy:** We believe current Fed policy is moderately restrictive with a fed funds rate of 4.75%-5.00%, which as we discussed above, exceeds the neutral rate. At the most recent meeting on September 18th, the Fed cut 50 bps and indicated that members expected a series of rate cuts in the future. The Fed believes rates are restrictive, inflation is trending toward the 2% target, and risks to inflation and employment are roughly in balance. The September jobs report, released on October 4th, was much stronger than expected with 254,000 jobs created, an unemployment rate that dropped from 4.22% to 4.05%. Average hourly earnings also accelerated from 3.9% to 4.0% on an annual basis. Rates markets immediately pared back future interest rate cut expectations on the strength of the report. Looking forward, we expect 25 bps cuts at both upcoming Fed meetings in November and December, but would not be surprised to see a pause in the first half of 2025 should the economic data continue to come in strong.

**Interest Rates:** We expect the front-end of the yield curve to be led lower by continued cuts to the federal funds rate. However, we believe long-term rates are near fair value presently with balanced risks.

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**Investment-Grade Corporate Bond Third Quarter Performance and Outlook:** U.S. investment grade corporate bonds performed extremely well during the quarter, despite an early-August selloff following a weak jobs report for July. Per the Bloomberg U.S. Credit Index, investment grade corporate credit spreads tightened by 5 bps in the third quarter, and they rallied 22 bps from the intra-quarter high of 111 on August 5th. The Bloomberg U.S. Credit Index measures the investment grade U.S. dollar denominated, fixed-rate, taxable corporate and government-related bond markets. There are no positions in the portfolios with any credit or sustainability concerns through the market cycle, in our view.

Investment grade corporates were the best performing asset class during the third quarter, and they remain top performers year-to-date in 2024. Strong technical factors are still in the driver's seat as demand for investment grade credit remains overwhelming and supply is easing off the earlier record pace. In our view, the core driver for this demand is simply attractive yields and so it is unlikely to subside even as spreads move to levels that are near all-time tights.

**High Yield Bond Third Quarter Performance and Outlook:** High yield fixed income bonds returned 5.4% in the third quarter as the risk-on trade was fueled by confidence in a resilient economy leading CCCs to significantly outperform, returning 11.7% during the quarter. BB and B performance was more muted with a quarterly total return of 4.5% and 4.7%, respectively. High yield spreads started the quarter at 309 bps and ended at 295 bps, representing the tightest levels since January 2022. The asset class continues to offer relatively attractive carry, with yields in the 64th percentile based on the last 10 years, but we will continue to be very selective with our credit selection with spreads at or near historic tights. We believe defaults will remain around their long-run averages of 2% through 2024, but we do not believe investors are being compensated for the risk of an economic slowdown over the next couple years. High yield bond data is representative of the U.S. High Yield Corporate Bond Index that is designed to track the performance of U.S. dollar-denominated high-yield corporate bonds issued by companies whose country of risk use official G-10 currencies, excluding those countries that are members of the United Nations Eastern European Group.

## Conclusion

We believe fixed income remains an attractive asset class and investors have opportunities for increased income and yields by extending duration at this time. These unique economic times require a steady hand and a consistent, thoughtful approach to investing. While never losing sight of the global and domestic economic environment, we believe our long only, research driven style of investing has historically delivered excellent results over the years with less volatility than our peers. We have been consistent in our investment philosophy, process and management style.

If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

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* **Past performance is not a guarantee of future results.** 7176886.1