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Income Investments

The fourth quarter, and 2023 in general, provided yet another example of how rapidly things can change in capital markets. After weak returns in the third quarter, intermediate and long-term interest rates moved down sharply to end the year, propelling the bond market to close the year with its highest two-month return in 30 years, according to the Bloomberg Global Aggregate Bond Market index. For the full year, the bond and equity markets navigated several surprises—including a first-quarter banking crisis, a mid-year "higher for longer" interest rate mantra from many Federal Reserve governors, and a U.S. economy that avoided a much-anticipated recession—to finish the year with strong returns and elevated expectations for 2024.

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In the fourth quarter, as anticipated, the central bank held the Fed Funds Rate steady at 5.25 to 5.5 percent during its December meeting, the same level at which it has been since July 2023. In sharp contrast to just two months ago, however, the Fed is now expected to cut interest rates aggressively in 2024 in response to rapidly cooling inflation and slowing growth. This was an unexpected about-face for the Federal Open Market Committee, whose many members argued for even more aggressive rate increases as recently as October. Astonishingly, the 10-year Treasury yield ended 2023 at exactly the same level it ended 2022—3.88 percent.

One figure Riverbridge watches closely is real interest rates (interest rates less inflation expectations) as a way to identify value in fixed income markets. Real rates reached some of the most attractive levels of the last 20 years in October, when rates were at their recent peak. While they have fallen somewhat since then, real rates remain higher than the average over the last 15 years by about 1.5 percent.

Inflation has slowed considerably since the summer of 2022 and appears to be heading into the Fed's target range of less than 2 percent. Real growth in the U.S. also appears to be slowing fast as well, with the average of the Bloomberg economic forecasts penciling in just 1.3 percent for 2024 GDP growth, down from 2.4 percent in 2023. Part of this expected slowdown is due to a decline in government spending, which had an outsized impact on the economy in 2023 due to the Inflation Reduction Act.

When the Fed Funds rate (5.5 percent) is substantially above current inflation (3 percent) and long-term inflation expectations (2.3 percent), returns in bonds tend to be outsized in the ensuing years as the Fed cycle concludes and they bring rates in-line with inflation and growth. That appears to be playing out currently, and based on history, bond yields have further to fall. The Fed Funds Rate and intermediate and long-term interest rates generally keep falling when the Fed cycle turns from rate hikes to cuts. In the last five interest rate cycles dating back to the late 1970s, the 10-year Treasury yield fell by a little more than 4 percent on average and the least amount it fell was 2.3 percent. Thus far the 10-year Treasury yield has fallen by about 1 percent from a high of 5 percent in October.

The events of 2023 reminded us of a lesson as old as time and markets themselves: no one, no matter how qualified, seems to be good at predicting the path of the economy, markets, or interest rates. This is why Riverbridge remains focused on the long-term, using a fundamental approach that seeks to provide clients with attractive yields for our stability and income allocations.

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