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Income Investments

The first quarter of 2024 built on the strength of last year by posting a gain of more than 10 percent for the S&P 500 index, the best opening quarter for the equity market since 2019. Stronger-than-expected corporate earnings drove stocks higher, with assistance from continued artificial intelligence momentum and economic data that generally suggested inflation should continue to cool. Meanwhile, as expected, the Federal Reserve left interest rates steady at a 5.25 – 5.5 percent Federal Funds Rate. They paused their hiking cycle in July 2023, and Chairman Powell recently suggested that the peak in rates is behind us. The 10-year Treasury yield still rose 30 basis points in the quarter, however, as investors adjusted their expectations for rate cuts due to higher-than-expected US growth and inflation. The market and Fed dot plots are currently aligned, with both indicating three cuts of 25 basis points each in the coming year. As happens regularly, both are bound to change in the months ahead.

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Total returns on traditional fixed income, reflected by the Bloomberg Aggregate Bond index, were down 0.3 percent. At the same time, floating rate sectors posted positive returns, and alternative income sectors such as business development companies (BDCs) posted positive returns of more than 5 percent.

Real 10-year Treasury Yields (yield minus inflation expectations) remain about 2 percent, substantially higher than the average over the last 15 years. One reason real interest rates have increased in recent years may be investors' unease with the federal deficits and debt load, as the US net debt held by the public sat near 100 percent of GDP at the end of 2023. As debts rise, interest costs can consume a substantial proportion of federal spending. Academic research suggests that when a country's debt-to-GDP grows significantly beyond 100 percent, it can become unsustainable and may lead to higher volatility in bond markets. The Congressional Budget Office (CBO) has projected that the US could reach a ratio of 116 percent by the mid-2030s, so while the issue cannot be ignored by policymakers, it also may not represent an imminent threat.

Instead, for the foreseeable future, interest rates will continue to be influenced primarily by growth, inflation, and Fed policy. Powell and the Fed have indicated they want to cut rates as growth and inflation slow. A sticking point, though, has been housing inflation, particularly rents. At a recent press conference, Powell expressed confidence that disinflation will continue and said he expects declining residential market rents to begin showing up in inflation soon, which would aid in a soft landing.

If the US economy cooperates, the Fed may be able to undertake a shallow easing cycle, whereby they only need to decrease rates modestly to achieve their targets. The most recent shallow easing cycles in the US were in 1995 and 2019, resulting in 5-year Treasury yields dropping 125 basis points, on average. We've already seen a drop in rates of 60 basis points from their peak in the third quarter of 2023, so we would expect a further fall in interest rates in this scenario and expect bonds to outperform money market investments.

No matter the fluctuations in growth, inflation, and interest rates, Riverbridge continues to invest for the long-term, using a fundamental approach to select income investments that have attractive yield and quality characteristics. Over time, such an approach has yielded attractive returns when clients remain invested through the inevitable ups and downs in the markets.

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