FIXED INCOME MARKET COMMENTARY

3RD QUARTER 2024

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Income Investments

The third quarter marked a seminal pivot point for the financial markets, as the Fed officially concluded its tightening cycle that began in 2022 by cutting interest rates. Surprising some observers, the Fed opted to begin this new cycle by cutting rates 50 basis points as opposed to the more conventional 25 basis points, and signaled its intention to reduce rates another 50 basis points in the fourth quarter.

The action by the Fed indicated they are seeing signs the economy is cooling and believe inflation has been sufficiently subdued. Employment data over the quarter moderated, with the unemployment rate rising from 4% to 4.2%. Inflation is settling near the Fed's target range of about 2%. The Fed's favored inflation measure, the personal consumption expenditures index (PCE), eased to 2.1% over the last three months. While both prongs of the Fed's dual mandate–employment and inflation–are moderating, consumer spending and forecasted growth have been in line with or better than expectations. Thus far, the economy and markets are signaling a soft landing-type scenario with moderating activity, higher stock and bond returns, and easing Fed policy.

Falling long-term interest rates boosted fixed-rate bonds and stock prices, with the Bloomberg Aggregate Bond Index rising 5.2% and the S&P 500 index up 5.9%. The 10-year US Treasury yield made a decisive move lower, from 4.4% to 3.8%, as long-term interest rates began to price in additional Fed cuts. Longer duration bonds did the best this quarter, with the corporate bond sector having the highest returns among investment grade bonds. Municipal bonds lagged as tax-exempt bond supply was high ahead of this November's elections.

The US economy is considered late-cycle, more likely to be slowing after the strong growth and inflation experienced in the wake of the pandemic and a historic amount of stimulus. Austin Goolsbee, Chicago Fed President, agrees with the market that Fed policy is restrictive and should be coming down. In a recent speech, he said, "If we want a soft landing, we can't be behind the curve...Yet rates are the highest they've been in decades. It makes sense to hold rates like this when you want to cool the economy, not when you want things to stay where they are...Rates need to come down significantly going forward if we want the conditions (unemployment and inflation) to stay that way."

While the Fed is certainly expected to lower rates, there is no shortage of uncertainty in other parts of the world, economy, and markets. Few quarters feature as many potentially market-moving scenarios as the one ahead. Earnings reports will be closely scrutinized for clues about corporate America's growth and capital spending plans for 2025. Jobs data will be analyzed for any hint of potential recession. Overseas problems feature a weak Chinese economy and Mideast tensions that could lead to a full-scale war. Last, but certainly not least, the November presidential election will be of keen interest to all market participants.

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While all these factors certainly matter, at Riverbridge, our clients know we will continue to invest for the long-term. For fixed income investors, this means seeking to identify value by choosing the most attractive relative yields and appropriate duration, along with a judicious approach to credit selection.

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