FIXED INCOME MARKET COMMENTARY

4TH QUARTER 2024

Chris Sebald, CFA
Income Investments

The fixed income market experienced a reversal in fortunes during the fourth quarter of 2024. Better-than-expected economic data, a slower decline in inflation, and high expectations about the incoming Trump administration's policies drove bond yields higher. Long-term interest rates rose sharply, with the 10-year Treasury bond yield rising from 3.8% to 4.6%, up 80 basis points for the quarter and 70 basis points for the year. This occurred despite the Federal Reserve's reduction of the federal funds rate to 4.25-4.5% during its December meeting and a cumulative easing of 1% in the third and fourth quarters. Ultimately, even with the rise in long-term rates, the Bloomberg Aggregate Bond index eked out a 1.8% gain for the year.

Long-term rates seesawed throughout 2024 as economic data, inflation readings, and Fed policy waxed and waned during the year. Long-term rates rose in the second quarter, fell in the third quarter, and rose again in the fourth quarter to finish near a cycle high. The incoming Trump administration's prospective policies appear to be spooking fixed income investors and the Fed by increasing growth and inflation expectations beyond what would normally be expected at this stage of the business and interest rate cycle.

Cash yields remain high compared to inflation (4.3% vs. 2.7%), which has many investors hiding out in money markets rather than longer-term bonds. This has resulted in high real bond yields (Treasury bond yields minus inflation expectations) and continues to make bonds look attractive. Real yields on the 10-year Treasury are 2.2%.

Many consumers are still contending with high prices. However, the inflation rate has declined substantially since reaching a peak of 9.1% in mid-2022. While recent inflation figures picked up, the average monthly CPI over the last six months was an annualized 2%.

The Fed is expected to lower its funds rate further in 2025, with its projections currently suggesting a midpoint of 3.875% by December 2025. Inflation and growth are expected to moderate and the unemployment rate is expected to rise slightly. Should the Fed lower interest rates as expected, the yield curve will likely steepen further, favoring bonds over cash.

A major wild card is how the incoming Trump administration's policies will impact growth, inflation, and interest rates. Trump's rhetoric around tariffs, if implemented, would in theory push up import prices and give domestic producers more pricing power, providing a boost to inflation, even if temporary.

While the potential inflationary effects of tariffs are dominating the conversation, the bond market is not completely buying it yet. Nearly 75% of the increase in long-term rates in the fourth quarter was due to the term premium (rise in real yields), not inflation expectations. So far, the bond market is not pricing in higher inflation driven by tariffs and other potential policy moves.

Remember the adage from the first Trump administration: "Take him seriously but not literally." Many of Trump's first-term policy promises never materialized; for instance, there was no major trade war, and the US remained in NATO. Pre-COVID, the economy performed well. A look back at the high-level economic and market measures three years into Trump's first term shows that unemployment, inflation, and bond yields remained low despite tariffs and other policy changes.

	EOY2016	EOY2019	EOY2024
Fed Funds Rate (upper bound)	0.75%	1.75%	4.50%
Inflation (CPI YOY)	1.70%	2.10%	2.70%
10 Year Real Yield	0.47%	0.13%	2.23%
10 Year Treasury Rate	2.45%	1.92%	4.57%
SP500 Div Yield	2.1%	1.8%	1.3%
Unemployment Rate	4.7%	3.6%	4.2%

What does this mean for fixed income investors? Policy uncertainty will likely remain high for months or quarters to come, which could drive interest rate volatility. That said, the old-fashioned reason for owning bonds—income and a cushion against falling stock prices—is back in fashion once again. Bond yields look attractive relative to inflation and the S&P 500 index's dividend yield, which are typically good signals for long-term investment value in fixed-income securities. It boils down to fixed income investors getting paid more without a commensurate increase in risk.

What fixed income investors should focus on in the coming year is value, not which way the market will swing in the short term. As interest rates have risen in the last two and a half years, bonds are more attractive versus inflation than at any time since 2008. Investors are getting paid to buy bonds and lock in the extra earnings.

Riverbridge continues to take a long-term approach to fixed income investing, focusing on value and client specific needs and circumstances that aren't influenced by the short-term seesaws in the market.

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