

Chris Sebald, CFA
Portfolio Manager,
Income Investments

MARKET COMMENTARY

Fixed-income yields rose substantially in the third quarter, driven by three forces: higher oil prices and the likely flow-through of energy costs to inflation as the war with Iran continues; a surge in debt supply needed to fund the artificial intelligence (AI) buildout and finance the U.S. fiscal deficit; and the Fed's pivot in September to address inflation concerns. The Fed raised the federal funds target rate by 25 basis points to 3.75%-4.00%, its first hike since 2023, and futures markets point to one more 25-basis-point hike before year-end.

The 10-year Treasury yield rose from 4.5% at the end of June to 5.3% at quarter-end, leaving it up about 0.8% for the quarter and over 1% higher year to date. Even more striking was the move in municipal bonds. The 10-year AAA municipal yield climbed from 2.9% to 4.1%, up 1.2% for the quarter. For investors in the highest federal tax bracket, that equates to a taxable-equivalent yield of about 6.9%, a premium of more than 1.6% over the 10-year Treasury and 4.5% over inflation expectations. For the quarter, the Bloomberg U.S. Aggregate Bond Index returned -4%, the Bloomberg Municipal Bond Index returned -6%, and the S&P 500 returned 2%.

Markets spent the first half of the year betting that the war with Iran would end quickly and that oil would drift back to pre-war levels, around \$70 per barrel of WTI, by year-end. This quarter, that view gave way to pricing for an extended conflict, with oil now forecast to end the year near \$90 a barrel.

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At the same time, financing needs for the AI buildout and the U.S. government arrived in force, at a moment when investors had little capacity to absorb more debt and were already worried about inflation. And after the Fed raised rates in September, the Warsh Fed is now seen as responding to markets rather than leading them. That is consistent with the "back-seat Fed" philosophy we discussed last quarter, but it also means the Fed is unlikely to be a source of resistance to current market trends.

Despite rising rates and inflation, long-term inflation expectations remain stable, with the 10-year TIPS breakeven inflation rate moving only from 2.25% to 2.37% during the quarter. Nearly all the rise in yields came from higher real yields: the 10-year real yield rose from 2.2% to nearly 3%. That means investors are now paid a substantial premium over inflation to own bonds, a complete reversal from the 2010s, when real yields bottomed at about -1%.

Starting yield is the single best indicator of long-term total return for fixed income, and starting yields today are compelling: roughly 5.3% for Treasuries, 6.2% for corporate bonds, 7% taxable-equivalent yield for municipal bonds, and 8.4% for high yield. High-quality municipal bonds stand out. Their taxable-equivalent yields exceed those of corporate bonds by about 1%, with higher average credit quality.

The result is a full menu of options for meeting income and capital preservation goals, with some options beginning to compete with long-term equity returns. With the S&P 500 trading above its long-term average valuation and highly concentrated in the AI trade, yields across most fixed-income markets look attractive and provide diversification relative to increasingly narrow equity indices.

OUTLOOK: WHAT HIGHER YIELDS MEAN FOR INVESTORS

This year has provided a vivid lesson in how quickly markets can change. At the start of the year, the 10-year Treasury yield was near 4.2% and expected to fall, with then-declining inflation and more than two Fed rate cuts priced into the forward curve.

Nearly everything in the bond market changed with the surprise war in Iran and the jump in energy prices. A resolution to the conflict and a reopening of the Strait of Hormuz would likely cause energy and other commodity prices to fall, and interest rates would likely follow. However, if the war is extended and oil prices keep rising or take longer to normalize, interest rates could move higher still.

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While rising yields do not appear to be deterring AI-focused companies or the U.S. government from borrowing more, higher borrowing costs generally weigh on consumer lending and spending and slow the economy. This works like an automatic stabilizer: the bond market is doing some of the Fed's work by raising borrowing costs to cool growth and inflation. It is likely a big reason long-term inflation expectations remain well anchored.

History is also encouraging. In several prior episodes when yields rose because of economic growth rather than higher inflation expectations, total returns over the following one, three, and five years were strong. Growth and corporate credit are well supported today: corporate earnings continue to hit records, free cash flow is strong, corporate leverage is not high, and interest coverage is solid.

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Riverbridge's approach is unchanged: we ground fixed-income investments in value rather than headlines or Fed meeting calendars. With real yields near 3% and high-quality municipal bonds offering taxable-equivalent yields of about 7%, investors are being well compensated to own fixed income.

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