INVESTMENT NOTE: SEPTEMBER 2024

Mind the Curve: Have Rates Moved Too Much or Too Little?

The only things certain in life are death, taxes, and a rate cut.

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Summary

The US yield curve has moved meaningfully this quarter, experiencing both a shift down and a yield curve twist. Even after these moves, most of the curve remains inverted.

During the first half of the year, we have seen the US Treasury ("UST") market materially overshoot the Fed a few times. While the Fed has yet to take action this quarter, the yield on the UST 10-year bond has moved in a 76 basis point range. Therefore, it is fair to ask if the curve has moved too much again or if it is right this time.

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In our opinion, the Fed has clearly signaled that a rate regime change is upon us with its published projections and Chair Powell's Jackson Hole speech in August. Two of the bigger questions right now are how fast and how far rate cuts will go. Speculation around the extent and timing of rate cuts will continue to impact the performance of fixed income credit markets over the next year. However, the shape of the yield curve over the next year - or two - may have an even bigger impact on the performance of fixed income portfolios.

In this note, we attempt to outline a simple framework to analyze the shape of the yield curve and whether rates along the curve have overreacted. The potential combinations of rate moves and yield curve shapes are endless, so we use only a few examples.

Assuming the path of rate cuts follows the Fed's projections[1] or the projections implied by the forward curve, the analysis indicates that:

- If one believes the yield curve will stay inverted, and maintain a fairly comparable shape to the current one, it appears better to stay in longer duration even after this recent move in UST rates.
- If one believes that the yield curve will steepen and become upward sloping over the next year as the forward curve is currently indicating, short-to-intermediate duration may be the better option.

[1] https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20240612.htm

What We Looked at For Future Rate Path

To estimate market expectations for where the Fed will move short rates and how quickly they will do it, one could use the UST forward curve or the CME Overnight Fed Funds Rate ("OFFR") futures. These are valuable tools to gain insights into the market expectations for rates.

Both of these tools have moved around considerably this year. The forward curve for the 10-year has shown that expectations for the 1-year forward have ranged between 4.4% and 3.8% during this quarter alone. CME futures have also shown a wide range of expectations this quarter, with the probability of a 50 basis point rate cut in September reaching as high as 85% and dropping as low as 30% more recently.[2] The volatility in these expectations makes it difficult to build an outlook. However, the Fed's FOMC does provide data on the committee members projected OFFR, and these are more stable as they are only revised periodically after FOMC meetings.

The UST forward curve is currently indicating that "market expectations" for rate moves through year-end 2025 are more aggressive than the Fed projections.[3] We believe the Fed projections show a reasonable, relatively smooth path that assumes no recession or sudden spike in inflation.

Exhibit 1: Forward Looking Rate Expectations

	FOMC Median Projections	Forward Curve Implied 1M Rate 8/30/2024	Difference
YE 2024	5.10%	4.44%	0.66%
YE 2025	4.10%	3.45%	0.65%
YE 2026	3.10%	3.45%	-0.35%
LT Rate	2.80%	--	--

Source: Federal Reserve, Bloomberg (FWCV). Past performance is not a guarantee of future results. For illustrative purposes only. Future allocations may materially differ. Diversification does not eliminate the risk of loss. Any trends depicted or described above may not continue.

Shape of the Yield Curve

The yield curve has remained negative for longer than any other period in history, as investors have waited for a major rate cut cycle to start for over a year.[4]

There are many popular attachment points for the yield curve. However, for the sake of simplicity in this exercise, we used the 1-month UST (as a proxy for OFFR), the UST 3-year (close to the High Yield Bond market OAD)[5], and the UST 10-year (close to the Investment Grade market OAD)[6]. Broadly, if one believes the yield curve will stay inverted over the next year, the longer duration UST 10-year would likely benefit from a larger price move than the 3-year (unless the curve remained inverted, and the 3-year steepened considerably more than the 10-year).

[2] https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html
[3] The FOMC OFFR projections are for Year end 2025 the US treasury Forward Curve measures 1 year forward to August 2025, so it is not exactly comparable, but the Forward Curve still indicates a more aggressive path through 2025
[4] The Fed's FOMC last raised rates in July 2023.
[5] ICE BofA U.S. High Yield Index (H0A0)
[6] ICE BofA U.S. Corporate Index (C0A0)

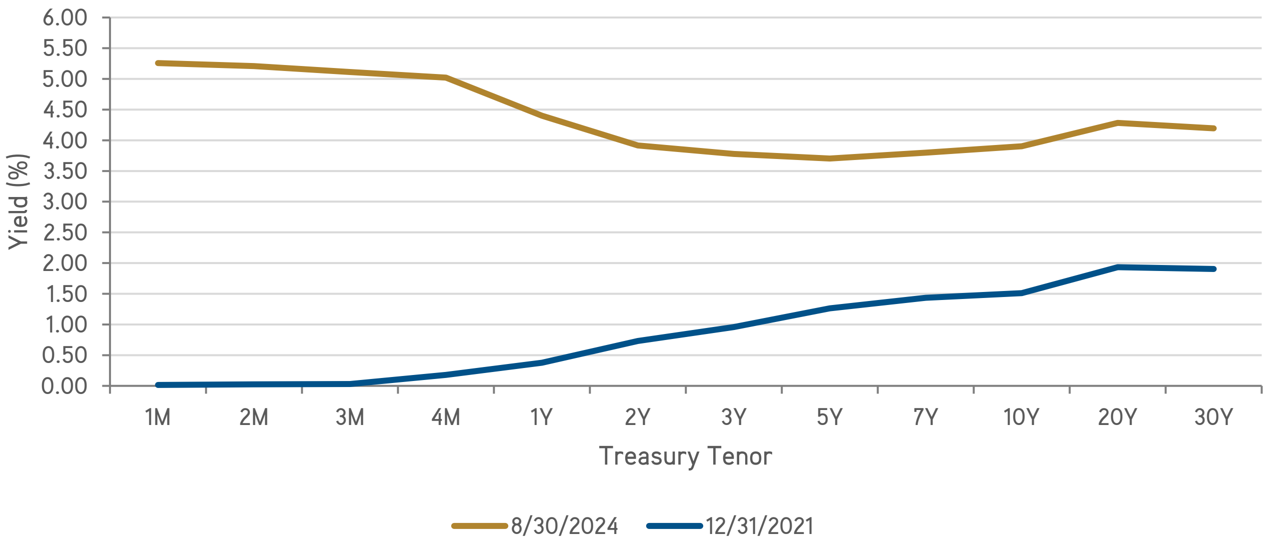
However, if the yield curve steepened and moved to where the forward curve indicates rates will be a year from now (see **Exhibit 2**), there would likely be a modest gain in the price of the 3-year and loss of price in the 10-year. It is worth noting that prior to the 2022 rates hikes, looking at longer-term averages, the yield curve would be materially steeper than the current shape (See **Exhibit 3**) and steeper than the forward curve is indicating it will be in one year.

Exhibit 2: Forward Yield Curve

	GT3	GT10
8/30/2024	3.78%	3.90%
8/30/2024 1Y Forward	3.53%	3.95%
Change to Forwards	-0.25%	0.05%

Source: Bloomberg. Past performance is not a guarantee of future results. For illustrative purposes only. Future allocations may materially differ. Diversification does not eliminate the risk of loss. Any trends depicted or described above may not continue.

Exhibit 3: Yield Curve Comparison



Source: Bloomberg. Past performance is not a guarantee of future results. For illustrative purposes only. Future allocations may materially differ. Diversification does not eliminate the risk of loss. Any trends depicted or described above may not continue.

Conclusion

This exercise highlights that a large part of how securities will perform in a rate cut environment may depend on how the yield curve adjusts. Because of the extreme inversion of the yield curve, the classic trade of buying longer duration in front of a rate cut may not benefit investors. This can help an investor consider whether it is worth pursuing duration after the recent UST moves and help to compare relative value between fixed and floating rate asset classes. When considering total returns, one should also factor in the interest income during the holding period. Generally, by obtaining longer duration assets in the corporate debt markets, one should move to higher rated and lower yielding instruments, further impacting total returns.

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