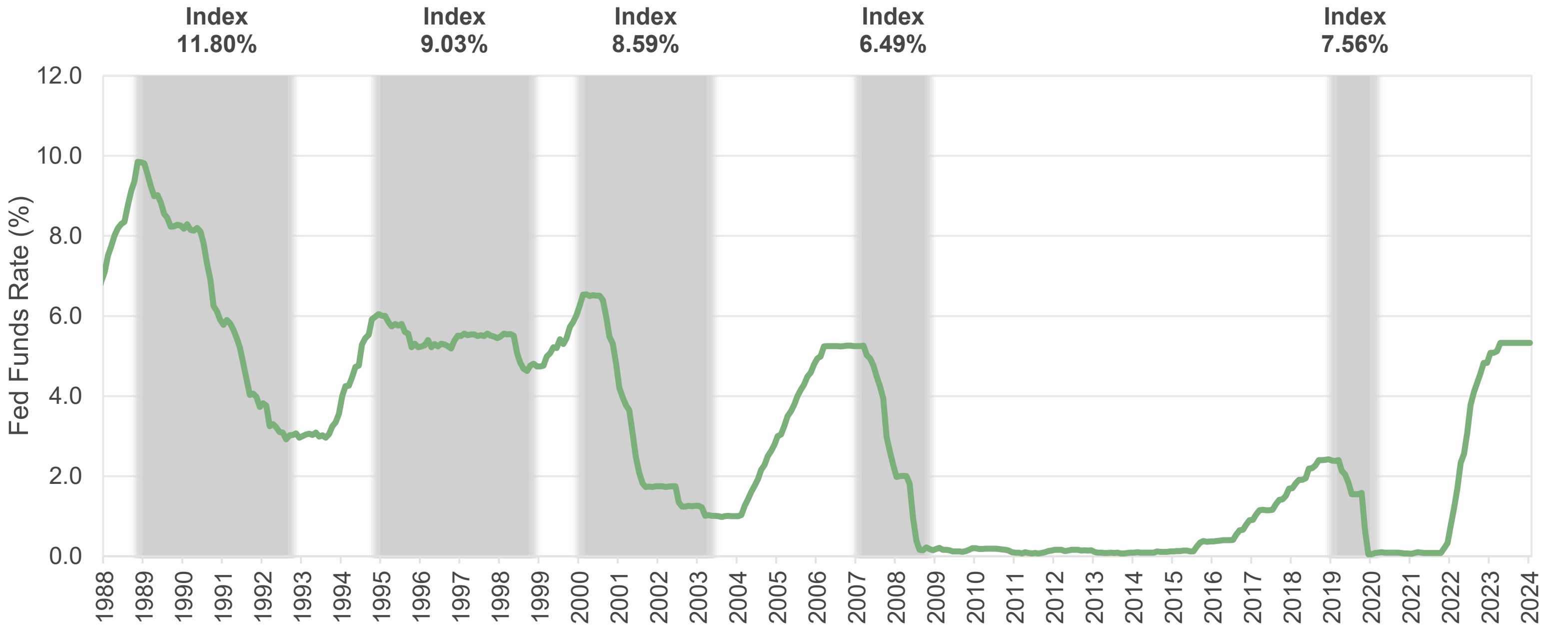
Fixed Income and Federal Reserve Rate Cuts: How Should We Expect Fixed Income to Perform?

June 2024

Fixed income security prices and interest rates generally move in opposite directions. When market yields fall, the discounted present value of a fixed stream of cash flows is worth more, and likewise is worth less when yields rise. Each security's sensitivity to changes in interest rates is measured by the bond's duration. Duration, defined as weighted average time until cash flows are received (in years), is more commonly thought of as an estimate of the sensitivity of a bond's price to changes in interest rates. For example, if we had a bond with a duration of six years and yields fell by 50 basis points (bps), we would estimate that the immediate impact of that rate decline would cause the price of that bond to increase by approximately 3% (0.50% rate move x 6-year duration = 3%).

As one would expect, in most historical periods where interest rates were declining, fixed income total return has been good, with investors capturing coupon income as well as benefiting from the increase in prices as rates fall. Looking at the history of the Bloomberg Aggregate Bond Index since 1988, in the previous five Federal Reserve (Fed) rate-cutting cycles, the index posted annualized returns averaging north of 8%, as illustrated below.

Fixed Income Performance in Declining Rate Cycles[1]



That said, interest rate duration isn't the whole story. The reason for the decline of interest rates also matters, as the macroeconomic environment will also impact risk premiums, or spreads, of fixed income securities relative to Treasuries with similar durations.

To get a better estimate for fixed income performance (and to make better decisions as to what types of fixed income we'd like to own) we also need to consider a bond's exposure to changes in these risk premiums, which is where spread duration comes in. Spread duration measures the sensitivity of a bond's price with respect to changes in the required spread over Treasuries of an equal maturity. Its impact on bond pricing is very similar to that of duration and regular changes in rates in that as required spreads rise, bond prices fall, and vice versa. Spread changes are often a large driver of how the various fixed income subsectors perform relative to Treasuries and, as such, are key to any fixed income outlook, in our view.

[1]The index total return periods include one additional month before and after each cycle to reflect market expectations and reactions. Returns are annualized for periods greater than one year. Fed funds rate data is as of 05.31.2024. Performance is compared to an index: however, the volatility of an index varies greatly and investments cannot be made directly in an index. Market conditions vary from year to year and can result in a decline in market value due to material market or economic conditions. Sources: Bloomberg L.P.; Federal Reserve Economic Data. Yields are subject to market conditions and are therefore expected to fluctuate. Charts are for illustrative purposes only. The views expressed represent the opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful. The performance presented represents past performance and is no guarantee of future results.

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There have been years in the past, most recently 2019-2020, as well as during the Great Financial Crisis (GFC) of 2007-2008, where aggregate fixed income indices posted negative “excess” returns relative to Treasuries, despite still having positive total returns as interest rates fell, due to fixed income risk premiums increasing as economic stress set in. In such years, we believe investors would be better served by owning Treasury securities and avoiding sectors like corporate bonds and securitized products which typically trade with an additional spread above Treasuries (hence the higher income potential in these sectors).

In deciding how best to position within fixed income ahead of a potential decline in yields today, we need to find a perspective regarding how interest rates and spreads might perform in various economic scenarios, such as a soft landing, hard landing, or no landing at all.

In a soft-landing economic scenario, inflation is generally moving back towards the Fed’s 2% target over time, the economy is slowing towards trend or moderately below trend, but importantly, a recession is avoided. The Fed is able to begin to cut rates but move relatively slowly in doing so. In this scenario, which is largely what is priced into markets as a base-case today, yields are likely to come down, with the front-end coming down more than longer-dated maturities, removing some of the inversion from the yield curve. Importantly, as the economy avoids recession, fixed income spreads for sectors like corporates, mortgage-backed securities (MBS), and asset-backed securities (ABS) are stable and these sectors are likely to post positive excess returns relative to Treasuries, primarily due to their yield advantage over Treasuries. In this scenario, robust total returns are expected for fixed income.

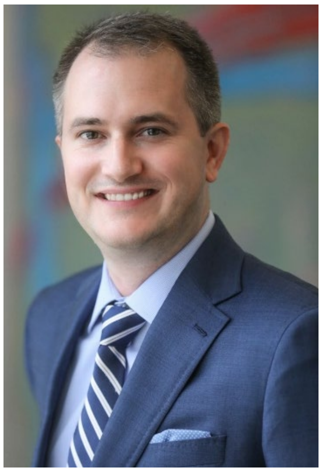
In a hard-landing scenario, which is a more common outcome of a Fed hiking cycle, high interest rates ultimately bring enough economic stress to induce a recession and inflation falls quickly as demand evaporates. Interest rates fall more quickly in this scenario as the Fed is forced to cut rates sharply to combat the economic stress and a flight-to-quality often ensues, causing risk premiums to rise and excess returns of many spread sectors, such as corporates and securitized products, to potentially lag behind the performance of Treasuries. This is what the market experienced in extreme form during the GFC, when fixed income total performance was still positive. We believe investors would have been better off in Treasuries and underweight the spread sectors.

The final scenario is one of "no landing", where inflation remains elevated and the economy remains resilient, potentially forcing the Fed to further raise rates to get inflation under control. In this scenario, the outlook for fixed income performance is less clear. Higher rates would generally cause prices to decline and for many securities, particularly securitized products whose underlying loans/assets are more sensitive to rate changes, could also result in risk premiums moving higher which would further pressure performance. While a resilient economy could offset some of this weakness, we would expect concerns that additional Fed hikes would ultimately cause more things to “break” would keep pressure on spreads more broadly. Total returns for fixed income could end up positive or negative, depending on how much higher rates had to go to successfully fight inflation.

Where does this leave us today? Fixed income markets currently appear to be pricing a soft-landing scenario, where economic growth slows and inflation ultimately moves toward the Fed’s target. Based on the data we have today, we agree that this scenario is the most likely. However, we see this process playing out slowly, with the Fed only able to get one to two cuts in by the end of this year. As the economy does slow and inflation resumes its downward trend, spreads for corporates and securitized products are likely to remain stable or biased tighter, and total and excess returns are expected to be positive, a solid backdrop for fixed income investors, in our view.

Still, we certainly acknowledge the risks of a hard- or no-landing scenario and are keeping risks within the portfolio relatively low, with a bias up-in-quality to limit exposure to potential spread-widening outcomes and preserve total return.

Important Information



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Jeffrey D. Ormsby, CFA®, Executive Director, joined Sterling Capital Management in 2010 and has investment experience since 2006. Jeff is a Senior Fixed Income Portfolio Manager. Prior to joining Sterling, he worked for Smith Breeden Associates as a CMBS trader and portfolio management analyst within the investments group. Jeff received his B.S. in Economics from North Carolina State University, where he was a summa cum laude graduate and was recognized as Valedictorian, and his M.B.A. from the University of North Carolina at Chapel Hill's Kenan-Flagler Business School, where he was the Norman Block Valedictorian Award recipient. He holds the Chartered Financial Analyst® designation.

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The **fed funds rate** is the interest rate that depository institutions (such as banks and credit unions) charge other depository institutions for overnight lending of capital from their reserve balances on an uncollateralized basis.

A Note on Indices: The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

The Bloomberg U.S. Aggregate Bond Index is an unmanaged index composed of securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. It is not possible to invest in the Bloomberg U.S. Aggregate Bond Index, which is unmanaged and does not incur fees and charges.

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