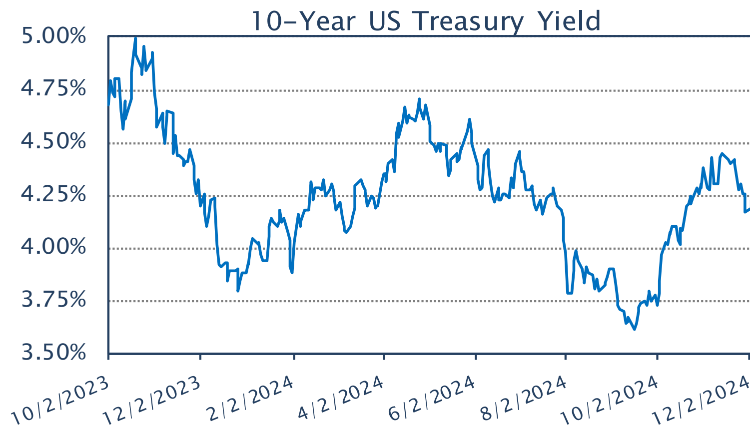
DECEMBER 2024

INVESTMENT UPDATE

As the curtain comes down on 2024—and, if you can believe it, on the first quarter of this century—we have the chance to look back on what has been an eventful year for bond investors. We'll hit the high and low points, with an eye towards what opportunities may be in store as we move into 2025.

It's fair to say that it's been an up-and-down year for the bond market, as investors have alternatively been both optimistic and pessimistic at times, particularly when it comes to US monetary policy. You may recall at this point last year most investors were convinced (at least judging by what they were buying) that the Federal Reserve's tough monetary policies would soon be ending. With inflation falling in the second half of 2023, bond investors were feeling downright ebullient, and money flowed into the bond market, boosting bond prices. The broad-based Bloomberg US Aggregate Index generated a return of 6.82% (unannualized) in the fourth quarter of 2023, the best quarterly performance for the high-grade US bond market since 1984.



By the new year, incoming data on US inflation leveled out at a rate well above the Fed's 2% target, dampening hopes for imminent rate cuts. As the chart on this page shows, after hitting a low of 3.80% in December of 2023, benchmark 10-year US Treasury yields spent the next four months steadily rising, reaching 4.68% by the end of April—an increase of nearly 90 basis points.

During the Spring, the labor market began showing signs of weakness, with the US unemployment rate jumping from 3.7% to 4.0%. Looking again at the chart of 10-year Treasuries, you can see that this weakness jumpstarted the bond market, with investors once again convinced that the Fed was really, truly going to have to ease up on its tough monetary policies and begin lowering the overnight Fed funds rate. And this time, the Fed was forced to agree. Just two days after opting to keep the funds rate at 5.25%-5.50% at its July 31 Federal Open Market Committee (FOMC) meeting, the unemployment rate jumped up to 4.3%, and the rally (which had begun in June) accelerated. Over the next few weeks the Fed began communicating that, even though inflation remained above its 2% target, there was sufficient evidence of a cooling economy to begin loosening policy. The only question was the magnitude of the first rate cut, which became clear on September 18th when the FOMC announced a 50 basis point (0.50%) cut in the Fed funds rate.

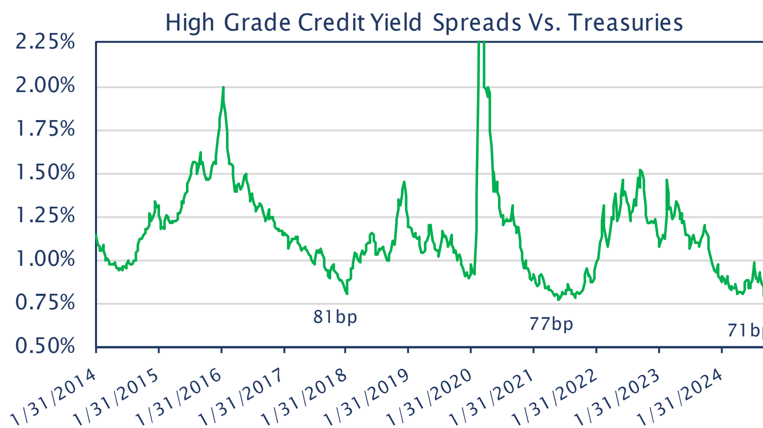
Of course, there was one more unexpected turn in the market, par for the course in this volatile year. As shown on the chart, bond yields began rising immediately after the first rate cut in mid-September and kept rising even after a second rate cut—this one of 25 basis points—on November 7th, with 10-year yields peaking at 4.45% in mid-November. Inexplicable, you might say, but bond investors are a fickle bunch, and even a cumulative 75 basis point drop in overnight lending rates couldn't erase the fact that inflation made little, if any, progress towards the Fed's 2% target in the second half of 2024.

Looking back on the year, it seems pretty clear that the Fed's policy of reacting to incoming data, rather than having a more formalized, model-driven policy that might provide "forward guidance" resulted in more uncertainty about the future path of interest rates than what bond investors had been accustomed to. As an example, when the Fed embarked on its hiking cycle in early 2022, the accompanying statement to that rate hike noted that the FOMC "anticipates that ongoing increases in the [Fed funds] target range will be appropriate." There was no such language when the Fed began its easing cycle in September; instead, the FOMC stated: "In considering additional adjustments to the target range for the federal funds rate, the Committee will carefully assess incoming data, the evolving outlook, and the balance of risks." Yes, the "dot plots"—the updated range of FOMC members' estimates of the future path of the funds rate—showed that the overnight rate would likely be coming down in the coming months (and years), but officially, there was no statement to that effect. In short, investors were left to figure it out for themselves.

In fairness, the Federal Reserve has long been loath to paint itself into a corner; remaining flexible in order to respond to changes in the economy is highly valued, especially in the Jay Powell era. It's also fair to point out that the economic picture has been mixed over recent months, with the US economy by turns indicating weakness and unexpected strength. And while we will not be drawn into a political debate, there's little ques-

tion that the newly-elected administration has espoused a set of policies that are, at least now in their formative state, difficult to handicap. What will be the size and breadth of US tariff policies? Will our immigration policy embrace "mass deportations" or a more measured approach to reform? How stimulative will tax policies be? We don't have nearly enough details yet, and neither does the Fed. Clearly, there's plenty for investors to chew on when considering future US monetary policy.

Away from monetary policy and its impact on Treasury yields and prices, 2024 has been a mixed bag for non-Treasury securities. The high-grade credit sector has generated very good relative returns, as investor demand has been strong and, as demonstrated by the S&P 500's 25%+ returns in 2024, taking risk on corporate profitability has been rewarded. Fundamentally, corporate America has held up well in this environment, with profits and free cash flow more than ample, leading to another year when ratings upgrades easily outpaced downgrades; this was particularly true among companies at the lower end of the ratings scale.



As a result, yield spreads for high-grade corporate credits narrowed in 2024 when compared to like-maturity Treasuries. The chart on this page shows the extra yield of the typical investment-grade credit compared to Treasuries. This period includes the spike in spreads that occurred in 2020, when corporate bonds briefly offered yields 300 basis points above Treasuries, and the remarkably rapid decline just a few short months into the pandemic. We also see that over the past 18 months or so (i.e., since the mini-bank crisis of early 2023) corporate bond yields spread have been on the descent, and now sit at their narrowest margin to Treasuries in more than a decade.

That narrowing means that corporate bond yields have fallen—and their prices have risen—when compared to Treasuries of similar maturity over this period. Translated into total returns, the average high-grade credit has outperformed benchmark Treasuries by more than 2.3% so far in 2024. What's more, lower rated bonds have experienced the largest compression in yield spreads, and therefore have generated better relative returns, with BBB-rated bonds outperforming like-duration Treasuries by 3.1%, compared to 2.1% for A-rated bonds.

While the strong performance of credits over recent months has been good news for those willing to take on a bit of credit risk, the bad news is that, with yield spreads now at their skinniest levels this cycle, most of the juice has been squeezed out of this sector. That doesn't make them a poor choice for investors, necessarily, as we've experienced extended periods in the past where corporate yield spreads remained tight for years. But what it does mean is that investors shouldn't expect to earn much more than coupon income from this sector in the coming quarters, as excess returns have all but been wrung out of the credit markets. As value investors, we're also aware that the Graham-Dodd "margin of safety" cushion is thinner than average when corporate yield spreads are narrow, meaning that investors should be especially selective in the corporations whose bonds they buy.

At the positive end of the relative value spectrum are US agency mortgage-backed securities (MBS), a sector of the high-grade bond market that remains overlooked and underappreciated by many investors. You will recall that the Fed (a ubiquitous presence in our market over the past few years) bought essentially all of the supply of newly-issued agency MBS in the post-COVID period in order to keep mortgage lending rates down, indirectly supporting households by propping up home prices during the pandemic. This came on the heels of a similarly large program after the 2008 financial crisis, a program which itself lasted for nearly a decade. Even though the Fed ended its MBS buying program in 2022, the net effect was that MBS prices were artificially inflated for the better part of the last fifteen years.

Not only has the MBS sector been jilted by the Fed, but commercial banks—traditionally the "natural buyers" of agency MBS—have been largely absent as well. Banks are seeing strong demand for loans, which have a greater profit margin than MBS. Many banks are also carrying trillions of MBS purchased at much higher prices during the pandemic (before inflation ravaged bond prices), which continues to impair banks' regulatory capital, limiting their appetite for additional MBS purchases.

This vacuum of demand for MBS means that their prices are somewhat depressed, providing total return investors (like Agincourt) the opportunity to buy US government-backed bonds with yields that rival, and in many cases beat, those of lower quality corporate bonds. Agency MBS continue to represent very good relative value for investment-grade bond buyers, and with their US government backing, offer a safer haven than corporate bonds should the economy unexpectedly weaken in 2025.

In all, 2024 has provided both opportunities and a few stumbling blocks for bond investors, and 2025 is looking like it could continue that same pattern.

As always, we'd like to thank you for the trust you've placed in our team. Happy Holidays from all of us at Agincourt!