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Capital Management, LLC

Fixed Income and Credit: The Federal Reserve Hikes Again.

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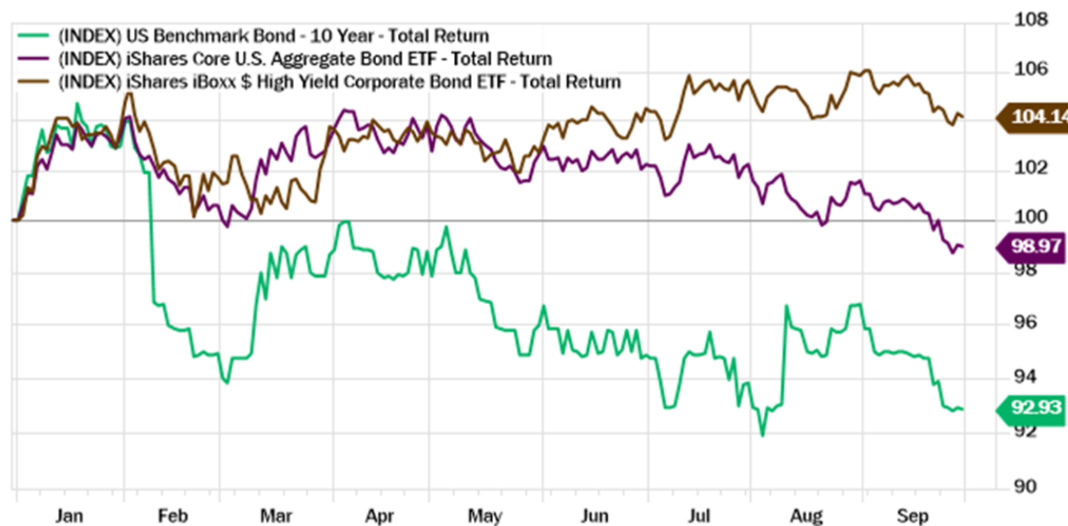
October 2023

The yield curve shifted higher as the Fed hiked again in July.

Interest rates rose in the quarter and finished at year-to-date highs across the yield curve. The move higher in rates weighed on performance, with both benchmark 10-year Treasury Notes and the US Aggregate Bond Index, a broad measure of the investment grade debt market, now negative for the year. 'High Yield' debt outperformed the broader market as credit spreads tightened, continuing the trend since the start of the year. Credit spreads represent the incremental yield above Treasury yields of the same maturity and are a measure of credit risk for corporate bonds.

Total Return Performance: Year-to-date



Source: FactSet. Performance indexed to 100 as of Jan 1st, 2023.

A key theme of the quarter was the definitive move higher in medium- and long-term rates. For example, the 0.76% increase in 10-year Treasury yields was much higher than the 0.17% increase in 2-year yields. While headlines tend to focus on the Federal Reserve and rate hikes, the Fed only directly controls an overnight rate of interest (the Federal Funds rate) and exerts influence across the 'short-end' of the yield curve (i.e., from overnight to about 2-years). Longer-term rates tend to move in relation to expectations for long-run growth and inflation. So even as the Fed nears the end of its rate hike journey, long-term yields can and will continue to adjust to the prevailing economic environment. As shown in the following charts, U.S. corporate yields repriced significantly higher in the quarter, up by nearly 70

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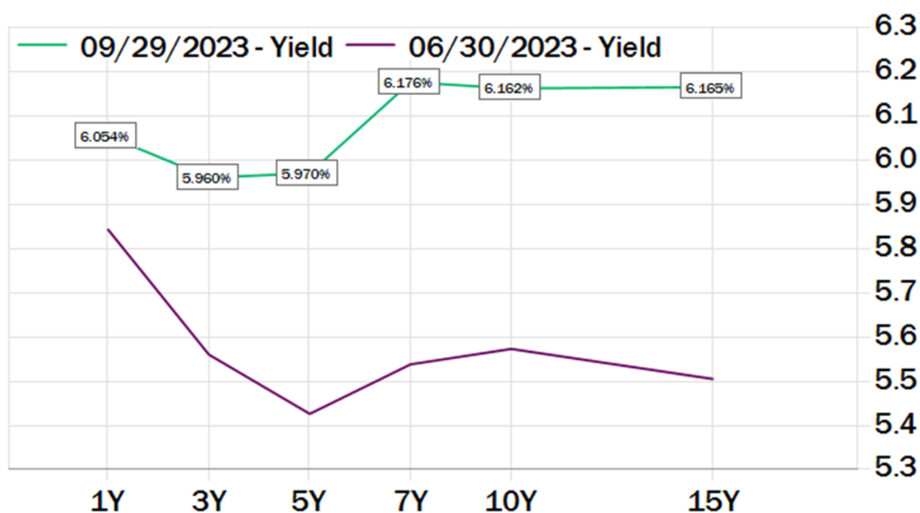
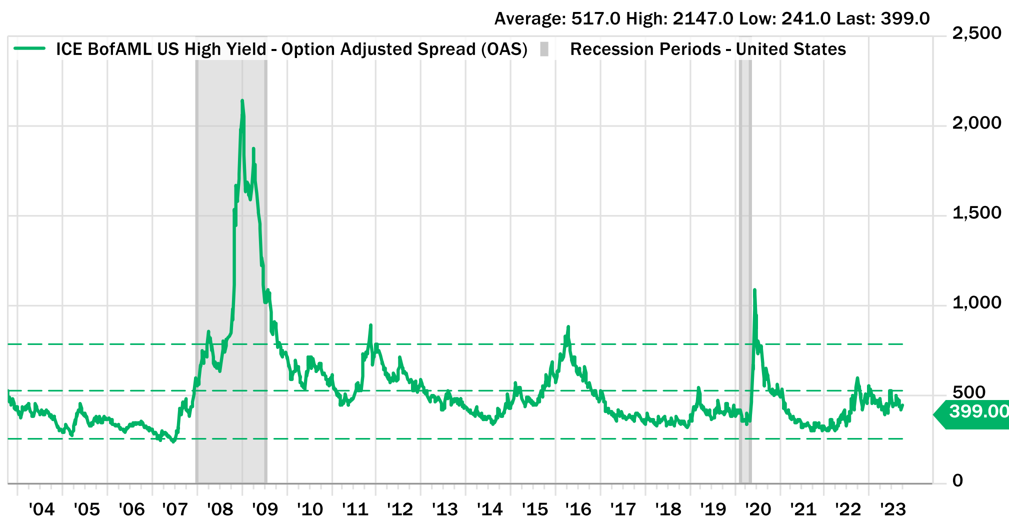
basis points (0.70%) at the longer end of the curve. Meanwhile, credit spreads remained quiet, ending the quarter just off year-to-date lows, and remaining well below the long-term average. Notwithstanding the slight move higher to end the quarter, credit spreads aren't currently implying much of a recession at all.

U.S. Corporate Yield Curve



Source: FactSet

High Yield Credit Spreads



Source: FactSet

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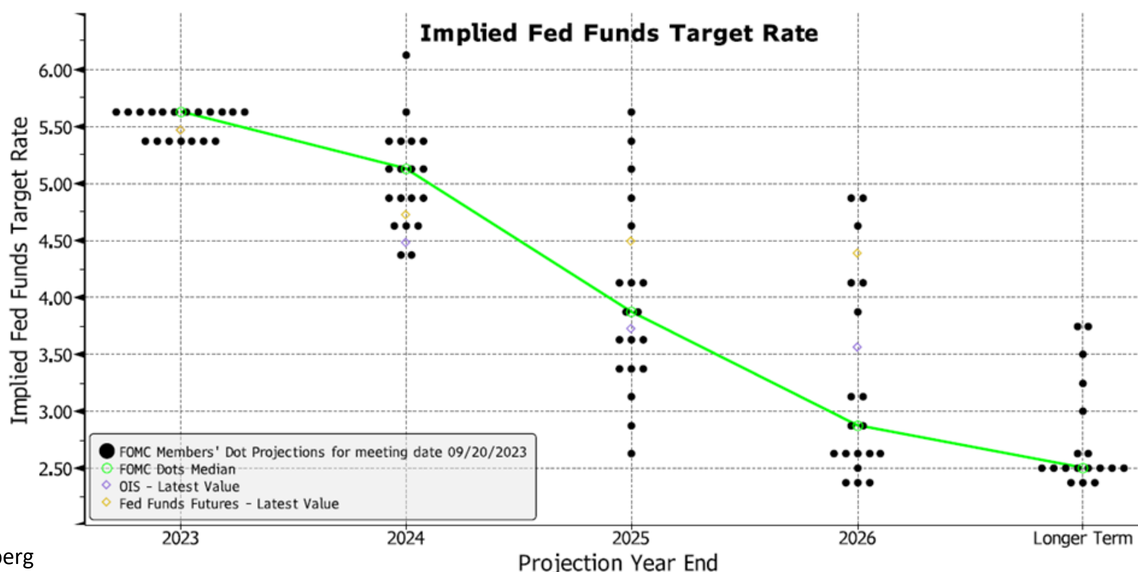
The fight against inflation isn't over yet.

The third quarter ended with the September Federal Open Market Committee (FOMC) meeting resulting in no change to the Federal Funds rate. The result was not surprising; however, the updated "Dot Plot" does offer new insights into the Fed's view on inflation and the future path of rates. The updated Dot Plot exhibits the inclination among Fed Presidents to hike one more time in 2023, although only by a narrow margin. Additionally, bigger changes are forecast in 2024 and 2025. The year-end median rate now implies just ~2 rate cuts in 2024, two fewer than was forecast in June. Another two rate cuts were removed from the year-end 2025 forecast. The net effect is a longer, more gradual path toward the "longer-term" target of 2.50%.

So, why the new "higher for longer" forecast? The answer is in part due to a better economic outlook and the still-too-high level of inflation. Along with a new Dot Plot, the Fed also publishes quarterly economic projections which display a sharp turn higher in real GDP growth in 2023 (2.1% from 1.0% previously) and 2024 (1.5% from 1.1% previously). Additionally, unemployment is seen ending the year at 3.8% (down from 4.1%). While the forecasts improve, Headline CPI inflation data has come in hotter than expected in Q3 breaking the precipitous fall seen over the first half of the year. Overall, the combination of higher growth, tighter labor markets, and stubborn inflation explains the slower evolution of monetary policy in 2024 and beyond.

September Dot Plot



Source: Bloomberg

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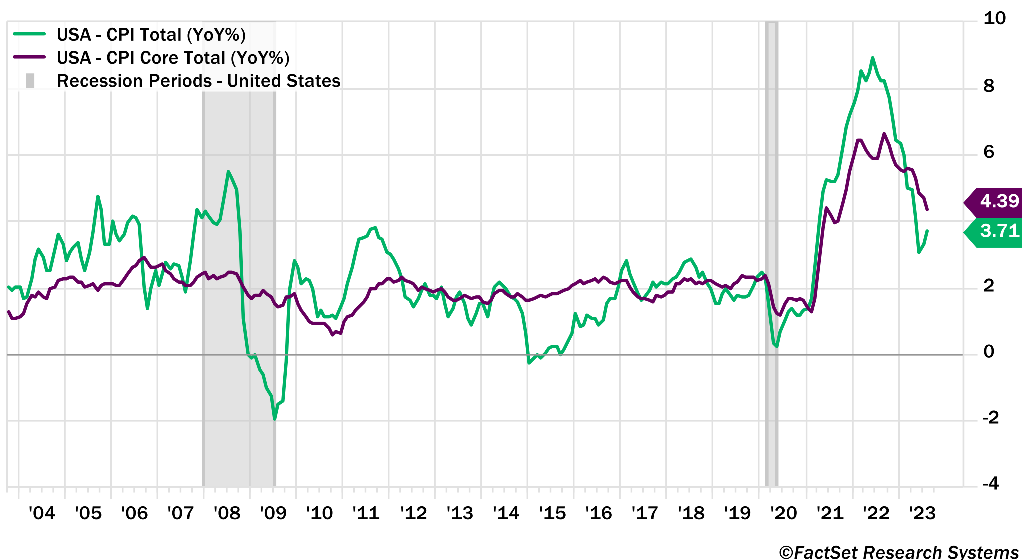
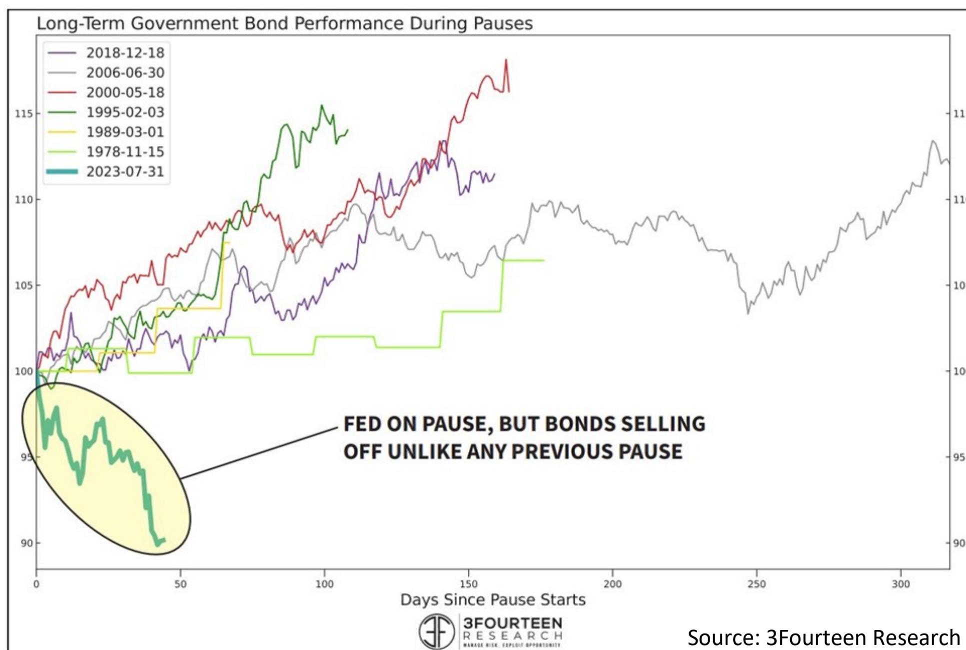
U.S. CPI Data – Last 12 Months



End of an era (almost)…. Looking ahead at a post-hike-cycle world.

As we approach the end of the rate hike cycle, let's look at how bonds have performed during previous "pause" periods (i.e., after the Fed's last rate hike and before the first rate cut). As depicted in the first chart, every pause period since 1978 saw bond prices rise (i.e., yields fall). This time, however, we've seen long-term yields continue to rise since the July hike as highlighted in the yellow circle.



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In the second chart, you can observe the very strong relationship of yield changes around the last Fed hike going back to 1984. Given the fact that yields continued to rise after the July hike, and if history is any indication, the yield curve may suggest one more hike could be in store in December. ■

US10Y bond yield move around last Fed hike

	US 10Y bond yield move (bps)									
	Aug 84	Sep 87	Feb 89	Feb 95	Mar 97	May 00	Jun 06	Dec 18	Average	Median
-12m	100	214	118	192	52	80	122	29	113	109
-11m	97	200	87	138	23	50	92	10	87	89
-10m	100	201	61	72	11	76	103	-12	76	74
-9m	97	232	17	62	-13	46	90	-10	65	54
-8m	79	216	49	54	-8	53	63	-16	61	53
-7m	96	207	28	34	1	36	72	-30	55	35
-6m	69	218	4	55	7	47	84	-14	59	51
-5m	7	175	42	49	23	12	68	-8	46	32
-4m	-14	82	57	6	63	-26	64	-11	28	31
-3m	-86	76	30	-24	42	-12	39	-31	4	9
-2m	-113	100	34	-27	14	18	14	-44	0	14
-1m	-76	51	44	-16	37	57	15	-31	10	26
Fed last hike										
1m	-13	29	4	-44	18	-45	-20	3	-9	-5
2m	-66	-41	-23	-46	-2	-33	-42	-12	-33	-37
3m	-125	-33	-76	-60	-32	-59	-57	-14	-57	-58
4m	-127	-50	-114	-146	-58	-58	-52	-20	-78	-58
5m	-116	-102	-135	-146	-38	-69	-67	-36	-89	-86
6m	-100	-101	-120	-119	-64	-76	-49	-73	-88	-88
7m	-81	-63	-117	-143	-78	-124	-30	-70	-88	-80
8m	-144	-37	-151	-148	-91	-119	-63	-115	-108	-117
9m	-200	-22	-159	-168	-102	-132	-55	-97	-117	-117
10m	-224	-52	-156	-195	-108	-165	-50	-100	-131	-132
11m	-229	-31	-101	-209	-115	-117	-31	-97	-116	-108
12m	-246	-29	-84	-206	-112	-98	-17	-83	-109	-91

Source: JP Morgan

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