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# A Bumpy Start to the Rate Cut Era

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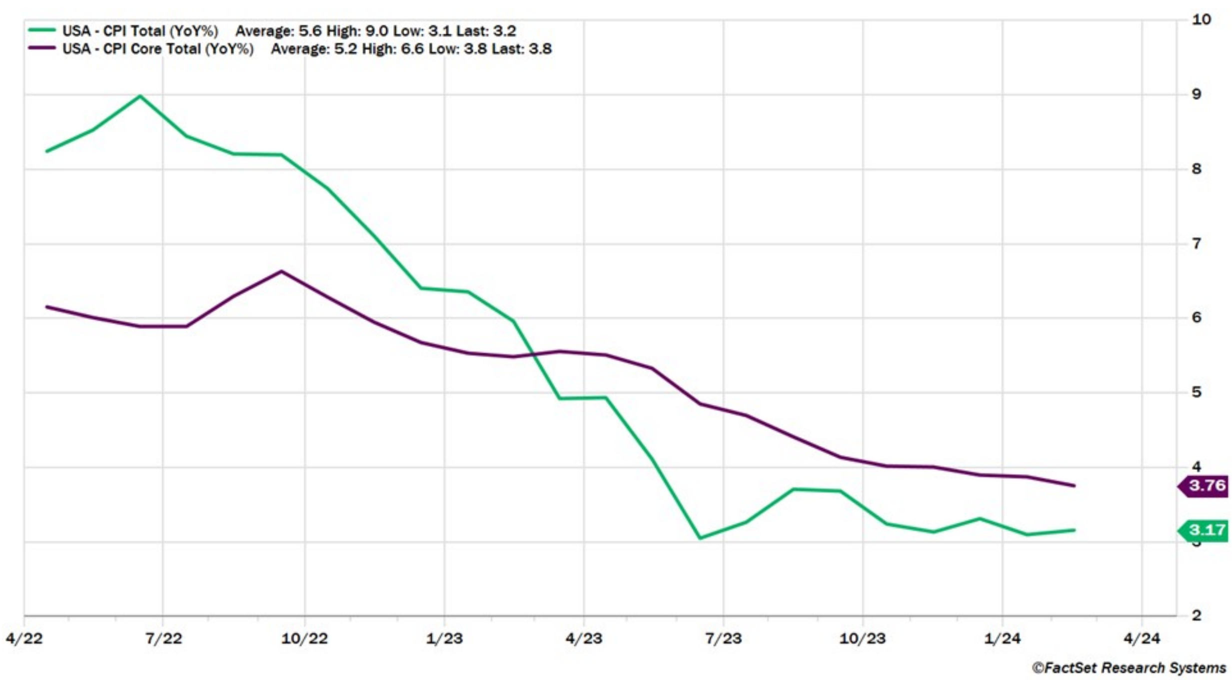
Fixed income markets kicked off the year with an atypical jubilance for an asset class designed to preserve capital and generate income. Nevertheless, a rapid decline in long-term rates over the last 70 days of 2023 led to fixed income investors expecting more in 2024. Why the exuberance? Let's do a quick recap:

- The Fed has been on pause since July (widely expected to be the last hike of the cycle).
- Disinflationary forces appear to be setting in, and inflation data cooled into year-end.
- The soft-landing narrative was winning supporters, captured by tightening credit spreads which finished the year at the lowest level since early 2022.
- These factors, among others, resulted in bond market capitulation whereby the benchmark 10-year Treasury yield tumbled from a ~15-year high by over 100 basis points (1.00%) in the fourth quarter.

Now with the first quarter of 2024 behind us, we know the disinflation process won't occur in a straight line. Inflation data has come in hotter than anticipated while the labor market remains very strong. Federal Reserve Chairman Powell has acknowledged these factors, and the official line is that the Fed can afford to be patient before cutting interest rates. Not quite the fanfare some hoped for, but so be it.

## U.S. CPI – Last 24 Months



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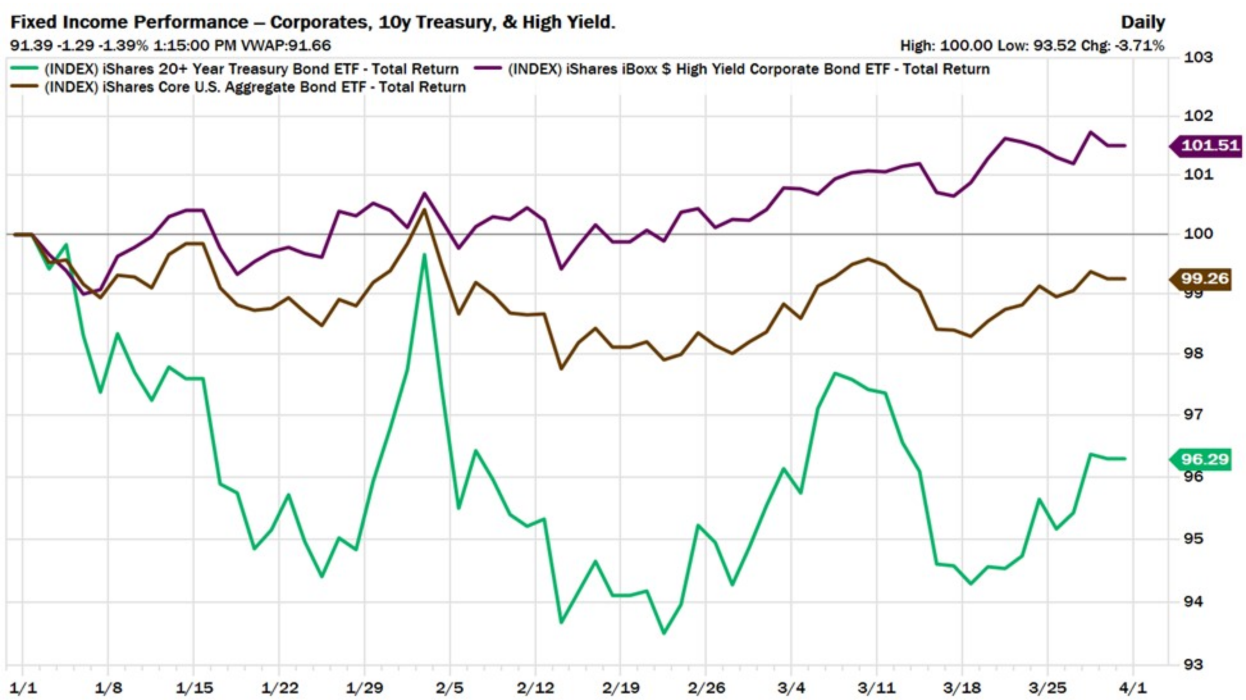
## Year-to-Date Performance

Through Q1, long-term Treasuries declined around 4% while corporate bonds performed better in part due to tighter credit spreads. The U.S. Aggregate Bond Index, a broad measure of the investment grade debt market, was down less than 1% in Q1. The High Yield Bond Index performed even better, up just over 1%. Within the Corporate bond complex, the best performing Investment Grade sectors were financials and energy. Leading sub-sectors included banking, finance companies, airlines, automotive, gaming, and home construction.




Source: FactSet Research

## The Federal Reserve Met in March. What happened?

On March 20th, the Fed concluded their latest meeting resulting in no change to the Federal Funds rate. The Committee released a highly anticipated "Dot Plot", which is a survey establishing where members see the Federal Funds rate in the future. The new plot displayed a minor but important change from the December version. The rate path in 2024 implies three cuts (unchanged), however it now implies four cuts in 2025 which is one less than previous. Also, the "longer-term" target moved slightly higher above 2.50%. A primary driver of the less aggressive rate path was the markedly higher GDP growth forecast, up to 2.1% for 2024 (from 1.4% in December) with a tighter labor market to boot. Overall, the meeting was slightly more hawkish than December showing a shallower path of rate cuts, but the overall trajectory remained the same.

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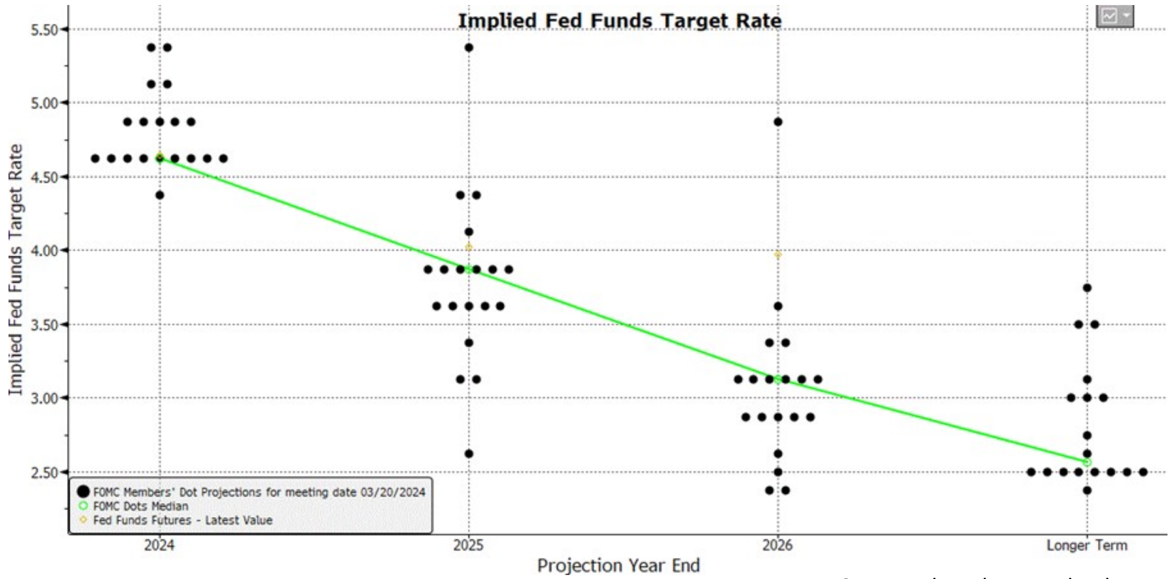
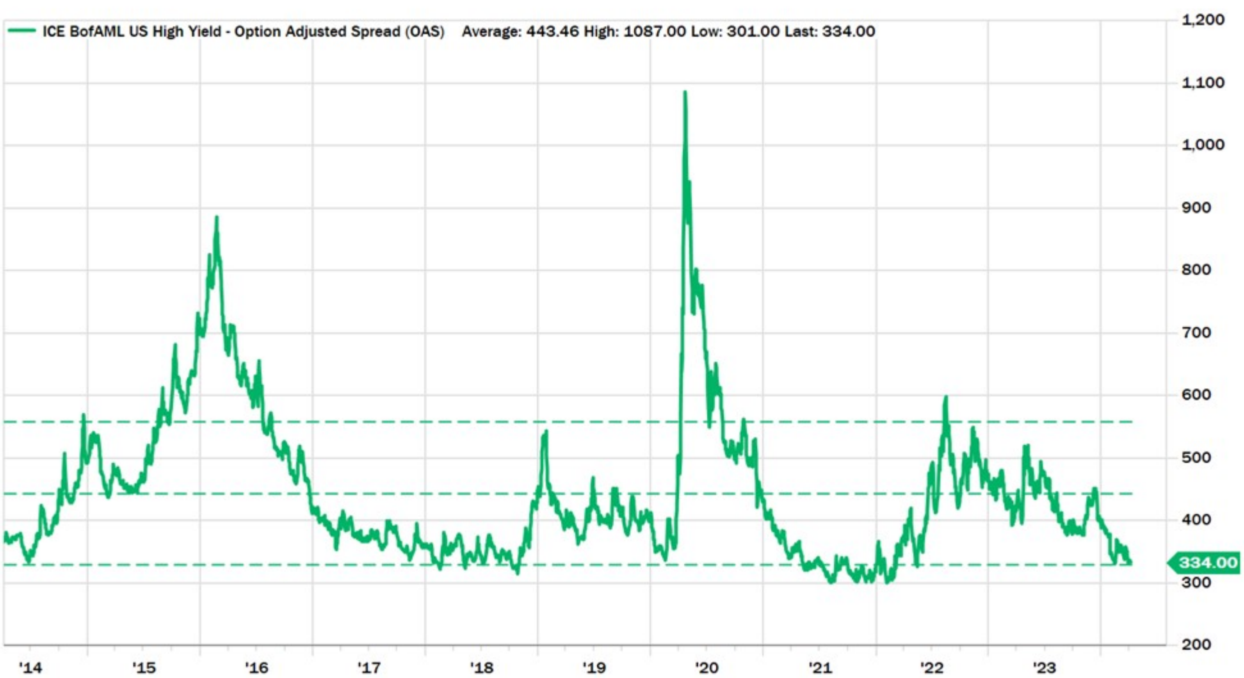



Source: Bloomberg, Federal Reserve

**Rate cuts get all the press… Some thoughts on other fixed income market dynamics.**

1. *Tightening credit spreads.*

Source: FactSet Research




Credit spreads, a measure of additional yield over a risk-free security required for riskier corporate bond issuers, continue to decline from the 2022 high watermark and are approaching 10-year lows. This narrowing of spread has supported returns for corporate bonds versus Treasury bonds.

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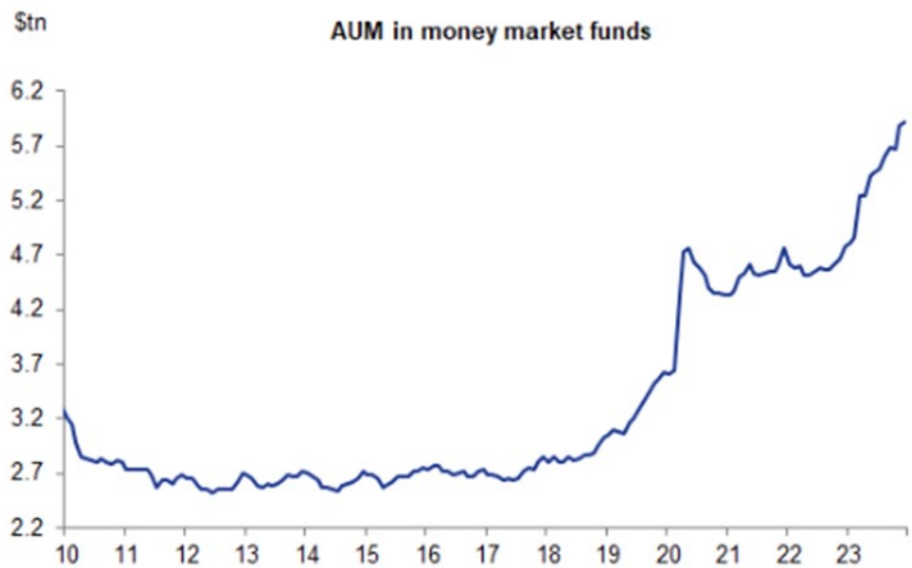
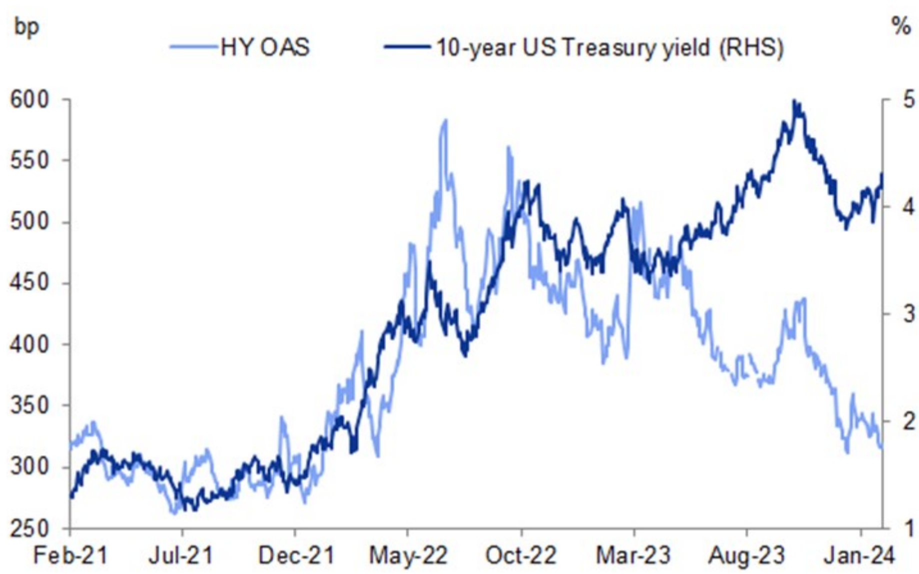
Spreads are near 10-year lows, can they get tighter? Perhaps. One avenue resides in the substantial assets in money market funds (MMF) today. Investors have increased allocations to MMF's as the Fed increased rates. When the Fed starts cutting rates, a rotation out of MMF's into longer-duration assets could support further tightening. MMF assets are at all-time highs.




Source: EPFR, Goldman Sachs Global Investment

An interesting dynamic is the recent breakdown in correlation between 10-year Treasury yields and credit spreads.




Source: Goldman Sachs

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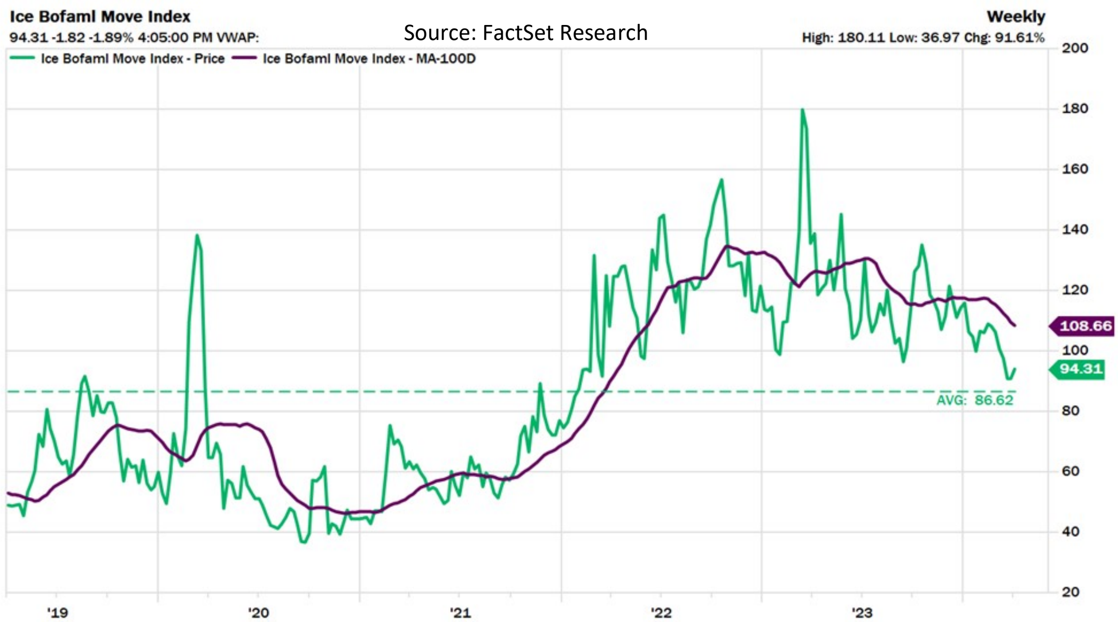
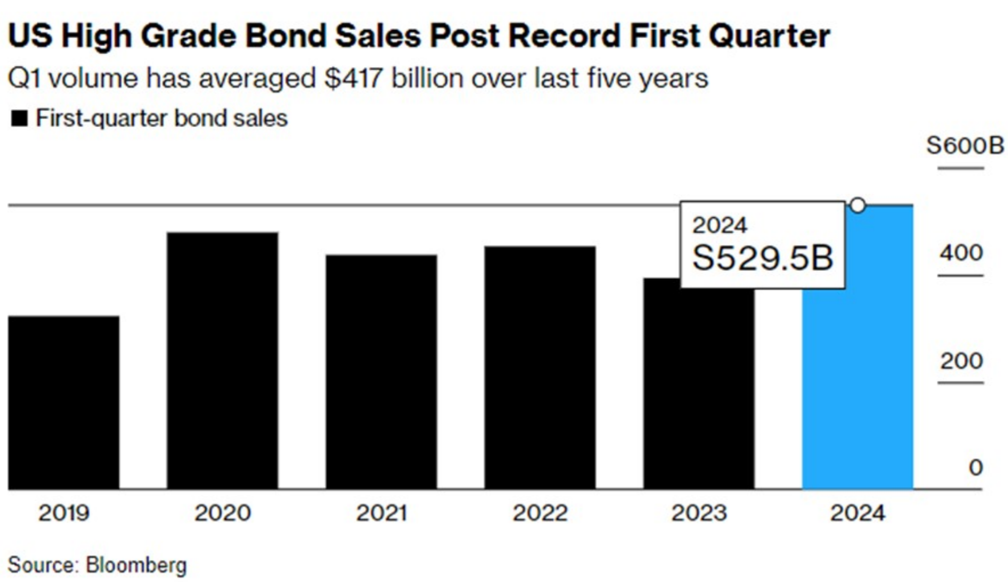
*2. Declining volatility.*

After two years of elevated volatility in Treasury markets, it appears a top has formed along with the start of a new downtrend. The ICE BAML Move Index, a measure of Treasury volatility, hovers just above the 5-year average.




*3. Bond issuance hit an all-time high in Q1.*

The U.S. Investment Grade bond market had a record first quarter.



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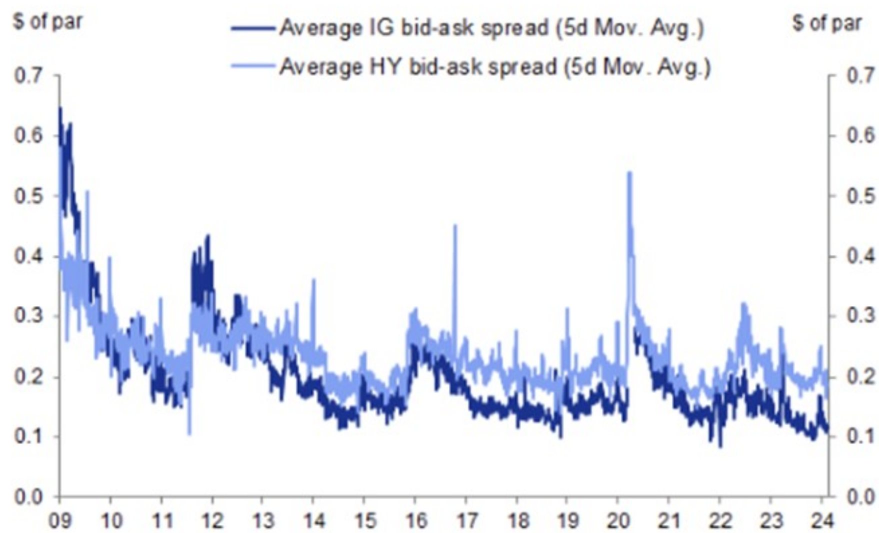
High Yield issuance is also having a banner start to 2024, with Q1 new issue volumes hitting the highest level since 2021. Also interesting to note is the strong rebound in CCC-rated debt after a notably weak 2023. This highlights the ample access to debt markets even for lower quality companies.

*4. Bond market liquidity: strong and improving.*

Bid/ask spreads, a common measure of liquidity, hover near record lows (i.e. better liquidity) and continue to trend lower.

5-day moving average of bid/ask spreads in the USD IG and HY markets




Source: FINRA TRACE, Goldman Sachs Global Investment Research

After reaching long-term (if not all-time) lows over the past few years, turnover in both Investment Grade and High Yield debt markets has improved significantly, ranking in the 93rd and 77th percentile, respectively, versus the last 10 years. ■

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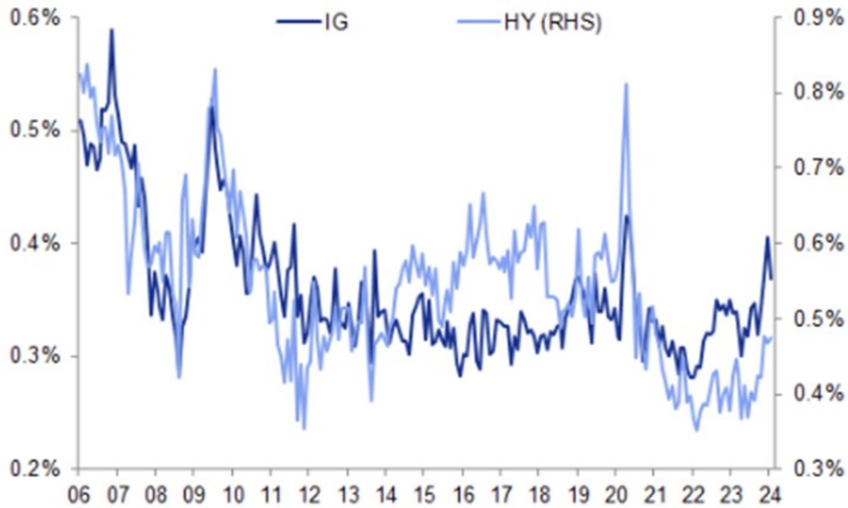
**Exhibit 9 : Turnover has risen off the rock-bottom levels of 2022-2023**
Estimated daily average turnover in the USD IG and HY markets




Source: FINRA TRACE, Bloomberg, Goldman Sachs Global Investment Research