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U.S. Fixed Income Market: Q2 2024

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Inflation imposed a more challenging than expected first half of 2024, delaying the start of the rate cut era. A patient Jerome Powell wants to see more data.

The second quarter of 2024 felt the consequences of a step back in the Federal Reserve's fight against inflation. Hotter than anticipated economic data in Q1 created an upward impulse in rates markets. For example, 2-year Treasury yields, which are a good representation of present and anticipated monetary policy, jumped 0.41% in April to a peak of 5.03%, the highest since November. Despite the initial jump, 2-year Treasury yields gradually retraced throughout the quarter ending just 0.10% higher on net. Year-to-date, the 2-year yield is higher by 0.47%.

Inflation Returned to Trend in Q2

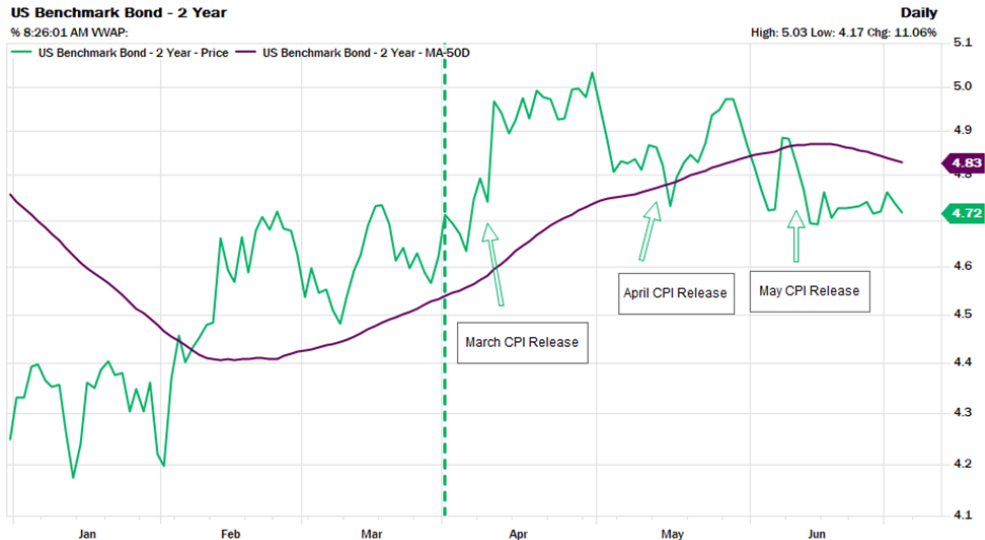
Interestingly, 2-year yields recorded the lowest quarterly variance since Q3 2021. This is partly the result of improving inflation data in May and June that halted the upward momentum. Both months saw sequential deceleration in Headline and Core inflation. Core PCE, a closely watched measure by the Federal Reserve, slowed to just 2.6% year-over-year in May, a clear sign of a cooling environment. Factoring in soft labor market data of recent, what had looked like a reflatting economy in Q1 now looks like it's back on the disinflationary trend the Fed so desires. While Powell has said he does not expect inflation to reach the 2% target this year, he has stated "the main thing is that we're making real progress."

The Fed's cut timeline syncs with the fall elections, what could go wrong?

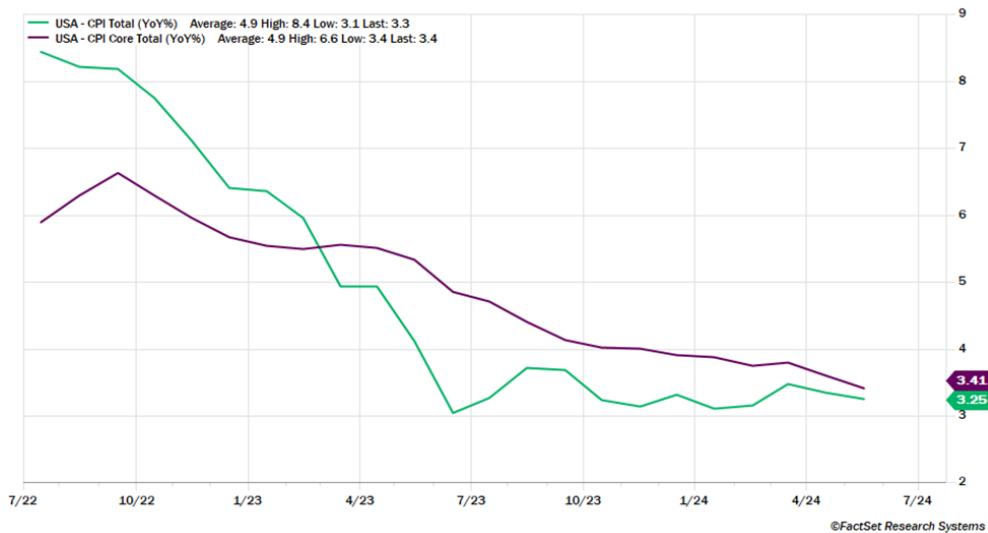
All in all, while interest rates felt a pinch from stubborn inflation data, the underlying trend would suggest gradually lower rates moving forward. The sentiment out of the Federal Reserve is that patience and more data are required before embarking on any policy changes just yet. Accordingly, the market looks to September for the first rate cut of the cycle. However, we shouldn't expect a smooth glide to the first rate cut with assets rallying in broad unison; the prospect of a Trump victory in November augurs a period of volatility and uncertainty. Will greater fiscal deficits cause long-term rates to jump? Would significant tariff barriers hit growth and productivity and cause rates to fall? These questions linger and, unfortunately, will feel entangled with the Fed's policy decisions.



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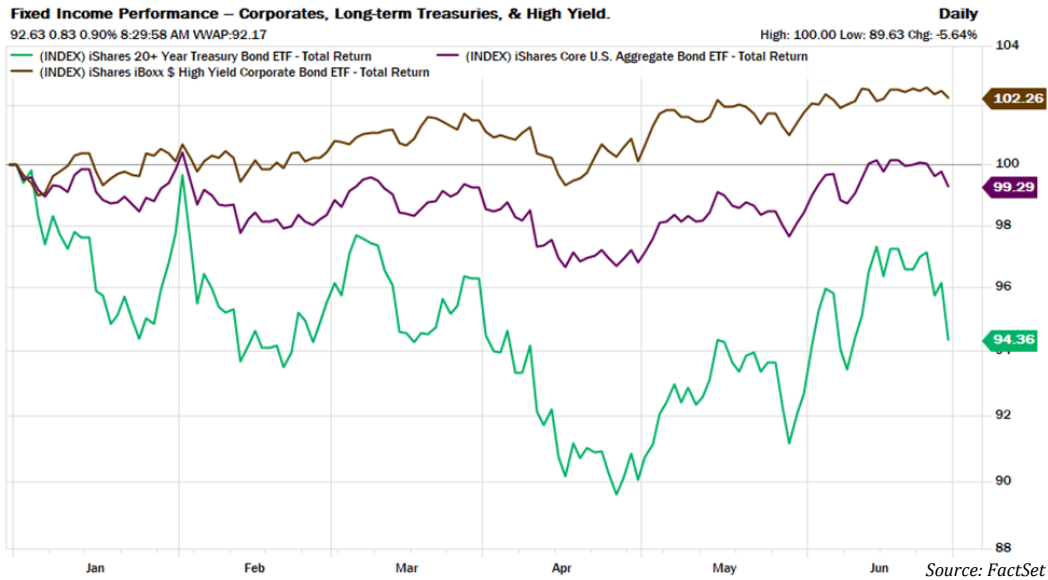
U.S. CPI - Last 24 Months



Year-to-Date Performance

Overall, the year-to-date shift higher in rates has mostly neutralized the benefit of high starting yields. The U.S. Aggregate Bond Index, a broad measure of the investment grade debt market, is down around 0.70% in 2024. The High-Yield Bond Index has performed better, up just over 2% on the back of tighter credit spreads. Long-term Treasuries are down nearly 6% due to higher long-term rates. Within the Corporate bond complex, the best performing Investment Grade sub-sectors were cyclicals such as airlines, home construction, gaming, and lodging. Banks and financial companies also fared well. The worst performing sector was energy, down only modestly in the quarter.

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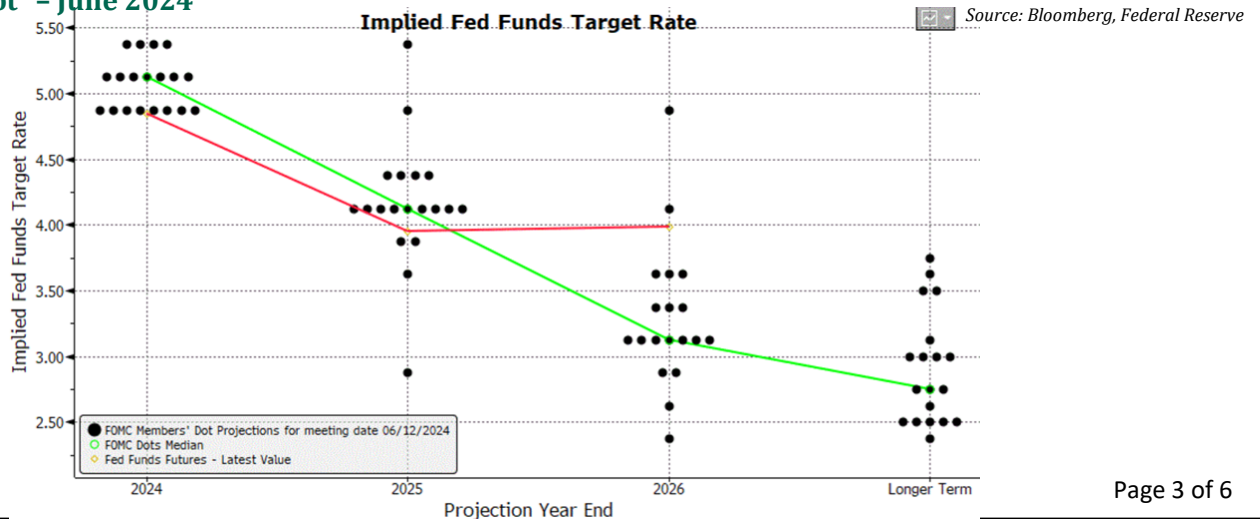


June FOMC Meeting: No change in policy, but a new Dot Plot.

The Federal Reserve met on June 12th resulting in no change to the Federal Funds rate (“Fed Funds”), however a new set of economic projections and Dot Plot were released. The meeting decision itself was widely expected but revisions to the Dot Plot, the aggregation of where Federal Reserve Presidents see the Fed Funds rate in the future, are always highly anticipated. As shown on the following Dot Plot, the green line implies just one rate cut in 2024 along with four in 2025 and four more in 2026. Compared with the March version, the Fed has maintained the total amount of cuts but pushed back the timing. Specifically, two cuts were moved from 2024 with one added to 2024 and the other to 2025.

Interestingly, a moderate divergence remains between the market’s positioning and the Fed’s projection as shown by the red line on the chart. The market implies two rate cuts this year, one more than the Fed, but remains skeptical of any additional cuts in 2026. The implication being the Fed’s nebulous “Longer Term” target of ~2.50-3.00% is highly discounted by the market at present and is potentially too low.

FOMC “Dot Plot” – June 2024



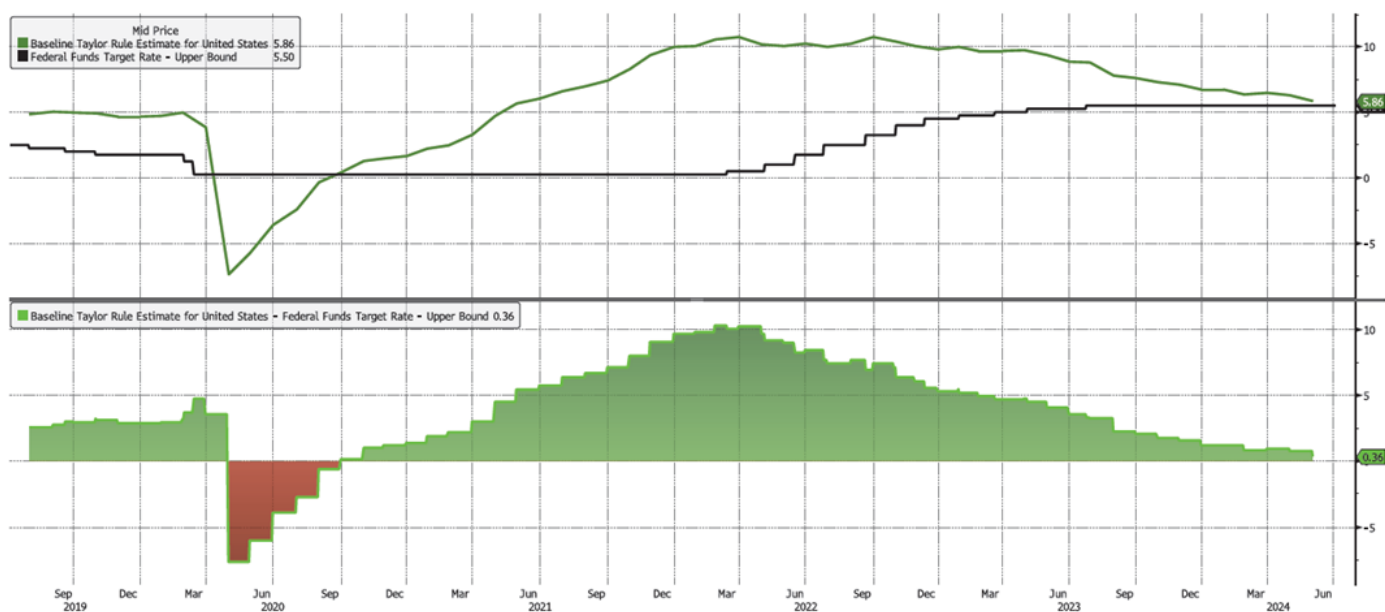
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What else is going on in the Fixed Income markets?

1. The Taylor Rule says it's time to cut.

The Taylor Rule is an objective, formulaic measure of where monetary policy should stand at a given moment. There are many pros and cons to managing monetary policy in such a way, but it is generally considered unreasonable for the United States to solely follow a formula to decide policy. Nevertheless, it's interesting to use as a benchmark across cycles. Today, interestingly, the Taylor Rule is the most in line with actual policy as it's been since 2020 (when this inflation and rate hike cycle began). Since 2020, the Taylor Rule has recommended a tighter policy stance than what the Fed enacted. Today, however, the Taylor Rule is essentially in line with policy, and, judging by the Rule's trajectory, would suggest the Fed is well positioned to start cutting rates soon.

Taylor Rule vs Fed Funds Rate - Last Five Years

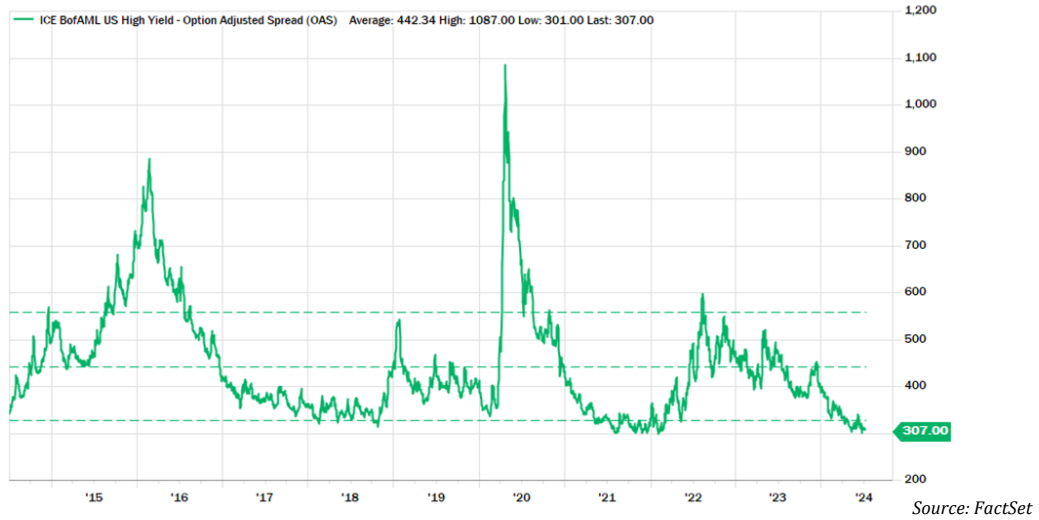


Source: Bloomberg

2. Credit spreads remain remarkably tight.

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

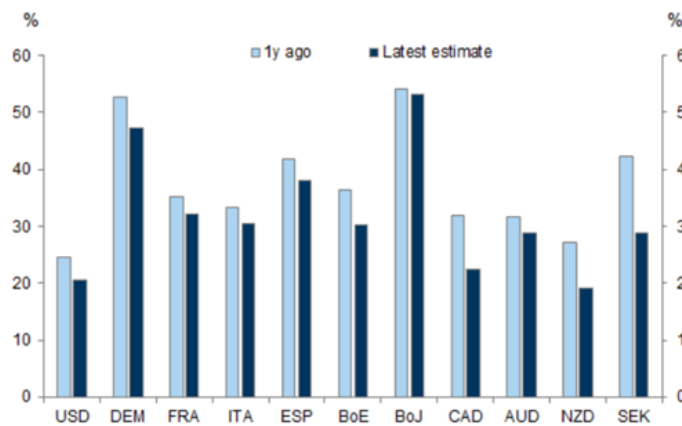
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3. Central Bank Stimulus – Another view.

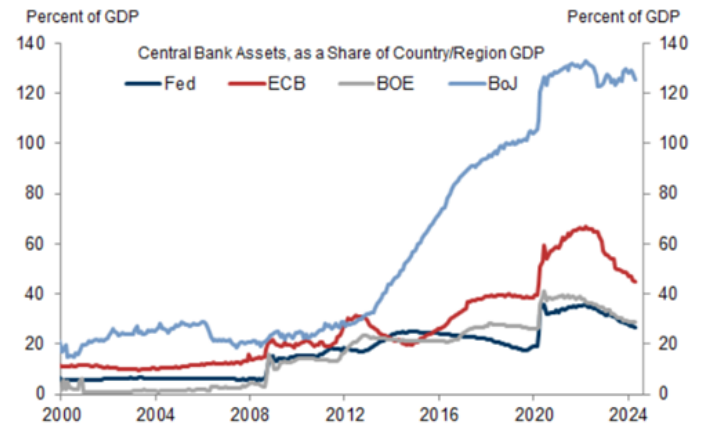
While rate cuts get all the press, there are other levers that Central Banks use to influence monetary policy. One such lever is buying and selling bonds, typically government issues, to influence the aggregate level of term rates. As shown below, Central Banks in each of the 11 countries listed in the bottom left chart own a smaller percentage of government bonds than a year ago. All else equal, this represents a gradual tightening of policy.

Central bank ownership of sovereign bonds, current vs. 1y ago



Source: Haver Analytics

Central bank assets as a share of GDP



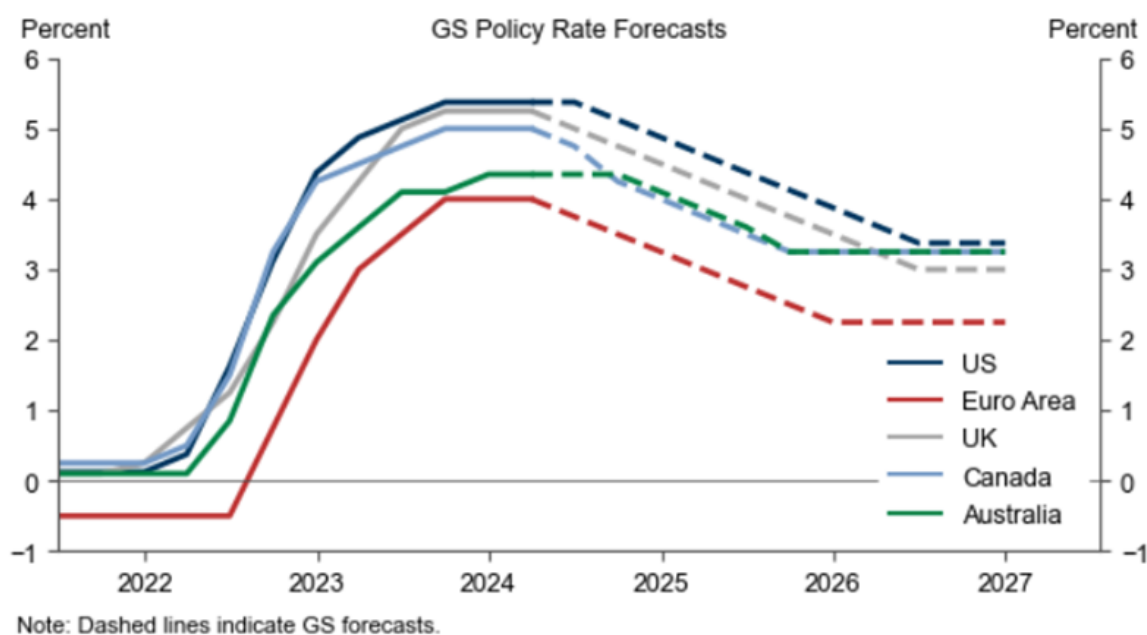
Source: Haver Analytics

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4. Central Bank easing: A global affair.

It's not just the United States at the precipice of a rate cut cycle. In fact, multiple Central Banks around the world have already started their easing cycles including the European Central Bank, Canada, and Switzerland. Many more are expected to follow in 2024.

Exhibit 1: We Expect the ECB, BoE, and BoC to Start Easing in June



Source: Haver Analytics, Goldman Sachs Global Investment Research

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