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Capital Management, LLC

The Rates They Are A-Changin’

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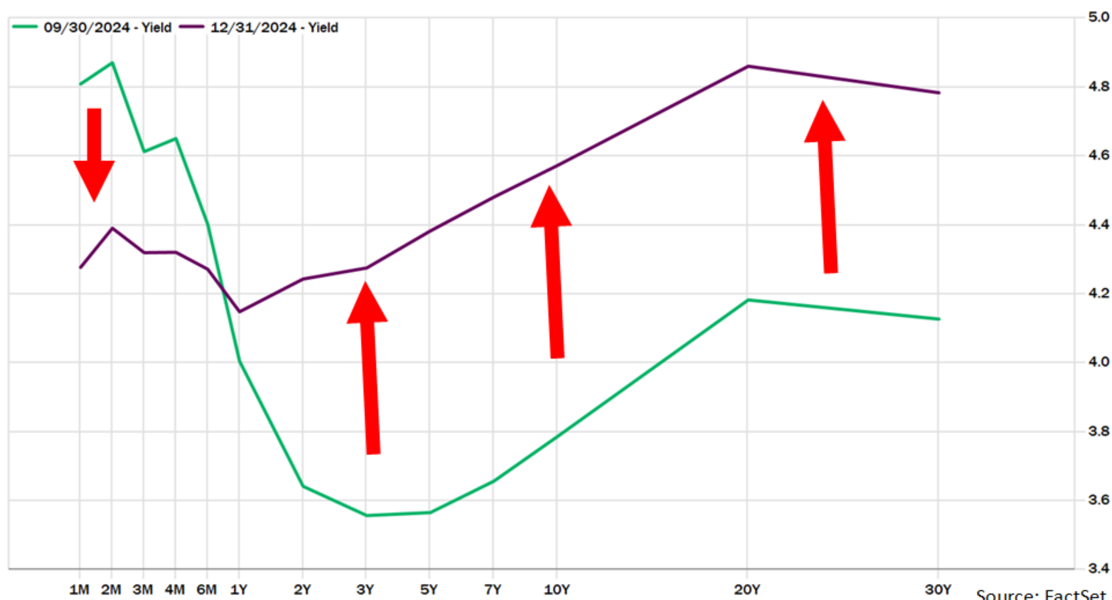
The bond market adjusts to a new policy era.

Rising yields in the fourth quarter of 2024 have become a defining feature of the market landscape entering 2025. The 10-Year Treasury yield rose nearly 1.00% to end the year, rising from approximately 3.60% and ending the year around 4.60%. The rapid backup in yields began in mid-September as the final stages of the Presidential election took shape and escalated all the way through election day in early November. The bond market reaction was driven by a confluence of political and economic forces. As the odds of a Trump victory increased, markets focused on potential policy outcomes. Most notably: the impact of potential tariff policies, if current tax policy would be updated or extended, and the ability (or lack thereof) of reigning in already excessive fiscal deficits. Concurrently, the U.S. economy continued to display remarkable resilience with GDP growth above expectations in Q4 and rounding out a very strong year of growth driven by productivity gains. Meanwhile, just down the road in Washington, DC, Jerome Powell and the Federal Reserve contemplated their own path forward. As described in more detail below, the December FOMC meeting resulted in a 0.25% rate cut but more importantly set the stage for a more moderate policy stance in 2025. While short term rates fell significantly in 2024, as Powell & Co reduced the Federal Funds rate by 1.00%, the prospect of President Trump’s second term helped lift medium- and long-term yields even more significantly, resulting in the steepest yield curve since May of 2022 (chart below). So, what does this mean for 2025? While not much is certain, we do know one thing for sure: starting yields are effectively the highest they’ve been in 15+ years and present a reasonably attractive opportunity especially for income-oriented investors.

Yield Curve Recut: The Trump x Powell Collab



Source: FactSet

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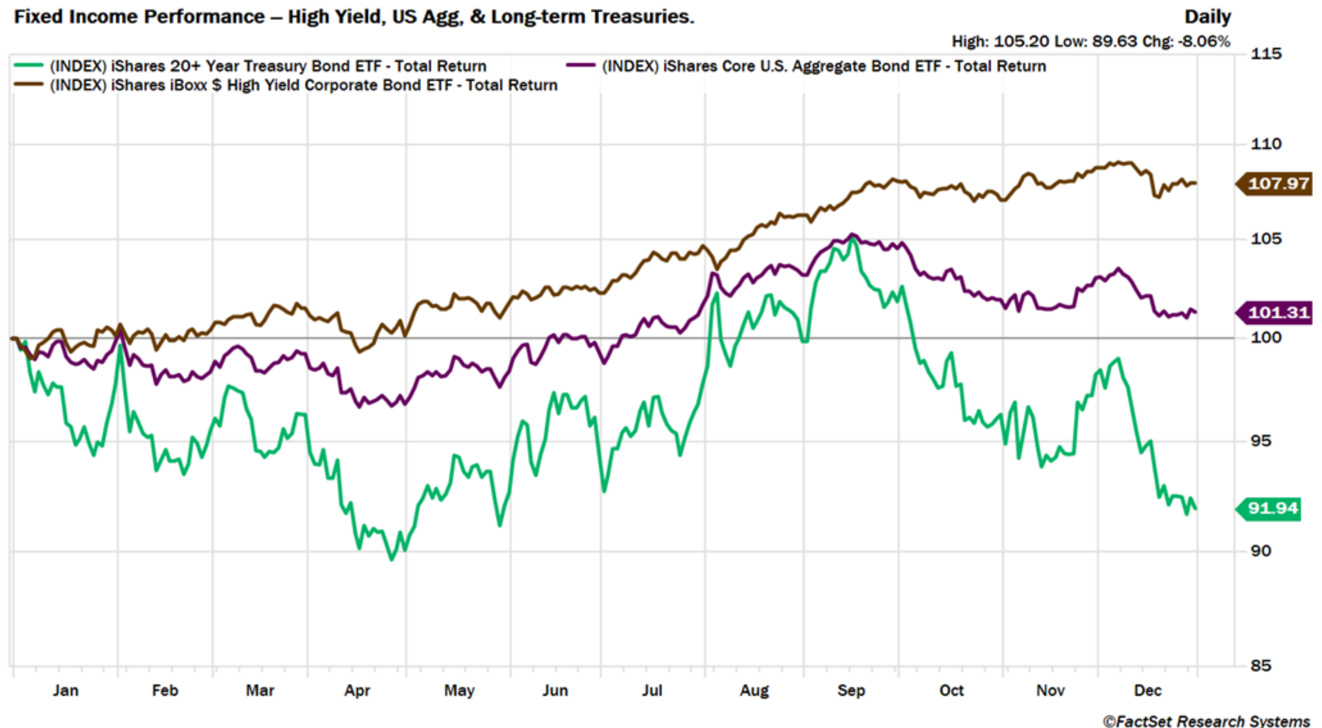
2024 Fixed Income Performance



U.S. Investment Grade Credit Highlights (on a total return basis):

- Best
  - Sectors: Financials, Utilities, Energy
  - Industry Groups: Airlines, Home Construction, Gaming, Finance Companies
- Worst
  - Sectors: Capital Goods, Consumer Staples, Technology
  - Industry Groups: Restaurants, Railroads, Integrated Energy, Pharma

Source: Bloomberg, Goldman Sachs Global Investment Research

December FOMC: The "Hawkish Cut" Meeting

The December FOMC meeting resulted in a 0.25% cut to the Federal Funds rate, in line with expectations, and was tied to an overarching message that the Committee would slow the pace of rate cuts in 2025. The degree to which the committee shifted their views, however, was rather surprising. The new "Dot Plot", which represents where each member of the FOMC projects the Federal Funds rate at the end of each year, shows the median dot implying just 0.50% of cuts in 2025, down from the 1.00% projected in September. This was a steeper decline than the market expected heading into the meeting. Furthermore, their economic projections shifted notably. Inflation is projected to be higher in 2025 while unemployment goes lower.

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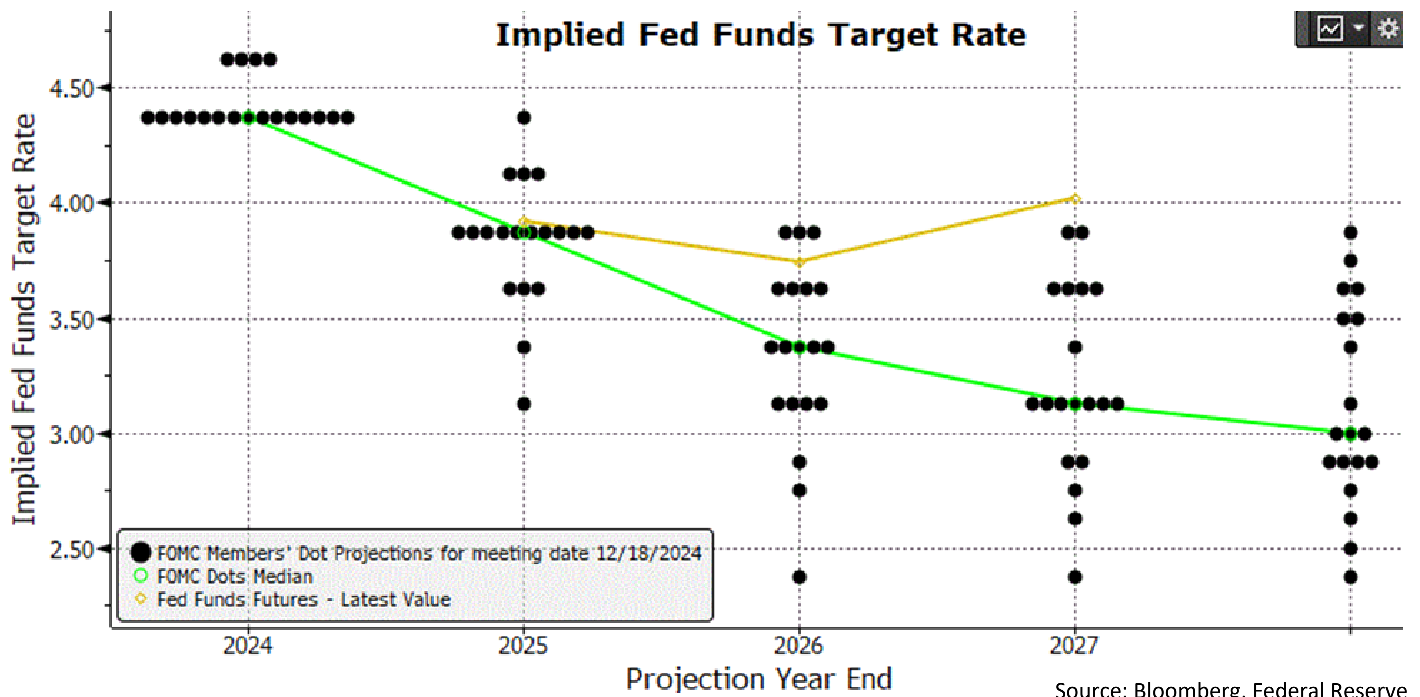
One could look at these updates and conclude one of a few things: 1) there is a hawkish shift within the committee, in part due to the return of President Trump and his anticipated policies (some members alluded to this), 2) the Federal Reserve is implicitly accepting a higher rate of inflation than their 2% target (still cutting even with higher forecasted inflation), and/or 3) the committee is building in space to adjust policy in 2025 due to elevated uncertainty (call this the "Trump effect"). Powell noted numerous times that he believes the labor market is not a source of inflation currently, and further that he is "confident" that inflation is "still broadly on track" to return to the 2% target. One thing is certain: 2025 will be a fascinating year.

December "Dot Plot"



Source: Bloomberg, Federal Reserve

Fixed Income Footnotes

1. *Mortgage rates & the housing market.*

Entering 2025, the typical 30-year mortgage rate is back to nearly 7%. Any optimism around a rebound in the housing market is likely suppressed at these levels. According to the National Association of Home Builders, housing's contribution to U.S. GDP is between 15-18%, which suggests that a downtrodden housing market will be a significant drag on 2025 GDP growth. An interesting feature of the current environment is that the average mortgage rate is still below 4%, a function of low activity since the pandemic driven boom at rock bottom rates.

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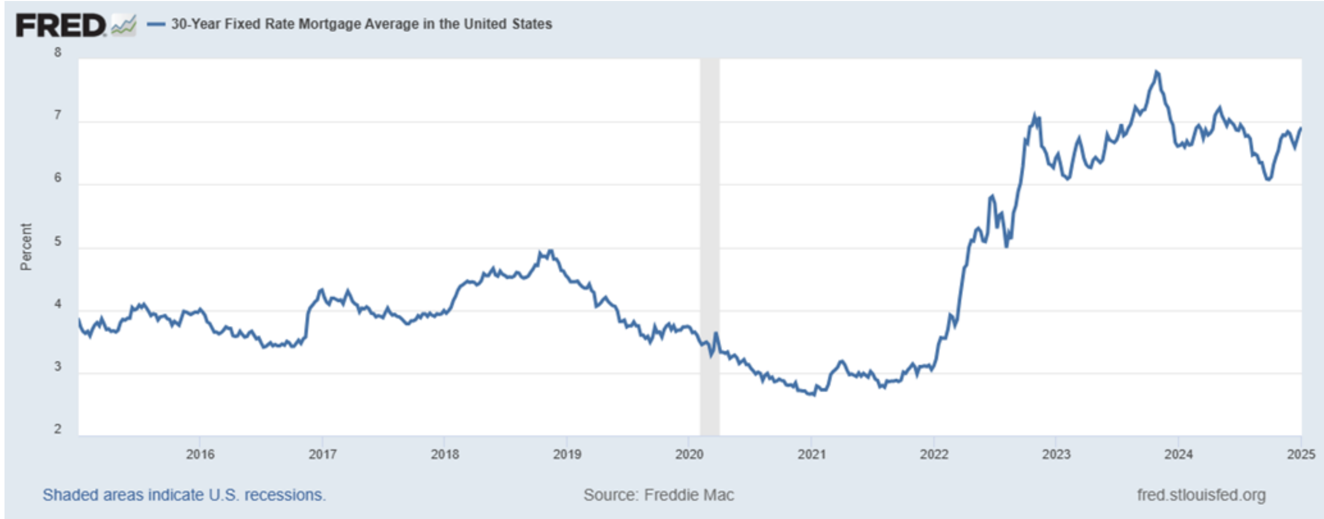
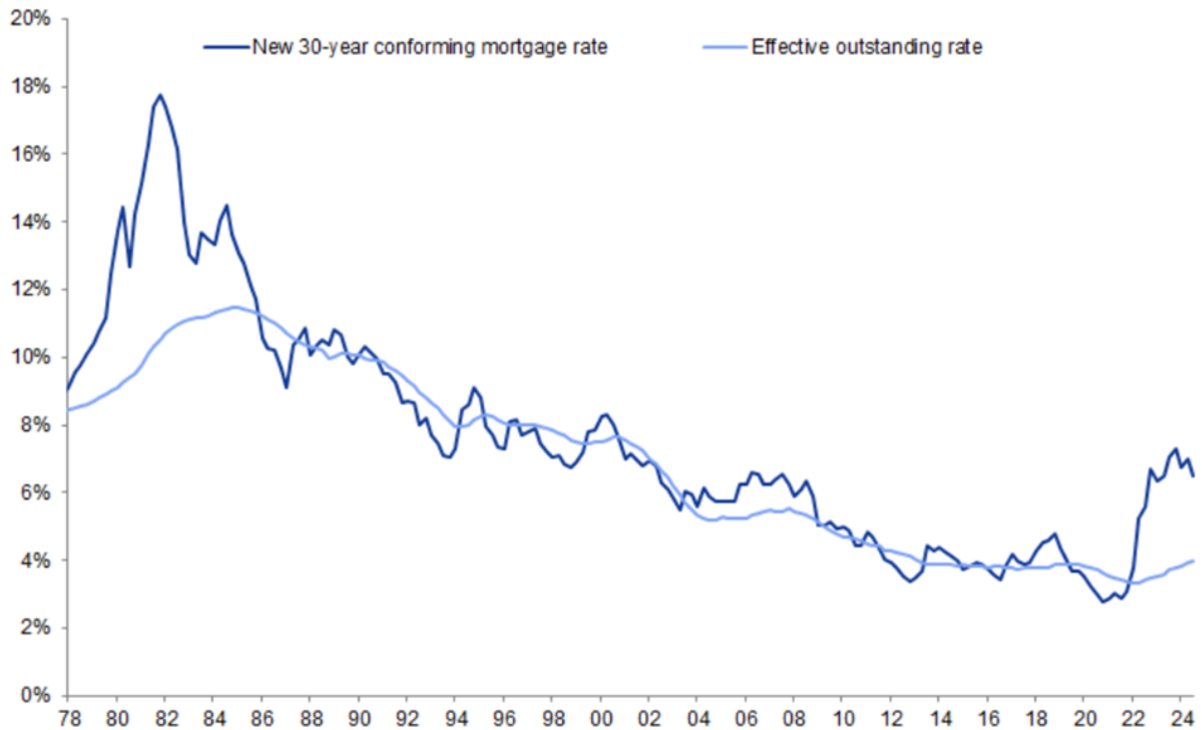


Exhibit 7: The interest rate gap between new and outstanding mortgages remains historically wide
New interest rate on 30-year conforming mortgages (using the Freddie Mac Primary Mortgage Market Survey Rate) vs. effective mortgage rate on outstanding loans



Source: Freddie Mac, Bureau of Economic Analysis, Goldman Sachs Goldman Investment Research

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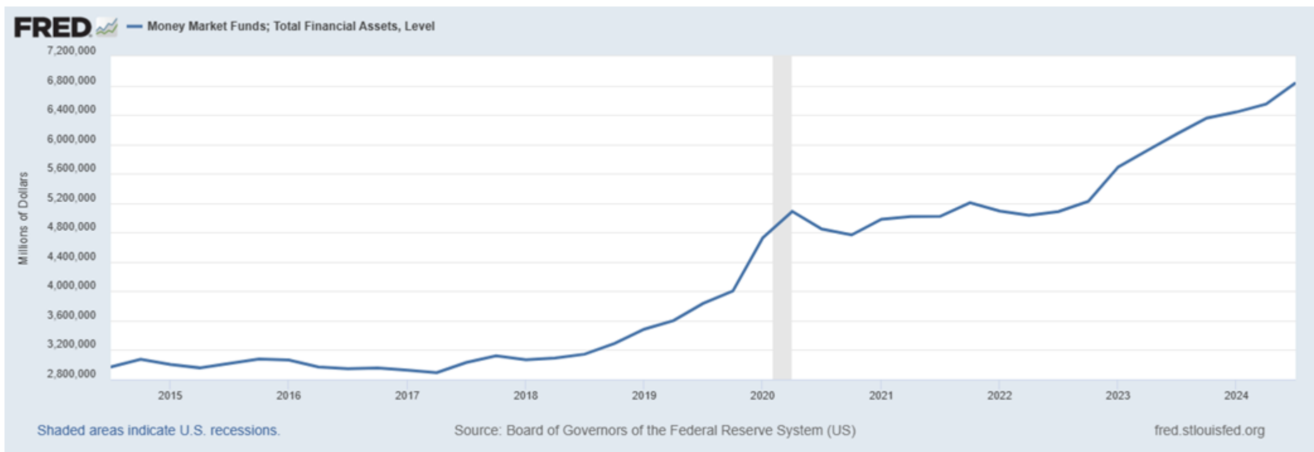
2. U.S. Money Market assets near $7T; potential to see yield chase higher rates by rotating into longer duration assets in 2025.

Money market assets have seen significant inflows over the last five years, and especially in the last two. Exiting 2024, total assets hover around $7 trillion. Now that short term rates are falling, with further declines expected in 2025, there is the potential for these funds to rotate out of money markets and into longer duration fixed income to seek higher yields. All else equal, this would pressure rates lower across the short-to-medium term portion of the yield curve.



3. Corporate credit spreads decline again in 2024; now at the lowest level since 2007.

Credit spreads, a measure of additional yield over a risk-free security required for riskier bond issuers, declined for the second straight year in 2024 and are presently at their lowest level since 2007 (and near an all-time low). Notably, this decline in spread has supported returns for corporate bonds versus Treasuries in 2024.

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