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# Monthly Market Update

Fixed Income and Rate Volatility | September 2023

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## Key takeaways

- Real yields have risen due to macroeconomic events, improving inflation and the Fed's commitment to keep rates higher for longer.
- Year to date, this has been a headwind for fixed income, resulting in a near-term pullback in bond prices. This also caused a slight re-steepening of the yield curve. As the Fed pauses and eventually lowers rates, long rates will likely follow suit based on historical correlations.
- In the longer term, real yields have been the most attractive since 2009, increasing the benefits of bonds relative to stocks.

## Market update

This update is provided in partnership with Clearnomics, a market insights platform for asset and wealth managers. Our goal is to help you stay abreast of ever-changing markets by putting current conditions into the context of economic and market history. Every monthly update will address key issues that clients are asking about and share real-time insights on these topics.

Interest rates have been volatile over the past two years in response to inflation, economic concerns and market volatility. After falling as low as 3.3% earlier this year, the 10-year U.S. Treasury is now yielding more than 4.2%, back to where it was roughly a year ago. However, while today's long-term yields look similar to last year's on paper, they are quite different from an economic and market perspective. Specifically, improving inflation has pushed real yields higher, even as nominal yields have remained the same.

The distinction between nominal and real values is an important concept across economics and investing. For instance, the 4.2% yield on the 10-year Treasury securities mentioned above is a

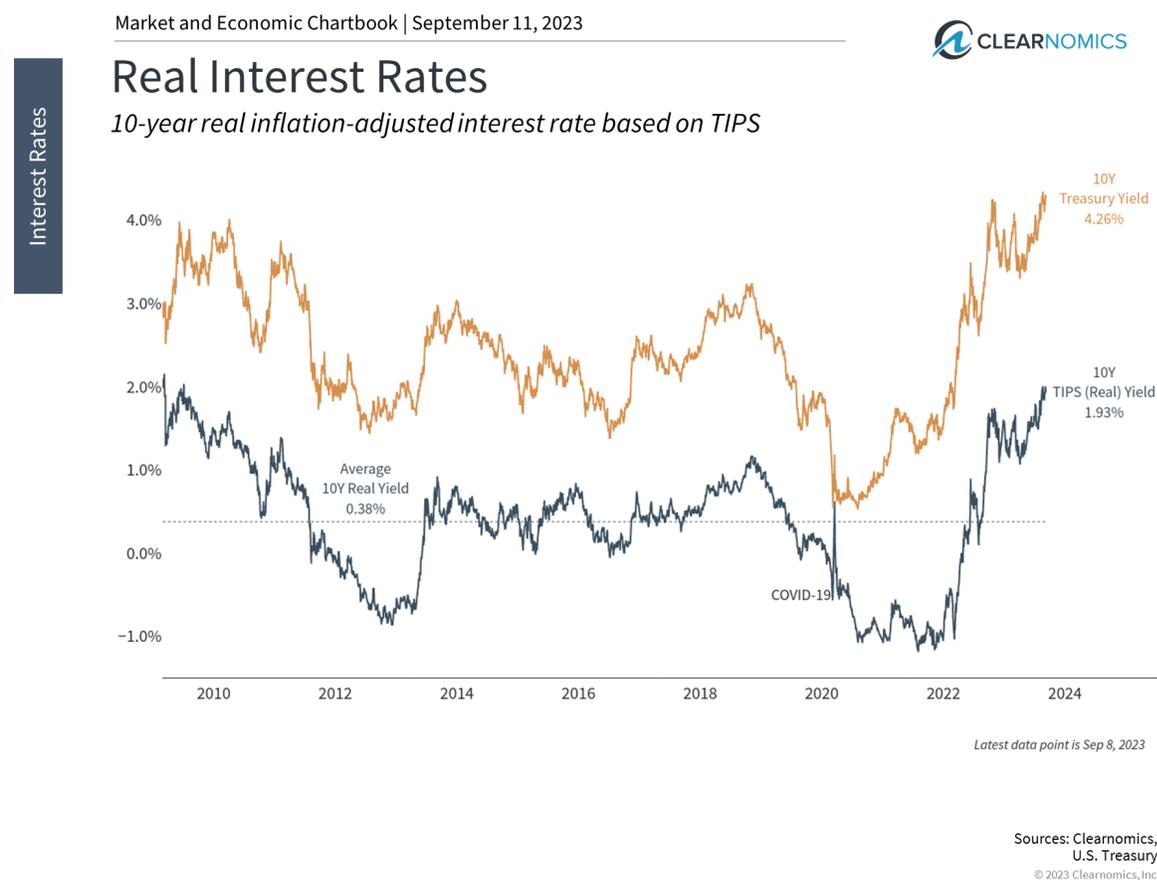


nominal yield. When inflation rises faster than expected, the actual purchasing power of the interest payments an investor receives will be lower, and vice versa. Thus, the real yield that one receives depends on the level of inflation and, in many cases, this is what should matter to long-term investors.

**Exhibit 1**

Real yields have risen as inflation has improved

Sources: Clearnomics, U.S. Treasury



Fortunately, real long-term yields have been at their highest level since 2009. This is because inflation expectations have improved and economic growth has surprised the upside. Moreover, the current 10-year Treasury real yield of 1.9% is far above the average since the global financial crisis of 0.38% when both nominal interest rates and inflation were low. Real yields were also historically low, even negative, during the pandemic, when many investors moved out of Treasuries and Treasury Inflation-Protected Securities (TIPS). Accordingly, while navigating this fixed income



environment has grown more challenging, bonds still play an important role in many diversified portfolios.

Other recent events have created volatility in the bond market. First, the U.S. debt downgrade by Fitch Ratings on August 1 led to a jump in rates across the board. This had ripple effects across the market, since U.S. Treasury securities serve as a benchmark for all bonds. However, just a week later, Moody's downgraded 10 banks, placed six under review and shifted the outlooks on 11 to negative. These ratings and outlook changes briefly renewed concerns over the financial system, which caused interest rates to fall. Since then, there have been concerns about the supply and demand of Treasury securities, worries over China's housing sector and more.

Despite these swings in rates and bond prices, it's important to maintain one's perspective on the bond market behavior of the past two years. Last year's historic surge in inflation resulted in the worst bear market for bonds in recent history. This year, bond returns have mostly been positive, and the current maximum intra-year decline of 4% is well in line with historical patterns.

The Fed is expected to keep policy rates high, but there may be less pressure to hike rates again if inflation maintains recent improvements. The probability of a so-called "soft landing" has increased as economic growth has remained steady. This has helped reduce credit risk concerns, which were elevated during the banking crisis. Ironically, only the yields on the highest-rated bonds have increased meaningfully due to the U.S.'s debt downgrade. Overall, this means that even if a recession does occur, markets expect that it would be mild and that companies would still be well positioned to repay their debts.

The fact that long-term real rates have risen may also help the Fed fight inflation in the short run. However, if and when the Fed believes it has achieved its mandate, they will likely begin to discuss cutting rates, possibly in 2024, according to the Fed's Summary of Economic Projections. Historically, long rates have followed short rates, with a correlation of 90%. Thus, today's yields could be quite attractive both historically and going forward, depending on the path of policy rates.

Finally, by taking inappropriate risks, investors can be better positioned than at any point since the global financial crisis to generate portfolio income today without "reaching for yield". A diversified index of bonds now yields 5%, nearly double the 2.6% average since 2009. Investment-grade corporate bonds generate 5.7% and high-yield bonds 8.5%. In contrast, the forward-looking dividend yield on the S&P 500 is now only 1.9% after this year's strong rally. Higher real yields also



impact the equity risk premium of the equity market, a topic that we'll investigate more deeply in the next monthly market update.

Thus, these market updates may warrant a fresh look at long rates from many investors. Additionally, the low correlations between bonds and stocks could continue to reassert themselves after last year's inflation-driven pullbacks. Bonds may once again provide ballast in portfolios while generating attractive real yields. Rather than trying to time the market, investors should consider how current bond yields can play a role in their long-term asset allocations.

Higher real yields have already changed the dynamics between major asset classes this year. This is further evidence that diversifying across stocks and bonds is still important when constructing well-balanced portfolios that can achieve income and growth while withstanding uncertain market environments.



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