COLUMBIA THREADNEEDLE INVESTMENTS

Bond outlook: From headwind to tailwind

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The Fed is going lower, and that's almost all you need to know about bonds.

Gene Tannuzzo, CFA
Global Head of Fixed Income

It doesn't pay to second guess the Fed
For many investors, the top-of-mind questions in the current market are: What is the Fed going to do about rates? And when? We already know the answer to the first question, and we think the answer to the second is mostly irrelevant. Here's why.

- **First, we know the path of rates will be lower because that's what the Fed has told — and keeps telling — us.** Despite better-than-expected growth, a healthy labor market, and thus far resilient capital markets, we need to remember that guidance and trust the Fed's intention. Rates are going lower. The direction of travel is most important, not every twist and turn along the way. The level of rates also matters, especially as compared to what the Fed views as neutral — which is 2.5%. With the fed funds rate currently above 5%, there is ample cushion to move lower.
- **Second, the reason for the Fed likely cutting rates will be different from in the past.** Historically, the central bank has loosened in response to a demand shock — the global financial crisis and pandemic being prime examples. This time, it's not about demand. It's about inflation, which has quickly decelerated back toward the Fed's 2% target. The last year has taught us that we can have lower inflation with growth. We don't have to be bearish on the market or economy to expect lower rates. We just have to know that inflation is going lower.

Investors shouldn't lose sleep over a longer Fed pause
We know that the next move from the Fed is most likely to be a cut. But does the timing matter? History suggests not. Because the market is forward-looking, Treasury yields have historically peaked and begun to move lower ahead of the first cut, and this dynamic has fueled bond market returns both before and well after the Fed begins to ease.

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Bonds can see strong performance before and after Fed rate cut

(Cumulative return, %)

	3 months before	3 months after	6 months after	1 year after
Cash equivalent	1.26	1.11	2.09	3.69
Short-term bonds	2.29	1.91	3.49	5.68
Core	3.57	2.63	3.93	5.77
High yield	-1.05	2.80	3.20	3.61
Munis	3.00	2.97	4.49	7.54

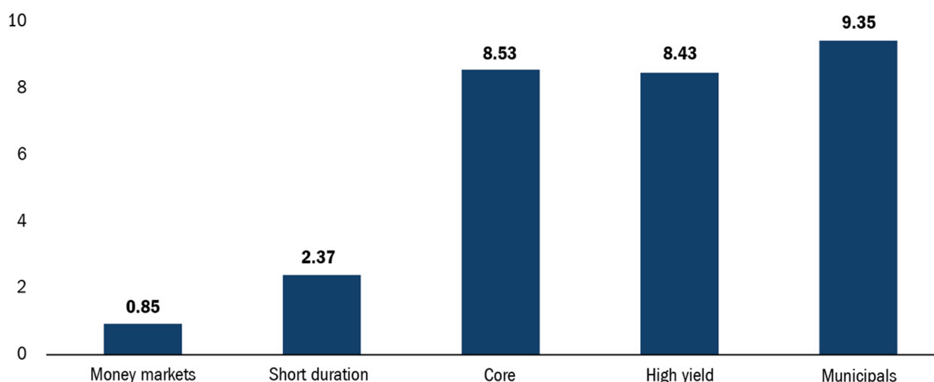
Source: Columbia Threadneedle Investments, Bloomberg. Represents data from June 1995 to December 2023 (i.e., five rate cutting cycles). Cash is represented by the Bloomberg U.S. Treasury Bill: 1-3 Months Index. Short duration bonds are represented by the Bloomberg 1-3 Year Government/Credit Index. Core is represented by the Bloomberg U.S. Agg Index. High yield is represented by the Bloomberg U.S. Corporate High Yield Bond Index. Municipals are represented by the Bloomberg Municipal Bond Index and reflect taxable equivalent return, which includes the impact of Federal tax exemption at the highest marginal tax rate on the income component of the periodic total return. Taxable equivalence applied to the income component of municipal bond returns using the top marginal tax rate in effect at the time plus the 3.8% net investment income tax. Other taxes are possible. **Past performance is not a guarantee of future results.** It is not possible to invest directly in an index.

Now's the time to get off the cash train

One byproduct of the rapid rise in rates and poor bond market performance over the past few years is a high percentage of cash in investor portfolios. Cash yields appear optically attractive, but the Fed's shift away from further hikes diminishes their long-term utility. Falling rates mean reinvestment risk, which cash investors face instantaneously with each cut. Finally, cash investments don't offer the potential for price upside as yields decline. The 2023 year-end rally perfectly illustrated this opportunity cost. While cash generated a positive total return, it was meaningfully lower than anywhere else in the bond market.

Money markets lagged in the last fixed-income rally

(Cumulative performance in November–December 2023 rally, %)



Source: Columbia Threadneedle Investments and Bloomberg for the period 10/31/23–12/31/23. Money markets are represented by the average return for the Morningstar taxable money market category. The Morningstar information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Short duration bonds are represented by the Bloomberg Short-Term U.S. Agg Index. Core is represented by the Bloomberg U.S. Agg Index. High yield is represented by the Bloomberg U.S. Corporate High Yield Bond Index. Municipals are represented by the Bloomberg U.S. Municipal Bond Index and reflect taxable equivalent return, which includes the impact of Federal tax exemption at the highest marginal tax rate on the income component of the periodic total return. Taxable equivalence applied to the income component of municipal bond returns using the top marginal tax rate of 37% plus the 3.8% net investment income tax. Other taxes are possible. **Past performance is not a guarantee of future results.** It is not possible to invest directly in an index.

One of the simplest and most effective ways to redeploy that cash is to move it into short-term bonds. Those investors who aren't yet comfortable stepping further out the maturity spectrum can still benefit from generationally high yields with short-term bonds. These yields beat those on cash and provide the opportunity to participate in price upside when yields fall further.

Differentiation matters as much as the direction of rates

Going forward, we think that dispersion within fixed-income sectors will emerge as a key theme. At the aggregate level, risk compensation has become less attractive. However, notable exceptions persist. For instance, investors can earn a higher risk premium in government guaranteed agency mortgage-backed securities than in investment-grade corporate bonds. Within investment grade, capital rich, high-quality banks offer relative value over cyclical industrial companies, which may underperform in the event of an economic correction. Similarly, we think high-yield energy companies will experience very different default outcomes and cashflow generation than a leisure and hospitality company in coming years.

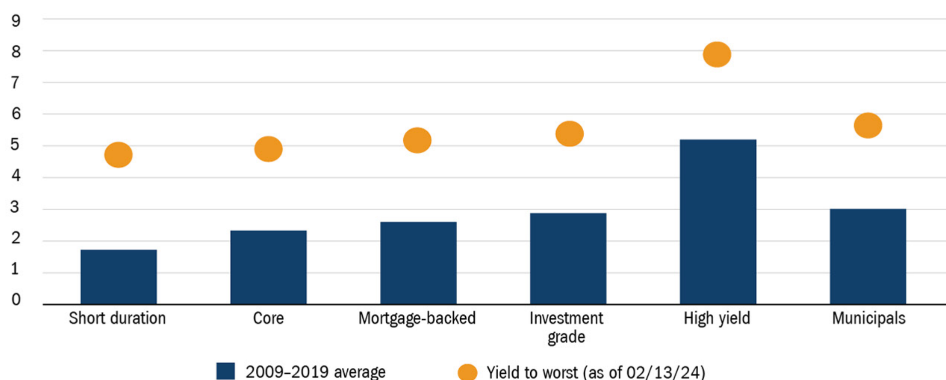
Identifying these examples of dispersion plays into our organization's research capability. We think there is a significant opportunity to uncover yield-enhancing opportunities from the bottom up, with credit ideas that are agnostic to the direction of the Fed and that can work in a number of interest rate and economic scenarios.

Bottom line: There's still room for bonds to run

After a dismal couple of years, the bond market rebounded dramatically in the last quarter of 2023. Investors may be worried that they missed out on the recovery, but we see a different story. Yields across fixed-income sectors are well-above their post-global financial crisis average; Treasury yields remain above 4% across the curve, representing the highest level in nearly two decades. The Fed has consistently communicated an intention to cut rates before the end of 2024. This, along with declining inflation, should provide a tailwind for fixed-income returns. And enough dispersion exists to create an environment for security selection to shine. The road has been painful, but today the conditions appear much more favorable for fixed-income investors. The key is getting back into the market.

Current yields across fixed income remain well-above the average of the last decade

(Yield to worst, %)



Source: Columbia Threadneedle Investments, Bloomberg. Short duration bonds are represented by the Bloomberg 1-3 Year Government/Credit Index. Core is represented by the Bloomberg U.S. Agg Index. Mortgage backeds are represented by the Bloomberg MBS Index. Investment grade is represented by the Bloomberg U.S. Corporate Index. High yield is represented by the Bloomberg U.S. Corporate High Yield Bond Index. Municipals are represented by the Bloomberg U.S. Municipal Bond Index and reflect taxable equivalent yield, which includes the impact of Federal tax exemption at the highest marginal tax rate on the income component of the periodic total return: in effect at the time. As of 02/13/24, taxable equivalence applied to the income component of municipal bond returns using the top marginal tax rate of 37% plus the 3.8% net investment income tax. Other taxes are possible. **Past performance is not a guarantee of future results.** It is not possible to invest directly in an index.

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