RAYMOND JAMES | INVESTMENT MANAGEMENT

INVESTING AROUND THE PEAK OF THE CYCLE

Real rates, the yield curve, and recession

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High yield: Different behavior at different tiers

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The most aggressive U.S. Federal Reserve (Fed) tightening cycle in more than 40 years continues to reshape the landscape for fixed-income investing. Rising interest rates challenge the performance of equities and fixed income investments alike. Yet some investment professionals are still finding attractive opportunities.

It's no accident, say fixed-income portfolio managers from three independent investment boutiques at Raymond James Investment Management. Investing around the peak of the Fed's interest rate-hiking campaign, they say, requires paying close attention to real rates of interest, the dynamics of inflation, the lessons of history, and the potential benefits of active management.

Real rates, the yield curve, and recession

Two major concerns for fixed-income investors are real rates of interest and the inverted yield curve.

"The best arbiter for value in the fixed-income world, from a 30,000-foot view, is real rates of interest," said Todd Thompson, CFA, Managing Director and Portfolio Manager at Reams Asset Management. "That is the real governor, or braking mechanism, or easing mechanism, for accelerating or decelerating economic growth."

Real rates of interest include the effects of inflation, which means that real rates are negative when inflation exceeds interest rates. Negative real interest rates encourage easier access to credit and looser lending conditions. "The real level of interest rates was negative for most of 2020 through the middle of 2022, and it didn't turn demonstrably positive until 2023," said Thompson. "The Fed still had their foot on the gas, even though they didn't want to be in that situation."

The move to positive real rates was accomplished by the most rapid sequence of interest rate increases in recent history, and it remains to be seen whether the U.S. economy will slow down without entering a full-blown recession.

"I liken it to hitting the brakes on a truck," said James Camp, CFA, Managing Director of Fixed Income and Strategic Income at Eagle Asset Management. "The payload doesn't move all the way through the windshield right away, but it's moving."

"I think the best of the good news is behind us," said Camp. "The indicators, and sort of the script that is written about recessions, to us, is playing out right on cue." One such indicator is the inverted yield curve, showing that short-term investments offer higher returns than their long-term equivalents. The yield curve on U.S. Treasuries has been inverted since the end of 2022.

"History has shown that the path from an inverted yield curve to a normal, upward-sloping one has been a recessionary environment in which the Fed is forced to cut short-term rates," said Matt Orton, CFA, the Chief Market Strategist at Raymond James Investment Management and the moderator of a recent panel discussion on investing around the peak of the cycle. "A recession's not a poison pill. It's just part of a healthy economic cycle."

The possibility of a recession, and the Fed's ability to manage a recession's severity through changes in monetary policy, have driven the debate over a "hard" or "soft" landing for the U.S. economy. This links back to real interest rates: "The longer you stay at these levels, and you have stronger economic growth, the less chance of a hard landing," Thompson said.

However, Thompson also said that the full effects of the Fed's decisions have yet to be felt. "There's just so many other crosswinds that have slowed down or stymied what would be the normal effect of this tightening of financial conditions that we've witnessed, but they're still likely to happen in our view," he said.

Inflation's 'big kahuna'

Inflation remains another concern for fixed-income investors for many reasons, including its effect on real rates of interest and how it guides the Fed's future interest rate decisions.

Camp is particularly concerned about inflation's impact on consumers.

"To the vast majority of Americans, this is a very big regressive tax, a very big bite into their purchasing power and lifestyle," he said. He noted that the Fed has seen some success in bringing down inflation, but the main issue for consumers are prices themselves, not the rate at which those prices change.

Thompson agreed that the Fed has seen some success in managing inflation, but he also cautioned that there was some nuance involved in the calculations used to determine the core Consumer Price Index (CPI) — the Consumer Price Index for All Urban Consumers: All Items Less Food & Energy. Abnormally high prices for used vehicles had artificially boosted core CPI numbers that have since returned to normal. And although core CPI ignores energy costs, rising prices for jet fuel could still have an effect by driving airfare costs upward.

"Obviously, the big kahuna on all inflation is going to be housing. It's such a large component," Thompson said. He noted that although the owners' equivalent rent of residences (OER) component of CPI calculations has increased, it has lagged behind the S&P CoreLogic Case-Shiller Home Price Indices. "That housing issue will be around for a while," Thompson said, "because of this yawning gap that exists between Case-Shiller and what's baked into the CPI prices."

"The resiliency of the labor market, the uptick in commodities, all of the inertial inflation pressures are still with us," Camp said. "I think that's why the Fed is going to continue to be, at least, maintaining very high levels of short rates for the foreseeable future, meaning well into 2024."

Higher interest rates mean better returns for cash and money market funds, and Orton noted that incredibly elevated short-term rates have driven large fund flows into money market funds.

Camp acknowledged that an allocation to cash and cash equivalents can generate noteworthy returns in the present environment. "It is not, however, going to preserve purchasing power, or have a diversification effect, or generate the long-term income stream that investors want."

As an alternative, Camp suggested that the guaranteed cash flow of longer-duration bonds was a way to avoid the reinvestment risk inherent in "rolling the inevitable short-term yields, which in six months, 12 months, will be evaporating on you." Camp is a strong advocate for fixed-income investments following the peak of a Fed rate-hiking cycle. "The subsequent returns to fixed-income assets, meaning duration for one, three and five years post-Fed peak, historically tend to be unambiguously good," Camp said.

"In my career, which dates back to the late 1980s, there have been five tightening cycles," he said. "In each, if you look at subsequent returns to bonds, they have been better than cash and cash equivalents."

Securitized products: A 'perfect storm' for attractive MBS valuations

Thompson said he finds mortgage-backed structured products to be the most attractive they've been for more than a decade for three reasons:

- First, the U.S. government — a big buyer of mortgages since the 2008 Global Financial Crisis — ended its quantitative easing programs and stopped its purchases;
- Second, the Federal Deposit Insurance Corporation (FDIC) took over three failed banks, liquidating balance sheets that were full

of residential mortgages, which increased the supply available in the market; and

- Third, the Treasury market is experiencing unusual volatility.

From a historical perspective, the change in Treasury market volatility is a return to normal. "What was abnormal was the last 15 years, where it was quiescent and almost too low," Thompson said. This rising volatility has made mortgage-backed structured products more attractive because it increases the value of mortgage prepayment options that are embedded in such instruments.

"The U.S. government's not buying, the FDIC is liquidating, and you have exaggerated volatility: three forces that created this perfect storm of a very attractive valuation in the fixed-income landscape," Thompson said.

Camp agreed. "They're AAA-rated assets right now with six-handle yields" – that is, yields above 6% – "because of what's going on in the banking world, and there's not a natural buyer anymore, because of the bank issues. We know what these mortgages look like now, so these are great times to be involved in that kind of market."

High yield: Different behavior at different tiers

"There's two primary reasons you'd consider high yield in a portfolio, today and always," said Andy Toburen, CFA, Senior Portfolio Manager at Chartwell Investment Partners. "Those two are income and diversification." Historically, high-yield performance has not been highly correlated with other areas of fixed income. "In fact, it tends to be negatively correlated with highly rate-sensitive securities like Treasuries," Toburen said.

The credit quality of high-yield bond issuers has also shifted over time. "The high-yield market, the last 10 years, it has been up in quality," Thompson said. "It's gone from 40% triple-B's to 50% triple-B's and triple-C's going from 20% down to 10%."

The difference in credit ratings can make a meaningful difference in performance. "Spread widening in down cycles, for the weakest parts of high yield — for single B-rated names or triple-C rated issuers — is typically two to three times what you see or what you experience in the higher quality issuers," Toburen said.

"I had this argument with one of our sales folks," who asked, " 'Why are you recommending junk when we're going into recession?' " Camp recalled. To that, Camp counters that many issuers with double-B ratings are not what he considers junk. "Many of these names could easily migrate up the stack," he said, suggesting that the issuers' credit ratings could easily improve.

"It's extremely heterogenous, from a quality standpoint in particular," Toburen said. "The higher quality tiers of the market behave very differently than the lower quality tiers, and that's particularly true at inflection points."

"The high-yield market is still one where there are plenty of inefficiencies that tend to persist, and it's an area where active management can be very effective in mitigating risk," Toburen said. "The challenge with passive strategies in high yield — and I'm thinking of ETFs in particular — is that they own everything, and the companies with the most debt are the names where they have the largest positions."

Disclosures

Investing involves risk, including risk of loss.

Diversification does not ensure a profit or guarantee against loss

Risks associated with Fixed Income investing:

Many investors consider bonds to be "risk free" investment vehicles. Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors that may affect the risk and return profile of a fixed-income portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. Bonds issued by the U.S. government have significantly less risk of default than those issued by corporations and municipalities. However, the overall return on government bonds tends to be less than these other types of fixed-income securities. Investors should pay careful attention to the types of fixed-income securities that comprise their portfolio and remember that, as with all investments, there is the risk of the loss of capital.

This material may include forward-looking statements. These statements are not historical facts, but instead represent only beliefs regarding future events, many of which, by their nature, are inherently uncertain. You should not place undue reliance on forward-looking statements as it is possible that actual results and financial conditions may differ, possibly materially, from the anticipated results and financial conditions indicated in these forward-looking statements. There are uncertainties, unknown risks, and other factors that may cause actual results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance, or achievements expressed or implied by these statements.

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Definitions

Bond Ratings: Ratings are by Moody's, S&P, and/or Fitch. This is not an offer to buy or sell any securities. All prices and yields are subject to market fluctuation and availability. Past performance is not indicative of future results. Ratings provided by nationally recognized statistical rating organizations, also called ratings agencies, are appraisals of a particular issuer's creditworthiness, including the possibility that the issuer will not be able to pay interest or repay principal. Ratings are not recommendations to buy, sell or hold a security, nor do ratings remove market risk. Securities with the same rating can actually trade at significantly different prices. In addition, ratings are subject to review, revision, suspension, reduction or withdrawal at any time, and a rating agency may place an issuer under review or credit watch. Individual investors may request Moody's and S&P credit reports from their financial professionals. Additionally, Fitch reports are available for municipal bonds. More about ratings is available at moodys.com, standardandpoors.com, and fitchratings.com.

Core inflation, as measured by the "Consumer Price Index for All Urban Consumers: All Items Less Food & Energy" is an aggregate of prices paid by urban consumers for a typical basket of goods, that does not include food and energy. Core CPI is widely used by economists because food and energy typically have very volatile prices.

Correlation is a statistic that measures the degree to which two securities move in relation to each other.

The owners' equivalent of rent of primary residences (OER) is a component of the Consumer Price Index that helps measure changes in the cost of shelter in the United States. It is based on the answers from consumers who own their homes to the question: "If someone were to rent your home today, how much do you think it would rent for monthly, unfurnished and without utilities?"

The FDIC (Federal Deposit Insurance Corporation) is an independent government agency that supervises and examines banks and savings associations. The FDIC's primary duty is to insure deposits at U.S. member banks in case they fail.

A "hard landing" scenario is one where a central bank tightens monetary conditions to the point where it triggers a widespread recession. Conversely, a "soft landing" scenario is one where a central bank's monetary decisions have avoided triggering a widespread recession.

High-yield bonds pay higher interest rates because they have lower credit ratings than investment-grade bonds. High-yield bonds have credit ratings below BBB- from Standard & Poor's or below Baa3 from Moody's.

Quantitative tightening refers to central banker attempts to reverse the effects of quantitative easing (QE), which is a form of unconventional monetary policy in which a central bank purchases longer-term securities from the open market in order to increase the money supply and encourage lending and investment. In quantitative easing, buying securities adds new money to the economy, and also serves to lower interest rates by bidding up fixed-income securities. It also expands the central bank's balance sheet. In quantitative tightening, reducing those purchases is a policy primarily aimed at interest rates and at influencing investor perceptions of the future direction of interest rates.

The S&P CoreLogic Case-Shiller Home Price Index Series seeks to measure changes in the total value of all existing single-family housing stock.

Term structure of interest rates is the relationship between interest rates or bond yields and different terms or maturities, and is represented by a yield curve. It reflects the expectations of market participants about potential future changes in interest rates and their assessment of monetary policy conditions.

A real interest rate is an interest rate that has been adjusted to remove the effects of inflation. Once adjusted, it reflects the real cost of funds to a borrower and the real yield to a lender or to an investor. A real interest rate reflects the rate of time preference for current goods over future goods. For an investment, a real interest rate is calculated as the difference between the nominal interest rate, which is not adjusted for inflation, and the inflation rate.

Securitized products, such as asset-backed securities (ABS) and mortgage-backed securities (MBS), are created by pooling loans from a variety of sources and issuing bonds that are backed by these loans. Creditworthiness stems from the credit quality of the underlying loans, as opposed to corporate bonds in which creditworthiness is derived from the earning power of the issuing company. The primary risk of these securities is interest-rate risk. Rising interest rates might cause loan principal prepayments to slow, resulting in less available principal to invest at prevailing higher rates. Conversely, rate decreases might accelerate prepayments, leaving more dollars to invest at lower rates.

A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. Investors and market analysts watch certain yield curves for signs of inversion, when yields for longer-term debt instruments fall below yields on short-term debt with the same credit quality. Inversions are watched as potential signs of a weakening economy and in certain cases, a harbinger of recessions.

A yield spread, typically expressed in basis points or percentage points, is a measure of the difference between the yields of separate debt instruments with differing varying maturities, credit ratings, issuer, or risk level. The spread is calculated by subtracting the yield of one instrument from the other.

About Raymond James Investment Management

Raymond James Investment Management is a global asset management company that combines the exceptional insight and agility of individual investment teams with the strength and stability of a full-service firm. Together with our boutique investment managers – Chartwell Investment Partners, ClariVest Asset Management, Cougar Global Investments, Eagle Asset Management, Reams Asset Management (a division of Scout Investments) and Scout Investments – we offer a range of investment strategies and asset classes, each with a focus on risk-adjusted returns and alpha generation. We believe providing a lineup of seasoned, committed portfolio managers – spanning a wide range of disciplines and investing vehicles – is the best way to help investors seek their long-term financial goals.

About Eagle Asset Management

Eagle Asset Management provides a broad array of fundamental equity and fixed-income strategies designed to meet the long-term goals of institutional and individual investors. Eagle's multiple independent investment teams have the autonomy to pursue investment decisions guided by their individual philosophies and strategies.

About Chartwell Investment Partners

Chartwell Investment Partners LLC, is an investment management firm dedicated solely to the investment advisory business. Chartwell's philosophy is to rely on proprietary, bottom-up research to find high quality investments across its various product offerings.

About Reams Asset Management

Reams Asset Management is a fixed income specialist whose mission is to provide institutional quality investment expertise and unmatched client service to a diverse group of investors. Reams applies their consistent investment process across a range of strategies and customized client solutions, seeking to maximize risk-adjusted total returns over a full market cycle by taking advantage of volatility and reacting opportunistically to dislocations in the bond market. Reams Asset Management is a division of Scout Investments, Inc. Scout Investments is a wholly owned subsidiary of Raymond James Investment Management, which in turn is a wholly owned subsidiary of Raymond James Financial, Inc.

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