FIRST MANHATTAN

FIXED INCOME UPDATE

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FEDERAL OPEN MARKET COMMITTEE CUTS POLICY RATE

Falling interest rates generally signal a good backdrop for asset prices, as it makes investing and spending more affordable for the government, businesses, and consumers alike. In the Fall of 2024, the Federal Open Market Committee embarked on its easing cycle by cutting the policy rate three times to 4.5% and continuing to reduce its holdings of government and agency mortgage-backed securities. Despite above-target inflation, there is optimism about the incoming administration's plans to boost economic growth, cut excess spending to fund growth initiatives, and address the deficit by improving both sides of the equation.

As we enter a new year, investors are concerned about the speed with which the incoming administration's plans will take flight, including as it relates to the quantity of government debt outstanding both in terms of magnitude and as a percentage of gross domestic product. However, bond investors can take comfort in one thing we know for certain—yields that can be obtained by buying bonds are much higher than they have been in almost 20 years. The chart to the right shows the yield of the 10-year U.S. Treasury compared to intermediate-term, high-quality, tax-exempt municipal and corporate bonds over the past 20 years.

Given the higher all-in yields, bond investors now have a greater margin of safety to absorb losses if yields were to climb and prices fall. For example, if the Fed is forced to pivot to raising rates this year in reaction to a resurgence in inflation, starting from a higher yield will help portfolio performance vs. calendar year 2022 when rates started at 0% and were raised by 4.75%. On the contrary, if the Fed continues to cut rates this year, total returns for bonds could be higher than expected because prices would rise alongside the coupon income received. Put simply, if a bond is earning a yield of 4% and the price falls by -3%, the return is +1%.

MUNICIPALS

During 2024, the municipal bond market continued to offer a compelling combination of tax-advantaged income and portfolio diversification, making it a valuable component of our clients' asset allocation. For clients in mid to higher tax brackets, the 3%+ market yield on tax-exempt municipal bonds is above 5% on a taxable equivalent basis. Overall, client portfolios have an average coupon in the mid-4% area, which provides an opportunity to draw income or redeploy cashflows into more bonds. The modestly positive total returns generated in 2024 were buoyed by interest rate cuts and dampened by slightly rising yields. Thanks to a little volatility (which provided buying opportunities), yields that remain very attractive overall, and robust municipal bond issuance (which reached record levels), we have had ample opportunity to invest available cash and lock-in yields for longer.

Source: Bloomberg as of Dec. 31, 2024

Municipal credit fundamentals remained resilient. State and local government tax revenues softened vs. the highs experienced in 2021 and 2022, reflecting slower, yet positive, economic growth and reduced federal pandemic aid, and credit rating upgrades continued to outpace downgrades throughout the year. Some pockets of stress emerged in smaller municipalities with high debt loads and concentrated economies, and smaller private colleges and universities, which continue to face a secular downshift in enrollment.

We maintain a bias toward higher-quality issuers that are supported by revenues from essential services, property taxes, or have credit enhancements from reserve funds or bond insurers. We seek to buy securities that we believe we can hold to redemption; however, we do not hesitate if we become wary of an issuer or a sector or when we see a better investment opportunity. Throughout the year, we sold exposure to issuers when we felt the risk of owning outweighed the future return potential; we also sold some lower coupon securities, which we replaced with higher coupons.

CORPORATES

Corporate bond markets were also resilient in 2024. Despite higher interest rates, high-quality companies have been able to refinance maturing debt at rates that are proving to be manageable. Sustained economic growth has enabled businesses to grow sufficiently to manage higher inflation and rising labor costs, resulting in strengthened corporate balance sheets. Companies with large cash balances also benefitted from the higher rates earned on cash. Rating agencies upgraded more high credit quality companies than they downgraded, providing a solid backdrop for clients with corporate bond holdings.

2024 was also marked by: (1) Huge demand for high-quality corporate bonds by both domestic and foreign investors, given very attractive yields, (2) Favorable outlook for corporate credit, which led to a decline in the extra yield that is an investor's compensation for buying a corporate bond as compared to a Treasury, and (3) Unattractive term premium for most of the year (the yield advantage for buying a longer maturity bond). As we monitor all this, at times, we may buy U.S. Treasuries if we feel the risk-adjusted return profile is more attractive and/or shorter maturities (within five years) if we see no urgency in buying bonds with a longer time to maturity. We stand ready to invest in longer bonds when markets make the investment more appealing and may selectively sell some shorter maturities or lower yielding bonds to raise cash for the opportunity.

Client portfolios generated total returns in the low-to-mid single digits in 2024, which is slightly below the all-in yield due to some weakness during the fourth quarter as markets started to price in worries about the year ahead. Higher market yields on client portfolios provide a cushion for volatility in the coming year. Consistent cash flows from coupon payments and redemptions provide cash that can be redeployed at yields that will enable a higher income stream and more attractive total returns than were possible over the past decade.

First Manhattan – Stay in the Know

In 2025, we believe the bond market and our client portfolios are well positioned to navigate a unique set of opportunities and challenges. Please contact your First Manhattan Wealth Management team if you would like to schedule a meeting to discuss your fixed income holdings or your excess cash available for investment.

60 FIRST MANHATTAN CELEBRATING 60 YEARS

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