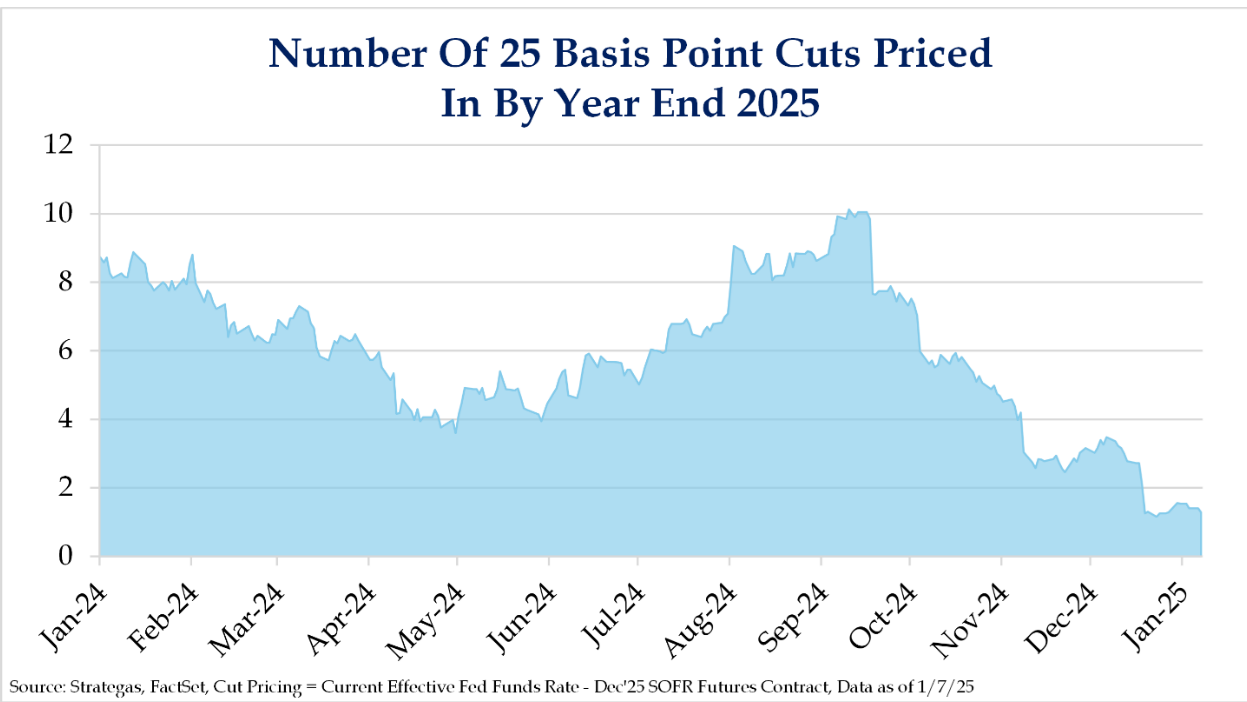
4Q 2024 – Quarterly Commentary

Relative to market consensus at the end of the third quarter, developments in the fourth quarter meaningfully shifted the market narrative on both future monetary policy and interest rates. Amid signs in the middle of last year that economic growth was beginning to slow, the Federal Reserve reduced the target fed funds rate by a cumulative 100 basis points through year end. Intermediate term interest rates did not respond as one might expect however. Instead of declining, Ten-Year U.S. Treasury yields moved sharply higher and now appear on a near-term trajectory to reach the psychologically important 5.0% level last seen in October 2023. This counterintuitive increase in bond yields reflects growing evidence that despite some minor cracks, the U.S. economy remains quite strong and the Fed's battle to defeat inflation is likely not finished. In addition to pricing in better than expected economic developments, the bond market is also adjusting to the risk that the Trump administration's proposed trade and fiscal policies may exacerbate inflationary pressures and worsen an already troublesome budget deficit. The Federal Reserve responded as one would expect by issuing guidance at the January meeting of the FOMC that policymakers will likely pause future interest rate cuts and adopt a more data dependent approach going forward, awaiting more information on economic developments and proposed fiscal policies. This renewed guidance for future rate cuts has materially shifted market expectations for the number of rate cuts anticipated throughout the coming year as evidenced below.



The myriad of factors currently impacting market sentiment, each of which have the potential to meaningfully alter market pricing (fiscal policy, trade policy, de-regulation, rate cuts) play important roles in how we manage risk with respect to sector allocation, yield curve positioning and interest rate exposure. Despite historically rich valuations, we continue to maintain above average exposure to corporate bonds, however given concerns over valuations we have adjusted the average maturity of this allocation to be less interest rate sensitive. Following the election, the yield curve has steepened sharply reflecting renewed fiscal concerns and inflation pressure. Despite the recent steepening, at current levels the 2/10 yield curve stands at a modest 37 basis points, still relatively flat compared to the long-term average of 1.0 percent. Our expectation is the curve will continue to normalize towards steeper levels and we have positioned portfolio yield curve exposure with reduced exposure to longer dated maturities which are more susceptible to higher interest rates. We continue to favor short to intermediate maturities that will benefit from a continued steepening of the yield curve. As we enter 2025, our outlook for forward returns in the bond market is very positive with yields on a large segment of high-quality bonds now approaching 6.0 percent.

Birch Run Investments, LLC
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