InvAsset's Voice

WHEN BONDS DEFY GRAVITY

THE TREASURY YIELD CONUNDRUM



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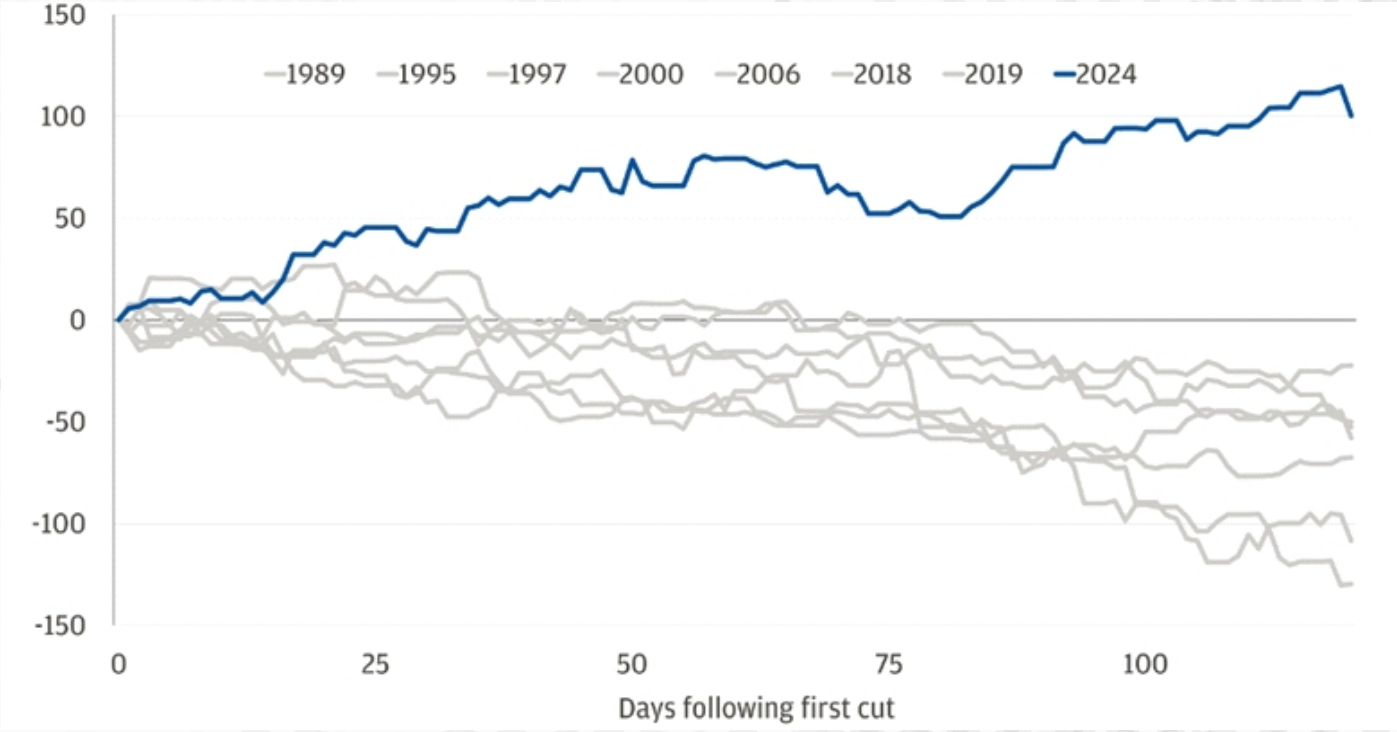
In a plot twist straight out of the financial playbook, 10-year U.S. Treasury yields have been soaring—even as the Federal Reserve has been busy cutting rates. Historically, bond yields bow to gravity during rate-cutting cycles, but not this time. Why? The answer lies in a cocktail of unexpected growth and brewing uncertainty, shaken with a twist of resilience



THE ECONOMY
THAT OUTPACED ITSELF

The U.S. economy in 2024 had all the swagger of an underdog turned champion. Growth projections started the year at a modest 1.2% but doubled to 2.7% by December, fueled by a late-game surge in Q4. Stronger growth means fewer rate cuts, and fewer cuts mean higher yields. It's as simple—and as complicated—as that.

CHANGE IN 10-YEAR YIELD POST FIRST FED CUT



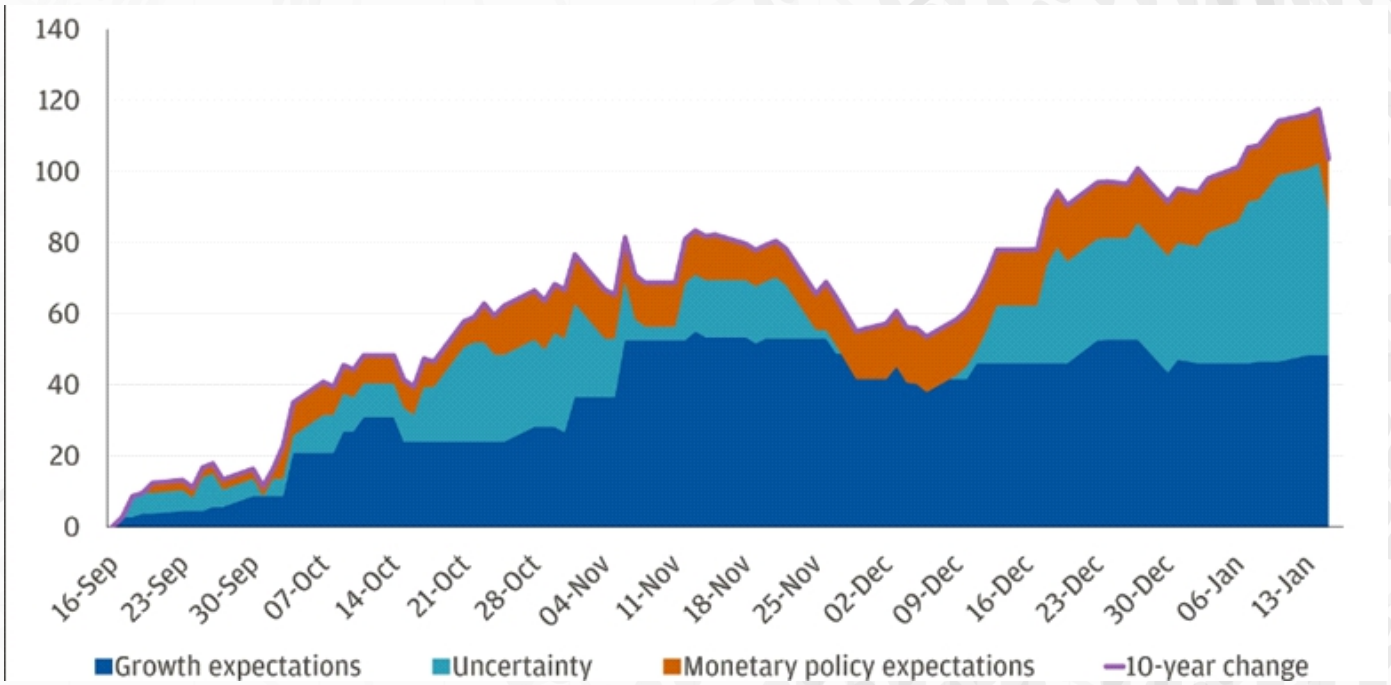
The chart shows the change in 10-year yield in basis points (bps) following the first Federal Reserve interest rate cut for various years, with a particular focus on the year 2024, which is highlighted in blue. Significant data points for 2024 are as follows: 0 days following the first cut, the change in the 10-year yield was at 0 bps. Approximately 25 days following the first cut, the change in the 10-year yield was around 45 bps. Approximately 50 days following the first cut, the change in the 10-year yield was around 78 bps. Approximately 75 days following the first cut, the change in the 10-year yield was around 52 bps. Approximately 100 days following the first cut, the change in the 10-year yield was around 94 bps. The chart also includes historical data for the years 1989, 1995, 1997, 2000, 2006, 2018 and 2019, shown in lighter gray lines. In these years, changes in the 10-year yield following the first Fed cut generally remained below 50 bps and often dipped into negative territory.

UNCERTAINTY CASTS A LONG SHADOW



While economic strength kept the wheels turning, questions lingered. Where will the Fed stop? What policies will the new administration unveil? Even within the Federal Open Market Committee (FOMC), opinions on terminal rates differ by a staggering 150 basis points. Add geopolitical tension and inflation speculation to the mix, and it's clear: uncertainty is the market's constant companion.

GROWTH EXPECTATIONS AND UNCERTAINTY ARE **THE PRIMARY DRIVERS OF RECENT RATE INCREASES**

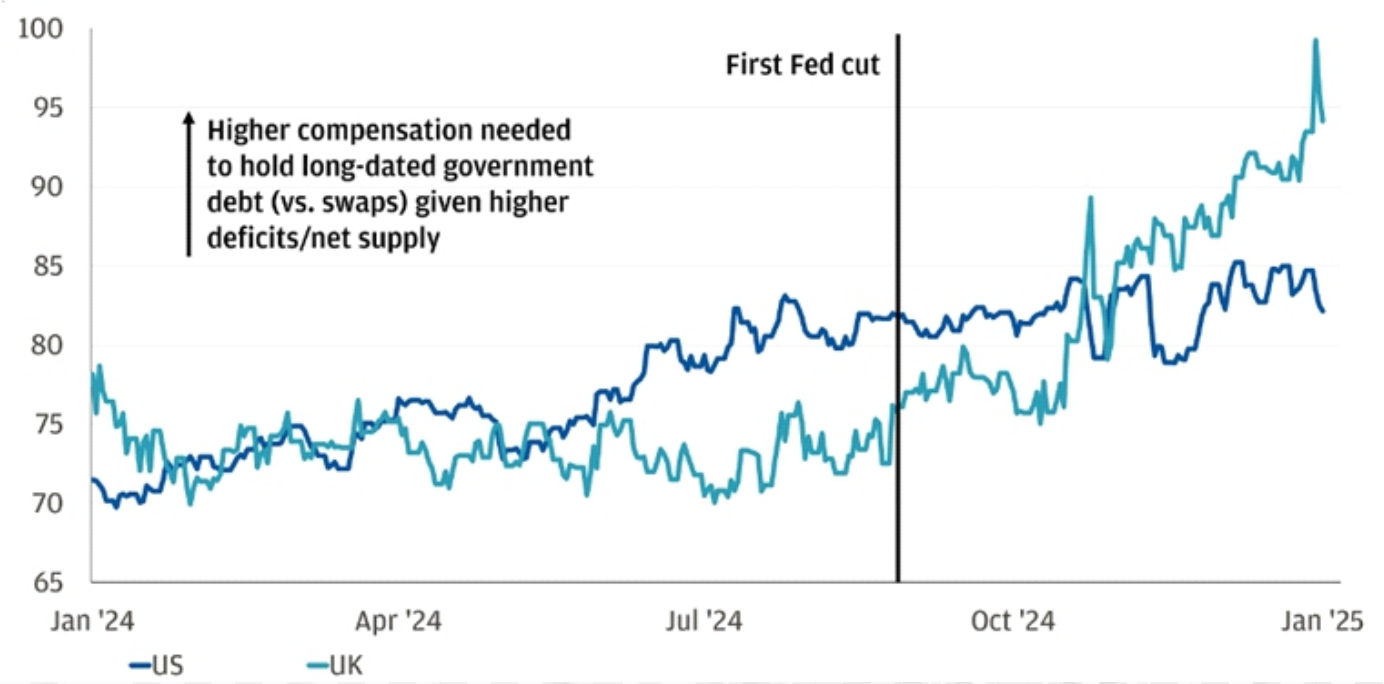


The dataset represents the GIS sign-restriction model, illustrating the cumulative 10-year change in bps for growth expectations, uncertainty, monetary policy expectations and the overall 10-year change from September 16, 2024, to January 15, 2025. Significant data points are as follows: On September 16, 2024, growth expectations for the cumulative 10-year change were 0.0 bps, uncertainty for the cumulative 10-year change was 0.0 bps, monetary policy expectations for the cumulative 10-year change were 0.0 bps, and the 10-year change was 0.0 bps. On October 4, 2024, growth expectations were 20.8 bps, uncertainty was 4.9 bps, monetary policy expectations were 9.3 bps, and the 10-year change was 35.0 bps. On October 21, 2024, growth expectations were 24.0 bps, uncertainty was 26.7 bps, monetary policy expectations were 7.2 bps, and the 10-year change was 57.8 bps. On November 1, 2024, growth expectations were 36.5 bps, uncertainty was 26.3 bps, monetary policy expectations were 13.8 bps, and the 10-year change was 76.6 bps. On November 13, 2024, growth expectations were 54.9 bps, uncertainty was 16.0 bps, monetary policy expectations were 12.4 bps, and the 10-year change was 83.4 bps. On December 23, 2024, growth expectations were 52.4 bps, uncertainty was 28.6 bps, monetary policy expectations were 15.8 bps, and the 10-year change was 96.9 bps. On January 7, 2025, growth expectations were 46.0 bps, uncertainty was 45.5 bps, monetary policy expectations were 15.2 bps, and the 10-year change was 106.7 bps. On January 15, 2025, growth expectations were 48.3 bps, uncertainty was 40.0 bps, monetary policy expectations were 15.2 bps, and the 10-year change was 103.6 bps.

MARKET MOVES
A BALANCING ACT

A cooler inflation report brought some much-needed cheer. Core consumer prices rose just 0.2% in December, pulling the year-over-year figure to 3.2%. Equity markets responded with gusto—the S&P 500 climbed 1.9%, small caps led the charge with a 3.5% jump, and all 11 sectors ended the week higher. But for bonds? Yields dipped briefly before resuming their upward climb, refusing to align with historical norms.

DISCOUNT FOR OWNING LONGER DATED GOVERNMENT BONDS VS. INTEREST RATE SWAPS



The chart illustrates the discount in bps for owning longer-dated government bonds versus interest rate swaps in both the United States and the United Kingdom from January 2024 to January 2025. The chart also highlights the point of the first Fed interest rate cut. Significant data points are as follows: On January 1, 2024, in the United States, the discount for owning longer-dated government bonds versus interest rate swaps was approximately 77 bps, and in the United Kingdom, it was approximately 72 bps. Around April 2024, both the U.S. and U.K. discounts fluctuated, with the U.S. discount around 75 bps and the U.K. discount around 70 bps. In October 2024, shortly after the first Fed cut, the U.S. discount rose to approximately 85 bps, while the U.K. discount was around 78 bps. By January 2025, the discount in the United States reached approximately 95 bps, indicating higher compensation needed to hold long-dated government debt relative to swaps, while in the United Kingdom, the discount was around 85 bps. The chart indicates a general upward trend in discounts, with the United States showing more significant increases compared to the United Kingdom, particularly after the first Fed cut.

WHAT IT MEANS FOR YOUR PORTFOLIO



Here's the silver lining: higher yields have turned once-overlooked assets into golden opportunities.

- **Municipal bonds** now boast yields above their 25-year average, offering a tax-advantaged haven for U.S. investors.

- **European durations** present similarly attractive prospects, catering to global appetites for fixed income.

- For the bold, **U.S. preferreds and direct lending** deliver near double-digit yields—a reward for risk-takers with a taste for adventure.

ESTIMATED 12-MONTH FORWARD TREASURY YIELD %

Terminal Fed Funds Rate	2-year yield	5-year yield	10-year yield
4.25-4.50	4.70	4.90	5.15
4.00-4.25	4.45	4.65	4.90 Today
3.75-4.00	4.20	4.40	4.65
3.50-3.75	3.95	4.15	4.45
3.25-3.50	3.70	3.90	4.15
3.00-3.25	3.40	3.60	3.85

The table displays the 12-month forward Treasury yield percentages under different terminal federal funds rate assumptions, detailing the expected yields for 2-year, 5-year and 10-year Treasury securities. Significant data points are as follows: With a terminal fed funds rate of 4.25%–4.50%, the 2-year yield was 4.70%, the 5-year yield was 4.90%, and the 10-year yield was 5.15%. With a terminal fed funds rate of 4.00%–4.25% (highlighted as "Today"), the 2-year yield was 4.45%, the 5-year yield was 4.65%, and the 10-year yield was 4.90%. With a terminal fed funds rate of 3.75%–4.00%, the 2-year yield was 4.20%, the 5-year yield was 4.40%, and the 10-year yield was 4.65%. With a terminal fed funds rate of 3.50%–3.75%, the 2-year yield was 3.95%, the 5-year yield was 4.15%, and the 10-year yield was 4.45%. With a terminal fed funds rate of 3.25%–3.50%, the 2-year yield was 3.70%, the 5-year yield was 3.90%, and the 10-year yield was 4.15%. With a terminal fed funds rate of 3.00%–3.25%, the 2-year yield was 3.40%, the 5-year yield was 3.60%, and the 10-year yield was 3.85%.

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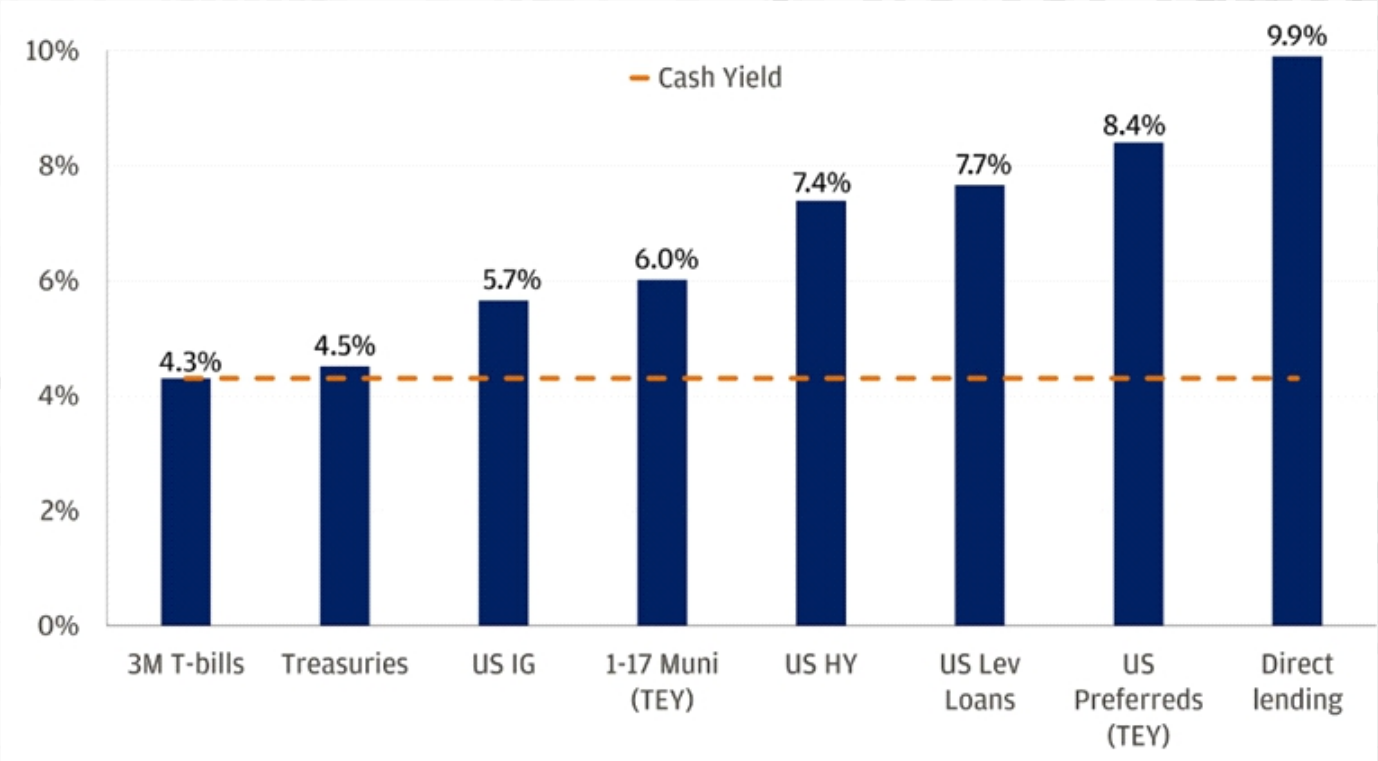
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YIELDS ACROSS THE FIXED INCOME UNIVERSE



The chart displays the yields across various segments of the fixed income universe, expressed as percentages. It provides a comparison of different financial instruments relative to a cash yield benchmark. Significant data points are as follows: The yield for 3-month T-bills was 4.3%. The yield for Treasuries was 4.5%. The yield for U.S. Investment Grade (US IG) was 5.7%. The yield for 1–17 year Municipal Bonds (TEY) was 6.0%. The yield for U.S. High Yield (US HY) was 7.4%. The yield for U.S. Leveraged Loans was 7.7%. The yield for U.S. Preferreds (TEY) was 8.4%. The yield for Direct Lending was 9.9%. The chart highlights how Direct Lending offers the highest yield at 9.9%, while 3-month T-bills have the lowest yield at 4.3%. The orange dashed line represents the cash yield benchmark for comparison.

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