GRIMES AND COMPANY

grimesco.com

01.15.25 I INVESTMENT MANAGEMENT

2025 Outlook Theme #2: Unusually, Interest Rates Look Normal

Benjamin B. Wallace, CFA – Portfolio Manager, Research Director

Interest rate movements, whether due to data releases or Fed policy announcements, have been one of the main market drivers in 2024. Rather than speculate about the direction of Fed policy or obsess over every economic release, we look at what type of economy and Fed policy is priced into the markets, then gauge if that is reasonable. Assuming 2% inflation and 2% trend growth (the Fed's two long term assumptions), we get a 4% neutral interest rate, bracketed by a 50 bps 3.75% to 4.25% neutral range. Second, we look at the 2yr yield as a proxy for Fed policy, and the 10yr yield as a proxy for the economy. Based on where the 2yr is relative to our neutral range, we can gauge the market's view of Fed policy, while the 10yr shows what type of economy the market is pricing.

Chart 1 shows these two rates, as well as an orange "Hot Economy, Tight Fed" range of 4.25% to 5.00%, and a blue "Cool Economy, Loose Fed" range of 3.00% to 3.75%.

During Q4, despite the Fed cutting rates twice, the 10yr returned to the "hot economy" range, rising to 4.57%, while the 2yr drifted up to the top of the neutral range, at 4.24%. This prices a neutral Fed and a solid economy. Both are reasonable expectations.

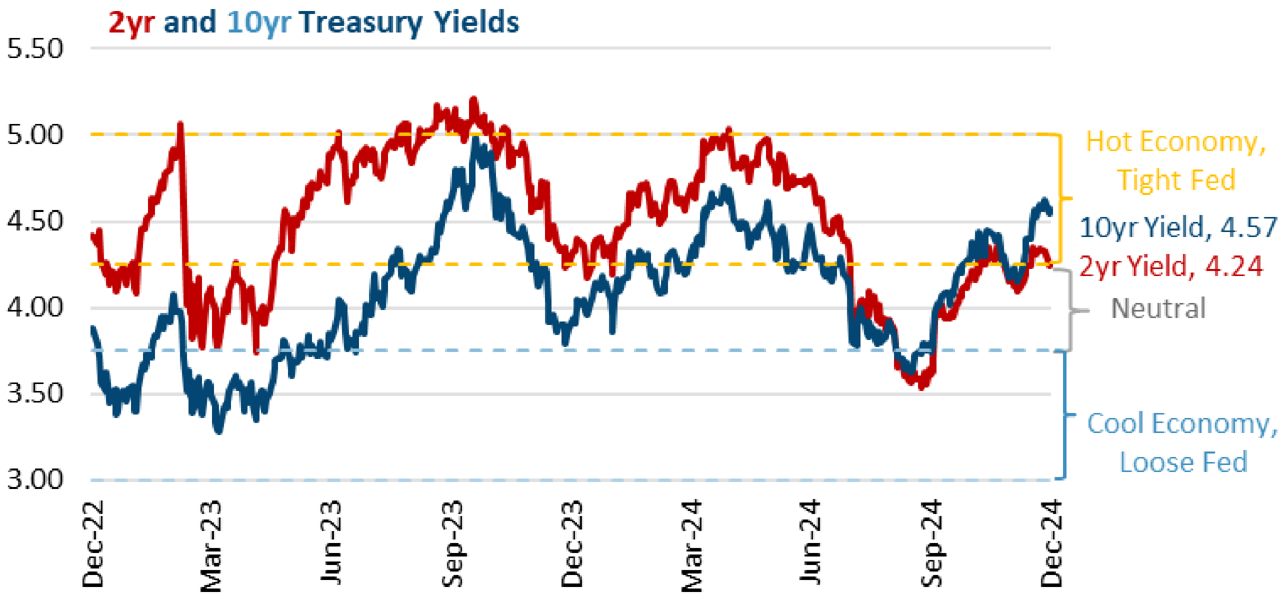

Chart 1

Bonds had a challenging 2024, because they entered the year with rates reflecting a slower economy and a looser Fed than was likely. Entering 2025, what do valuations say about the appeal of bonds at this interest rate level? For valuing bonds, one metric we focus on is the ratio of Duration to Yield. Duration measures the sensitivity of a bond's price to changes in interest rates, with the value representing the percent change in a bond's price for a 1% change in rates. For example, a bond with a duration of five would lose 5% if interest rates rose 1%.

The ratio of Duration to Yield compares interest rate sensitivity to the income it offers. This ratio for the Agg is to the left. Before the Global Financial Crisis in 2009, it was in a range of 1.0 to 1.4, but in the post Global Financial Crisis period, it was between 2 and 4, then rose above 6 during covid. During the two recent highs for interest rates (October 2023 and April 2024), the yield on the Bloomberg Barclays Aggregate (Agg) exceeded 5%, and the Duration/Yield rate finally returned to the 1.0 to 1.4 range.

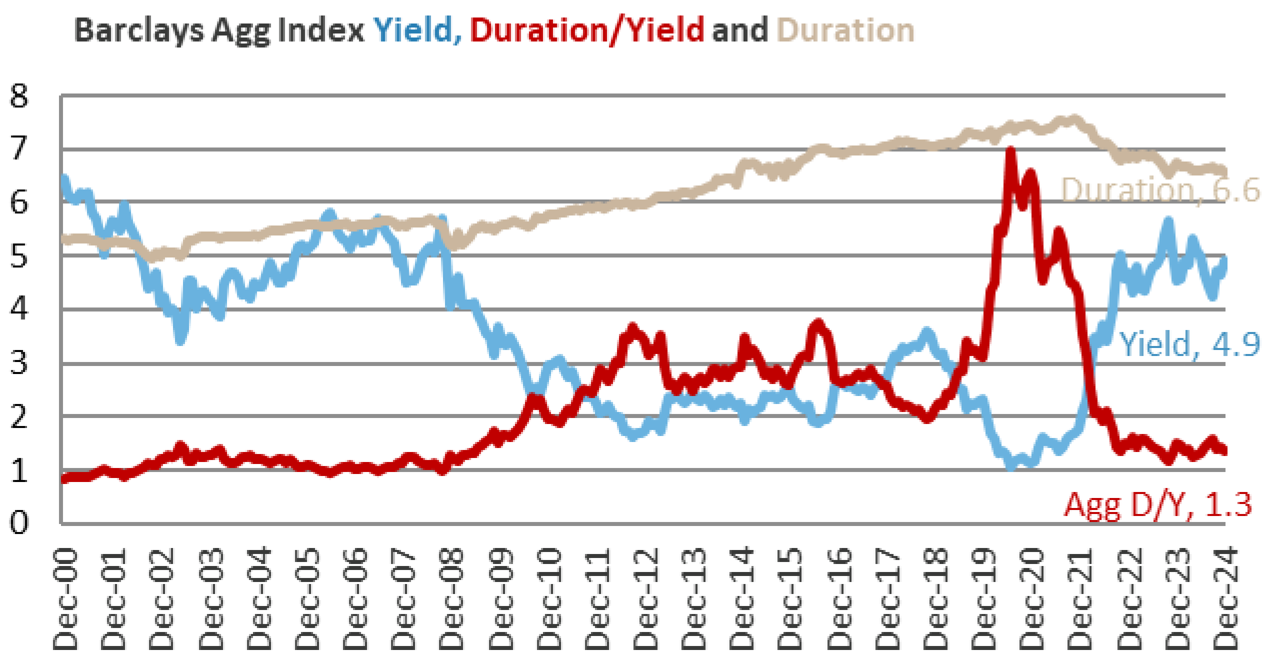

Chart 2

The Agg's yield rose to 4.9% In Q4, causing its price to decline and leaving it with flat returns for 2024, but lowering the Duration to Yield ratio back down to 1.3, the upper end of the pre-GFC range. The good news is that higher yields (and a lower Duration to Yield ratio) sets up the bond market for a better 2025.

In addition to Fed policy and the duration to yield relationship normalized to pre-GFC levels, another sign of interest rate normalization is the yield curve. Typically, short term rates are lower than long term rates. However since 2022, the 2yr Tsy yield has been higher than the 10yr. The 2yr fell below the 10yr in September, joined by the 1yr in November. Driven by a concept known as the "term premium", an upwardly sloped yield curve encourages investors to lend longer term by offering better compensation for taking on potential interest rate volatility, as opposed to sitting in short term debt. It allows the banking system to function more smoothly as well.

Overall, as the Fed has raised rates and the markets have adjusted, the bond market, which has been distorted for more than a decade, seems to be returning to normal. While a positive for functioning capital markets and investor portfolios, there are two issues.

First, the economy needs to adjust to higher rates as well. Mortgage and auto financing rates, for example, are not as low as they have been. Second, market participants need to adjust, as well. Bond investors should not expect rates to plummet to near zero again, and so should not be expecting excess return from duration.

The 10yr and 2yr reflect a reasonable economic and Fed outlook; the duration to yield ratio is back to pre-GFC levels; the yield curve is no longer inverted. These three factors have not all been "normal" at the same time for 15 years. That is why

Unusually, Interest Rates Look Normal.

IMPORTANT DISCLOSURES:

Please remember that past performance is no guarantee of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Grimes & Company, Inc. ["Grimes]), or any non-investment related content, made reference to directly or indirectly in this commentary will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this commentary serves as the receipt of, or as a substitute for, personalized investment advice from Grimes. No amount of prior experience or success should not be construed that a certain level of results or satisfaction if Grimes is engaged, or continues to be engaged, to provide investment advisory services. Grimes is neither a law firm, nor a certified public accounting firm, and no portion of the commentary content should be construed as legal or accounting advice. A copy of the Grimes' current written disclosure Brochure discussing our advisory services and fees continues to remain available upon request or at www.grimesco.com. **Please Remember:** If you are a Grimes client, please contact Grimes, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services, or if you would like to impose, add, or to modify any reasonable restrictions to our investment advisory services. Unless, and until, you notify us, in writing, to the contrary, we shall continue to provide services as we do currently. **Please Also Remember to advise us** if you have not been receiving account statements (at least quarterly) from the account custodian. Historical performance results for investment indices, benchmarks, and/or categories have been provided for general informational/comparison purposes only, and generally do not reflect the deduction of transaction and/or custodial charges, the deduction of an investment management fee, nor the impact of taxes, the incurrence of which would have the effect of decreasing historical performance results. It should not be assumed that your Grimes account holdings correspond directly to any comparative indices or categories. **Please Also Note**: (1) performance results do not reflect the impact of taxes; (2) comparative benchmarks/indices may be more or less volatile than your Grimes accounts; and, (3) a description of each comparative benchmark/index is available upon request.

The information contained herein is based upon sources believed to be true and accurate. Sources include: *Factset Research Systems Inc.*, Bureau of Economic Analysis, Bureau of Labor Statistics, Congressional Budget Office, Board of Governors of Federal Reserve System, Fred: Federal Reserve Bank of St. Louis Economic Research, U.S. Department of the Treasury

-The Standard & Poor's 500 is a market capitalization weighted index of 500 widely held domestic stocks often used as a proxy for the U.S. stock market. The Standard & Poor's 400 is a market capitalization weighted index of 400 mid cap domestic stocks. The Standard & Poor's 600 is a market capitalization weighted index of 600 small cap domestic stocks.

-The NASDAQ Composite Index measures the performance of all issues listed in the NASDAQ stock market, except for rights, warrants, units, and convertible debentures.

-The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 21 emerging markets. The MSCI All Country World Index is a free float adjusted market capitalization index designed to measure the performance of large and mid and cap stocks in 23 developed markets and 24 emerging markets. With over 2,800 constituents it represents over 85% of the global equity market.

-The Barlcays Aggregate Index represents the total return performance (price change and income) of the US bond market, including Government, Agency, Mortgage and Corporate debt.

-The BofA Merrill Lynch Investment Grade and High Yield Indices are compiled by Bank of America / Merrill Lynch from the TRACE bond pricing service and intended to represent the total return performance (price change and income) of investment grade and high yield bonds.

-The S&P/LSTA U.S. Leveraged Loan 100 is designed to reflect the largest facilities in the leveraged loan market. It mirrors the market-weighted performance of the largest institutional leveraged loans based upon market weightings, spreads and interest payments.

-The S&P Municipal Bond Index is a broad, comprehensive, market value-weighted index. The S&P Municipal Bond Index constituents undergo a monthly review and rebalancing, in order to ensure that the Index remains current, while avoiding excessive turnover. The Index is rules based, although the Index Committee reserves the right to exercise discretion, when necessary.

-The BofA Merrill Lynch US Emerging Markets External Sovereign Index tracks the performance of US dollar emerging markets sovereign debt publicly issued in the US and eurobond markets.

-The HFRI Fund of Funds index is compiled by the Hedge Funds Research Institute and is intended to represent the total return performance of the entire hedge fund universe.

