APTUS CAPITAL ADVISORS

Fixed Income Commentary

Yields Up Big Post Rate Cuts?

Bond Yields Are Broken Down into 2 Components:

#1: Expected Fed Funds Rate (FFR)

Currently, the expected neutral rate (where the Fed bottoms out its cutting cycle) is ~3.75%. Looking ahead, we expect the Fed funds rate to average approximately this rate.

#2: Term Premiums

The term premium of a bond is simply the additional spread a lender requires for longer-duration bonds over what is available at the front end of the curve. This could also be referred to as the “Price of Time.”

Average of Expected FFR Over Life of Bond + **Term Premium** = **Nominal Treasury Yield**

Source: Trading View

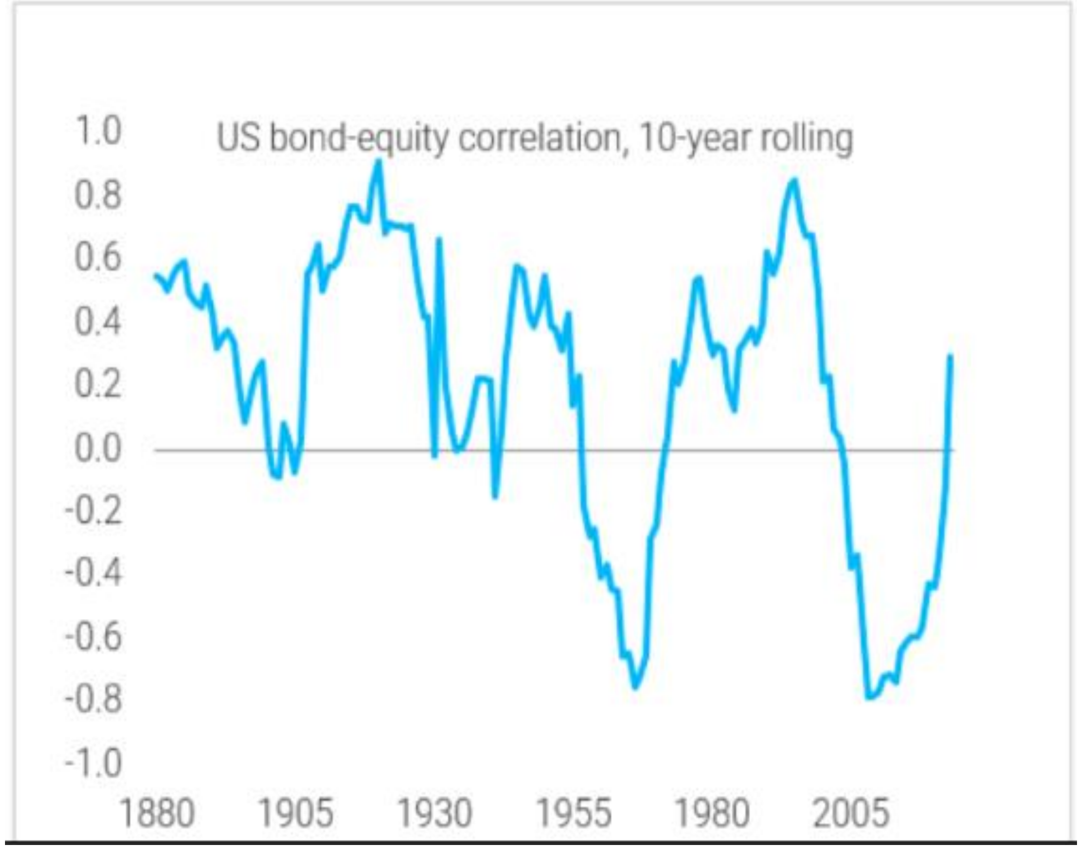
1 day | 5 days | 1 month | 6 months | Year to date | 1 year | 5 years | All time

Stock/Bond Correlations

Most investors assume negative correlations between stocks and bonds are a fact of life. This is the bedrock of modern portfolio construction, think "60/40". This has been a modern phenomenon and not what historical data indicates.

How it Translates to Portfolios:

- Investors buy bonds for portfolio stability, and they accept a lower rate of return because bonds can serve as a hedge to risk assets when things get choppy.
- The last couple of years have challenged that theory and bonds and stocks have been positively correlated, limiting the effectiveness of bonds in an allocation.
- If bonds are positively correlated to stocks, investors SHOULD require more compensation for bonds given the lack of certainty of protection which should pressure bond yields higher.



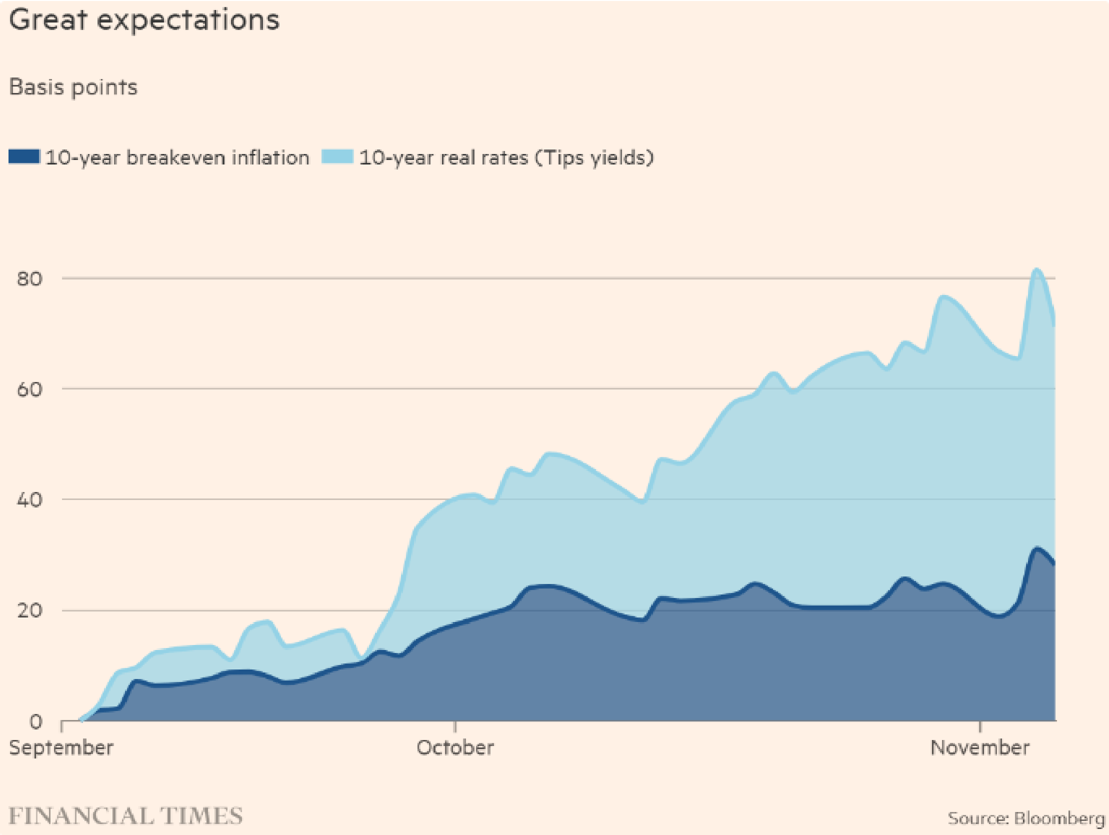
Source: TS Lombard

What's Driving Yields Higher

The chart breaks down the increase in 10-year Treasury yields since they bottomed in late September. The larger part of the increase is accounted for by real interest rates, here proxied by yields on inflation protected Treasuries (Tips), in light blue. Almost 40 per cent of the increase is, however, down to higher break-even inflation (the difference between nominal yields and Tips), in dark blue.

How it Translates to Portfolios:

- Growth expectations are certainly driving rates higher as the aggressive Fed cuts increase a higher likelihood of a soft landing.
- Higher inflation expectations are also playing a role in higher yields.
- Investors require more premium to compensate themselves for higher interest rate volatility (fiscal risks.)



Bottom Line: Bonds After Tax/Inflation is Not Exciting

- The Fed sets short-term interest rate policy and has less control on longer term rates (unless they are actively doing QE and buying LT bonds).
- Long-term yields are a factor of growth and inflation and are set by the markets based on many things (supply and demand, inflation, growth rates, volatility, etc.).
- Fed funds rate is 4.75% (after the cut last week) with neutral expected to be 3.75%
- Term premiums average 75bps when inflation is low and 150bps when inflation is high/ volatile… Making Fair Value of 10yr 4.75%-5.25%.

JL's Take

#1: A higher nominal growth rate signals stronger economic activity and higher inflation, both of which tend to push bond yields up as investors seek compensation for inflation and risk associated with higher growth.

Nominal GDP at 5.7% and Money supply at 5-7% growth, why would you want to own something yielding less than this??

#2: At 4.30% yield on a 10yr Treasury after tax, 1.72% goes to Uncle Sam (@ 40% rate) leaving you with 2.58% net. If inflation averages 3% over the 10yr period (which has been long term avg and I'd argue it's going to be higher the next 10) you are left with a real return of -0.42%.

Not very attractive!

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The 2 Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 2 year.

The 10 Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 10 year. The 10 year treasury yield is included on the longer end of the yield curve. Many analysts will use the 10 year yield as the “risk free” rate when valuing the markets or an individual security.

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The Consumer Price Index (CPI) measures the change in prices paid by consumers for goods and services. The CPI reflects spending patterns for each of two population groups: all urban consumers and urban wage earners and clerical workers.

Treasury Inflation-Protected Securities, or TIPS, provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index.

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