Market Minute

HOW WOULD A FED RATE CUT LIFT RETURN POTENTIAL FOR BOND INVESTORS?

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A simple equation reveals attractive opportunities, particularly for investors with cash-equivalent accounts.

FED LIKELY TO LOWER INTEREST RATES

Market expectations for the Federal Reserve (Fed) to cut interest rates have risen recently. Here's why:

- The labor market has shown signs of weakening.
- Overall economic growth is likely to slow down amid tariff uncertainties and a softer jobs market.
- As growth decelerates, consumer demand may ease, causing inflation to moderate.
- Fed officials have characterized the current interest rate environment as still modestly restrictive.

Figure 1 | Markets Expect Several Fed Rate Cuts in the Months Ahead

Percent Ranges for the Federal Funds Target Rate and Corresponding Probabilities

Fed Policy Meeting Date	1.75-2	2-2.25	2.25-2.5	2.5-2.75	2.75-3	3-3.25	3.25-35	3.5-3.75	3.75-4	4-4.25	(Current) 4.25-4.5
9/17/2025						0.0%	0.0%	0.0%	0.0%	83.1%	16.9%
10/29/2025	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	44.4%	47.7%	7.9%
12/10/2025	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	35.4%	47.0%	16.0%	1.6%
1/28/2026	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	15.7%	40.5%	33.3%	9.6%	0.9%
3/18/2026	0.0%	0.0%	0.0%	0.0%	0.0%	8.0%	28.3%	36.8%	21.2%	5.2%	0.4%
4/29/2026	0.0%	0.0%	0.0%	0.0%	2.5%	14.3%	31.0%	32.0%	16.2%	3.7%	0.3%
6/17/2026	0.0%	0.0%	0.0%	1.4%	9.1%	23.7%	31.6%	23.2%	9.2%	1.8%	0.1%
7/29/2026	0.0%	0.0%	0.4%	3.7%	13.5%	26.0%	29.0%	19.0%	7.0%	1.3%	0.1%
9/16/2026	0.0%	0.2%	1.7%	7.5%	18.4%	27.2%	25.1%	14.3%	4.8%	0.8%	0.1%
10/28/2026	0.0%	0.4%	2.7%	9.5%	20.0%	26.8%	23.2%	12.6%	4.1%	0.7%	0.0%
12/9/2026	0.1%	0.9%	4.1%	11.5%	21.3%	26.1%	21.1%	10.9%	3.4%	0.6%	0.0%

Data as of 8/19/25, when the federal funds rate was 4.25% - 4.5%. Source: CME FedWatch Tool. The percentages represent the market probabilities of the federal funds rate landing in a specific range after upcoming Fed meetings. For example, investors indicated a 47% probability of the rate dropping to 3.75% - 4% at the Fed's December meeting, reflecting two 25 bps rate cuts by year-end.

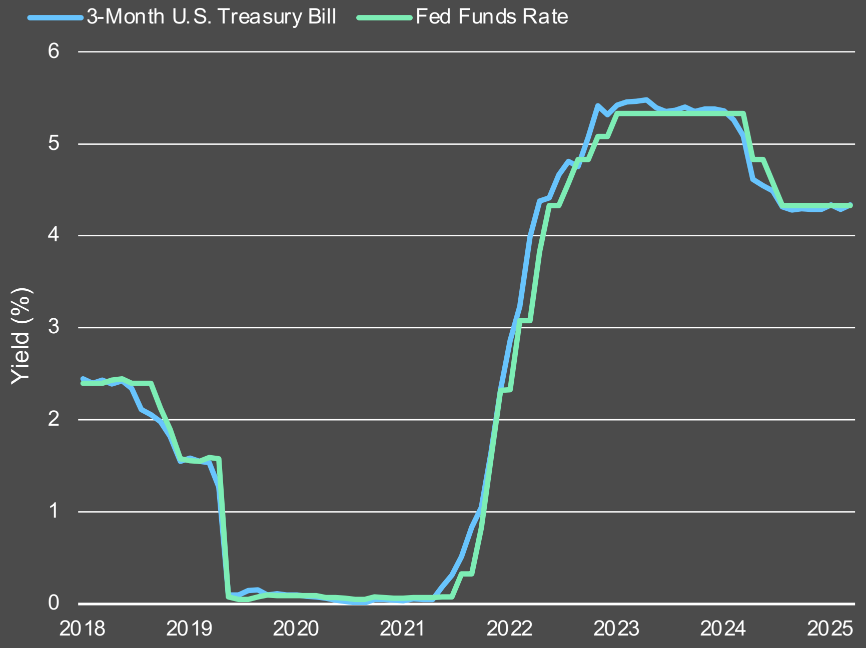
LOWER RATES MEAN LESS INCOME

While Fed easing may mean lower rates for auto, home equity and other loans, it also drives down other yields:

- Yields on Treasury bills, CDs and other cash equivalents typically move in tandem with the federal funds rate.
- So, when the Fed cuts rates, yields on these popular savings vehicles generally follow suit, and reinvestment risk rises. This means you may not be able to reinvest your cash flows at the same yield you've been earning.
- The bottom line: You'll likely earn less monthly income from your cash holdings.

Since the Fed's 50-basis-point (bp) rate cut in September 2024, the yield on the three-month Treasury bill has dropped 64 bps.* The Fed subsequently cut rates by another 50 bps before the end of 2024.

Figure 2 | Treasury Bill Yields Have Tracked Fed Rate Cuts



Data from 12/31/2018 – 7/31/2025. Source: FactSet. **Past performance is no guarantee of future results.**

*As of August 13, 2025; reported in *The Wall Street Journal*. The three-month Treasury bill yield was 4.86% on September 17, 2024, the day before the Fed started cutting rates.

LOWER RATES ALSO MEAN HIGHER TOTAL RETURN POTENTIAL

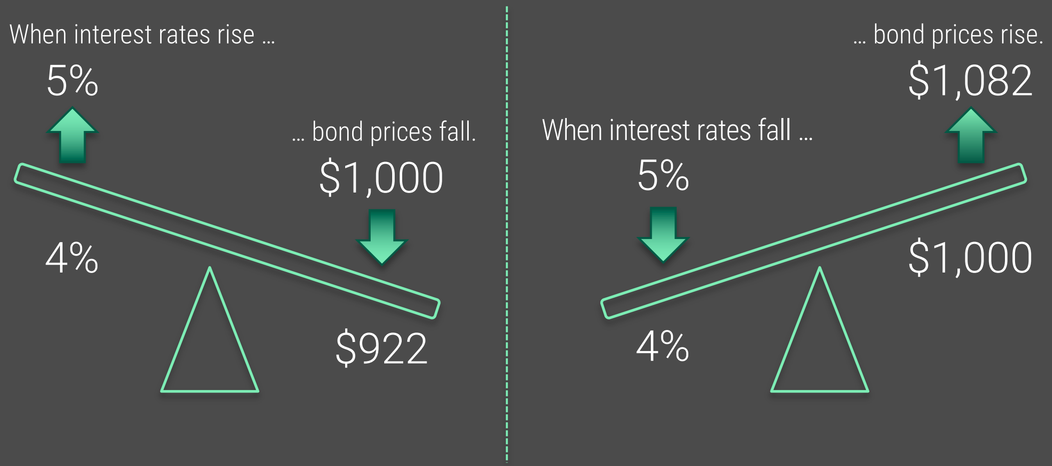
While cash-equivalent accounts typically pay lower yields after Fed rate cuts, most bond funds offer greater return potential.

When the Fed cuts interest rates, yields on newly issued bonds generally fall. However, lower interest rates usually trigger higher return potential for existing bonds.

That's because existing bonds — with their higher yields and income streams — become more valuable to investors in the lower-rate environment.

So, prices on previously issued bonds typically rise when interest rates decline, boosting their total return potential.

Figure 3 | Interest Rates and Bond Prices: An Inverse Relationship



For illustrative purposes only. Assumes a bond paying 4% with a fixed semiannual coupon and a 10-year maturity.

GAUGING THE IMPACT OF A FED RATE CUT ON BONDS

Two key bond fund metrics can help you measure the potential performance effects of a Fed rate cut:

- **Yield to maturity (YTM):** Expressed as an annual rate, yield to maturity shows a bond fund's estimated total return if you hold the fund to maturity.
- **Duration:** Expressed in years, duration measures a bond fund's price sensitivity to interest rate changes.

In general, bond funds with longer durations are more sensitive to changes in interest rates. When the Fed cuts rates, longer-duration funds tend to experience greater price appreciation.

But they're also more likely to drop in value when the Fed raises rates. As such, longer-duration bond funds may offer higher interest rate risk than many investors seek when considering a shift out of cash equivalents.

Meanwhile, short-duration funds may provide a compelling alternative.

HOW A HALF-POINT RATE CUT COULD RAISE RETURN POTENTIAL

In today's yield environment, shorter-duration bond funds may offer attractive performance potential if the Fed cuts rates. Consider the characteristics of the average fund in Morningstar's short-term bond category:*

Yield to maturity: 4.7%

Duration: 2.34 years

Assume the Fed reduces its short-term interest rate target 50 bps by year-end. The average short-term bond fund could see its total return potential increase more than 100 bps.

Using duration, YTM and bond math reveals this potential.

A simple equation calculates the effect interest rate changes may have on a bond fund's return potential:

Rate Change x Fund's Duration = Change to YTM

0.5 x 2.34 = 1.17 percentage points

A half-point rate cut would boost the average fund's YTM by 1.17 percentage points to 5.87% (4.7 + 1.17).

The math works in the other direction, too. A Fed rate increase would reduce the fund's YTM by 1.17 percentage points.

Even in the unlikely event of a near-term Fed rate hike, we believe short-term bond fund yields should remain attractive versus cash equivalents.

*As of June 30, 2025. There were 132 funds in Morningstar's short-term bond category. Short-term bonds funds invest primarily in corporate and other investment-grade U.S. bonds and have durations of one to 3.5 years. If duration is unavailable, they have average effective maturities of one to four years.

COMBATING REINVESTMENT RISK: THE CLOCK IS TICKING

With the Fed likely to cut interest rates in the months ahead, we believe reinvestment risk continues to rise for investors with significant cash holdings. And the time frame to effectively confront this risk is shrinking.

In our view, adding modest duration exposure before the Fed makes another move may help investors address this risk:

- Bond prices typically climb in declining interest rate environments. So, boosting total return potential by moving into higher-yielding alternatives may cost more once rates drop again.
- Unlike cash equivalents, short-duration bonds offer price appreciation potential that can help offset the effects of lower interest rates.

GLOSSARY

Basis points (bps): Used in financial literature to express values that are carried out to two decimal places (hundredths of a percentage point), particularly ratios, such as yields, fees and returns. Basis points describe values that are typically on the right side of the decimal point. One basis point equals one one-hundredth of a percentage point (0.01%).

Duration: An indicator that measures the price sensitivity of a fixed-income investment to changes in interest rates. The longer the duration, the more a fixed-income investment's price will change when interest rates change.

Federal Reserve (Fed): U.S. central bank responsible for monetary policies affecting the financial system and the economy.

Federal funds rate: An overnight interest rate that banks charge each other for loans. It's an interest rate that's mentioned frequently within the context of the Federal Reserve's interest rate policies.

Price changes from market changes: These are short-term price changes reflected in the daily market pricing of fixed-income securities prior to maturity. They can reflect market adjustments in inflation expectations, credit quality perceptions and/or interest rate levels. These price changes aren't locked in unless the security is sold before maturity.

Total return: A standard performance measurement that incorporates both income (primarily from interest payments) and changes in the prices of the securities (see Price changes from market changes).

U.S. Treasury securities: Debt securities issued by the U.S. Treasury and backed by the direct "full faith and credit" pledge of the U.S. government. Treasury securities include bills (maturing in one year or less), notes (maturing in two to 10 years) and bonds (maturing in more than 10 years). They are generally considered among the highest quality and most liquid securities in the world.

Yield: A rate of return on bonds and other fixed-income securities. "Yield to maturity" is a common calculation that considers total annual interest payments, the purchase price, the redemption value and the amount of time remaining until maturity.

Yield to maturity: A common performance calculation for fixed-income securities, which takes into account total annual interest payments, the purchase price, the redemption value, and the amount of time remaining until maturity.