Fixed Income Allocation Strategy

NDR
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Fixed Income Market Update

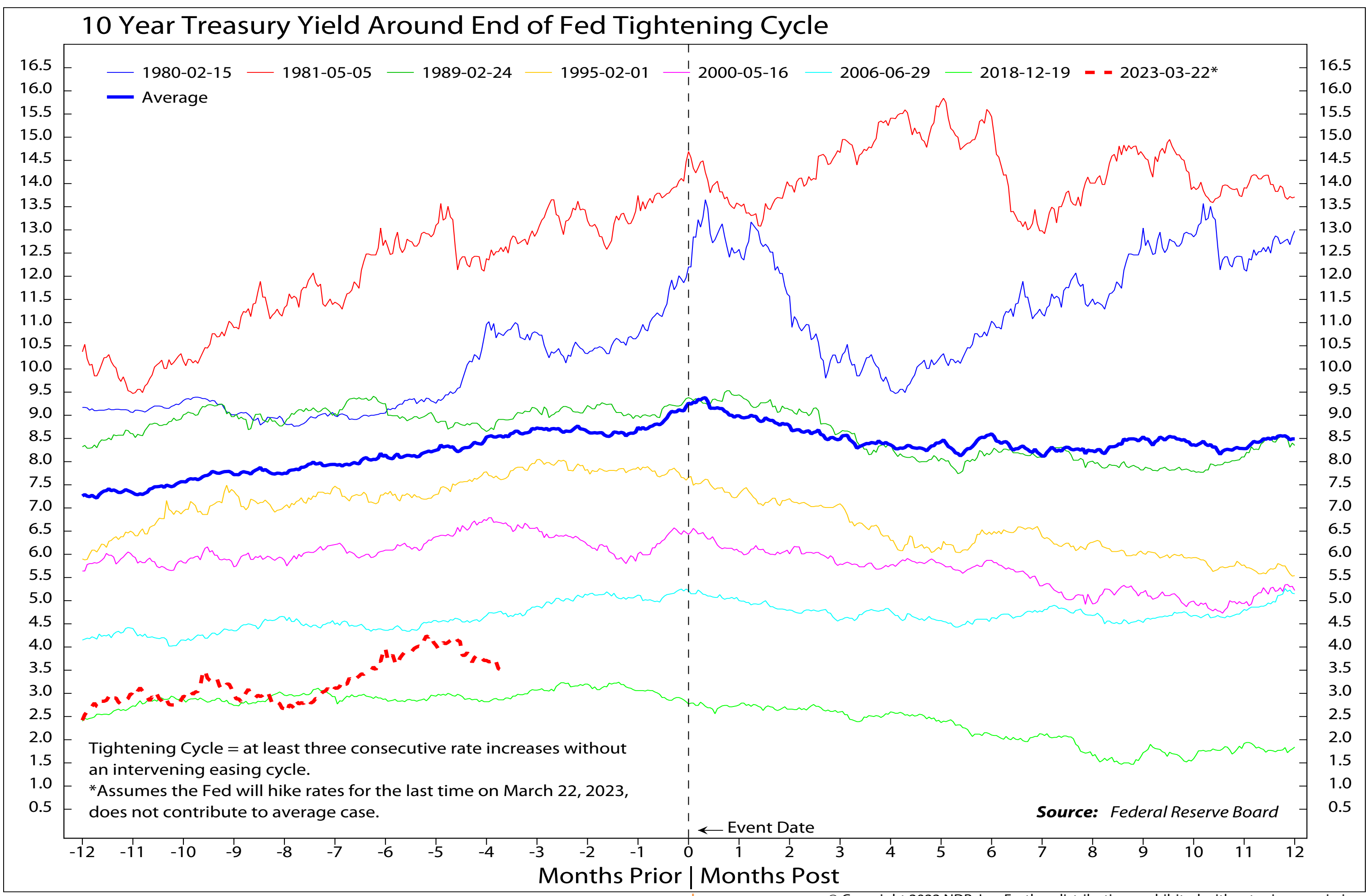
This year has been challenging for fixed income investors, but November provided some glimmer of hope as risk assets rallied. The Bloomberg Barclays U.S. Aggregate rose more than 3.5% in November. The index has risen only three months this year. In the other eight months, the index dropped by more than 100 basis points (bps) each time.

At the early November meeting, the Federal Open Market Committee (FOMC) raised the fed funds target range by another 75 bp to 3.75% to 4.00%, the highest since January 2008. It was the fourth straight 75 bp increase for a total of 450 bp this cycle.

In his late November speech, Fed Chairman Powell indicated that a downshift in the size of the rate hikes could occur at the December 14 meeting--market participants are now expecting a 50 bp hike. He also cautioned that monetary policy is likely to stay restrictive for some time until real signs of progress emerge on inflation. The ultimate fed funds rate level is likely to be between 4.75% to 5.00%. That should keep both risk assets and the economy in a choppy period until inflation comes down enough for the Fed to pause and then eventually reverse course.

During October, the 10-year yield hit 4.23%, levels not seen since 2008. At the start of December, the 10-year was at 3.89%. Typically, the 10-year Treasury yield peaks at or before the end of the Fed tightening cycle (chart below), so a Q1 Fed pause is possible and repositioning fixed income portfolios is likely warranted.

Entering December, the fixed income allocation strategy is overweight U.S. High Yield, U.S. Investment Grade, and Emerging Market Bonds, while being underweight Floating Rate Notes, U.S. Long-Term Treasurys, Treasury Inflation-Protected Securities, and International Investment Grade bonds.



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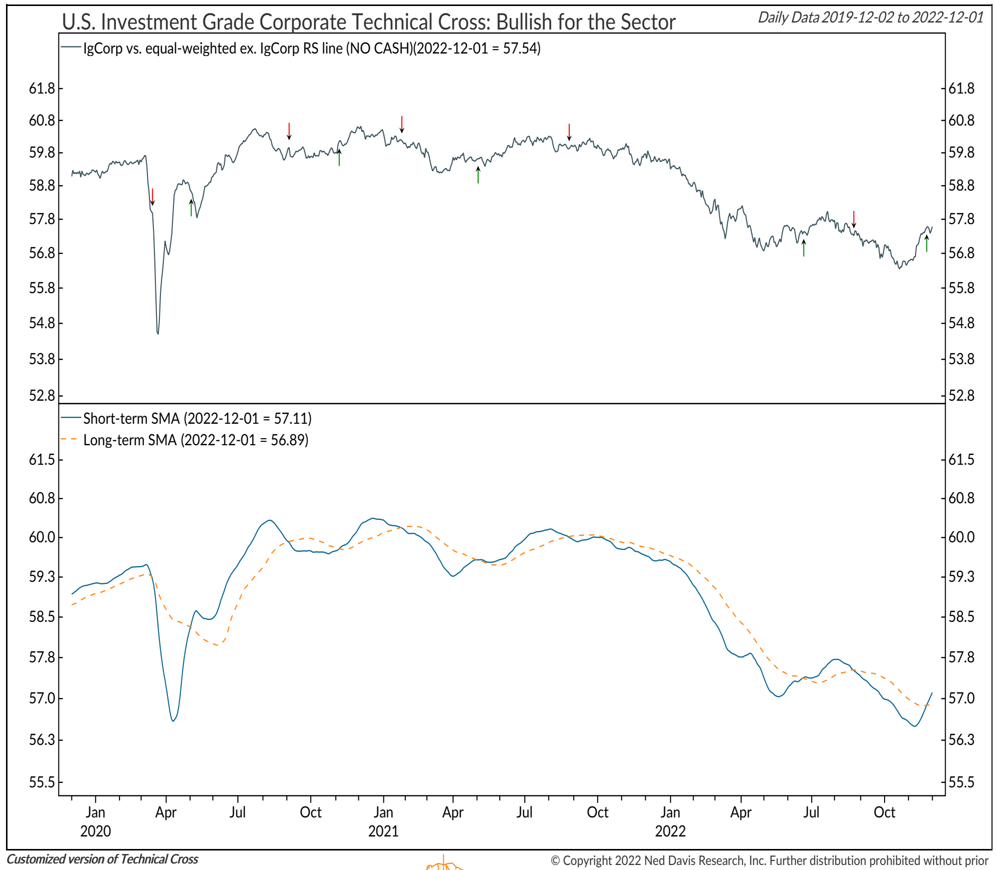
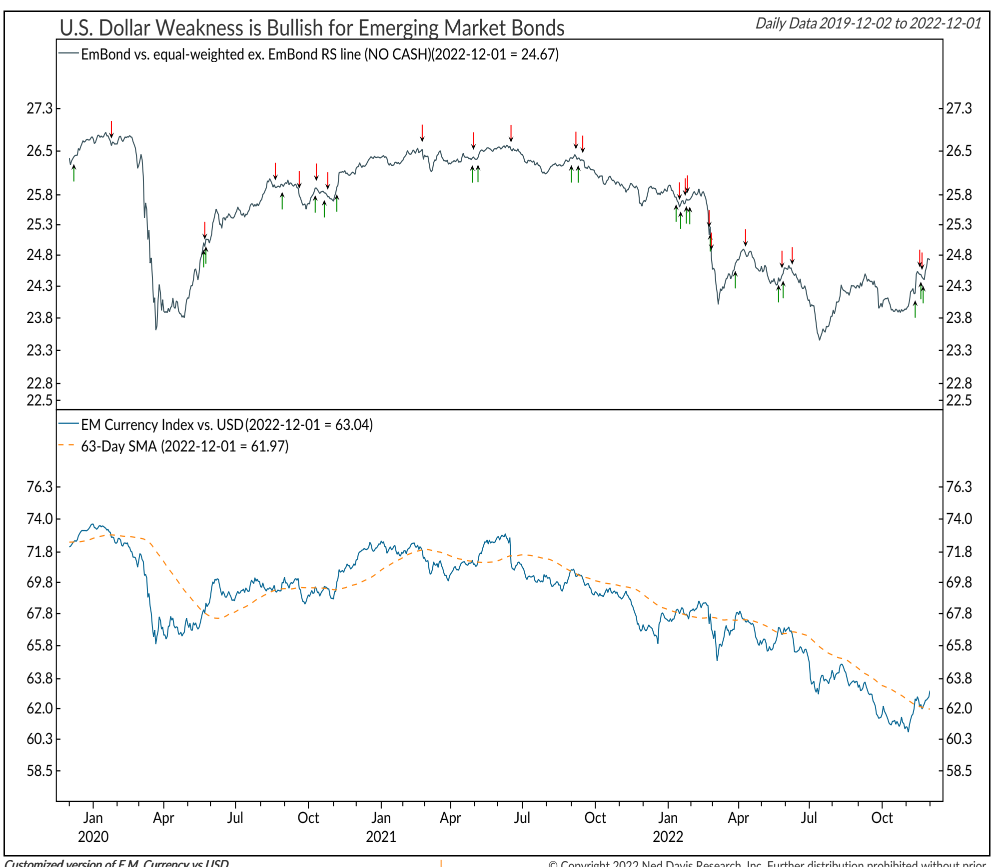
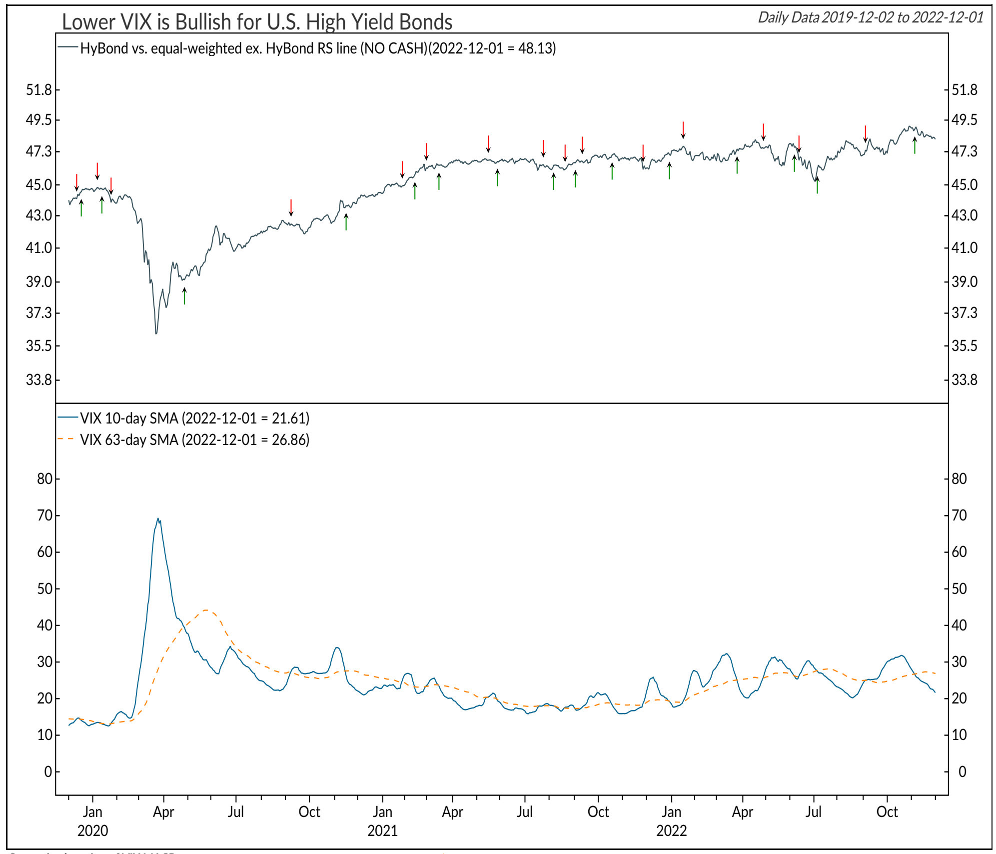
The U.S. Investment Grade sector jumped to the largest overweight allocation this month. Option-adjusted spreads narrowed and credit default swaps have been declining. Both measure the risk of default, so lower levels means decreasing investor concerns which benefits investment in credit sectors like Investment Grade. In November, the improving backdrop was confirmed by technicals, with the 50-day moving average crossing above the 200-day moving average (chart right).



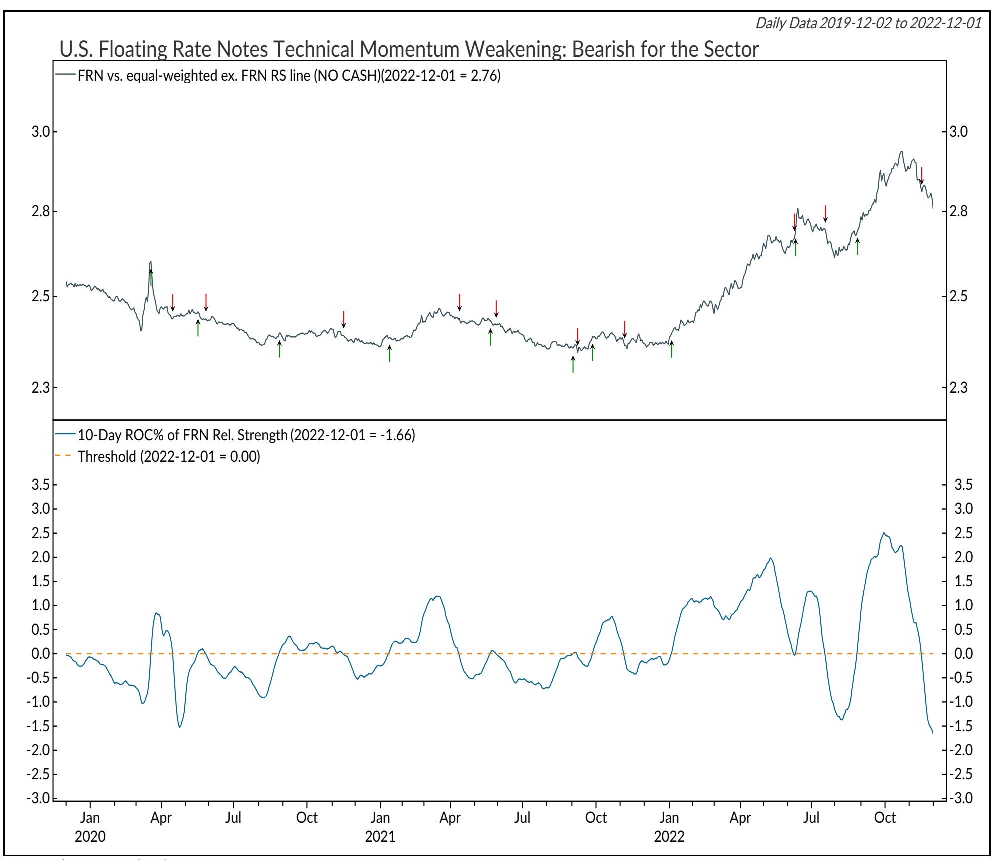


Emerging Market bonds jumped from underweight to a significant overweight allocation. With investors focused on the end of the tightening cycle, the U.S. dollar has rolled over from its peak levels. Due to the inverse relationship with Emerging Markets, a weaker dollar is a bullish condition for both emerging market equities and bonds (chart left). China makes up almost 17% of total EM USD-aggregate market value. China's zero-COVID policy has put a strain on its economy and market, and there's hope this policy may get relaxed in the near future. These factors drove a strong improvement in EM bond technicals, with absolute gains of about 10% in November.

U.S. High Yield maintained its large overweight allocation this month. The risk-on environment in November was driven by the continued expectations of a Federal Reserve downshift in rate hikes. Technical indicators remain positive on the recent move as absolute trend, relative strength, and high yield upside participation breadth are bullish. Additionally, volatility has subsided. A lower VIX has been bullish for riskier assets including high yield bonds (chart right).



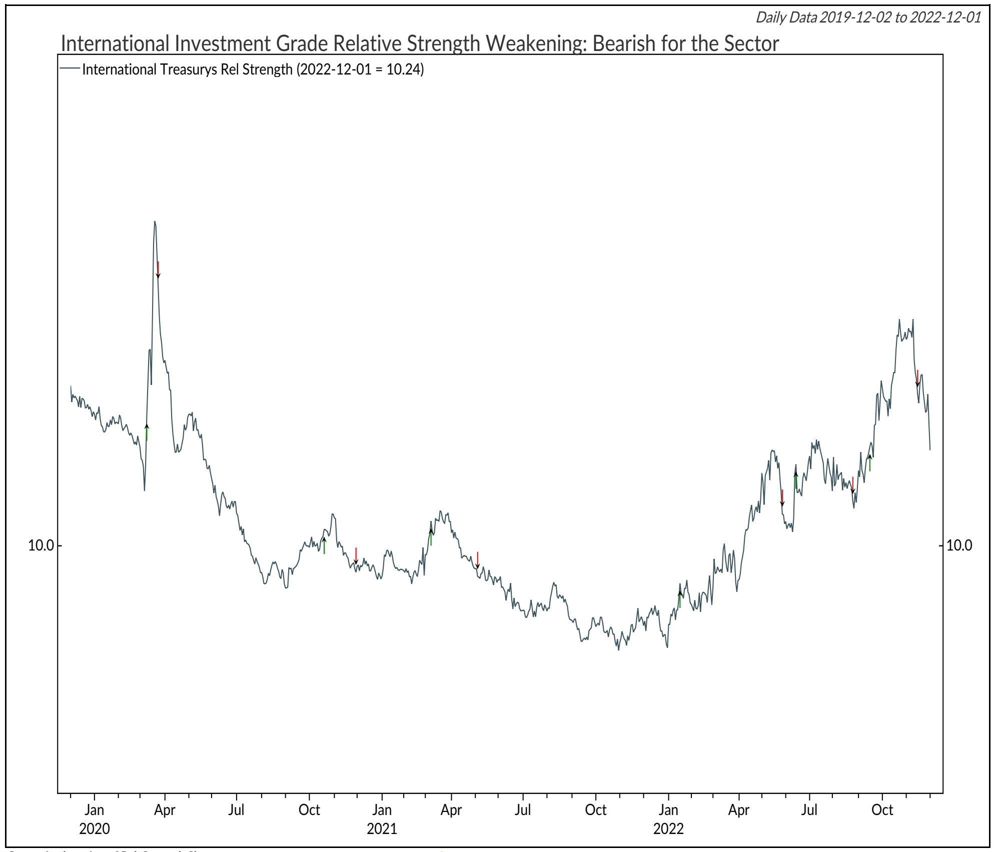
Customized version of VIX MACR



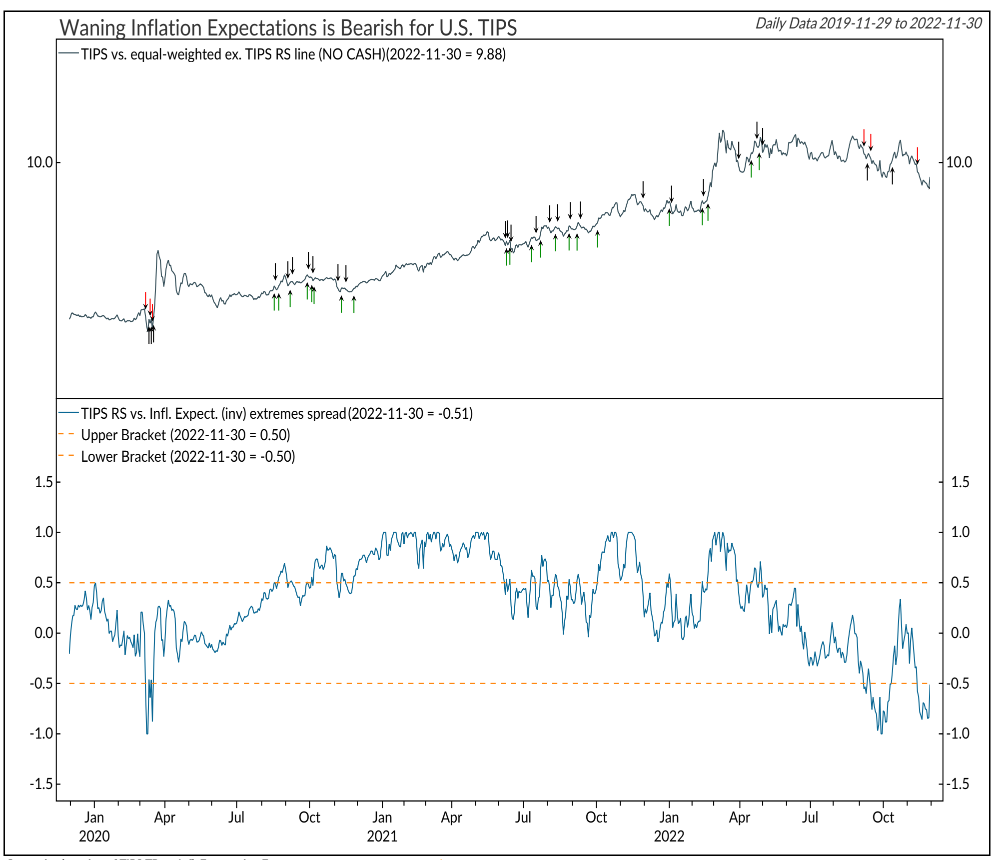
Customized version of Technical Momentum

Floating Rate Notes' allocation declined sharply to a significant underweight allocation. Trend and price momentum turned bearish. Relative strength rolled over versus other fixed income areas. Floating rate notes typically outperform during a rising rate environment. Market anticipation of a downshift in Fed rate hikes has likely led to the recent relative weakness (chart left).

International Investment Grade's weighting fell, as risk appetite continued to improve in November. This sector typically behaves as a defensive asset, so it typically underperforms other sectors as investors become less fearful. Although the VIX measures equity market sentiment, it serves as a good proxy for overall investment risk taking. Last month, the VIX rolled over further indicating decreasing fears. As a result, trend indicators have moved bearish for the sector (chart right).



Customized version of Rel. Strength Slope



Customized version of TIPS TR vs. Infl. Expectation Extremes

U.S. Treasury Inflation-Protected Securities (TIPS) are now under significant pressure and dropped to an underweight allocation. With inflation expectations receding (chart left), TIPS are less attractive to investors. Alternatively, investors might favor nominal Treasurys. Technical indicators are mostly bearish for TIPS.

Summary

With a likely downshift in Fed policy, the fixed income portfolios likely need to be repositioned. Credit conditions are tighter, but not too tight. Credit sectors such as high yield and investment grade have been relative outperformers and are both overweight. A declining U.S. dollar has led to emerging market bond outperformance and international investment grade underperformance. Lower inflation expectations have made U.S. TIPS less attractive, particularly compared with nominal U.S. Treasurys. However, U.S. Long-Term Treasurys needs to see technical improvement to exit its below benchmark weighting.

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