

FEBRUARY 2023

Fixed Income Market Update

After a challenging 2022, the Bloomberg Barclays U.S. Aggregate Bond Total Return Index gained about 3% in January. The index has been positive for only four of the past 12 months. Of the nine fixed income sectors we track (including cash), all of them had positive returns in January.

As widely expected, the Fed, once again, downshifted its pace of rate hikes to 25 basis points (bp) in February, following a slowdown in December to 50 bp. As a result, the fed funds target range is now 4.50% to 4.75%, the highest since October 30, 2007. The Fed has raised rates a total of 450 bp since March 2022, making it the fastest hiking cycle

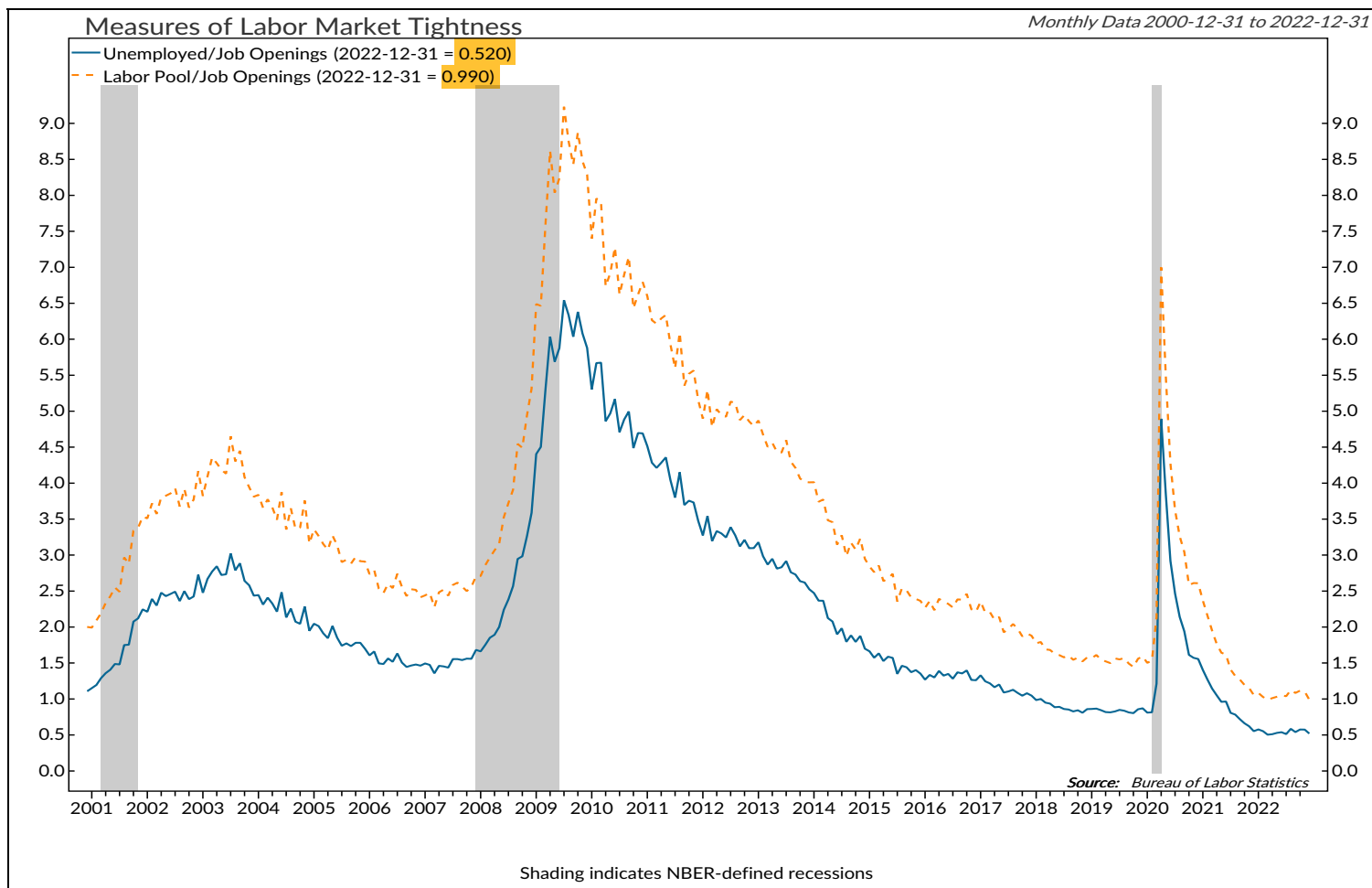
ever with data going back to 1963.

While the Fed acknowledged improvement in inflation at the February meeting, Chairman Powell continued to characterize inflation as “elevated,” and repeated that “ongoing increases...will be appropriate.” But he also reiterated that they will be data dependent and operate meeting by meeting.

Softer labor markets are the key for giving the Fed confidence that inflation is heading back to its 2% target. Powell, however, described the labor market as “out of balance.” Job openings are incredibly robust (chart below), and unemployment claims remain near their

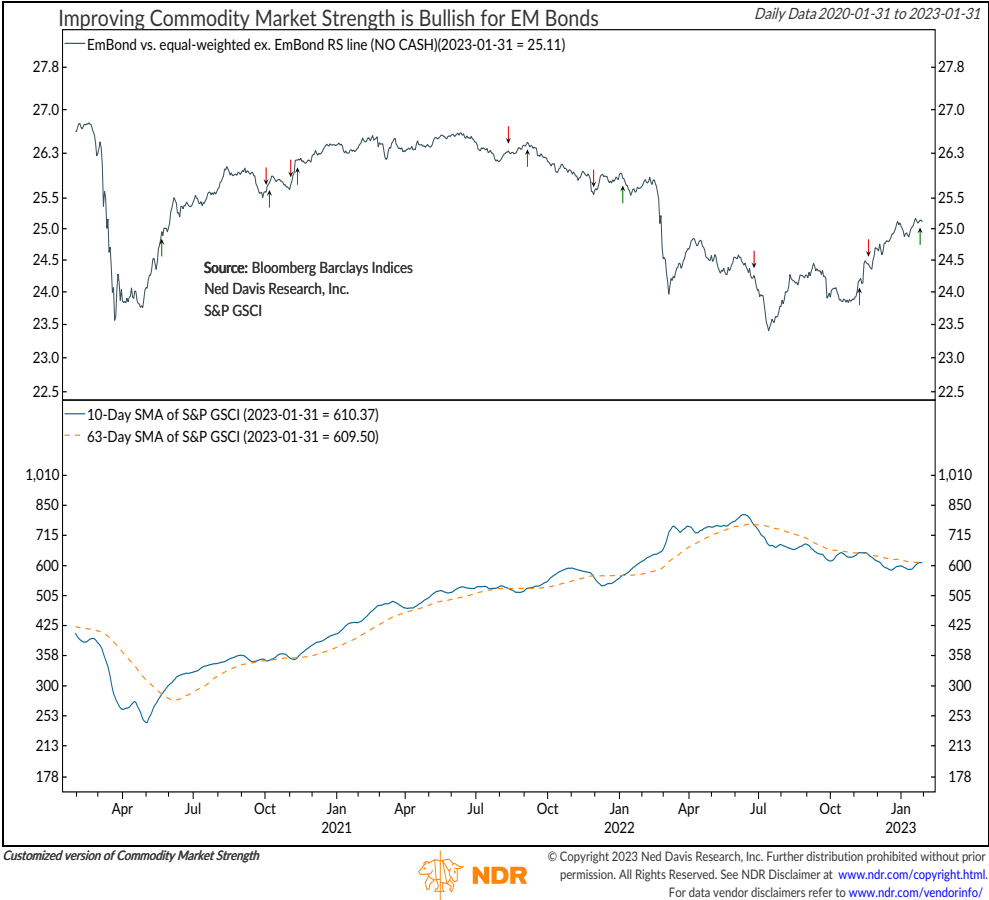
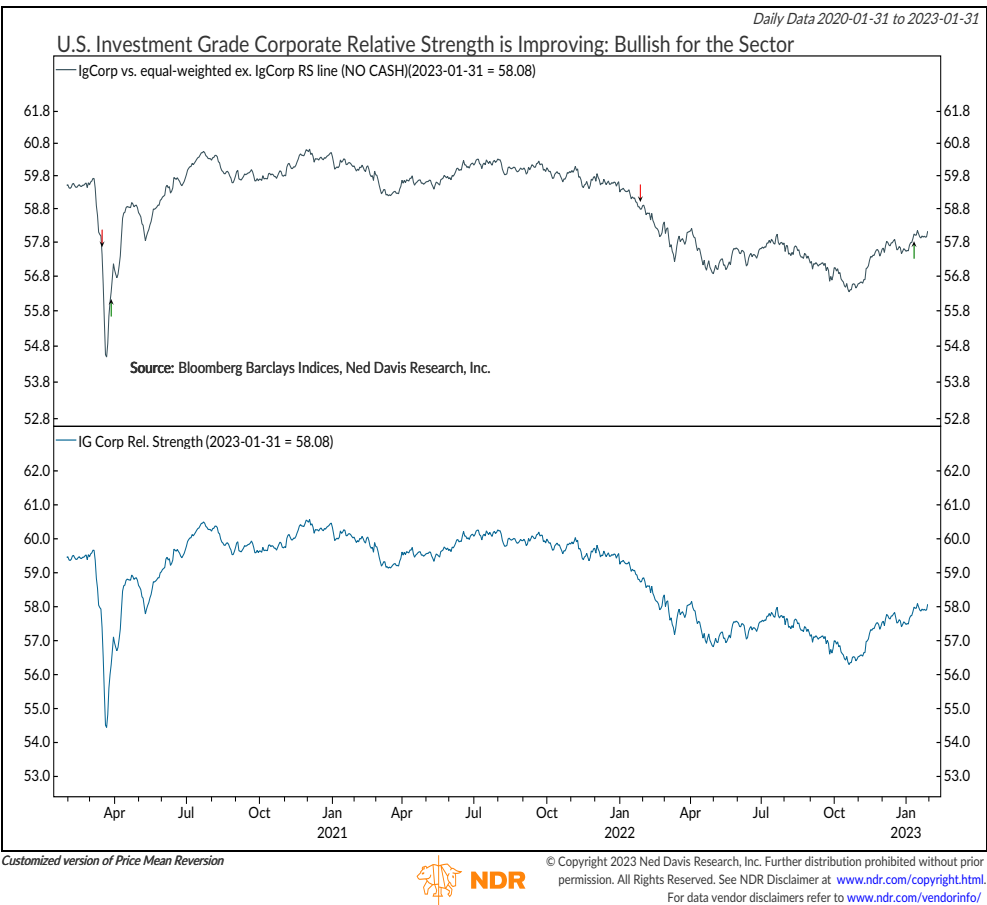
lowest level since 1969. If the Fed is going to pause and eventually reverse the course of monetary policy later this year, we better start seeing some more softness in the labor market data real soon. Investors “fighting the Fed” may be premature to do so.

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



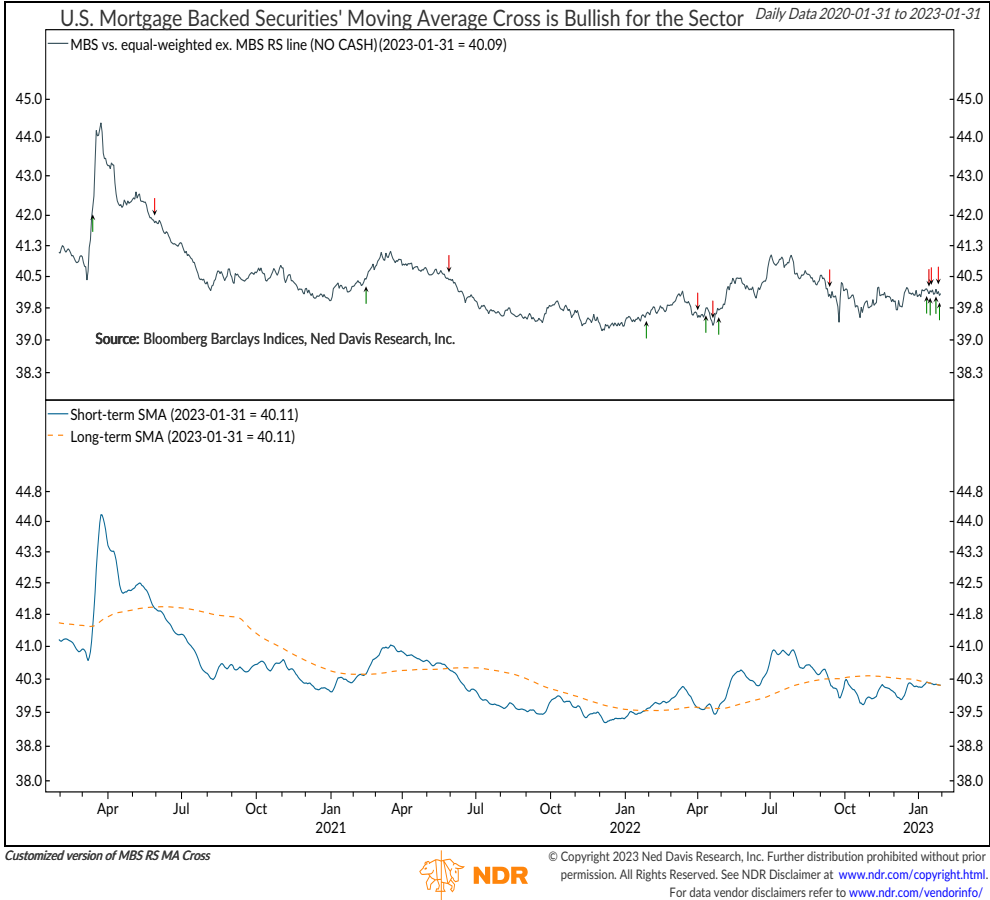
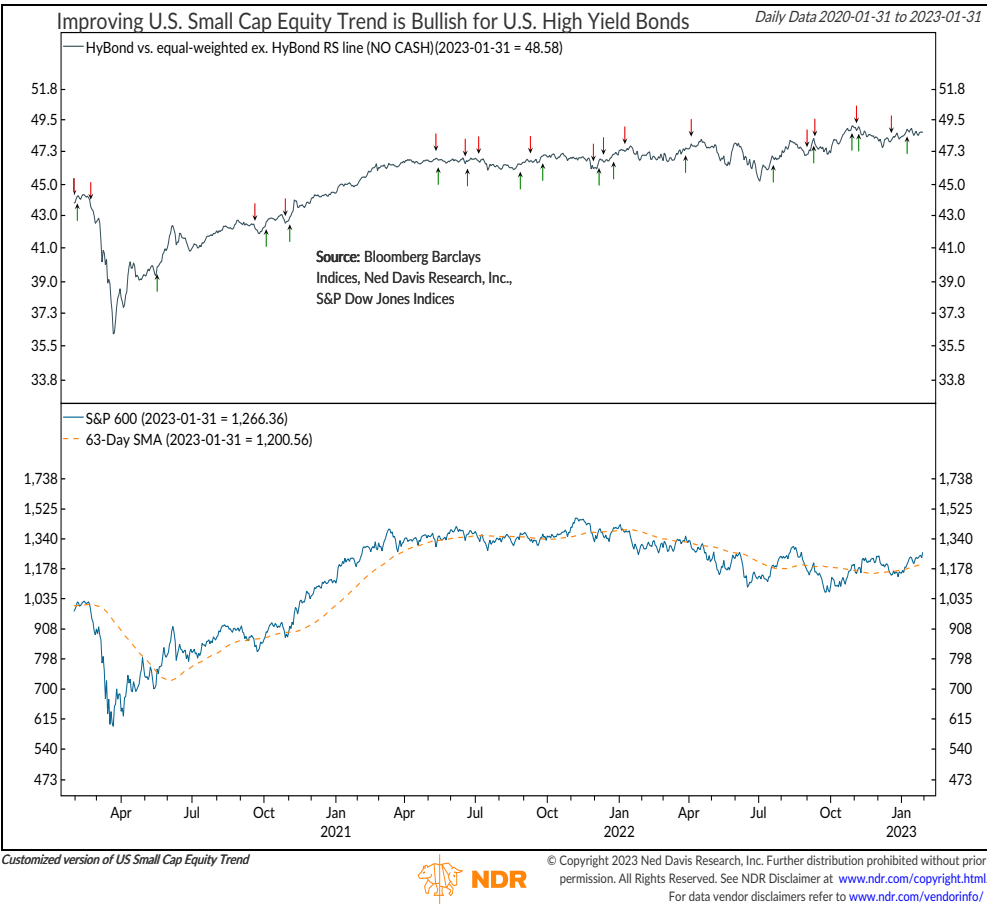
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The model's allocation to U.S. Investment Grade Corporate saw a sharp rise in February, which pushed it from a slight underweight to the largest overweight position. Four of the six indicators are now bullish. In February, option-adjusted spreads—a measurement of default risk—narrowed and is now neutral for the sector. Two other indicators moved bullish last month—bond volatility and mean reversion. With investors moving back into risk assets in January, relative strength has improved for the sector (chart right). Only the U.S. dollar remained bearish for the sector.



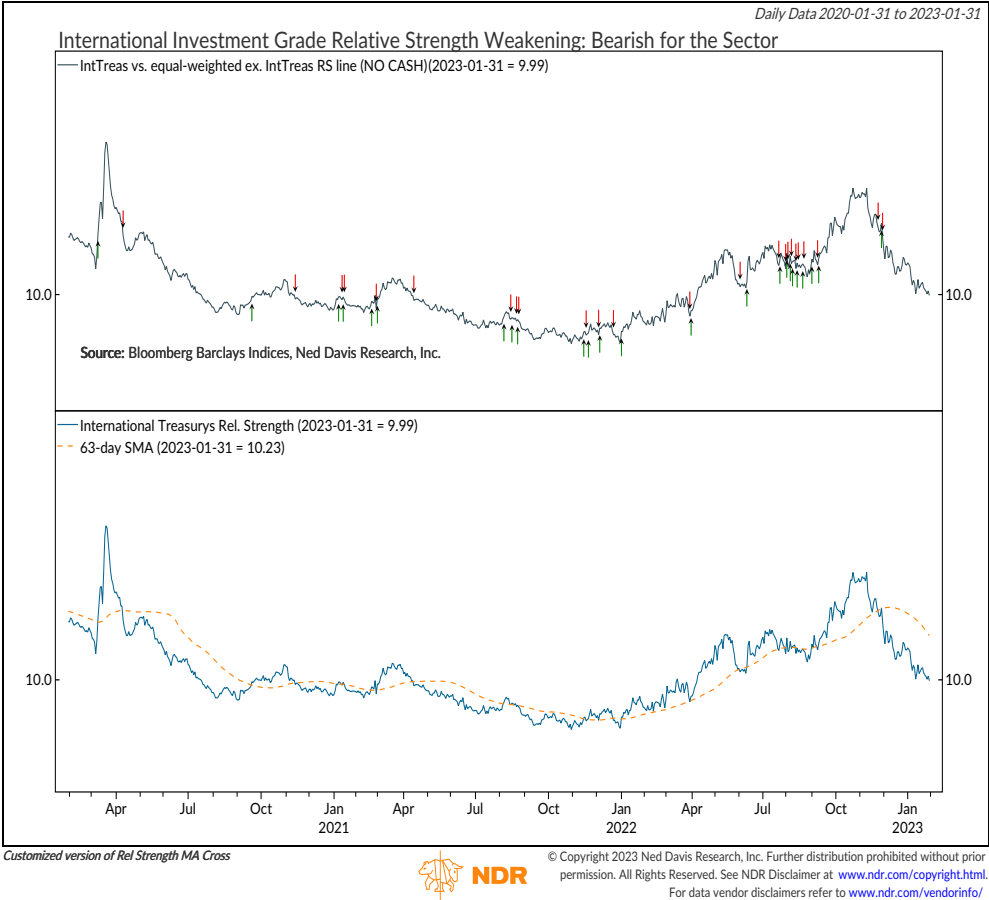
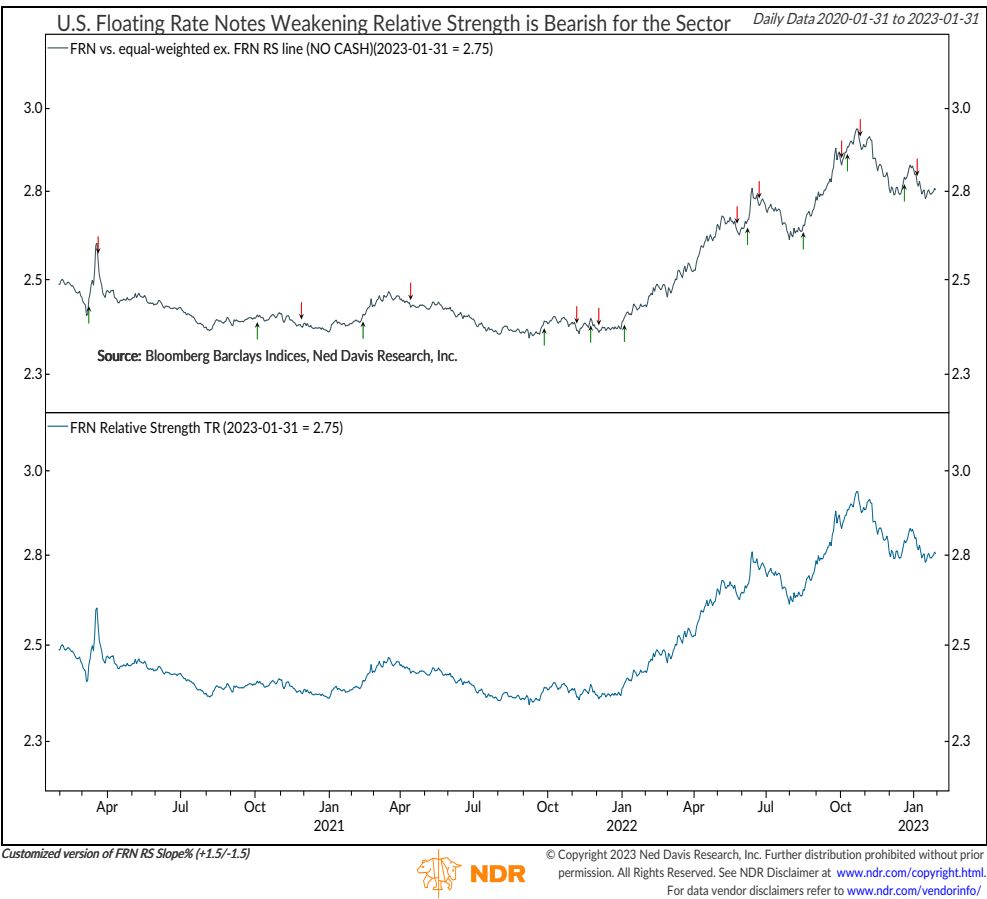
Emerging Market (EM) bonds overweight allocation rose in February. Technicals and fundamentals are bullish for the sector. The U.S. dollar continued to roll over from its peak levels. Due to the inverse relationship with Emerging Markets, a weaker dollar is a bullish condition for both emerging market equities and bonds. With the reopening of China, commodity market strength improved to a bullish level for EM bonds (chart left).

U.S. High Yield also increased in allocation this month and remains overweight. As investors moved back into riskier assets, high-yield bonds gained more than 3% in January. Fundamentals are bullish, including an improving small-cap equity trend (chart right). All technical indicators are bullish, with absolute trend joining the others this past month.



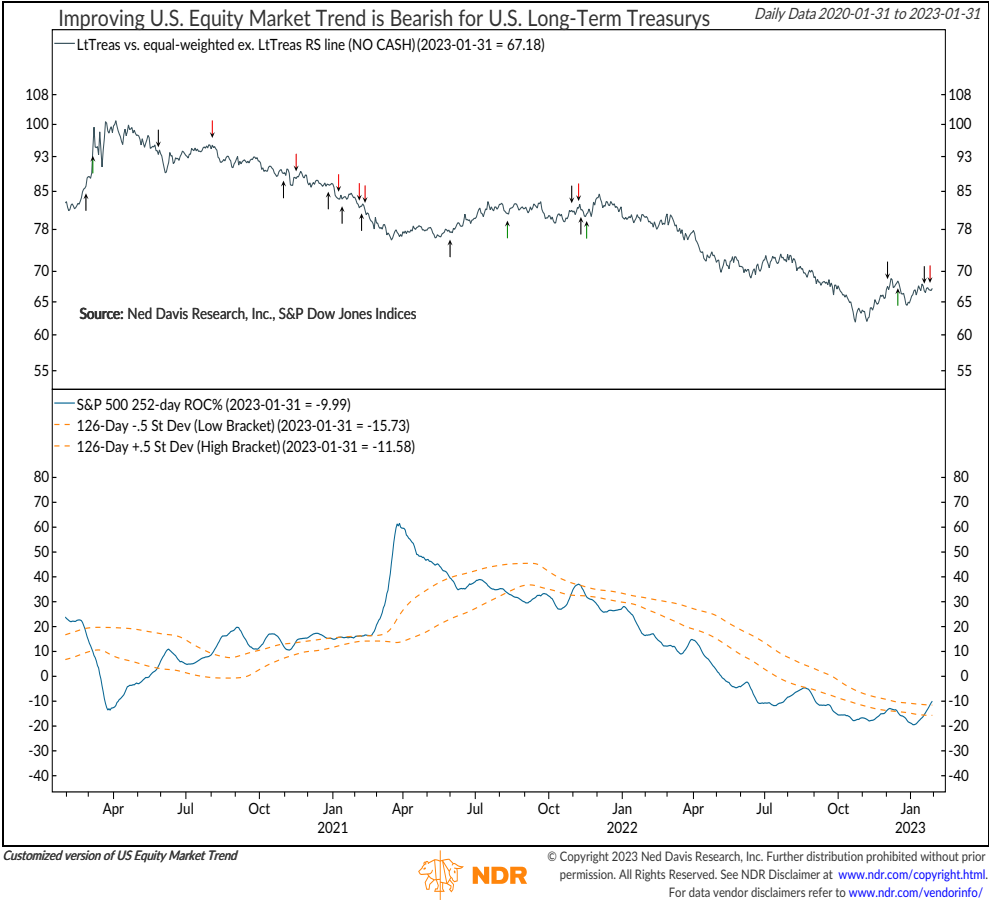
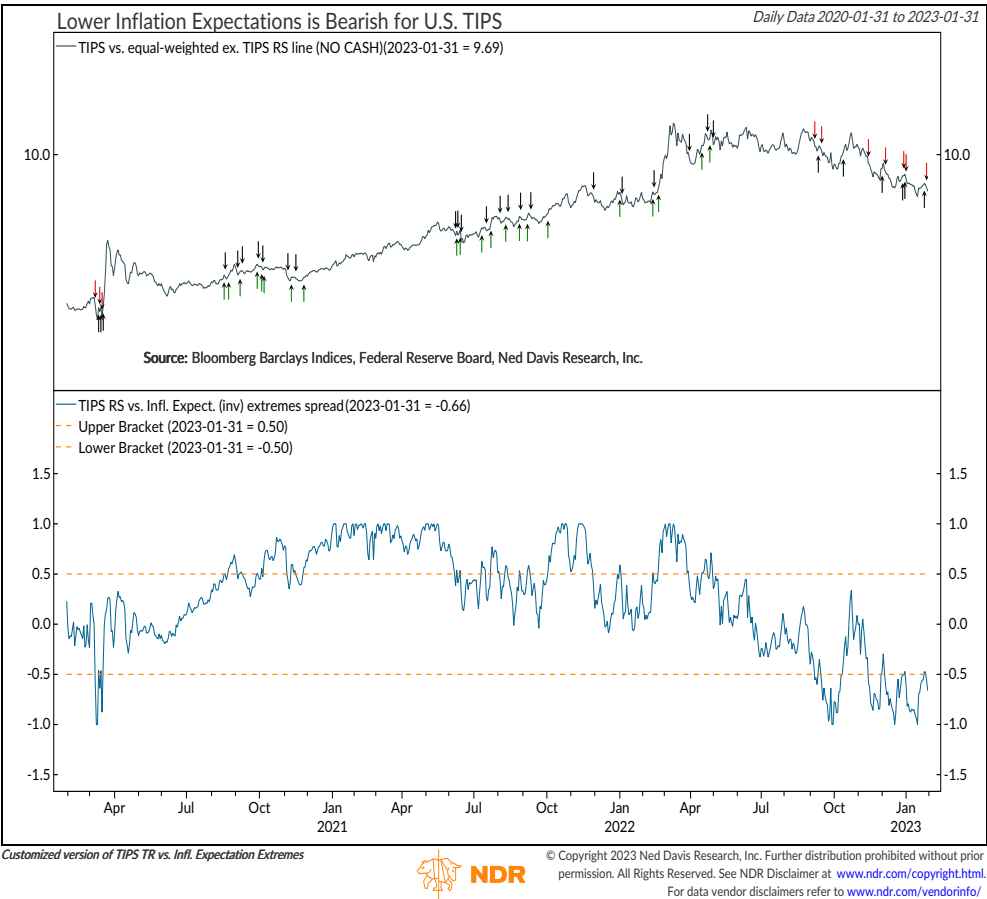
Mortgage-Backed Securities' allocation increased slightly and remained a modest overweight in February. While technical indicators aren't fully confirming yet, the sector's moving average cross flashed a bullish signal (chart left). This was partly offset by high-yield spreads which became bearish for the sector.

Floating Rate Notes' allocation dropped sharply in February and is now the largest underweight allocation. Floating rate notes typically outperform during a rising rate environment, but yields declined in January. Trend, price momentum, and spreads remain bearish for the sector. Relative strength versus other fixed income sectors deteriorated in January and is now bearish (chart right).



International Investment Grade bonds' allocation decreased and remains at underweight. Most of the fundamental and technical indicators, such as weakening relative strength (chart left), remain bearish for the sector. Only the extreme in 10-year swap spreads is neutral for this defensive fixed income sector.

U.S. Treasury Inflation-Protected Securities' (TIPS) allocation decreased further and remains underweight. Most fundamental and technical indicators are bearish for the sector. TIPS typically outperform during periods of rising inflation. With inflation measures moderating from last year's peak, inflation expectations have also declined, which is bearish for the sector (chart right).



The model's allocation to U.S. Long-Term Treasuries saw a sharp decline in February, moving it from an overweight to a slight underweight. Investors move back into riskier assets in January. As a result, the stronger equity market trend became bearish for this defensive sector (chart left).

Summary

While recessionary evidence was building in January, investors continue to “fight the Fed.” As a result, riskier assets—such as investment grade and high yield—saw much stronger performance. A declining U.S. dollar and reopening of China has led to emerging market bond outperformance. Lower inflation expectations have made U.S. TIPS less attractive. Defensive sectors such as U.S. Long-Term Treasuries and International Investment Grade have moved to underweight allocations.

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