NED DAVIS RESEARCH

Fixed Income Allocation Strategy

SEPTEMBER 2023

Fixed Income Market Update

The Bloomberg Barclays U.S. Aggregate Bond Total Return Index was down less than 1% in August. Returns have been flat or negative for eight of the past 12 months. Breadth weakened—five of the nine fixed income sectors we track had negative returns in August—weakness in U.S. Treasurys again dragged down the Aggregate.

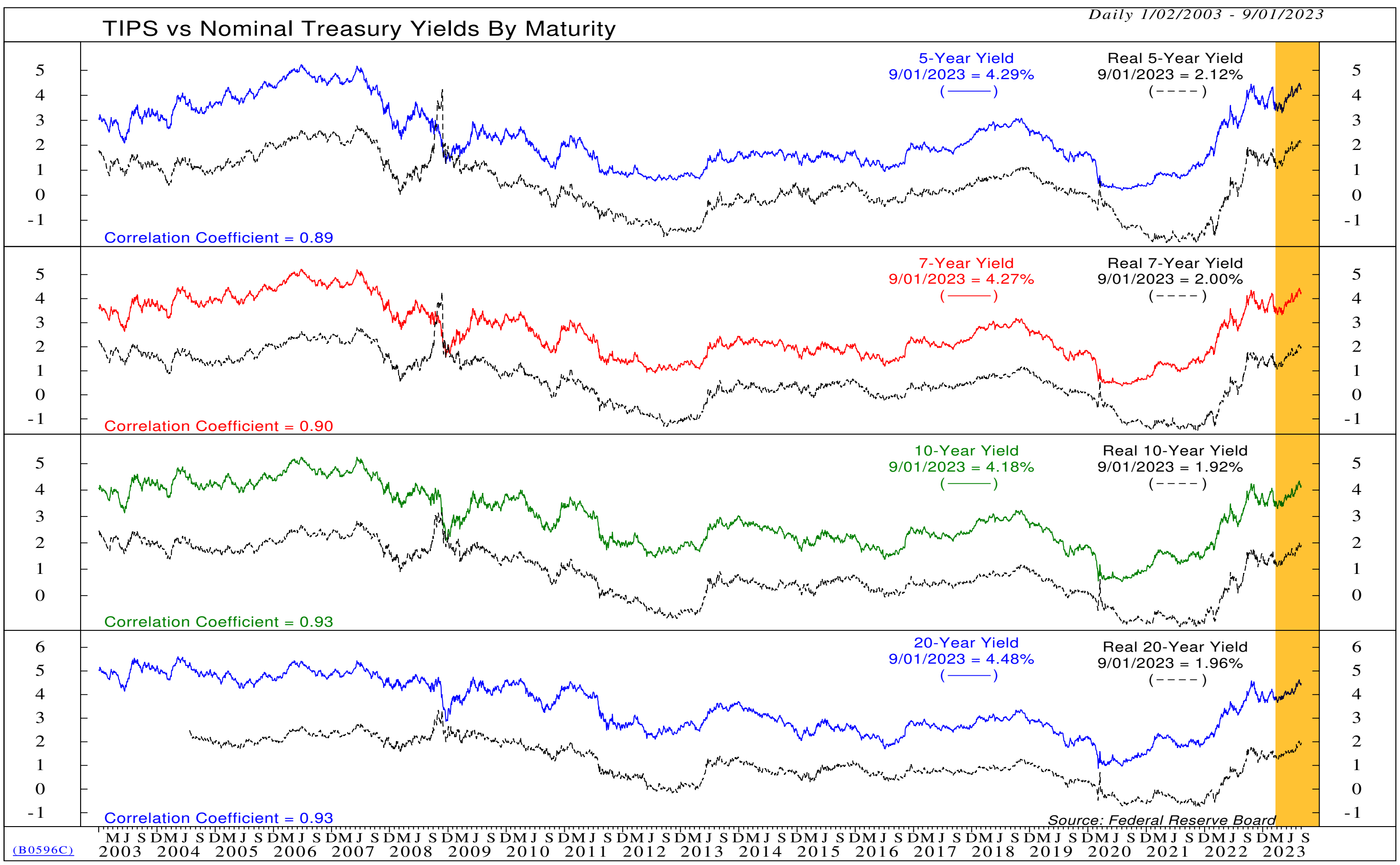
Bond yields have come a long way in a short period of time. Ten-year Treasury yields have backed up 100 basis points (bp) from their April lows. Nearly all of the rise has been due to higher real yields.

Over that span, the 10-year Treasury Inflation-Protected Securities (TIPS) yield has climbed 91 bp (chart below). Changes in growth expectations are the primary driver of real yields.

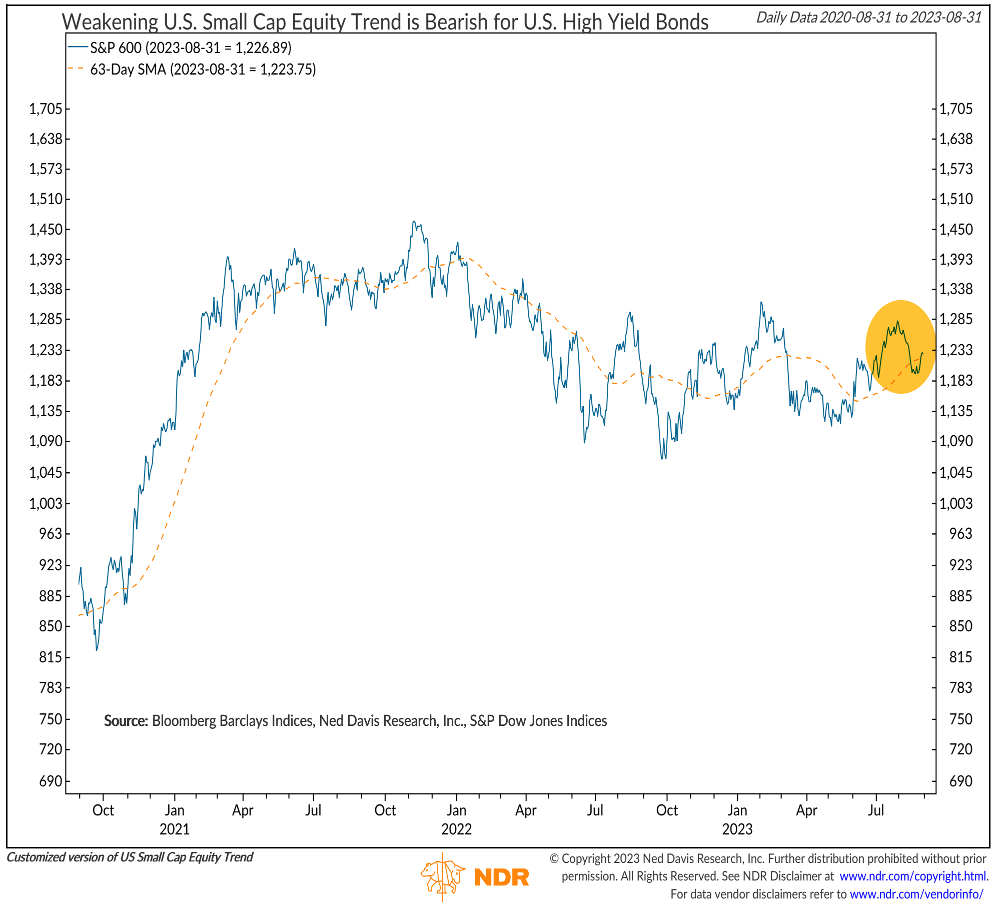
As the "soft landing" narrative has gained traction, real yields have risen. An increase in the supply of Treasurys also likely contributed to higher real yields. The market seemed surprised by the amount of issuance announced earlier in August. Although there was more planned issuance than had been anticipated for the current quarter, that was mostly due to timing, as less debt was issued in the prior quarter. Back in May, the Treasury had warned us that increased coupon supply was coming.

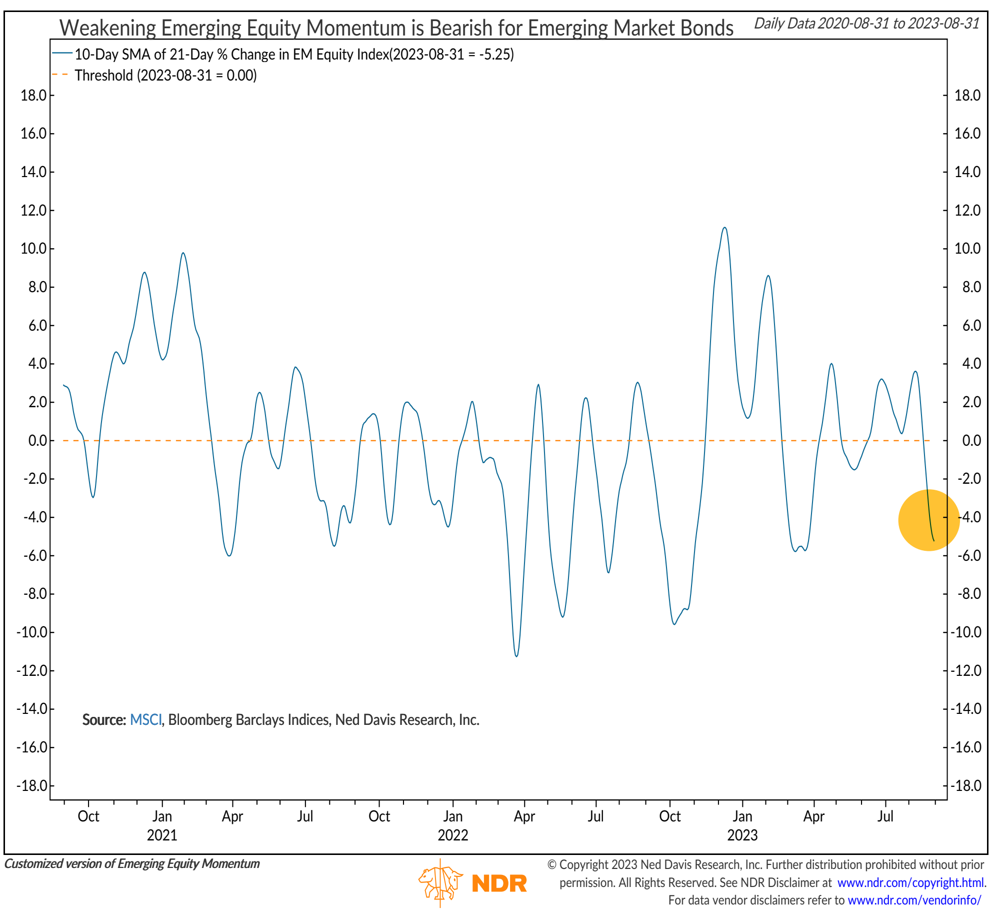
At the Jackson Hole address, Fed Chairman Powell noted that the outlook for economic growth and inflation remains shrouded in uncertainty, mainly stemming from the unknown duration of policy lags and changing labor market dynamics. While a soft landing is more likely, Fed policy will remain restrictive which will slow down economic growth in the coming year.

Entering September, the fixed income allocation strategy remains with a risk-on message and suggested no rebalancing from the month prior. The model remains overweight U.S. High-Yield Bonds, U.S. Investment Grade Corporate, Floating Rate Notes, and Emerging Market Bonds and underweight U.S. Long-Term Treasurys, U.S. Treasury Inflation-Protected Securities, and U.S. Mortgage-Backed Securities.



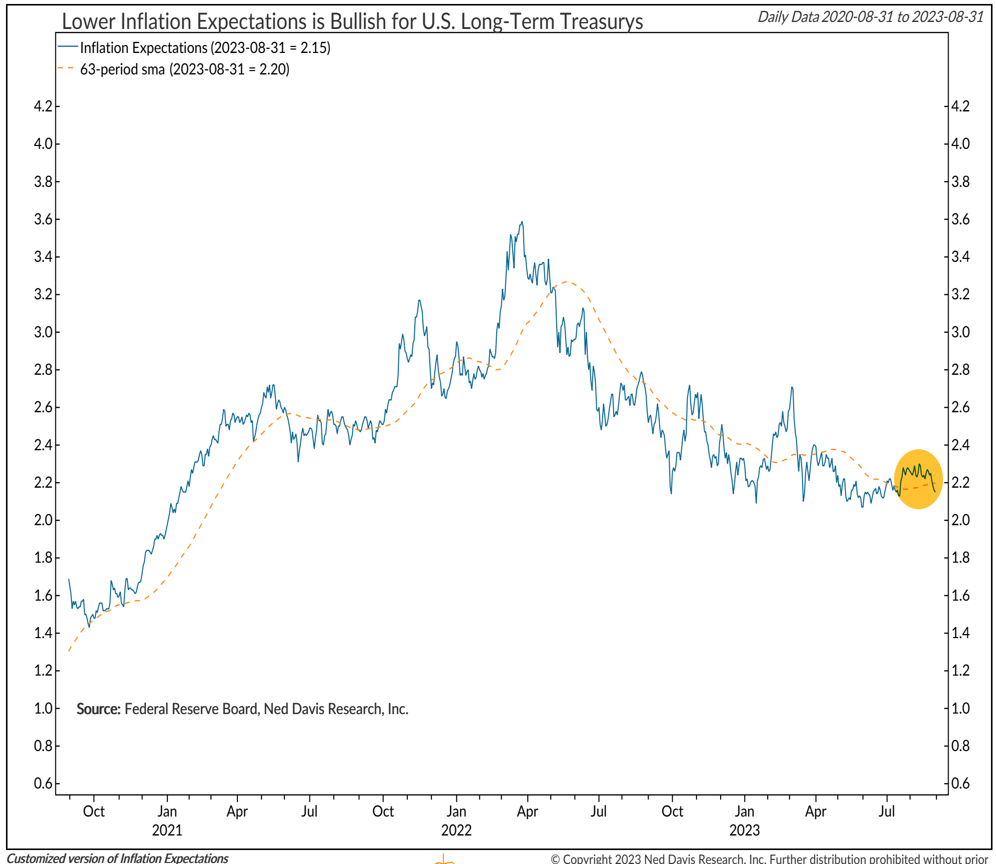
U.S. High Yield bonds' allocation was steady in August and remains the largest overweight position. While four of six indicators remained bullish, two flipped negative during the month—the VIX and the small-cap equity trend (chart right). However, the small-cap equity trend is hovering near its 3-month moving average, so this indicator might get whipsawed.

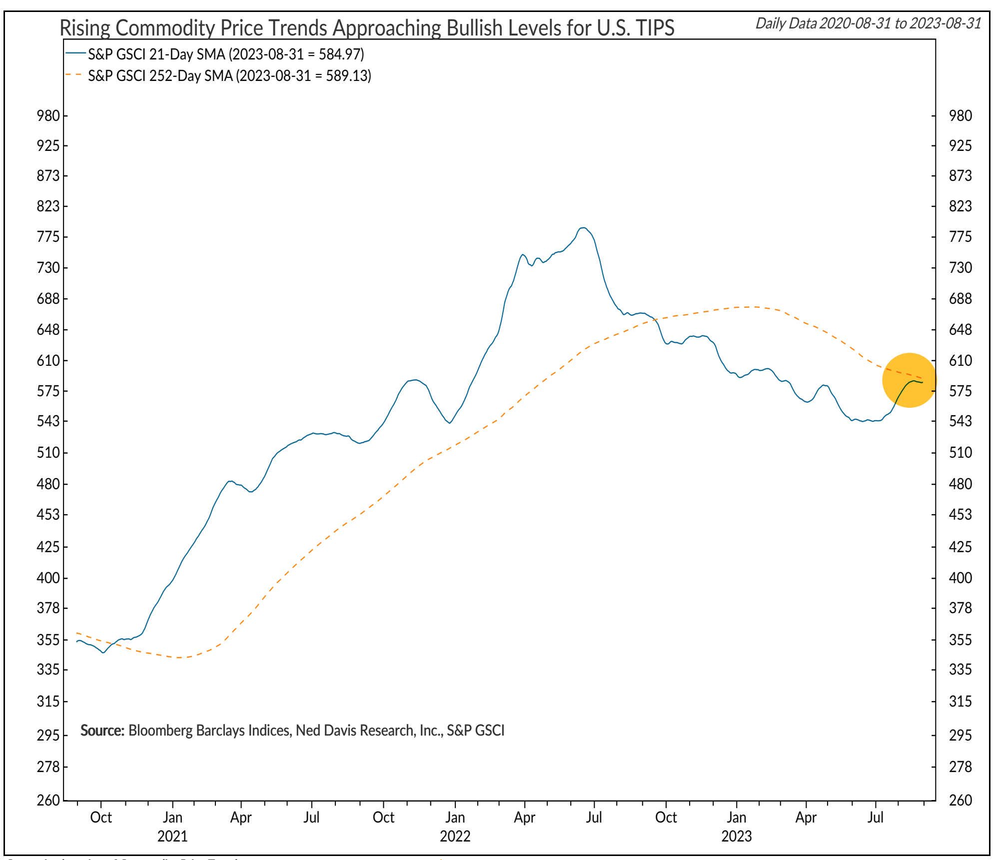




Emerging Market (EM) bonds' allocation was also steady in August and remains a significant overweight position. Four of the five indicators remained steady. Emerging Markets have a positive relationship with rising commodity prices. However, during the month of August, the short-term momentum of Emerging Market equities moved to a bearish level for the sector (chart left).

U.S. Long-Term Treasurys' allocation was steady in August and remains the largest underweight position. While the sector's trend and momentum remained steady for the sector, a few indicators changed during the month. The U.S. equity market trend and U.S. swaps moved neutral. Inflation expectations, which has been quite volatile this past year, flashed a bullish signal for the sector right before Powell's Jackson Hole speech (chart right).





U.S. Treasury Inflation-Protected Securities' (TIPS) allocation was steady in August and remains a significant underweight position. TIPS typically outperform when inflation is high. All six indicators remain bearish for the sector. We expected inflation to fall pretty hard into the spring and summer months, which it has. However, commodity prices—led by energy—have bounced, which could soon provide a tailwind for the sector (chart left).

Summary

Entering September, the fixed income allocation strategy remains with a risk-on message and suggested no rebalancing from the month prior. The model remains overweight U.S. High-Yield Bonds, U.S. Investment Grade Corporate, Floating Rate Notes, and Emerging Market Bonds and underweight U.S. Long-Term Treasurys, U.S. Treasury Inflation-Protected Securities, and U.S. Mortgage-Backed Securities.

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