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Fixed Income Allocation Strategy

AUGUST 2023

Fixed Income Market Update

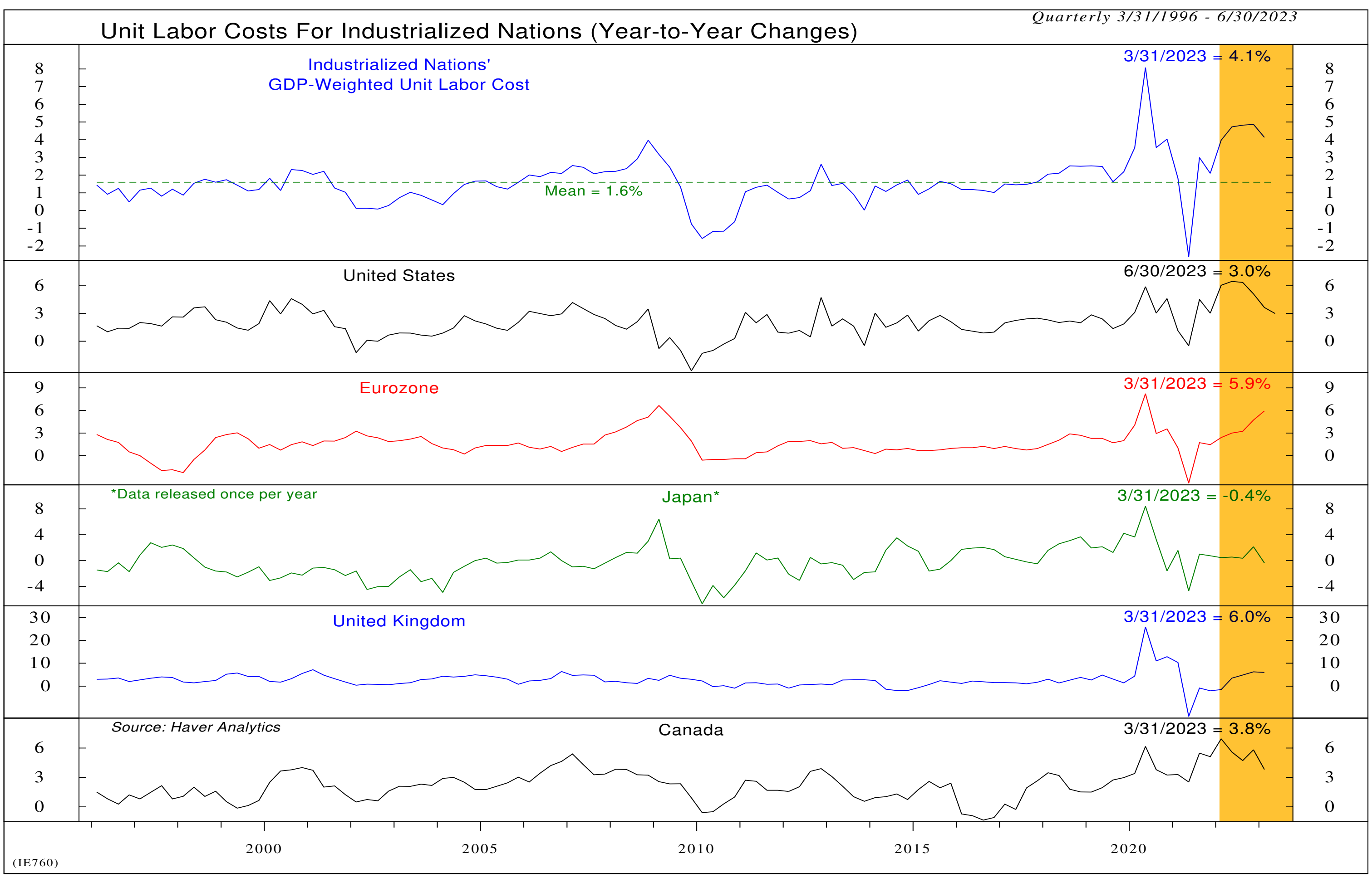
The Bloomberg Barclays U.S. Aggregate Bond Total Return Index was basically flat in July. Returns have been flat or negative for eight of the past 12 months. Breadth remained strong—seven of the nine fixed income sectors we track had positive returns in July—but weakness in U.S. Treasurys dragged down the Aggregate.

As widely expected, the Fed raised the target for the Fed Funds rate by 25 basis points in July to a range of 5.25% to 5.50%, the highest since March 2001. The Fed has raised rates a total of 525 basis points since March 2022, making it the fastest hiking cycle ever. The Fed also maintained its tightening bias and is keeping its options open with respect to another rate hike to underscore its commitment to fighting inflation.

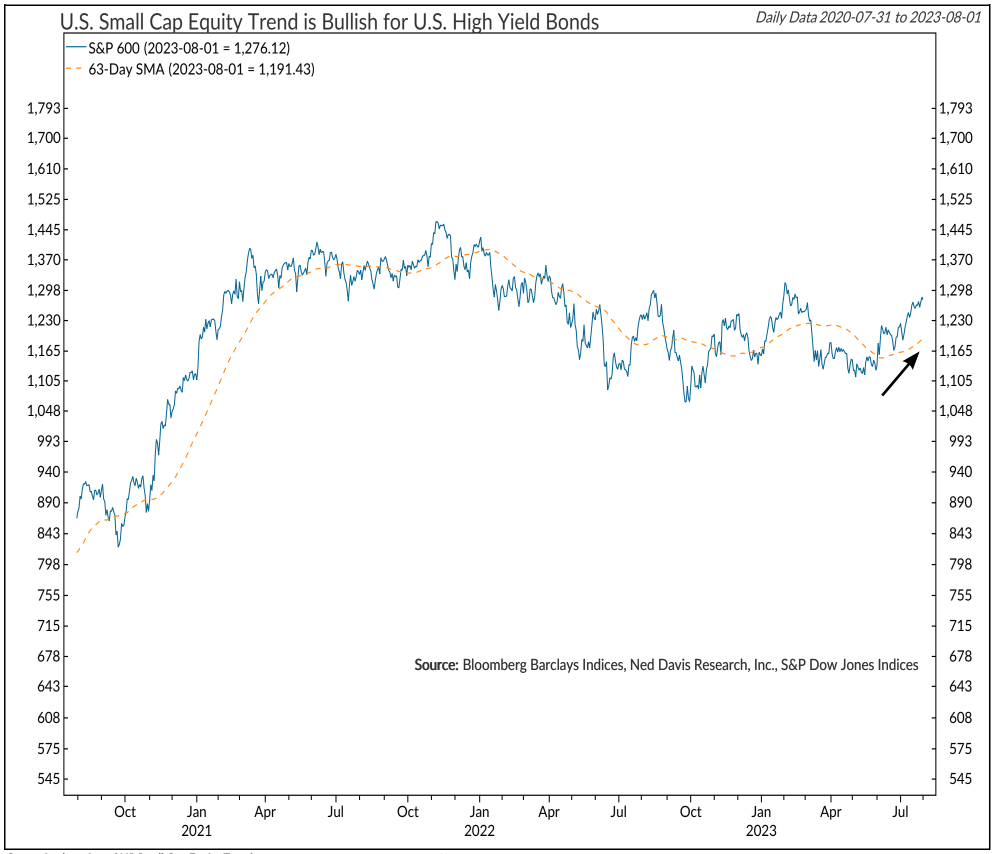
Although central banks have different mandates and face different economies, they share a common inflation objective of 2%. While all policy makers look at a wide array of data in making their decisions, none is more central than labor compensation. Wages are highly correlated with core inflation and are a good proxy for measuring inflationary pressures in the non-shelter services sector. The U.S. is making progress. Unit labor costs slid to 3.0% in Q2 from a peak of 6.5% in Q2 2022 (chart below), but it still has a way to go to get down to target.

If the data evolves as we expect, the Fed will likely skip raising rates in September. But upside risks to inflation could lead to another rate hike in Q4. However, the markets, once again, appear to be underpricing the risk of additional hikes.

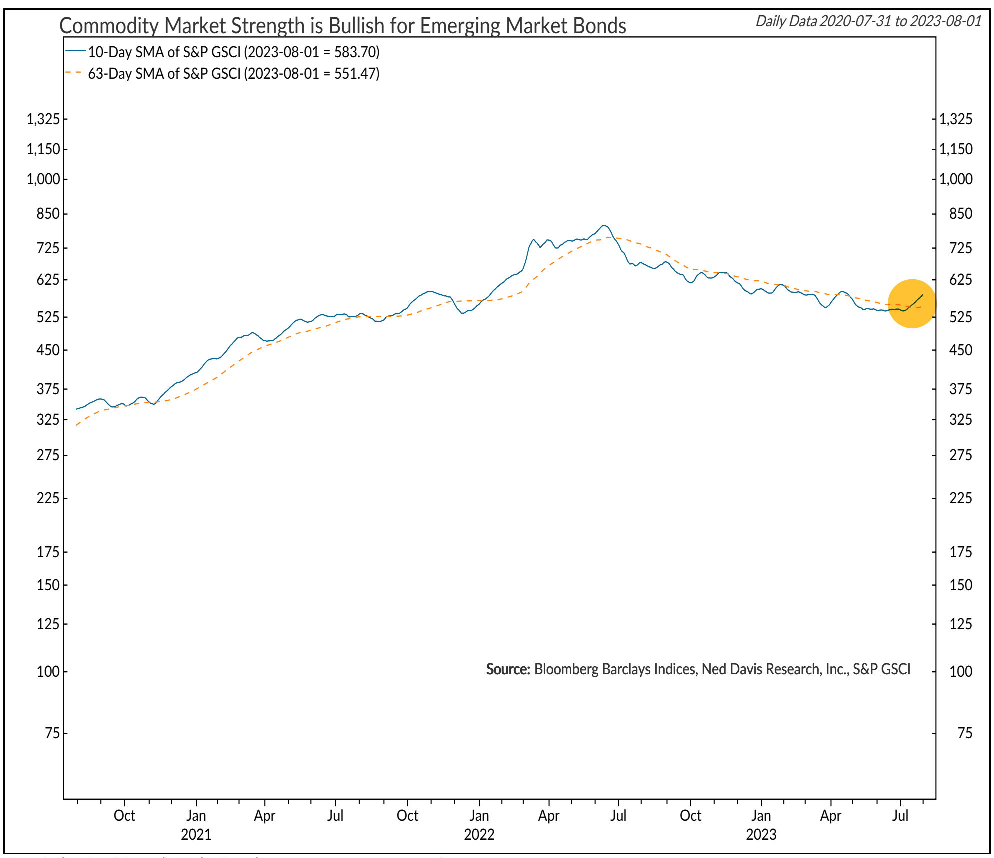
Entering August, the fixed income allocation strategy has a risk-on message. The model is overweight U.S. High-Yield Bonds, U.S. Investment Grade Corporate, Floating Rate Notes, and Emerging Market Bonds and underweight U.S. Long-Term Treasurys, U.S. Treasury Inflation-Protected Securities, and U.S. Mortgage-Backed Securities.



U.S. High Yield bonds' allocation rose over 600 basis points in July and is now the largest overweight position. All six indicators remained bullish. External influences such has the small-cap equity trend (chart right), the VIX, and option-adjusted spreads continue to provide tailwinds for the sector. The three internal (price-based) measures of trend and breadth confirmed.



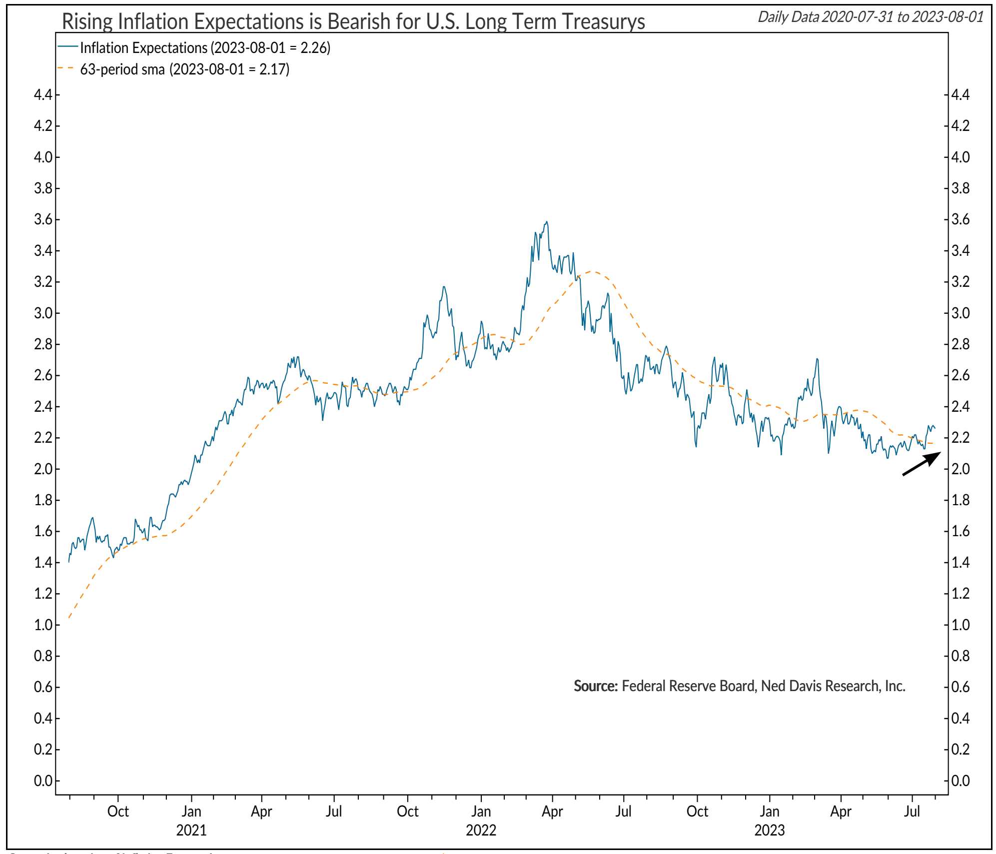
Customized version of US Small Cap Equity Trend



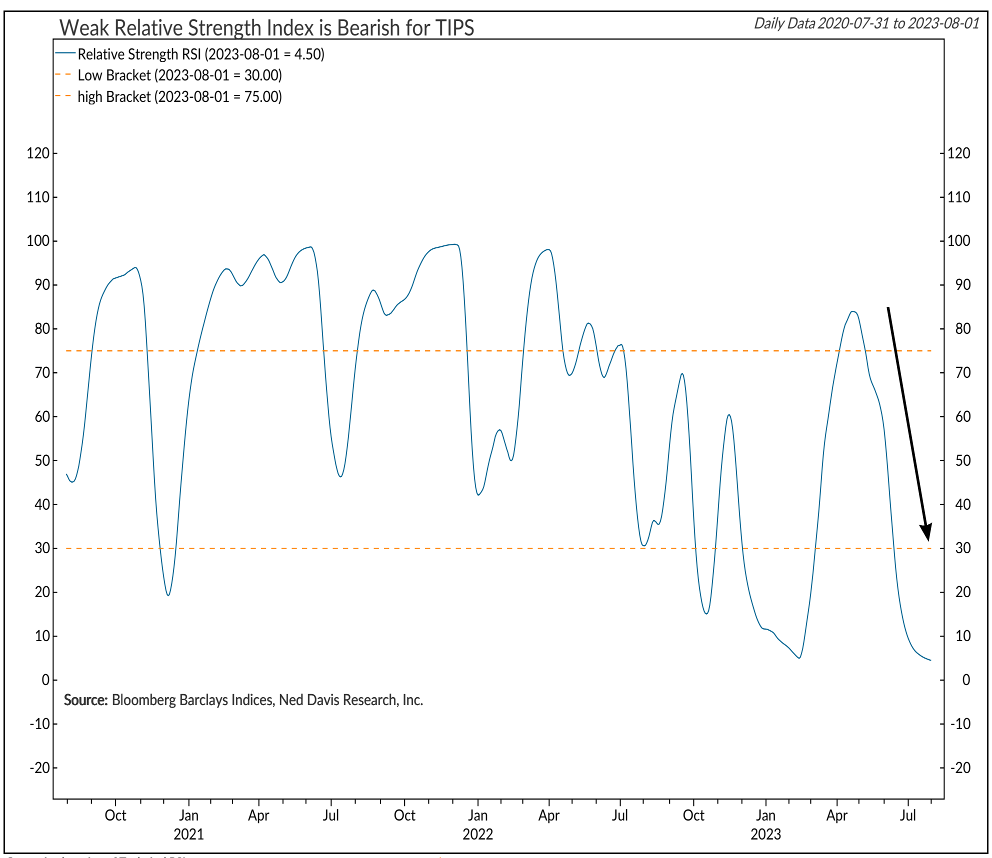
Customized version of Commodity Market Strength

Emerging Market (EM) bonds' allocation rose over 700 basis points in July and is now a significant overweight position. Four of the five indicators remained steady. Emerging Markets have a positive relationship with rising commodity prices. During the month of July, commodity strength improved to a bullish level for the sector (chart left).

U.S. Long-Term Treasurys' allocation dropped over 700 basis points and is now the largest underweight position. While the sector's trend and U.S. equity market trend remained bearish for the sector, a few indicators changed during the month. Momentum moved neutral and U.S. swaps became bearish. Rising inflation expectations, a sign that investors believe the Fed tightening cycle may not be over just yet, also flashed a bearish signal for the sector (chart right).



Customized version of Inflation Expectations



Customized version of Technical RSI

U.S. Treasury Inflation-Protected Securities' (TIPS) allocation was steady in July and remains a significant underweight position. TIPS typically outperform when inflation is high. Since we have passed the peak in inflation, the sector has been under pressure. All six indicators remain bearish for the sector. The sector's relative strength index (RSI) has been weak since early May (chart left).

Summary

Entering August, the fixed income allocation strategy has a risk-on message. The model is 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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