Fixed Income Allocation Strategy

NOVEMBER 2023

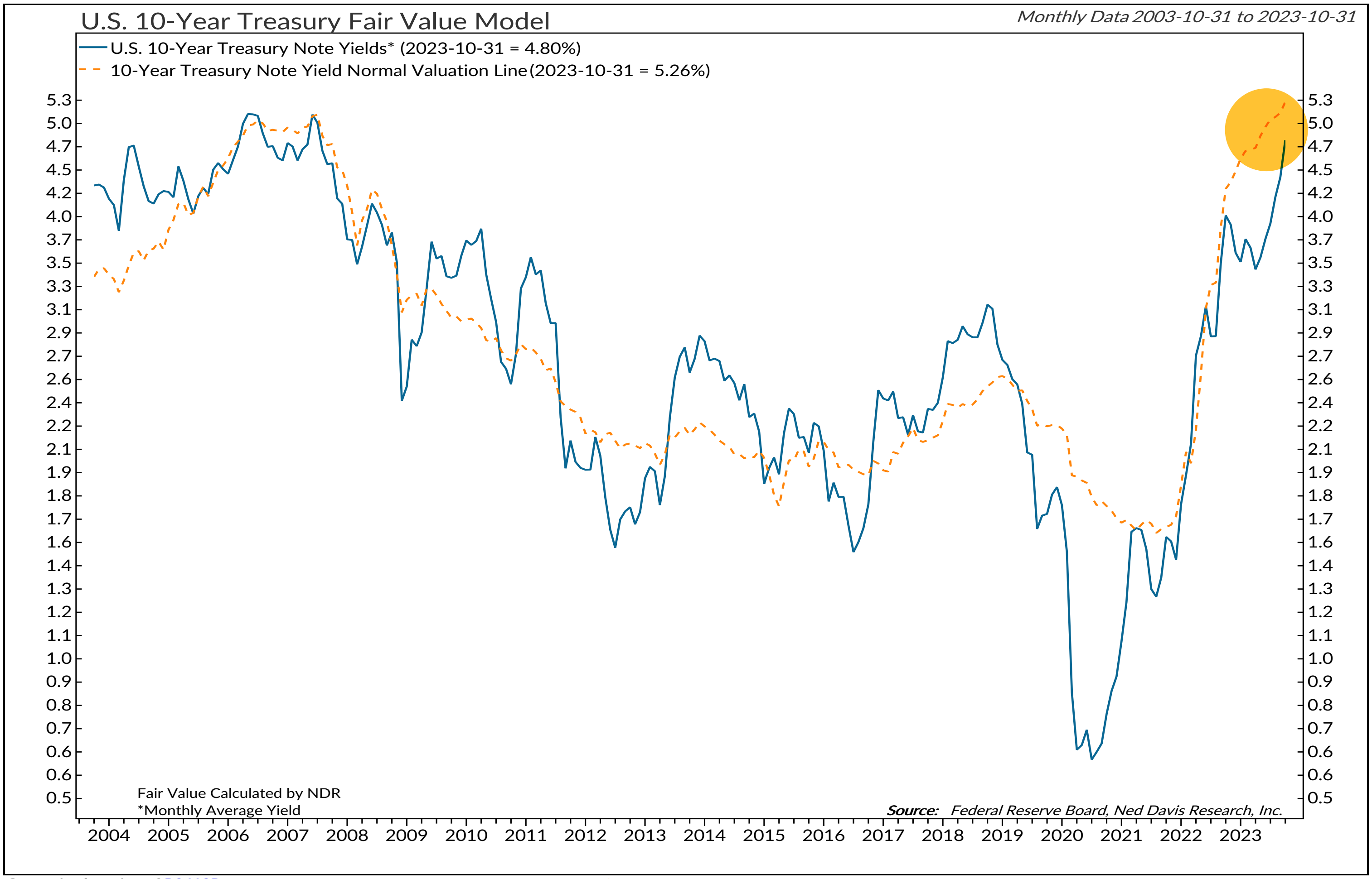
Fixed Income Market Update

The Bloomberg Barclays U.S. Aggregate Bond Total Return Index was down for the sixth month in a row, dropping about 1.6% in October. Breadth remained weak—seven of the nine fixed income sectors we track had negative returns in October—significant weakness in U.S. Treasurys again dragged down the Aggregate.

Fair value on Treasurys moved up to 5.26% with the October update (chart below), but it's likely a bit overstated due to the transient nature of the pandemic and the supply shocks from the Russia/Ukraine war. The 5.25% yield level was an important double-top in 2006-07 and represented the peak 10-year yield and fed funds rate of that tightening cycle. A sustained break of this level would not only indicate major technical damage but may imply a higher level for fair value. Where do rates go from here?

A move to 3.00% or less can't be ruled out and would be supported in a recession or disinflationary scenario, where nominal growth would sink significantly below the rate of interest. The greater long-term risk, however, is if yields went the other way–toward 7.00%. Prior to the pandemic, the term premium averaged 1.65% since 1961. PCE inflation has averaged 3.3% since 1960. Add all that up and you get 7.20%. So, getting comfortable with a 5.00% 10-year Treasury is actually quite conservative!

Entering November, the fixed income allocation strategy continued to favor mixed leadership. The model is overweight U.S. Floating Rate Notes, International Investment Grade, and U.S. Treasury Inflation-Protected Securities. The model is underweight U.S. Investment Grade Corporate, U.S. Long-Term Treasurys, and U.S. Mortgage-Backed Securities.



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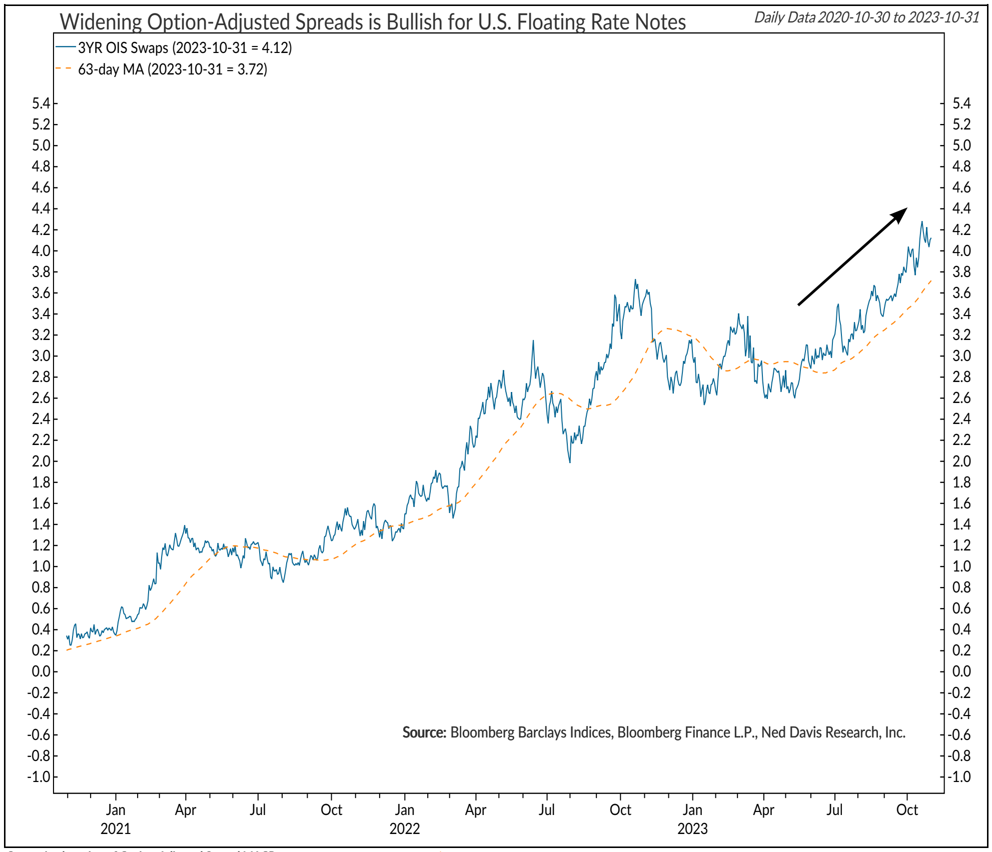
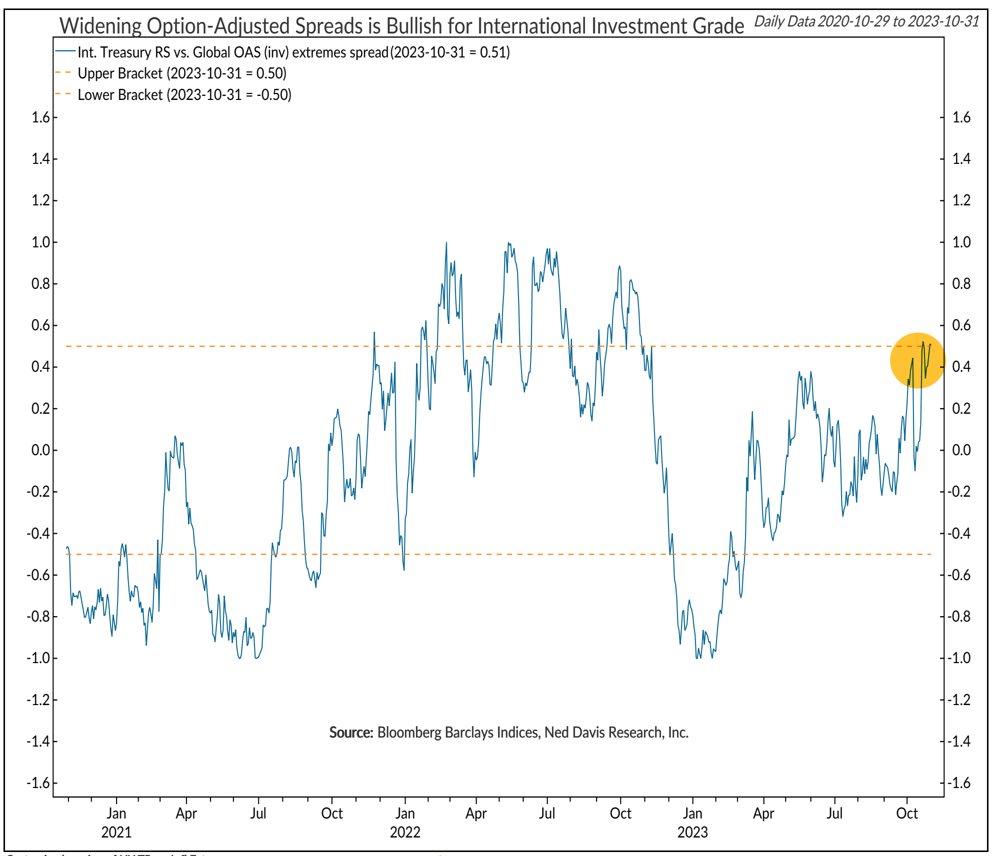
U.S. Floating Rate Notes' allocation was steady in October and remains a significant overweight position. Floating rate notes typically outperform when rates are rising, which occurred again in October. Widening option-adjusted spreads is a tailwind for the sector (chart right). Price-based measures confirm with all three indicators on bullish signals.



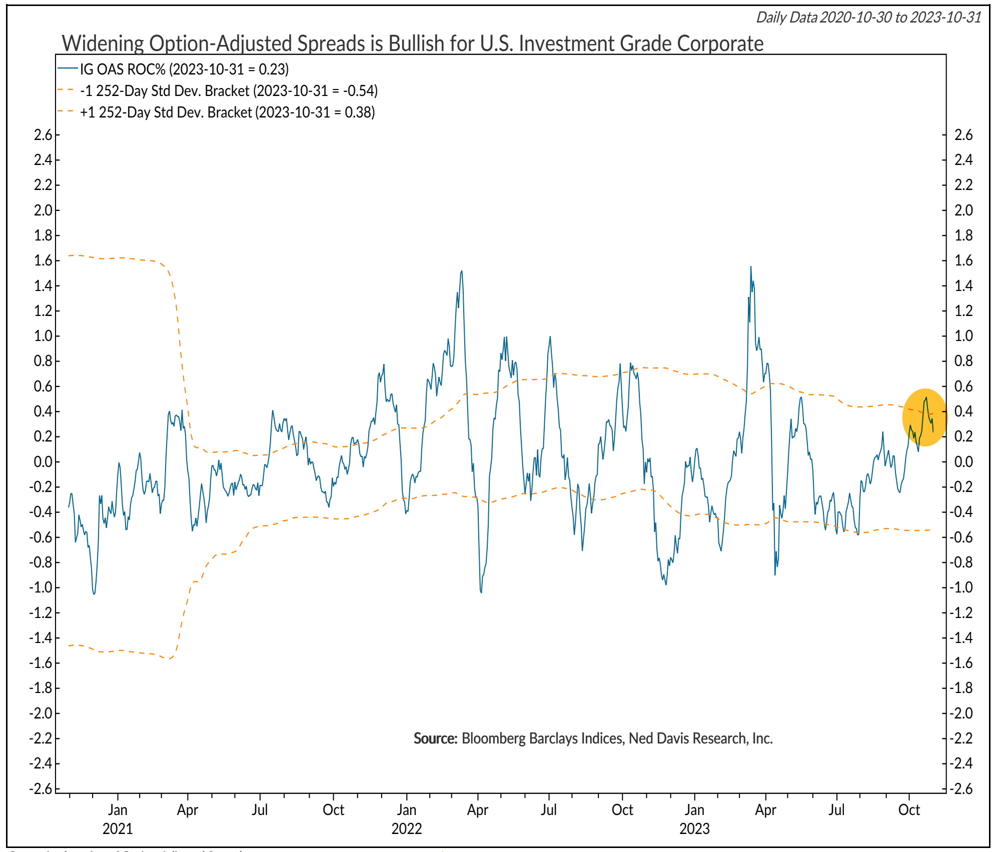
Customized version of Option-Adjusted Spread MACR



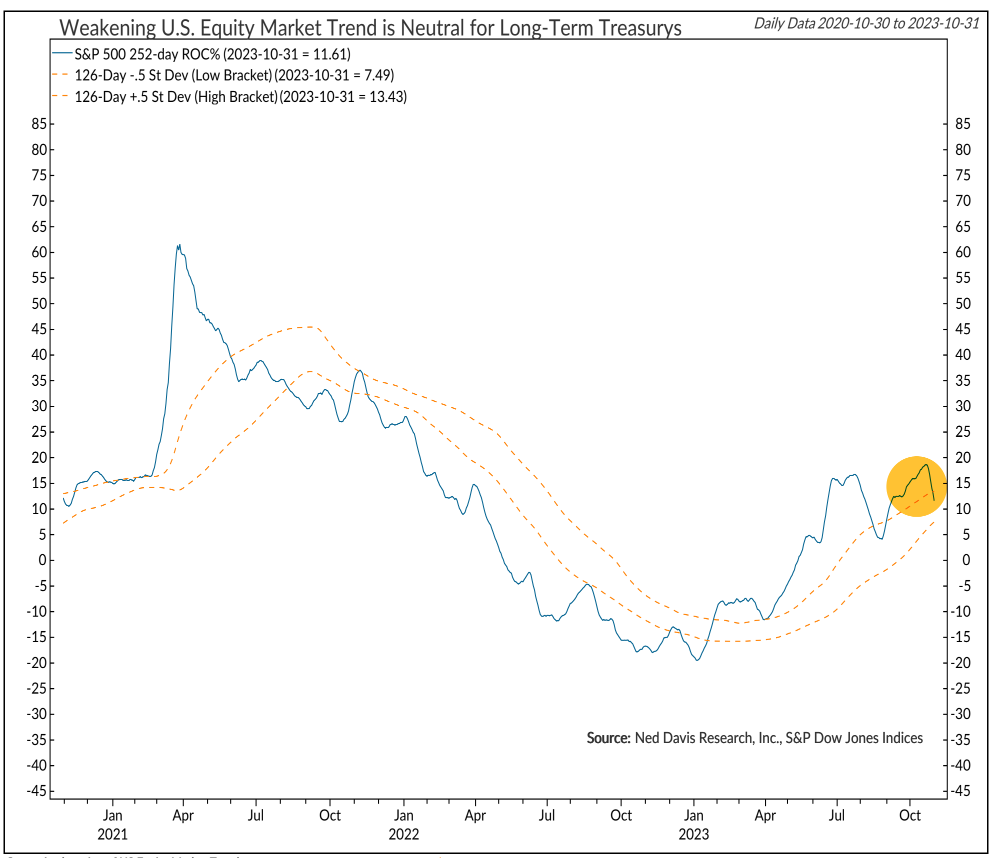
Customized version of HY TR vs. Infl Extremes

International Investment Grade bonds' allocation was steady in October and remained at overweight. While U.S. swaps remained neutral, widening global option-adjusted spreads flashed bullish (chart left) joining the equity volatility indicator. This is confirmed by two bullish price-based measures including rising relative strength trends.

U.S. Investment Grade Corporate bonds' allocation was steady and remains at a significant underweight. While bond volatility, credit default swaps, and short-term trend are bearish for the sector, the U.S. dollar and mean reversion are positive offsets. Only one indicator changed during the month—option-adjusted spreads moved bullish for the sector (chart right).



Customized version of Option-Adjusted Spread



Customized version of US Equity Market Trend

U.S. Long-Term Treasurys' allocation dropped modestly in October and remains underweight. Inflation expectations, U.S. swaps, and sector trend remain on bearish signals. However, both sector momentum and the U.S. equity market trend moved to neutral during the month (chart left). If investors see recession risks rising and/or the stock market's earnings yield deteriorates, Treasurys may have an opportunity to rally off their lows.

Summary

Entering November, the fixed income allocation strategy favors mixed leadership. The model is overweight U.S. Floating Rate Notes, International Investment Grade, and U.S. Treasury Inflation-Protected Securities. The model is underweight U.S. Investment Grade Corporate, U.S. Long-Term Treasurys, and U.S. Mortgage-Backed Securities.

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