Fixed Income Allocation Strategy

NDR
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NOVEMBER 2022

Fixed Income Market Update

This year has been challenging for fixed income investors. The Bloomberg Barclays U.S. Aggregate declined more than 15% through October. It has been the index's worst 10-month stretch going back to 1976. The index has risen only two months this year. In the other eight months, the index dropped by more than 100 basis points (bps) each time.

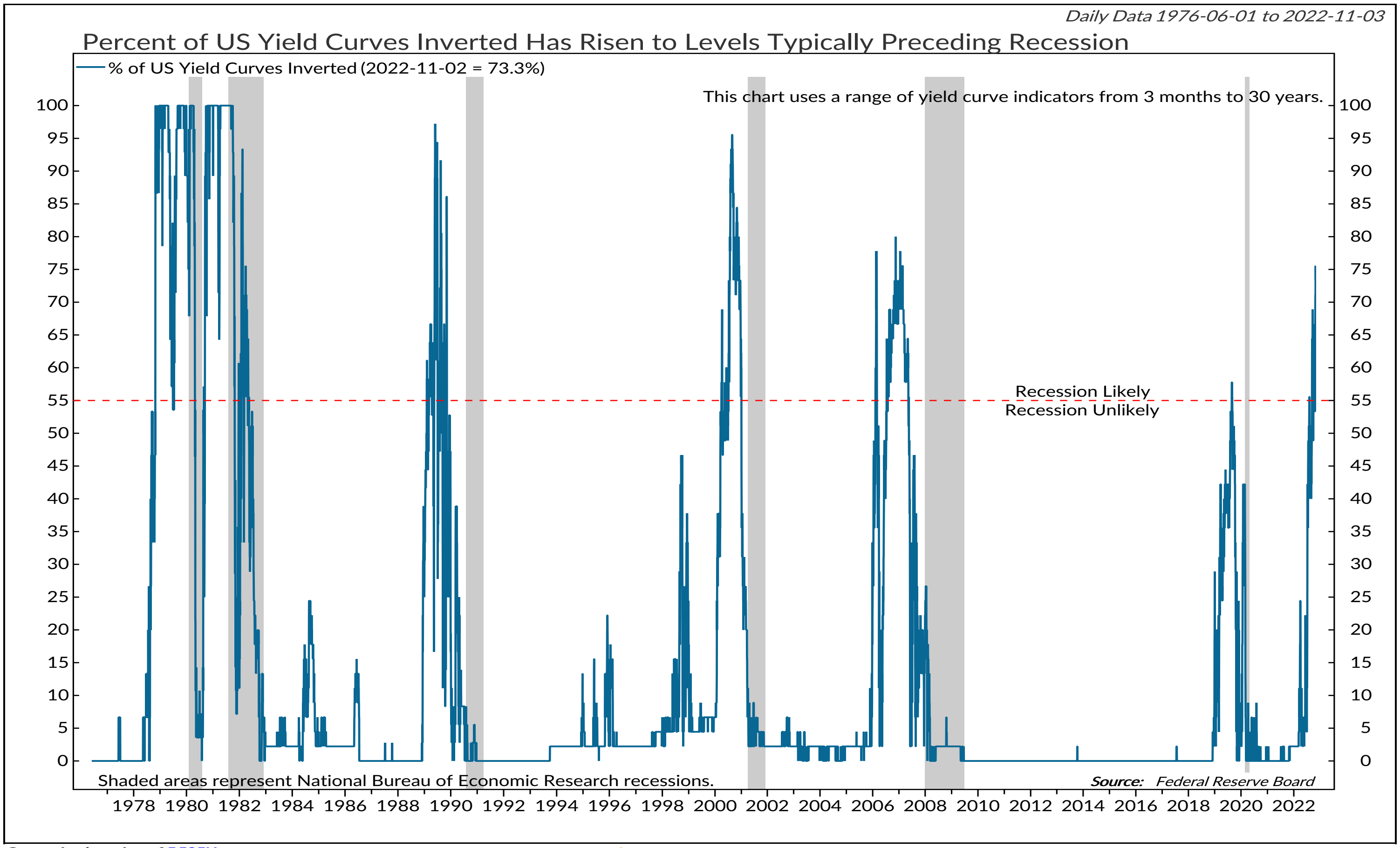
The Federal Open Market Committee (FOMC) recently raised the fed funds target range by 75 bp to 3.75% to 4.00%, the highest since January 2008. It was the fourth straight 75 bp increase for a total of 375 bp this cycle. It was the biggest increase in the policy rate since 2006.

Although more hikes are coming, a downshift in the size of the rate hikes is on the horizon. Fed Chairman Powell indicated that it would likely be at one of the next two meetings. But 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 reverse course.

Yield curves are reflecting the anticipation of weaker economic conditions. Almost 75% of yield curves (from three to 30 months) are inverted. The last time this happened was during the global financial crisis. Historically, this condition has preceded a recession (chart at bottom).

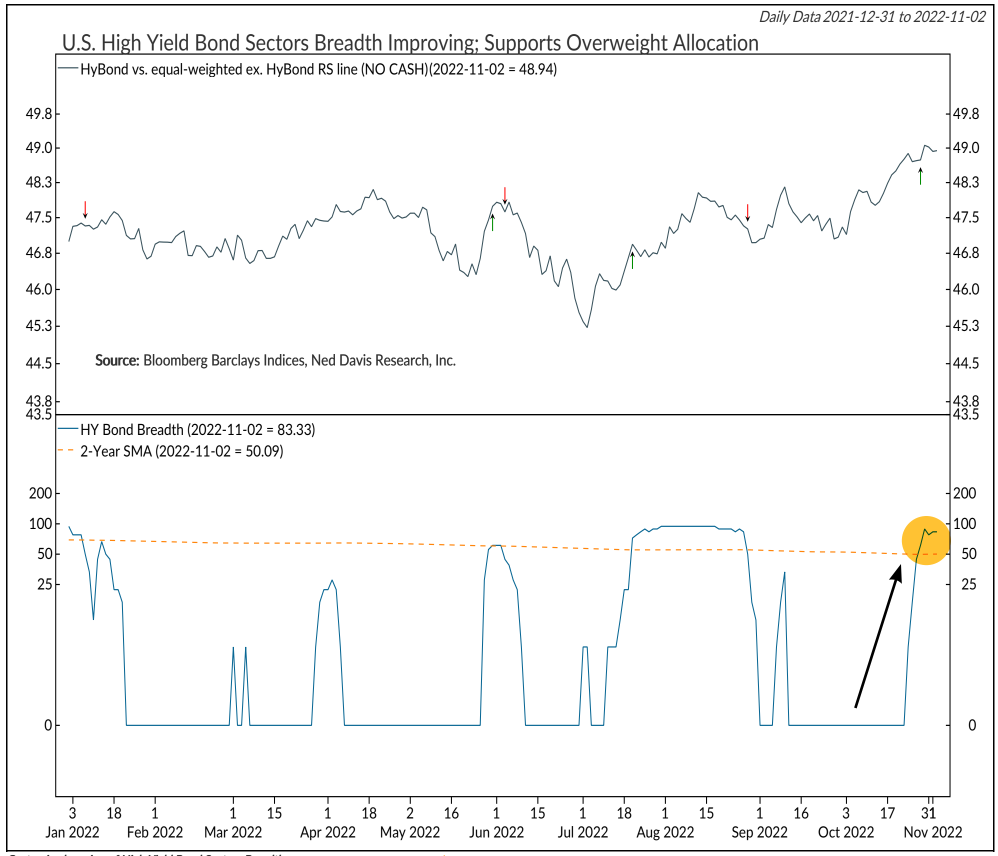
Although financial conditions are much tighter than the ultra-loose conditions during the pandemic, they are not yet tight by historical standards. With real borrowing costs being negative, financial conditions are not restrictive. Negative real borrowing costs are stimulative since you can pay off debt with cheaper dollars.

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

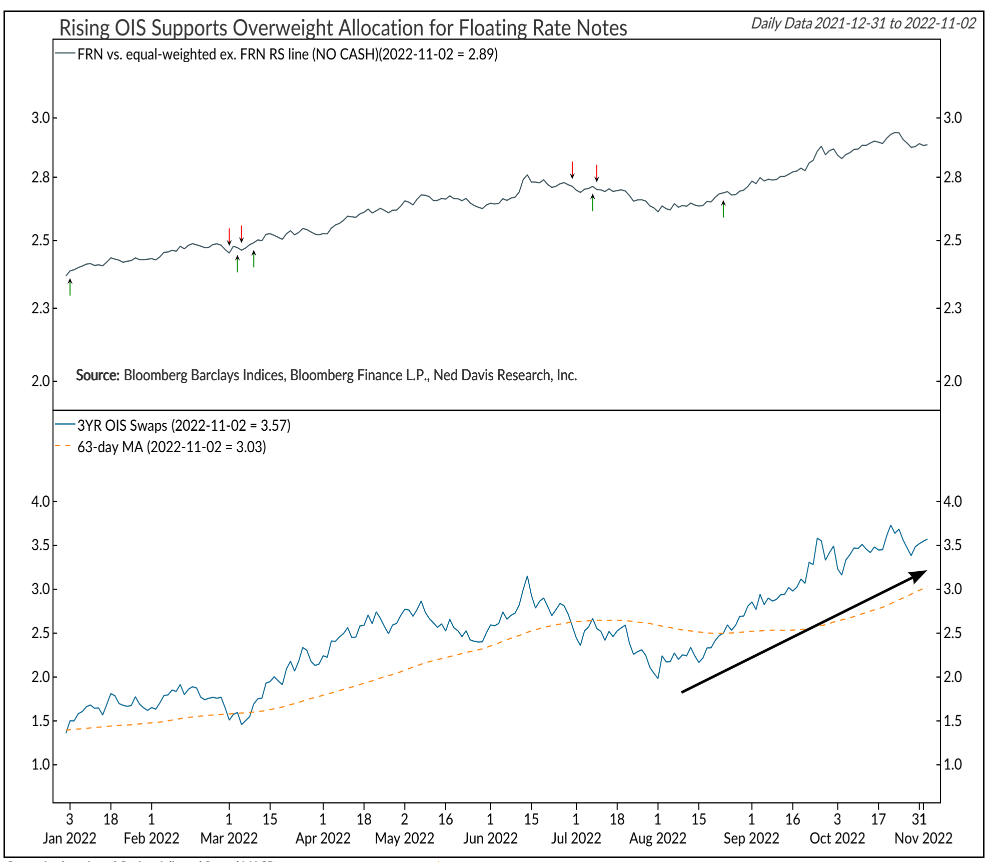


Customized version of B595U

U.S. High Yield jumped to the largest overweight allocation this month. The risk-on environment in October was driven by expectations of a Federal Reserve downshift in rate hikes. This led to outperformance by high yield within fixed income and small caps within equities. The technical indicators turned positive on the recent move as absolute trend, relative strength, and high yield upside participation breadth (chart at right) produced bullish readings.



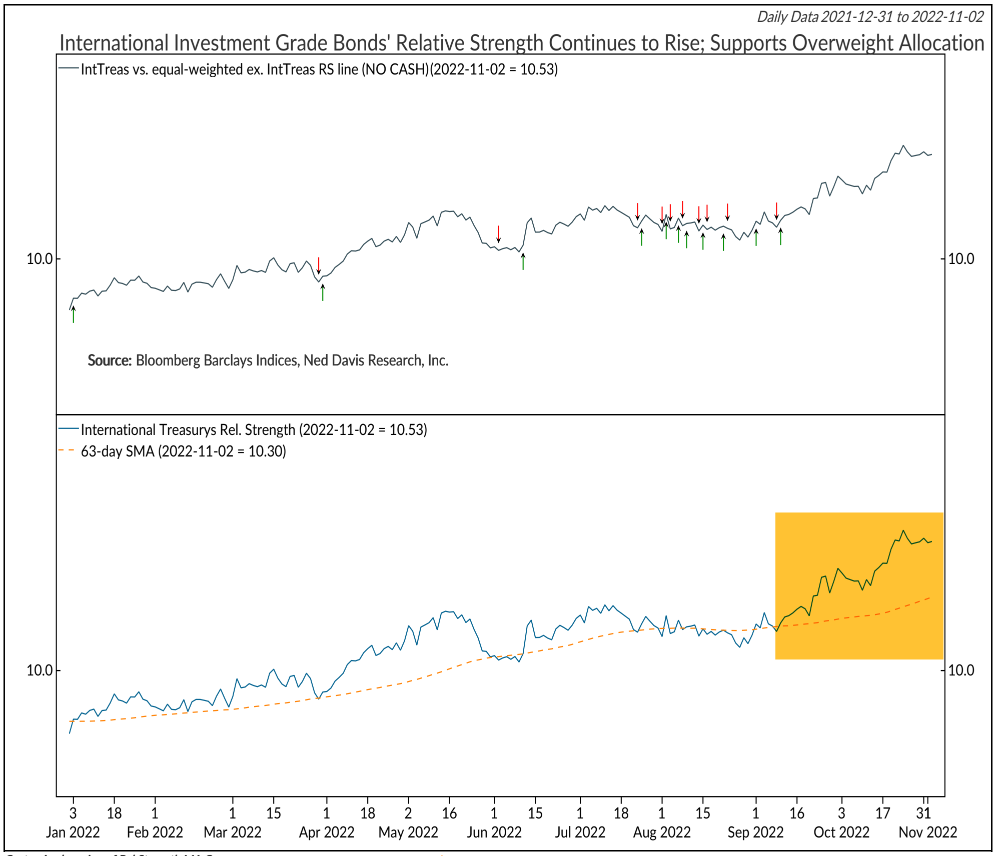
Customized version of High Yield Bond Sectors Breadth



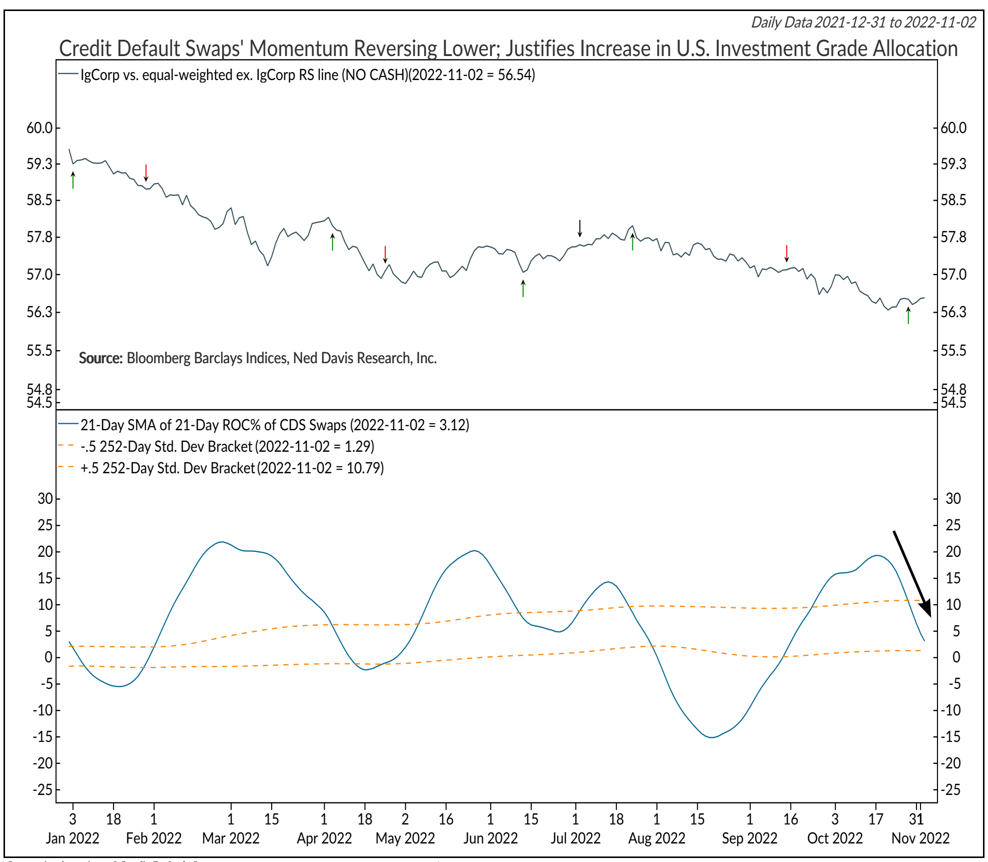
Customized version of Option-Adjusted Spread MACR

Floating Rate Notes' allocation declined, but the segment remains above benchmark weighting. The trend and price momentum remain favorable as confirmed by rising overnight index swap (OIS) levels (chart at left), which supports an overweight position. The allocation dropped as the sector's 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 may have led to the recent relative weakness.

International Investment Grade's weighting fell, as risk appetite improved in October. This sector typically behaves as a defensive asset, so it may underperform 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 indicating decreasing fears. However, International Investment Grade remains overweight as the trend remains firmly upward (chart at right). Currently, the only incentive foreigners have for investing in U.S. fixed income is to take advantage of a rising U.S. Dollar (USD). If the USD starts to roll over, U.S. bonds could encounter strong competition from foreign alternatives.



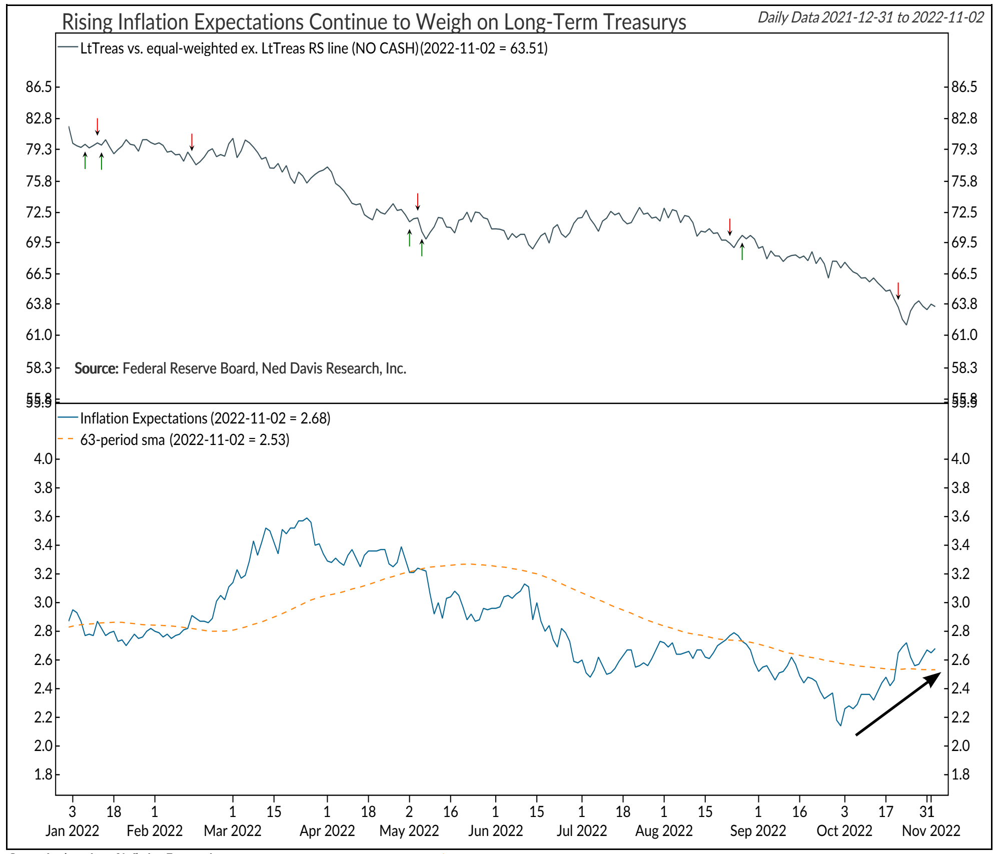
Customized version of Rel Strength MA Cross



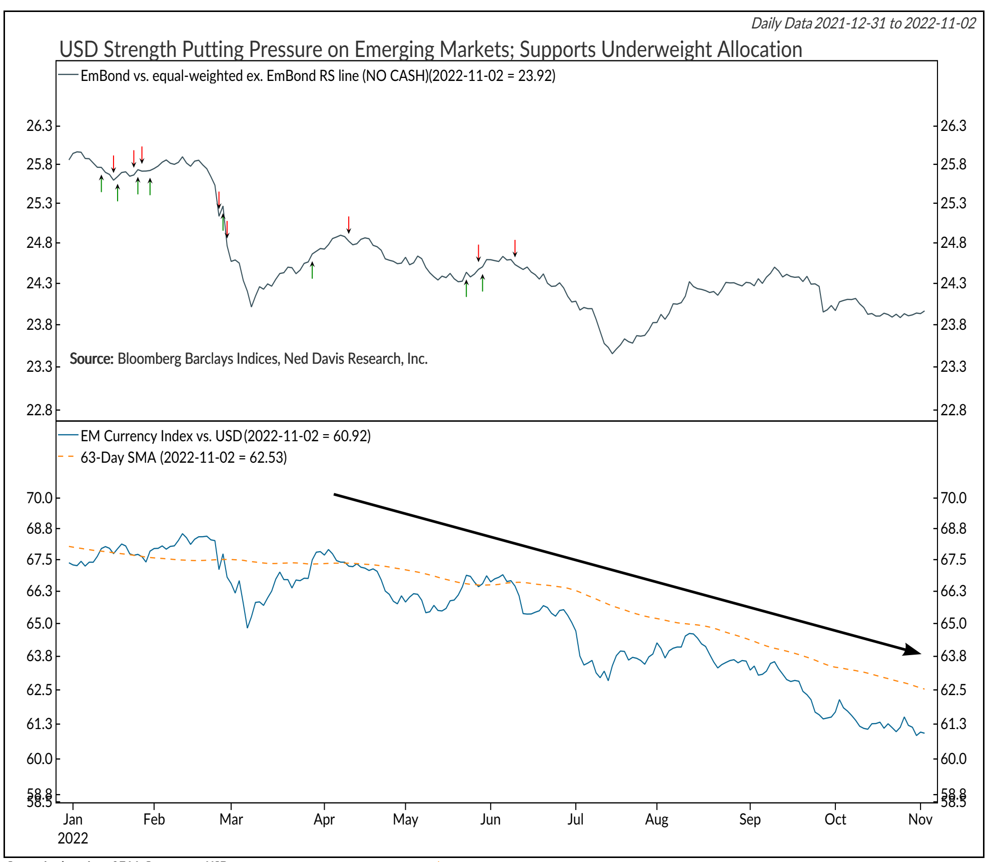
Customized version of Credit Default Swaps

The U.S. Investment Grade sector jumped in allocation as credit default swaps [CDS] (chart at left) fell from their highest levels since the COVID-19 lockdowns. CDS measures the cost of insuring exposure to debt. Falling levels indicate decreasing default concerns, which benefits investment in credit sectors like Investment Grade. This segment has not moved to an overweight position due to lacking technical confirmation from the trend.

U.S. Long-Term Treasurys continues to be under significant pressure. Rising inflation expectations (chart at right) are pushing interest rates higher and punishing Treasury investors. During October, the 10-year yield rose to levels not seen since 2008. NDR's 10-year yield fair valuation level indicates support near 4.25% (the 10-year was at 4.10% at the start of November). The technical indicators are firmly bearish on this sector.



Customized version of Inflation Expectations



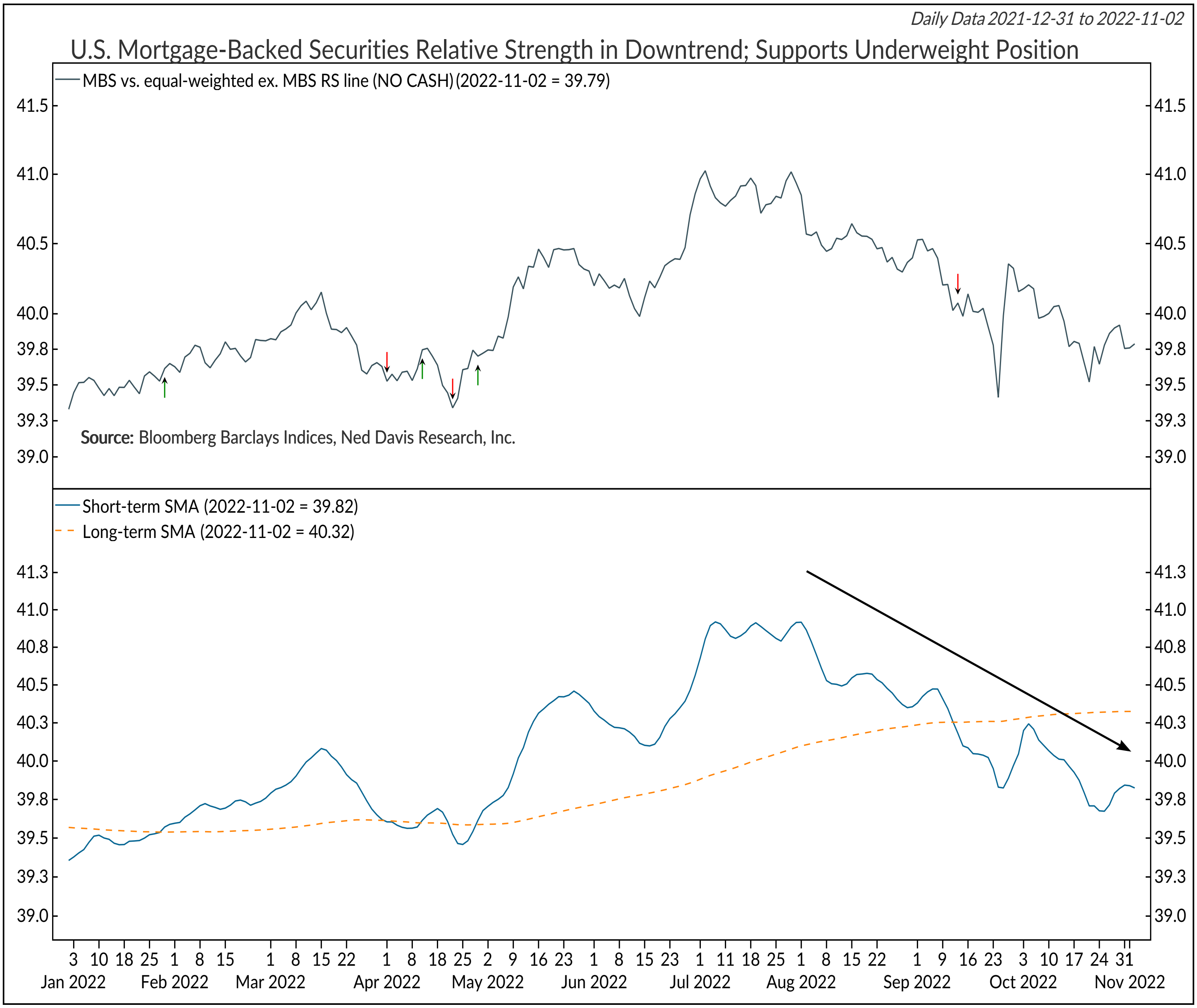
Customized version of E.M. Currency vs USD

Emerging Market bonds fell further underweight as the region faces numerous headwinds including a surging U.S. dollar (chart at left), falling commodity prices, deteriorating equity markets, and increasing likelihood of a severe global slowdown. 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. The absolute trend for EM bonds remains down.

U.S. Mortgage-Backed Securities (MBS) entered this month with the largest underweight position. The housing market is under pressure, as the National Association of Realtors' Housing Affordability Index (HAI) suffered the largest y/y point decline in its history back to 1981. The HAI measures whether a typical family can qualify for a mortgage loan on a typical home. Also, although they have started to roll over, option-adjusted spreads on MBS have widened to COVID-19 lockdown levels. The technical indicators are aligned with these environmental challenges. The relative strength of MBS to other fixed income sectors remains in a multi-month downtrend (chart at bottom).

Summary

The fixed income asset class continues to be under pressure due to high inflation and the Federal Reserve's tightening response. Rising rates favor an overweight allocation to floating rate notes. Credit conditions are tighter, but not tight. High yield has been a relative outperformer and is also overweight. International bonds (also overweight) could find increased buying pressure if the USD rolls over, which has been the primary reason for foreign investors to buy U.S. bonds this year. The housing market is under pressure, which is reflected by the large underweight allocation to MBS. Emerging Markets is also underweight as the rising USD, falling commodity prices, and weakening China have put pressure on the region. U.S. Long-Term Treasurys have been a consistent underperformer over the last year and need to see technical improvement to exit its below benchmark weighting.



Customized version of MBS RS MA Cross

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