Fixed Income Allocation Strategy

JULY 2023

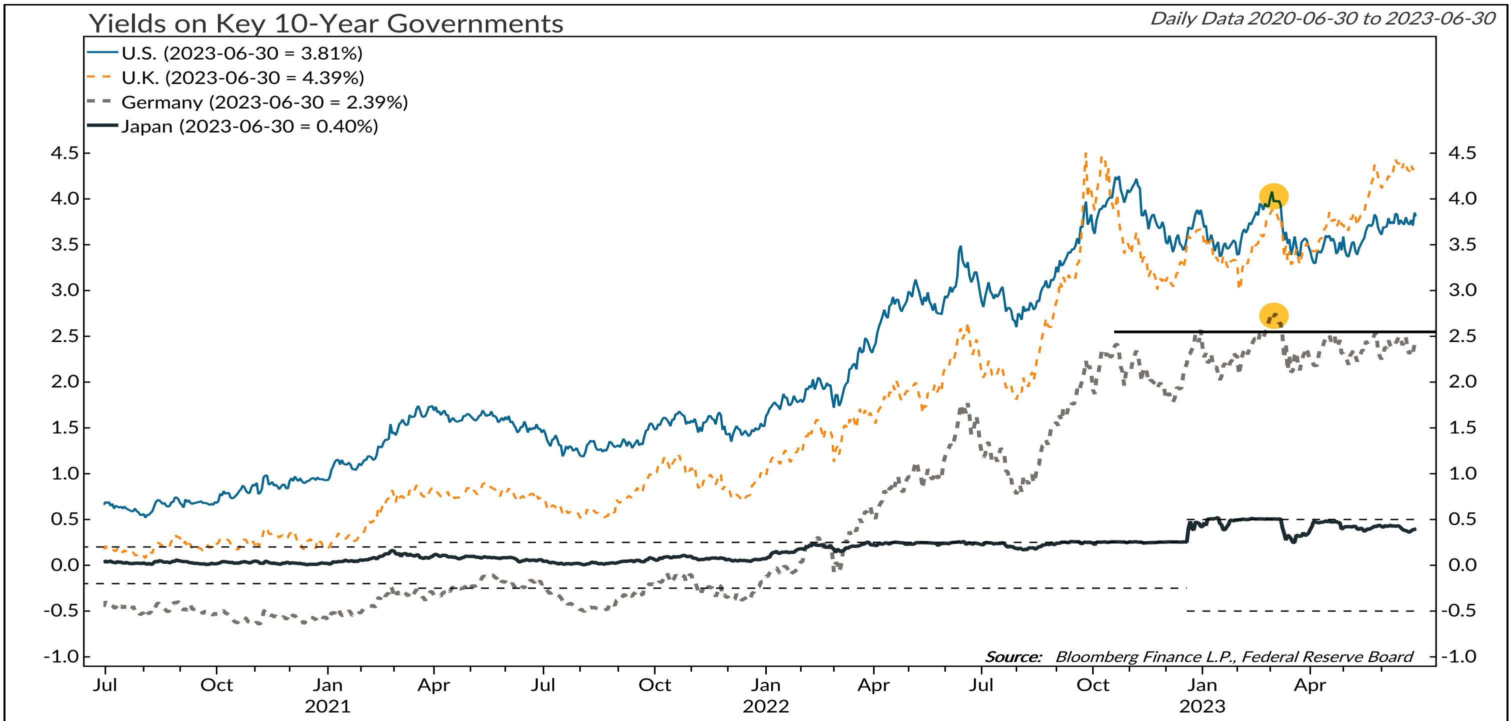
Fixed Income Market Update

The Bloomberg Barclays U.S. Aggregate Bond Total Return Index declined less than 0.5% in June. Returns have been negative for seven of the past 12 months. Breadth improved—seven of the nine fixed income sectors we track had positive returns in June—but weak performance by mortgage-backed securities (MBS) dragged down the Aggregate.

Fixed income markets are likely to chop around in the second half of 2023. Short-term yields are being pushed up by continued tightening by central banks in the developed markets. Longer-term yields are being pulled down by slower growth and cooling inflation expected later this year. After pausing their tightening cycles earlier this year, the Reserve Bank of Australia and the Bank of Canada resumed their rate hikes, as inflation remained sticky. The Fed paused in June but indicated two more hikes are coming later this year. The European Central Bank and the Bank of England never stopped hiking.

Technically, the March peaks are significant in this battle (chart below). We would be surprised to see 10-year Treasurys hold above 4.00% for very long, confirmed by German 10-year yields above 2.75%. These levels should provide an upward cap to global yields. The lower end of the range will be defined by 3.25% and 2.00%, respectively.

Entering July, the fixed income allocation strategy had very small changes in sector allocations. The model remains overweight Floating Rate Notes, International Investment Grade, and U.S. Long-Term Treasurys and underweight Emerging Market Bonds, U.S. High-Yield Bonds, U.S. Treasury Inflation-Protected Securities, and U.S. Mortgage-Backed Securities.



Full History Correlation Matrix 1992-01-02 to 2023-06-30

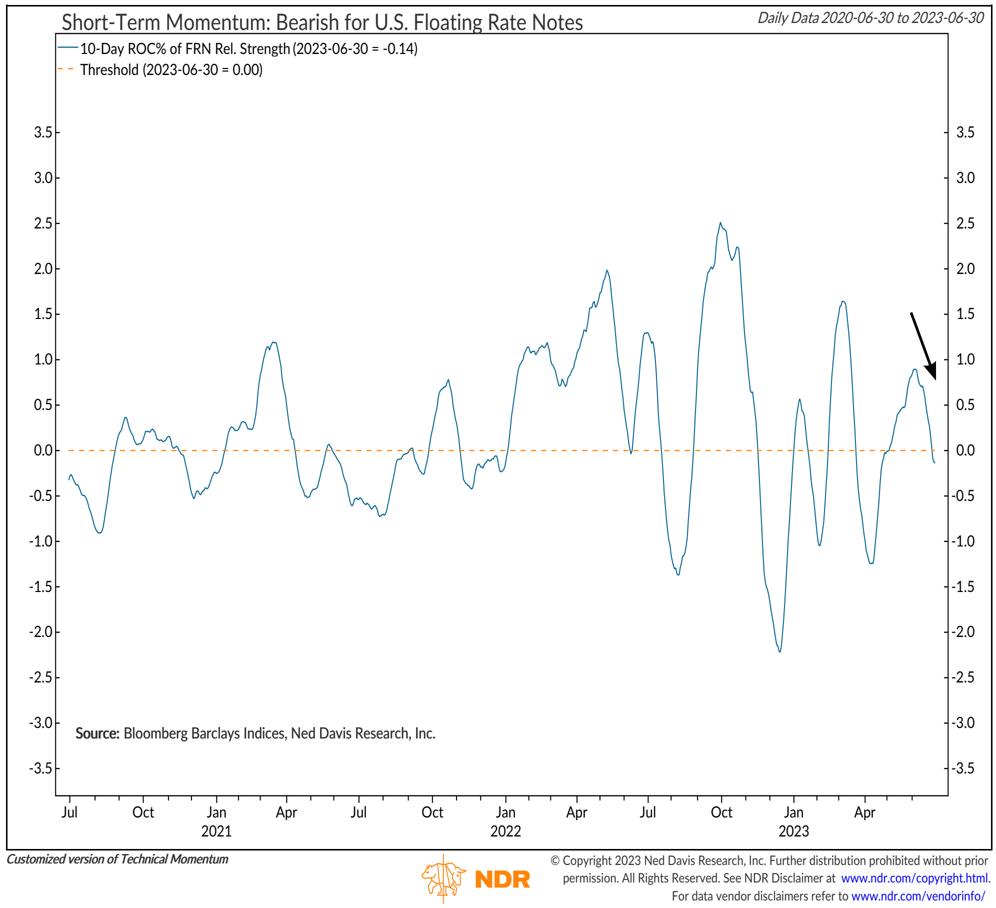
Assets	U.S.	U.K.	Germany	Japan
U.S.	1.00			
U.K.	0.96	1.00		
Germany	0.95	0.98	1.00	
Japan	0.86	0.92	0.90	1.00

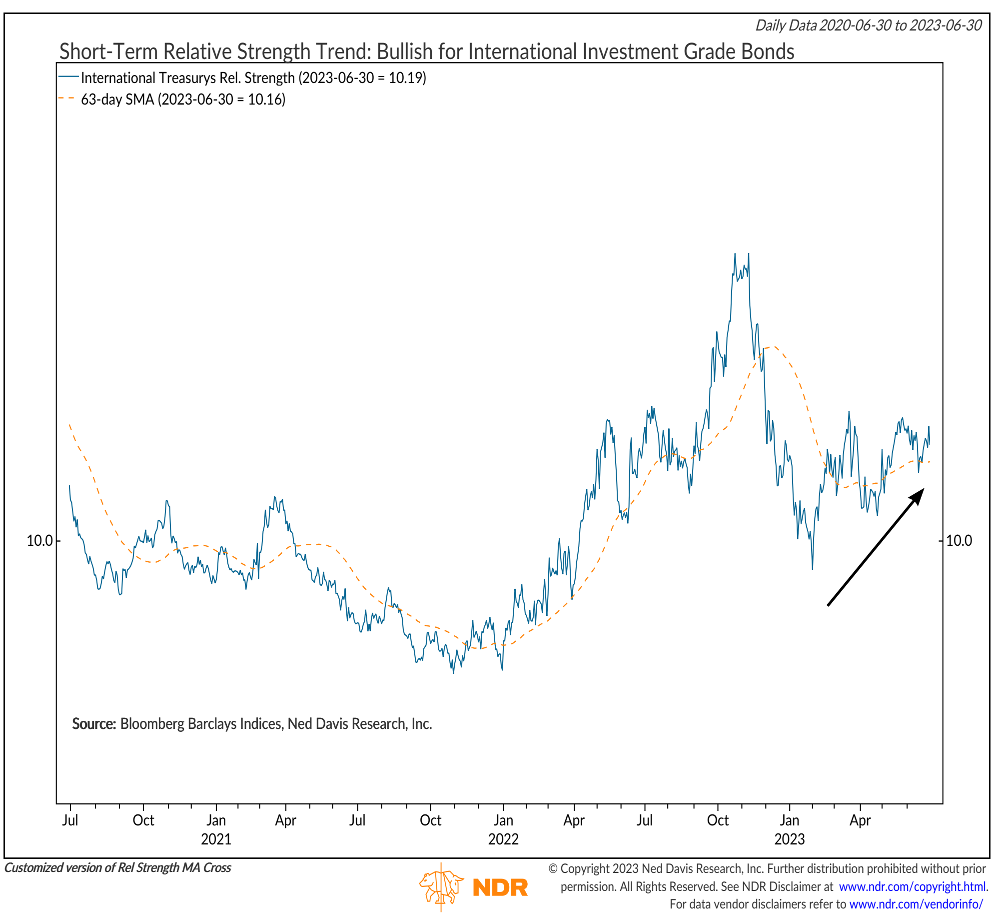
Chart History Correlation Matrix 2020-06-30 to 2023-06-30

Assets	U.S.	U.K.	Germany	Japan
U.S.	1.00			
U.K.	0.97	1.00		
Germany	0.97	0.98	1.00	
Japan	0.90	0.91	0.93	1.00

Customized version of B190

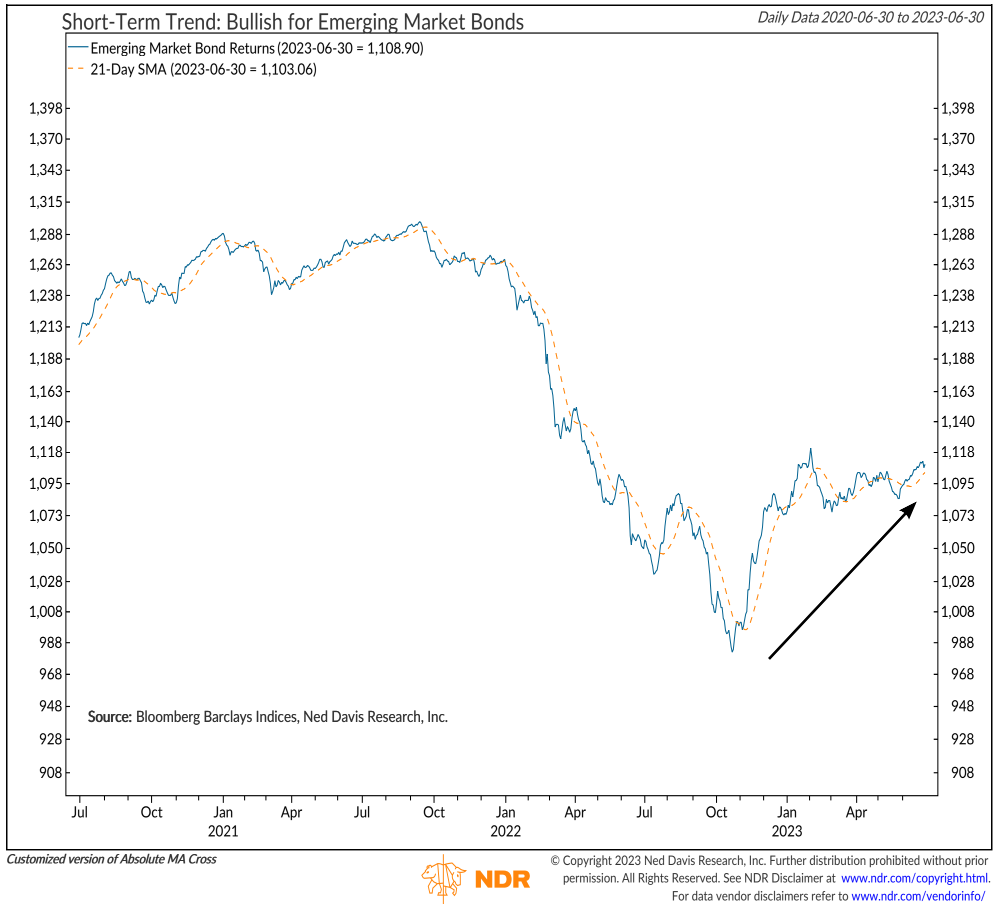
Floating Rate Notes' allocation was steady and remains the largest overweight position. Floating rate notes typically outperform during a rising rate environment—yields have recently been in a trading range. Four of five indicators remained steady in June. The only measure to change was the short-term price momentum indicator, which moved bearish this past month (chart right).

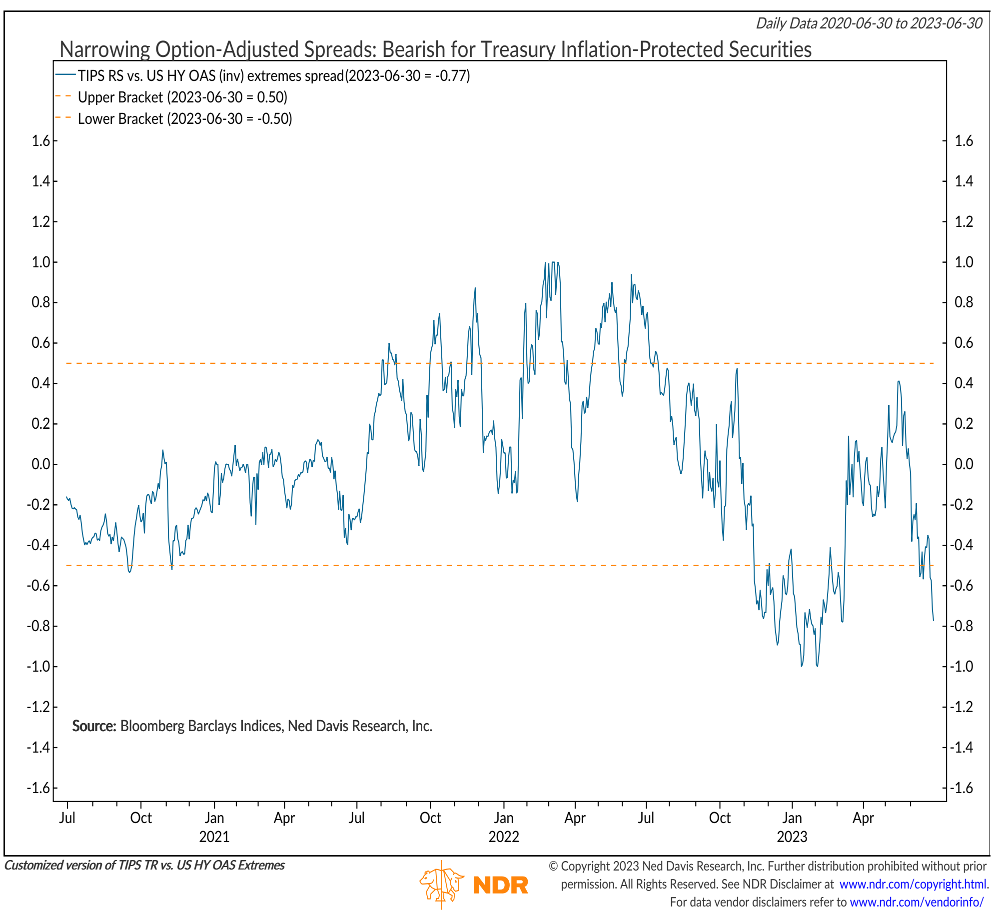




International Investment Grade bonds' allocation was also steady and remained at overweight. No indicators changed this month. External influences such has high-yield returns vs. inflation and U.S. swaps remained neutral for the sector. The three internal (price-based) measures stayed the same, including the bullish readings from relative strength trends (chart left) and the bearish reading from the equity risk VIX.

Emerging Market (EM) bonds' allocation was steady in June and remains at a significant underweight position. Three of the five indicators remained steady. Two price-based signals moved bullish during the month of June—EM equity momentum and EM bond trends (chart right).





U.S. Treasury Inflation Protected Securities' (TIPS) allocation was steady in June and remains the largest 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 are now bearish for the sector, including narrowing high-yield option-adjusted spreads which moved to an unfavorable level for TIPs (chart left).

Summary

Entering July, fixed income allocations remained steady. The model is overweight Floating Rate Notes, International Investment Grade, and U.S. Long-Term Treasurys while Emerging Market Bonds, U.S. High-Yield Bonds, U.S. Treasury Inflation-Protected Securities, and U.S. Mortgage-Backed Securities are underweight.

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