

MARCH 2023

Fixed Income Market Update

After a 3% gain in January, the Bloomberg Barclays U.S. Aggregate Bond Total Return Index dropped by over 2.5% in February. The index has been positive for only four of the past 12 months. Of the nine fixed income sectors we track, all of them except cash had negative returns in February.

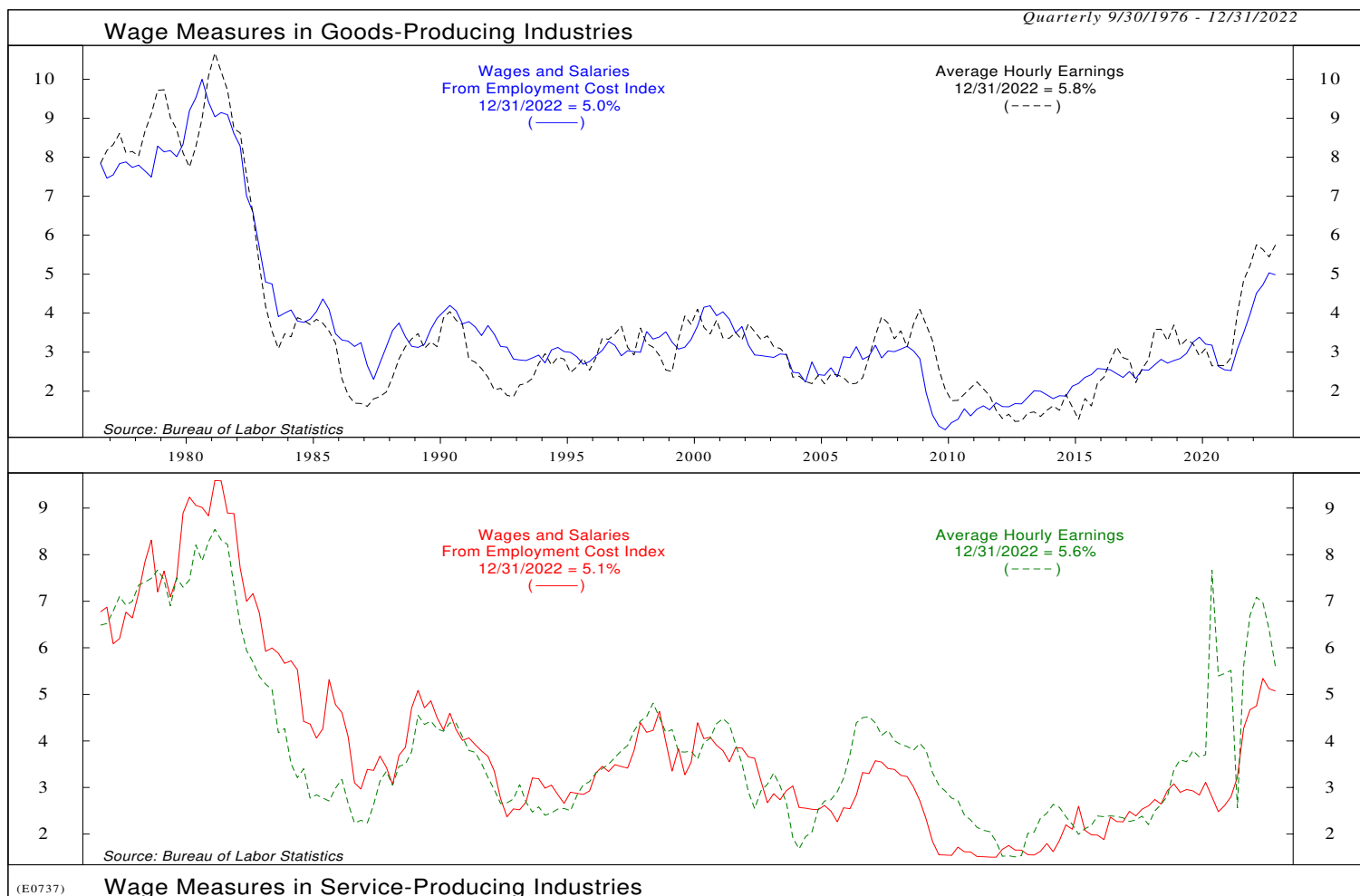
While the Fed acknowledged improvement in inflation at the February meeting, what is still in doubt is the pace at which inflation will continue to moderate and whether any progress on it will be sufficient for the Fed to loosen monetary policy. Following the

January CPI and PPI reports and strong retail sales, yields backed up, the U.S. dollar rose, and markets pushed off expected rate cuts into 2024.

While goods inflation has come down significantly, services inflation has not. Amid broad-based inflation, the focus should be on the labor market and wage growth (chart below). Persistent strength in the latter, particularly if productivity growth remains weak, will continue to put upward pressure on unit labor costs and inflation. All of this suggests that the road back to

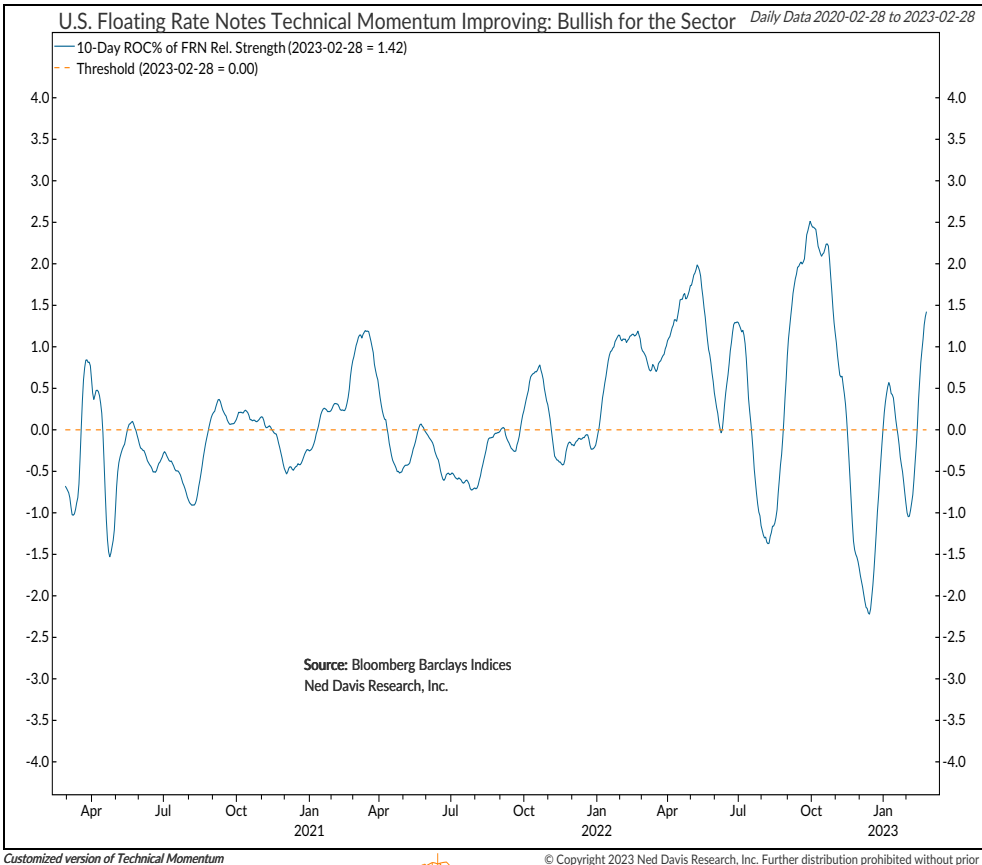
2.0% inflation will be bumpy, and it may take longer than anticipated. We currently expect two more rate hikes this year before the Fed pauses to evaluate the impact of cumulative tightening.

Entering March, the fixed income allocation strategy is overweight Floating Rate Notes, U.S. High Yield Bonds, and International Investment Grade, while Emerging Market Bonds, Treasury Inflation-Protected Securities, Mortgage-Backed Securities, and U.S. Investment Grade Corporate are underweight.

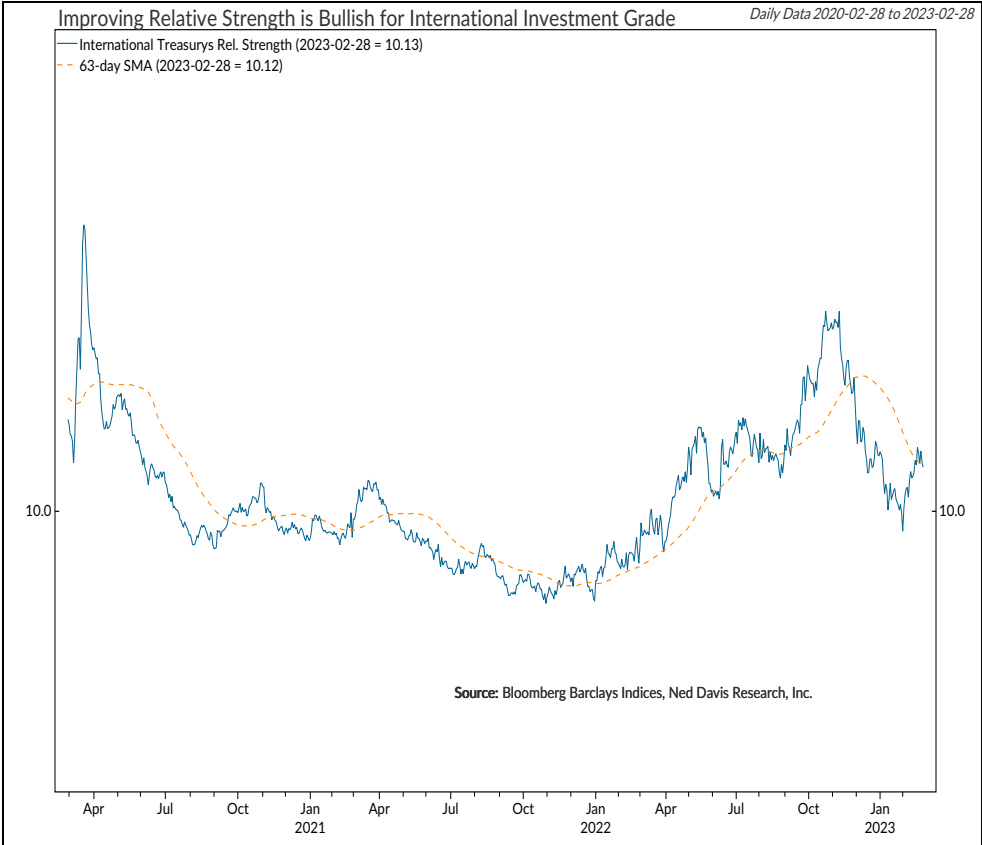


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Floating Rate Notes' allocation rose sharply in March, moving from the largest underweight to the highest overweight position. Floating rate notes typically outperform during a rising rate environment—yields across the board backed up in February. Trend, relative price momentum (chart right), and spreads turned bullish for the sector.



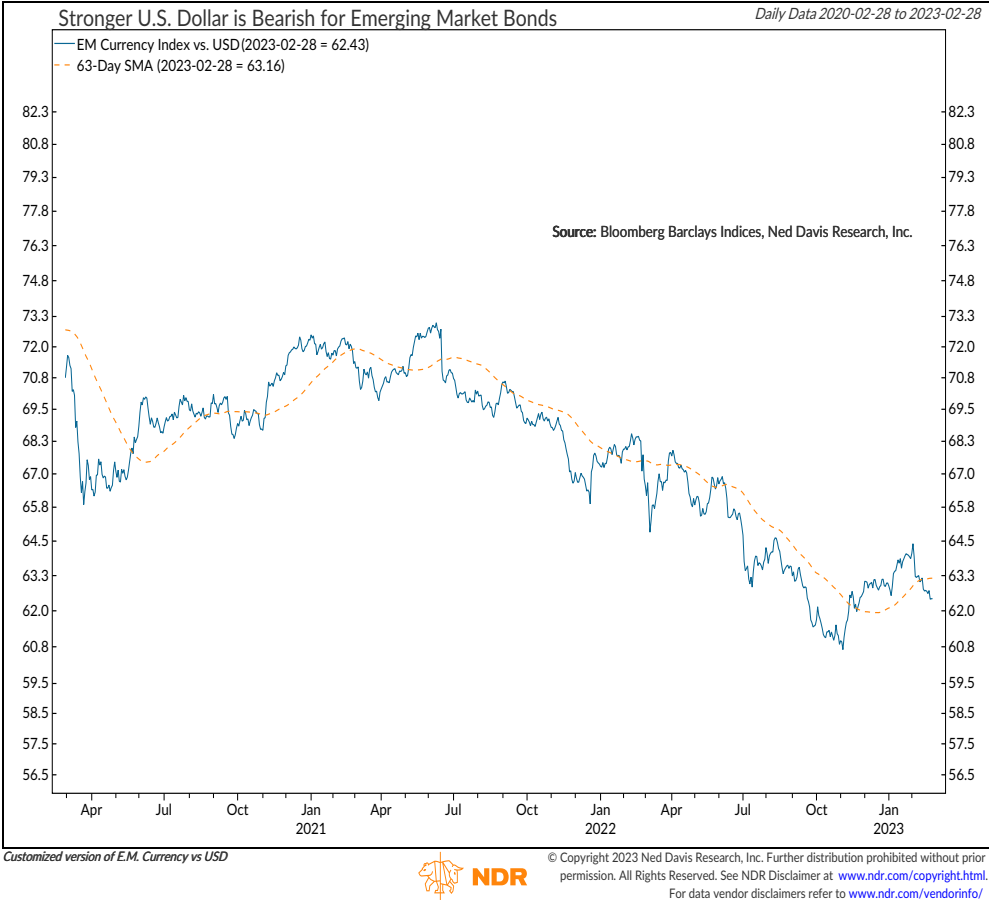
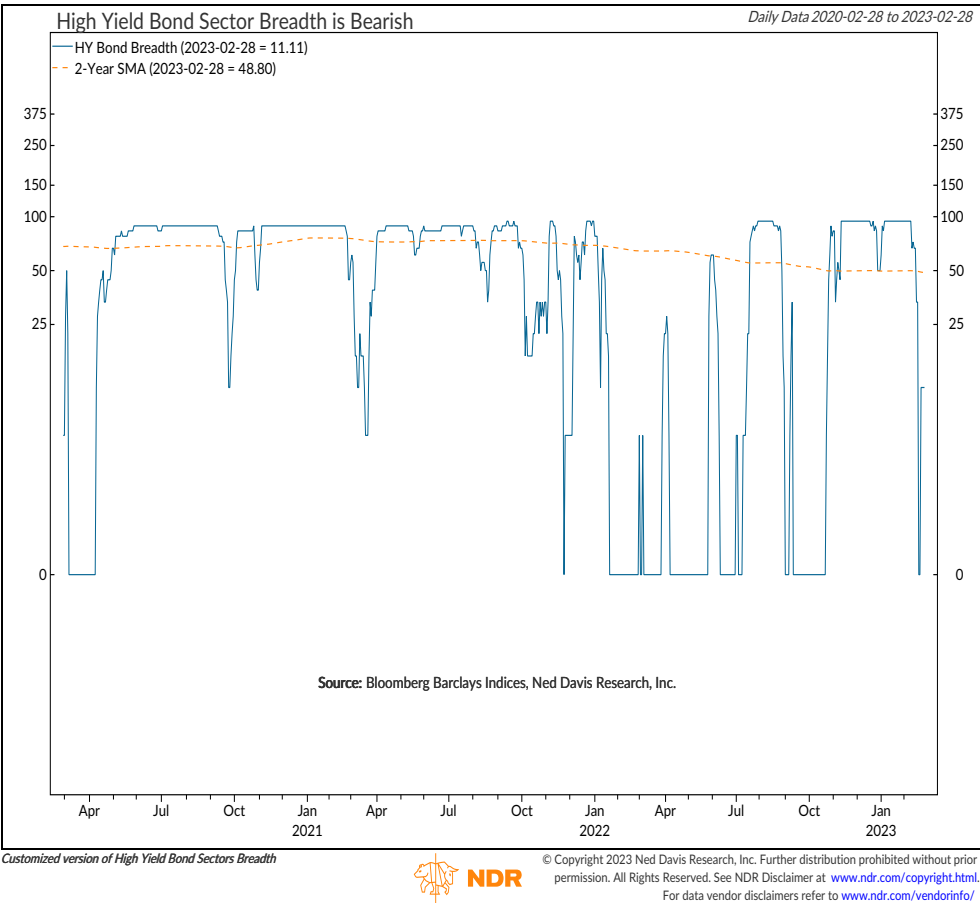
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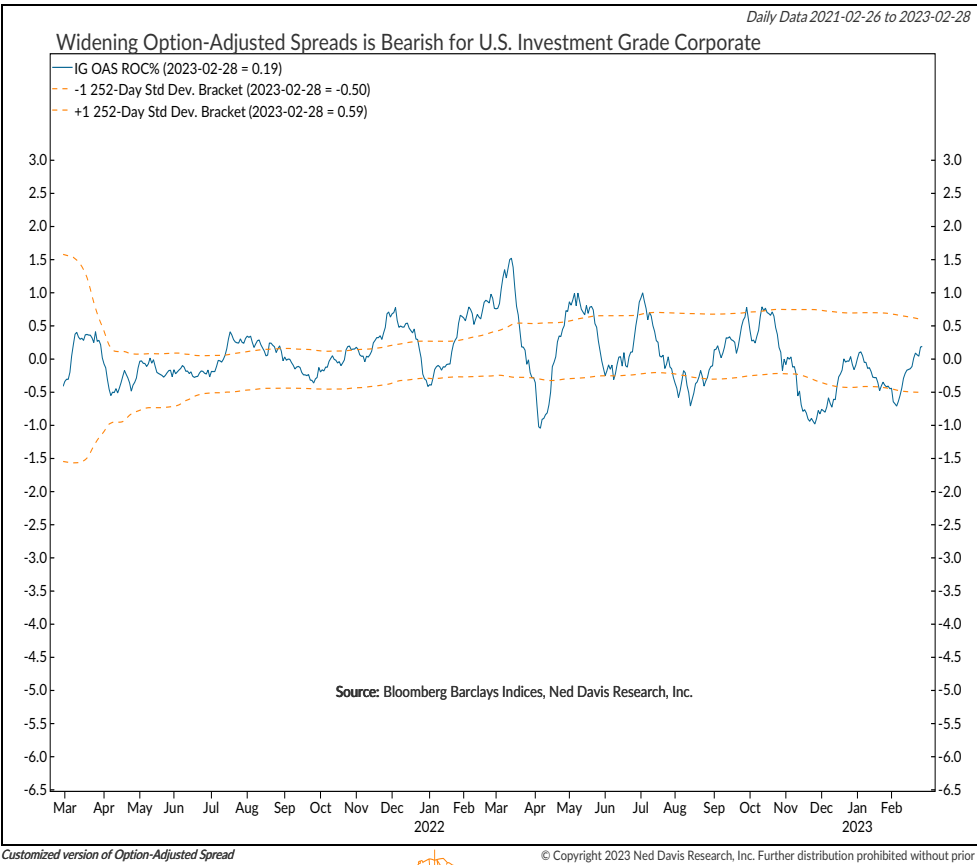
International Investment Grade bond allocation rose, moving it from an underweight to an overweight. The majority of fundamental and technical indicators, such as improving relative strength (chart left) are now bullish for the sector.

Allocation to High Yield bonds declined a bit in March but remained overweight. While technicals, the small-cap equity trend, and sentiment measures were bullish for the sector, breadth (chart right) and absolute price moved bearish.

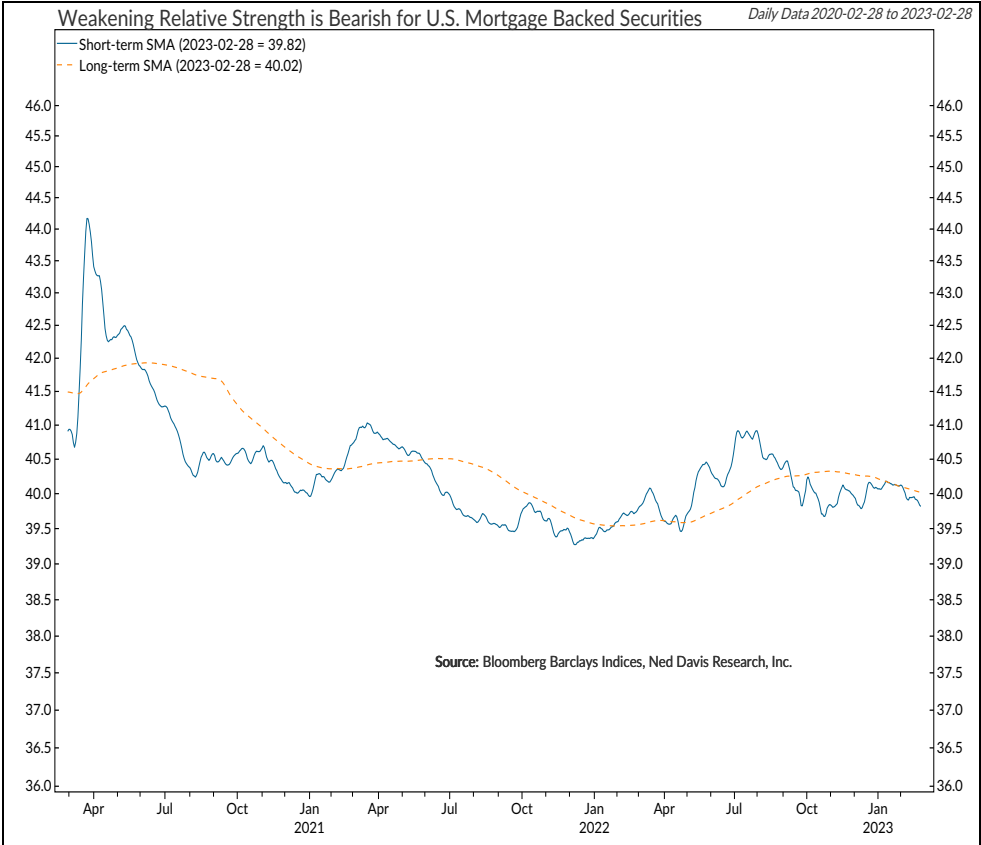


Emerging Market (EM) bonds' allocation dropped sharply in March, moving the sector from an overweight to an underweight. The main culprit was the U.S. dollar rally in February. Due to the inverse relationship with Emerging Markets, a stronger dollar relative to EM currencies is a bearish condition for both emerging market equities and bonds (chart left).

The model's allocation to U.S. Investment Grade Corporate saw a sharp drop in March, which pushed it from the largest overweight position to an underweight allocation. Three of the six indicators changed last month—the stronger U.S. dollar (bullish for the sector) was more than offset by widening spreads (chart right) and weakening technicals.



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Mortgage-Backed Securities' allocation dropped sharply, moving it from a modest overweight to an underweight position in March. With mortgage rates rising during February, four of the six indicators are now bearish for the sector. All three technical measures are bearish—the relative strength moving average cross indicator (chart left) joined the other two this past month.

Summary

With yields across the board rising in February, fixed income sectors suffered. Floating Rate Notes and International Investment Grade improved to overweight, while U.S. Investment Grade Corporate bonds dropped to underweight. Additionally, a rising U.S. dollar led to Emerging Market bond underperformance and an underweight allocation.

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