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Fixed Income Allocation Strategy

FEBRUARY 2024

Fixed Income Market Update

After the strong performance by the Bloomberg Barclays U.S. Aggregate Bond Total Return Index in November and December, the index dropped modestly in January (-0.275%). Breadth weakened—five of the nine fixed income sectors we track had negative returns in January with long-term Treasurys' performance the weakest.

In January, central bankers and economic data pushed back on market expectations of early rate cuts. In the U.S., better-than-expected data on retail sales, consumer sentiment, and unemployment claims, and comments from several Fed officials ran counter to a March rate cut that was nearly fully priced in before the Martin Luther King, Jr. holiday. As a result, markets unwound their Powell pivot rally.

As expected, at the late January meeting, the FOMC left the fed funds target range at 5.25% to 5.50%. Fed Chair Powell said March was not their base case for a rate cut. We affirmed our Q2 call, most likely in May, for the first cut. Ten-year Treasury yields have always fallen during the three months before the first rate cut going back to 1970. With the 10-year yield below 4.00%, yields should test their December lows, at a minimum and our message has been to buy backups in yield (chart below).

Entering February, the fixed income allocation strategy continued to favor risk-on leadership but did rebalance. The model remained overweight Emerging Market bonds, U.S. High Yield, U.S. Investment Grade Corporate, and U.S. Mortgage-Backed Securities. U.S. Long-Term Treasurys improved from underweight to marketweight. The model remained underweight U.S. Floating Rate Notes, U.S. Treasury Inflation-Protected Securities, and International Investment Grade.

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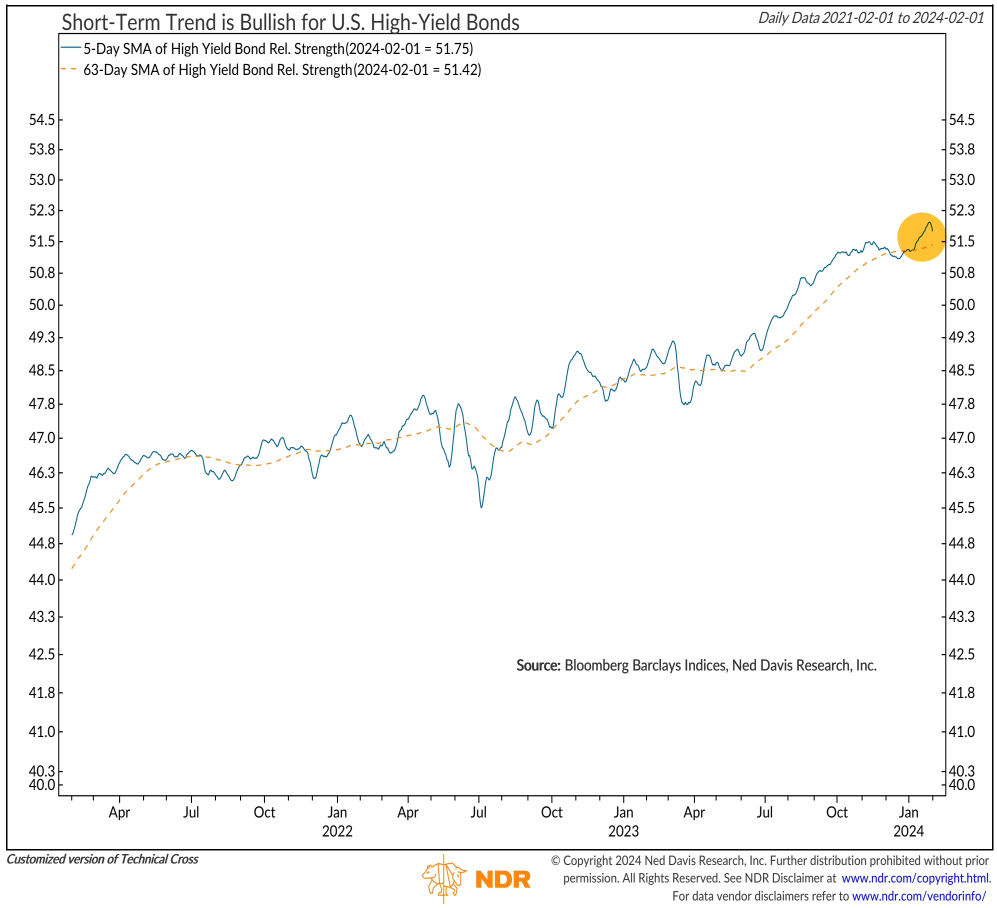
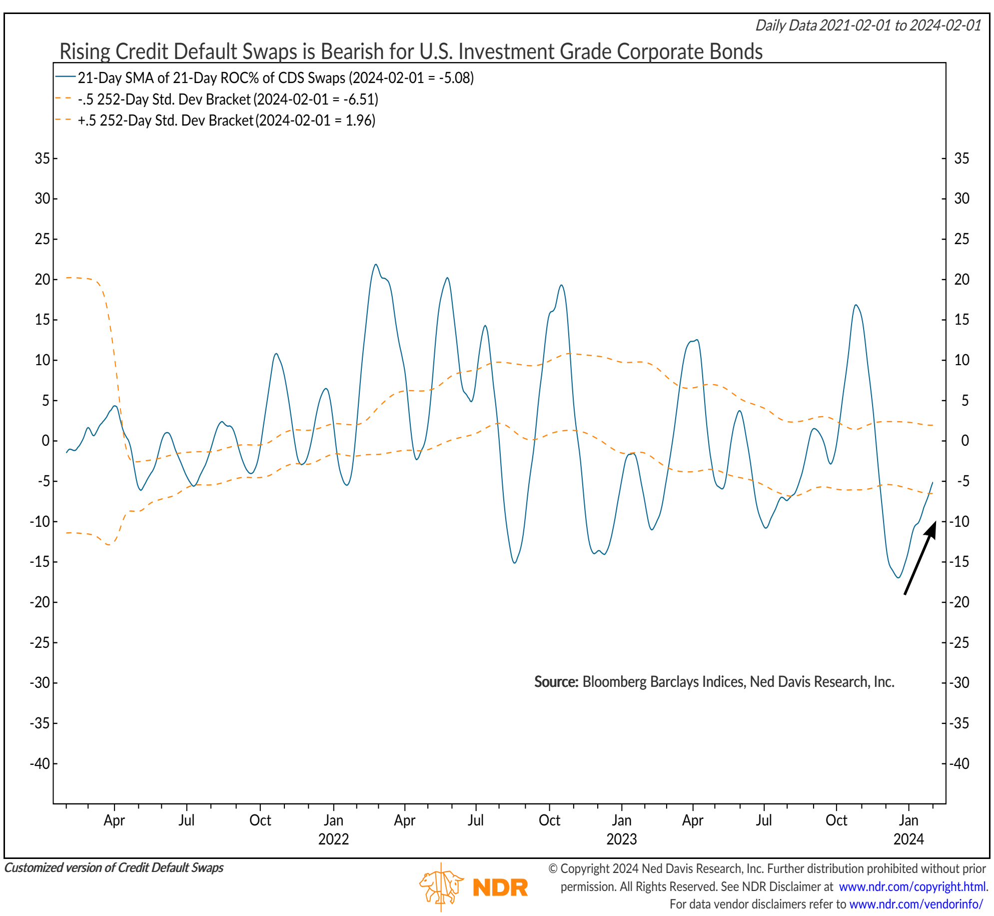
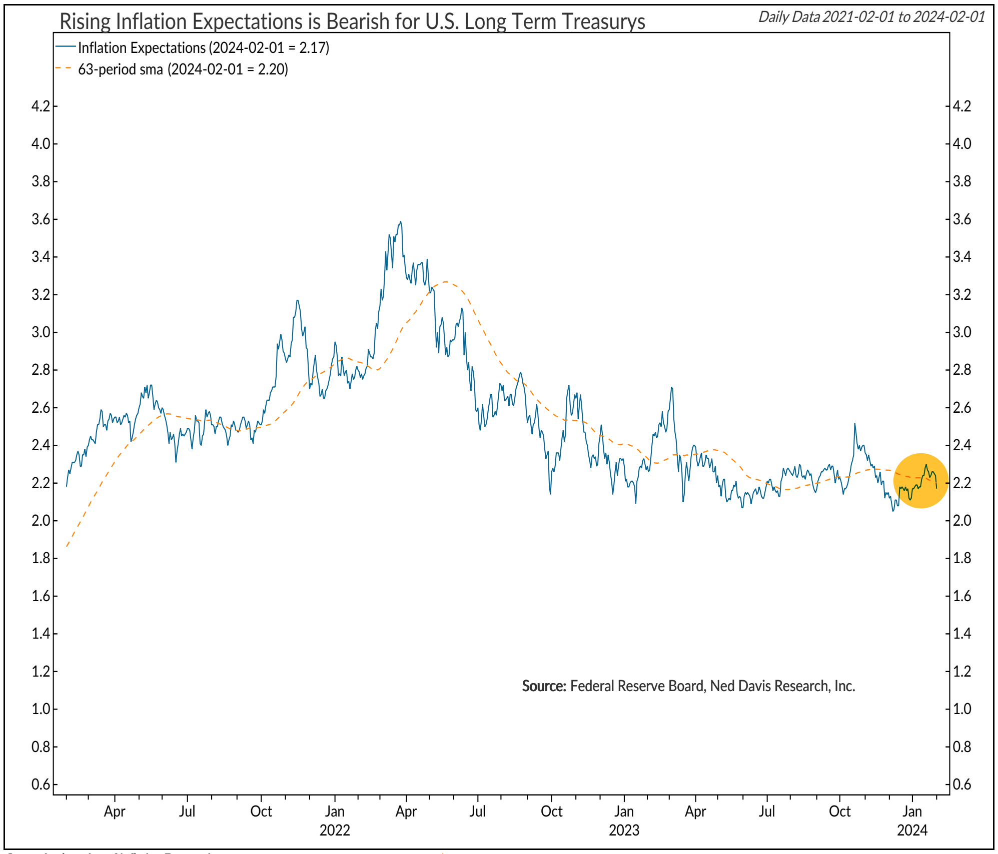
U.S. High-Yield bonds' allocation rose sharply and is now the largest overweight. All six indicators remain bullish for the sector. On a fundamental basis, the trend in small-cap equities and investor sentiment as measured by both the VIX and option-adjusted spreads are bullish. This is confirmed by bullish technicals including breadth and trend (chart right).

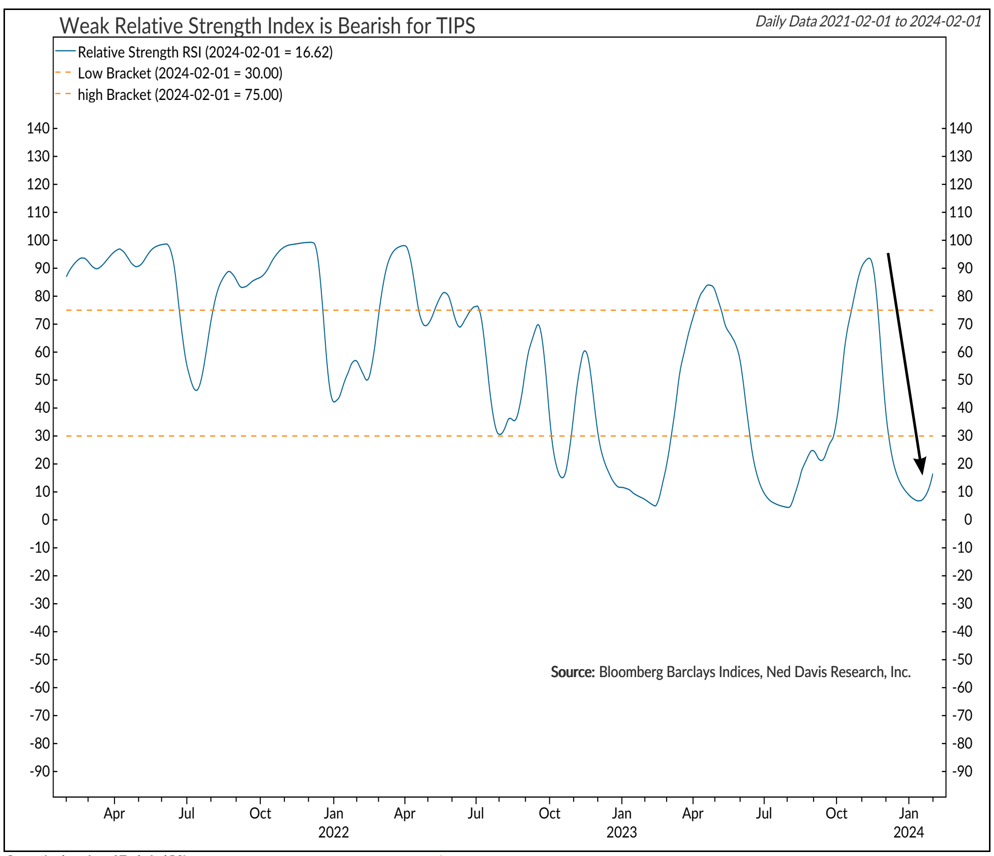




U.S. Investment Grade Corporate bond's allocation dropped but remained at overweight. Four of six indicators remain bullish, but two indicators changed during the month—the bullish trend in the U.S. dollar was offset by rising credit default swaps (chart left).

U.S. Long-Term Treasurys' allocation improved and was upgraded to marketweight from underweight. Price-based measures are now mixed—trend remains bullish while momentum moved neutral during the month. While rising inflation expectations moved bearish for the sector during the month, it has recently moved back to a bullish reading (chart right).





While U.S. Floating Rate Notes' allocation rose sharply, U.S. Treasury Inflation-Protected Securities' (TIPS) allocation dropped sharply—both remain at underweight. Commodity price trends and high-yield option-adjusted spreads remain headwinds for TIPS. These bearish measures are being confirmed by TIPS' weak technicals including the relative strength index (chart left).

Summary

Entering February, the fixed income allocation strategy continued to favor risk-on leadership. The model remains overweight Emerging Market bonds, U.S. High Yield, U.S. Investment Grade Corporate, and U.S. Mortgage-Backed Securities. U.S. Long-Term Treasurys improved to marketweight. The model remains underweight U.S. Floating Rate Notes, U.S. Treasury Inflation-Protected Securities, and International Investment Grade.

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