NDR
NED DAVIS RESEARCH

Fixed Income Allocation Strategy

OCTOBER 2023

Fixed Income Market Update

The Bloomberg Barclays U.S. Aggregate Bond Total Return Index was down for the fifth month in a row, dropping 2.5% in September. Breadth remained weak—seven of the nine fixed income sectors we track had negative returns in September—significant weakness in U.S. Treasurys again dragged down the Aggregate.

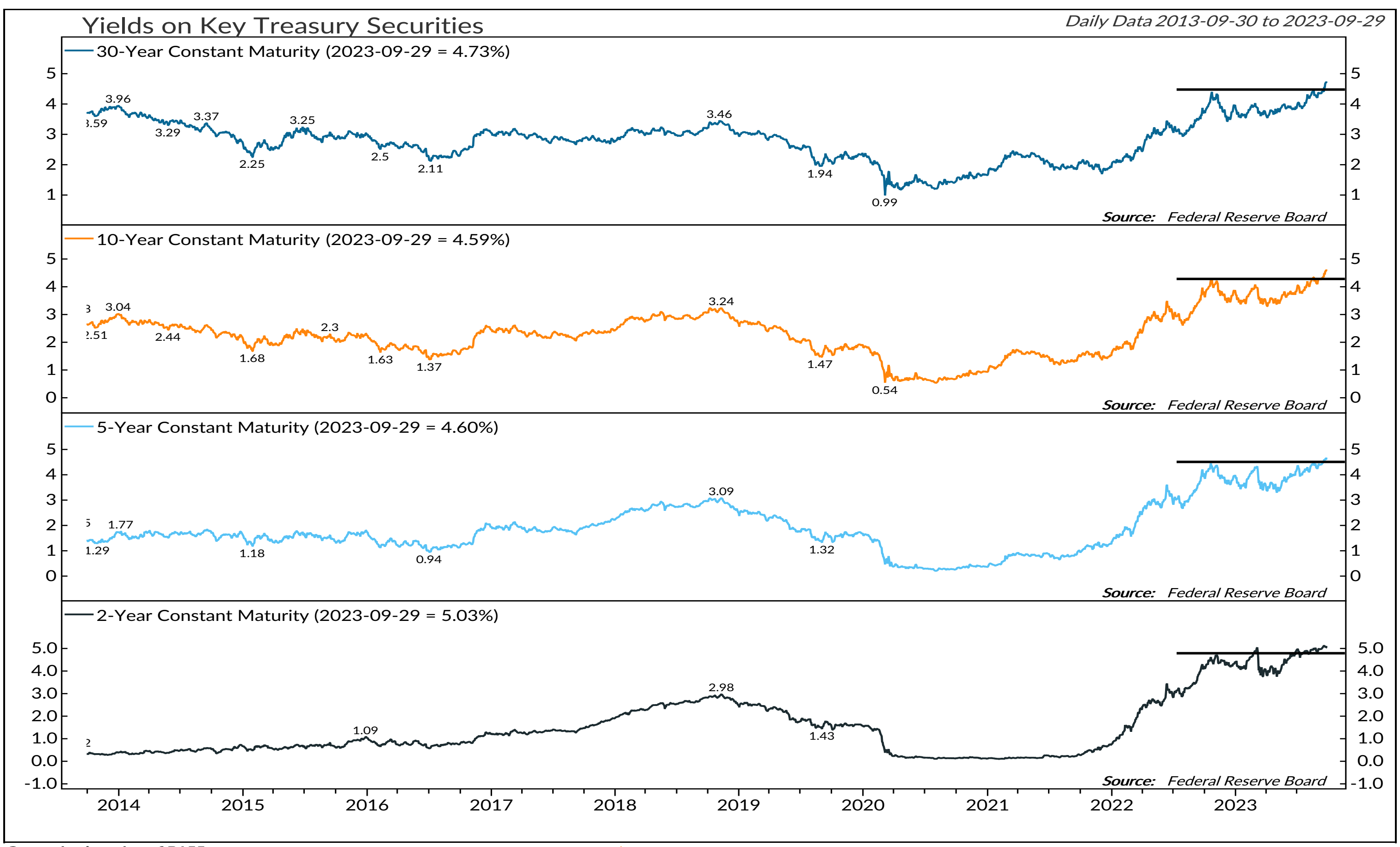
Sticky inflation, rising oil prices, and tight labor markets have been pushing yields higher all summer. Economic growth is likely to slow in Q4 and in 2024 (due to student loan repayments, strikes, etc.), labor markets should cool and get back into balance, and impacts from credit tightening should be increasingly felt.

In September, the Fed surprised the markets by reaffirming its projection for another rate hike this year, and indicating two fewer rate cuts next year, even though inflation was revised lower for 2023. The Fed successfully communicated a “restrictive for longer” policy stance.

The Fed’s policy projections had two important implications. One, is the pricing in of higher rates in the front due to a higher terminal rate than the market had been expecting.

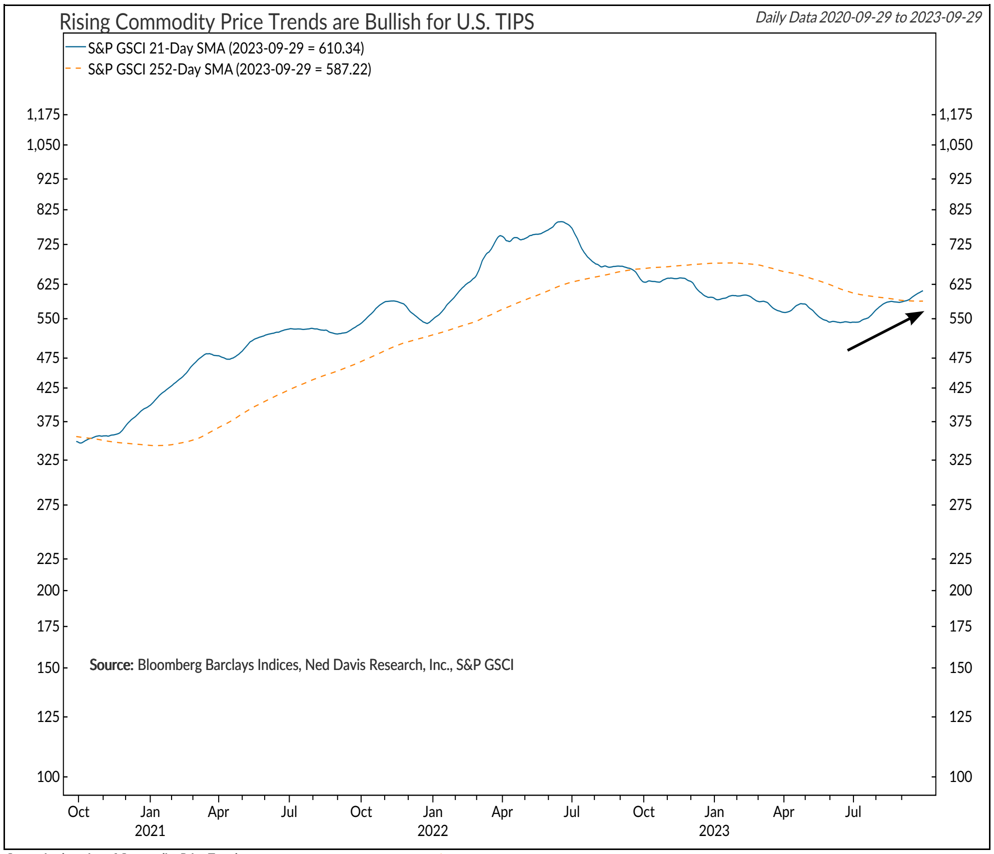
Two, is a steeper yield curve, since yields will be higher next year than previously thought. As a result, yields broke out across the curve and around the world (chart below), while yield curves steepened.

As a result, entering October, the fixed income allocation strategy rebalanced and favored mixed leadership. The model is overweight U.S. Floating Rate Notes, International Investment Grade, and U.S. Treasury Inflation-Protected Securities. U.S. High Yield and Emerging Market bonds were downgraded to marketweight. The model is underweight U.S. Investment Grade Corporate, U.S. Long-Term Treasurys, and U.S. Mortgage-Backed Securities.

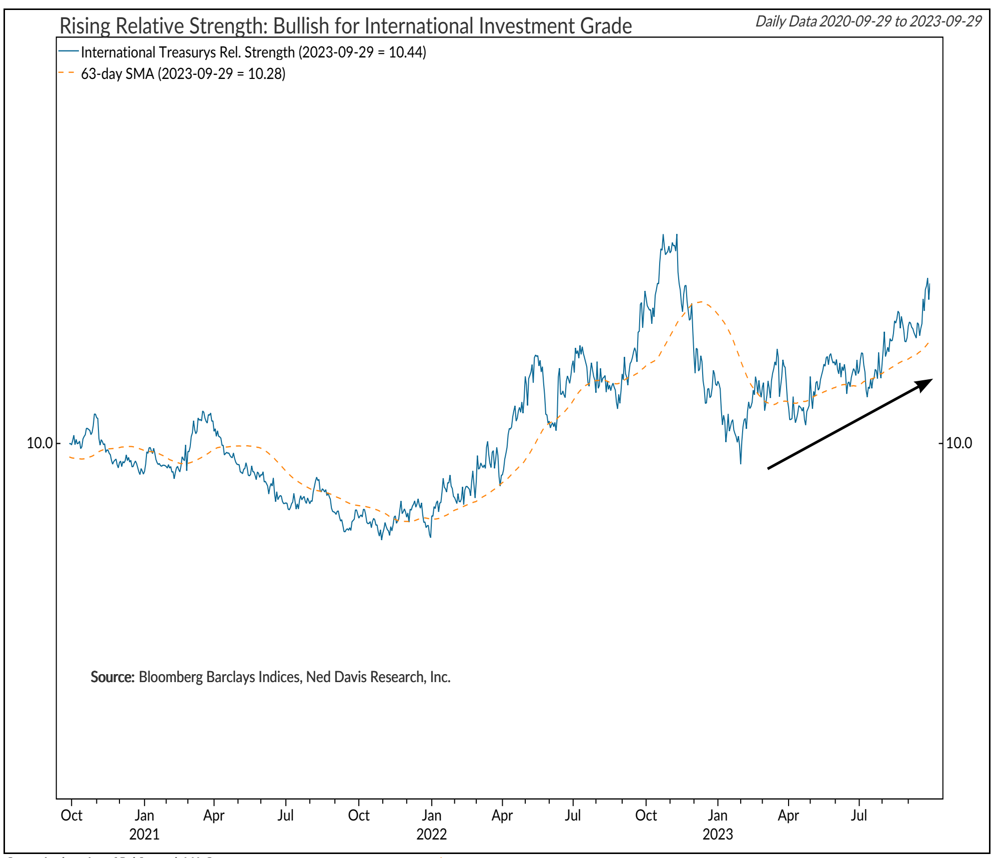


Customized version of B155

U.S. Treasury Inflation-Protected Securities' (TIPS) allocation rose over 600 basis points in September, upgrading it from a significant underweight position to a modest overweight. Similar to U.S. Floating Rate Notes (which increased its overweight allocation by over 500 basis points), TIPS typically outperform when inflation is high (which then leads to higher interest rates). While inflation is down from its peak, there are still areas that are sticky. Commodity prices—led by energy—are rising and has provided a tailwind for the sector (chart right). This positive development was confirmed by two relative strength measures flashing bullish signals during the month.



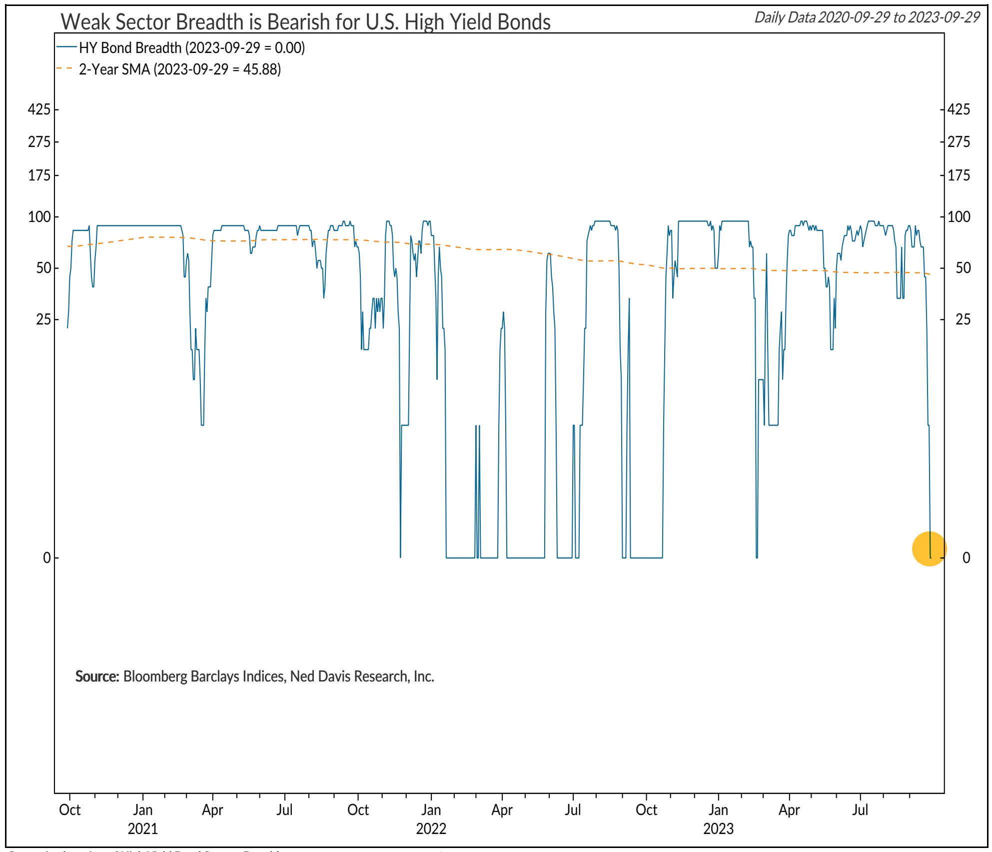
Customized version of Commodity Price Trends



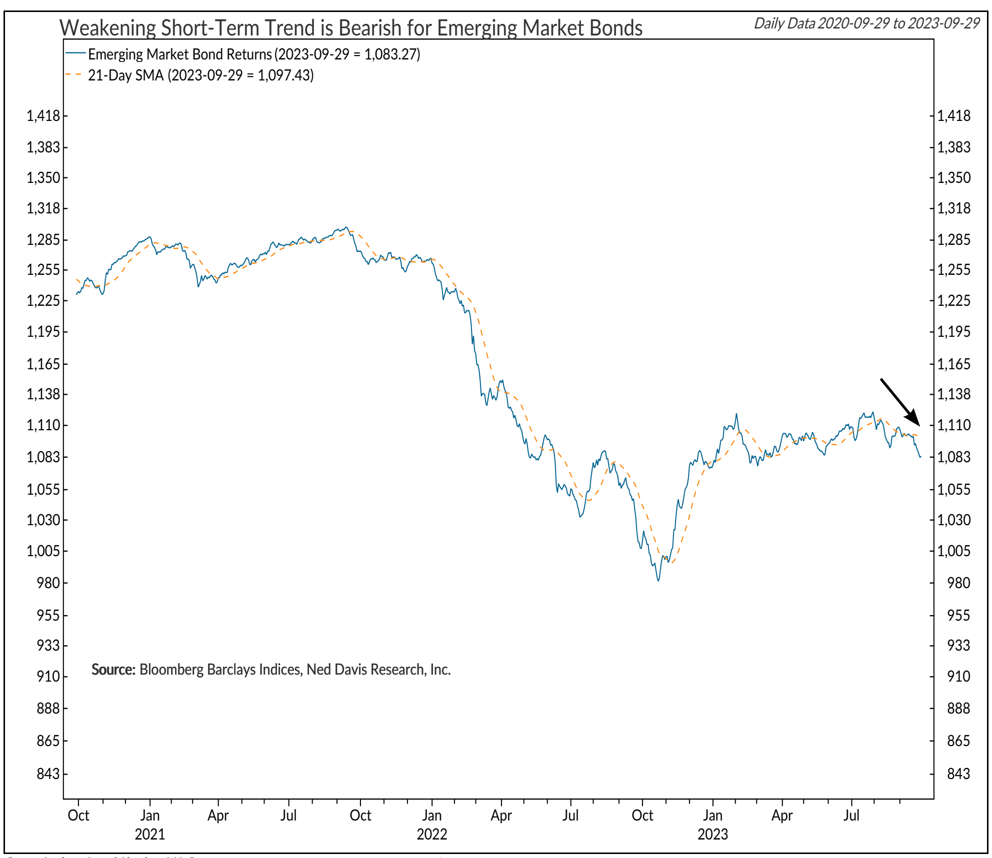
Customized version of Rel Strength MA Cross

International Investment Grade bonds' allocation was up over 350 basis points in September, upgrading it to overweight. While global option-adjusted spreads and U.S. swaps remain neutral, equity volatility is bullish. This was confirmed by two bullish price-based measures including rising relative strength trends (chart left).

U.S. High Yield bonds' allocation dropped over 600 basis points in September, downgrading it from the largest overweight position to marketweight. Four of six indicators are now bearish, with two flipping negative during the month—absolute trend and breadth (chart right).



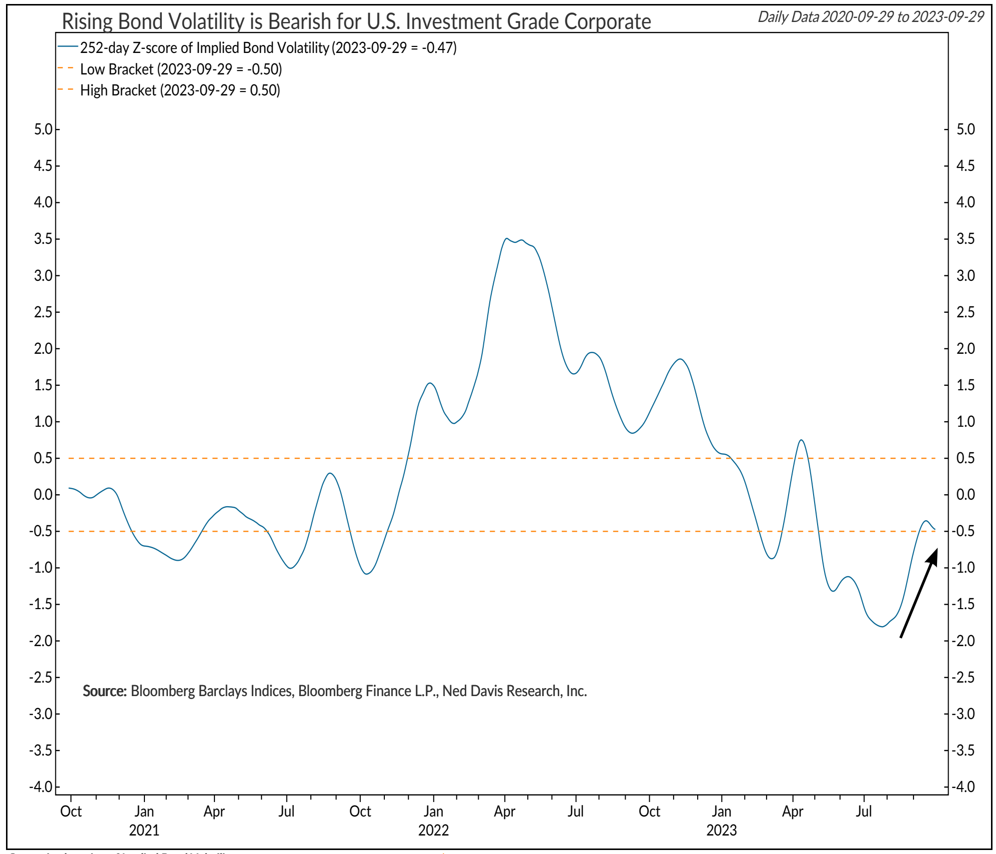
Customized version of High Yield Bond Sectors Breadth



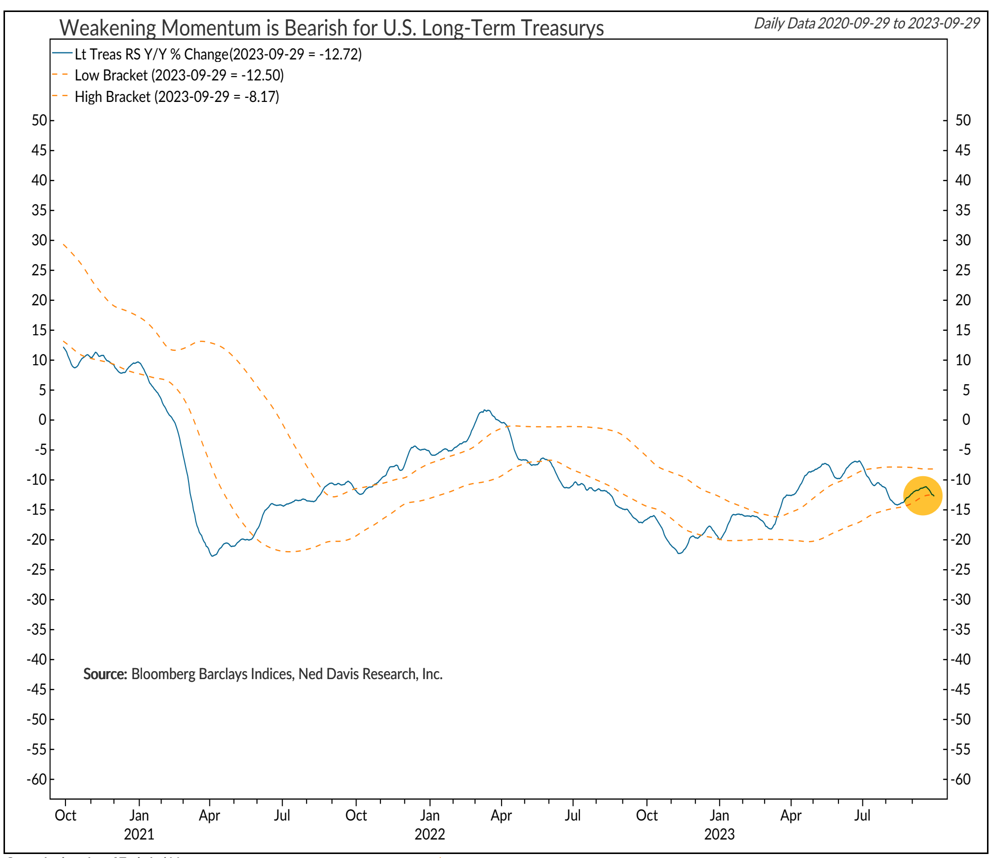
Customized version of Absolute MA Cross

Emerging Market (EM) bonds' allocation dropped over 450 basis points in September, downgrading it from a significant overweight position to marketweight. On a fundamental basis, while rising commodity prices is bullish for Emerging Market bonds, weakness in emerging market equity momentum and currencies have been an offset. Technicals are mixed—relative strength remains bullish, but absolute trend moved to a bearish level for the sector during the month (chart left).

U.S. Investment Grade Corporate bonds' allocation dropped over 800 basis points in September, downgrading the sector from overweight to the largest underweight position. Four of the six indicators are now bearish. While the U.S. dollar index and a mean reversion measure remained bullish for the sector, spreads, credit default swaps, and a trend indicator are bearish offsets. Additionally, implied bond volatility rose to a bearish level for the sector during the month (chart right).



Customized version of Implied Bond Volatility



Customized version of Technical Momentum

U.S. Long-Term Treasurys' allocation increased in September, but the sector remains underweight. While inflation expectations appear contained and have remained bullish for the sector since the Jackson Hole meeting, a few indicators changed during the month. The U.S. equity market trend, U.S. swaps, and sector momentum all flashed bearish signals during the month (chart left).

Summary

Entering October, 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. U.S. High Yield and Emerging Market bonds were downgraded to marketweight. The model is underweight U.S. Investment Grade Corporate, U.S. Long-Term Treasurys, and U.S. Mortgage-Backed Securities.

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