Fixed Income Allocation Strategy

MAY 2023

Fixed Income Market Update

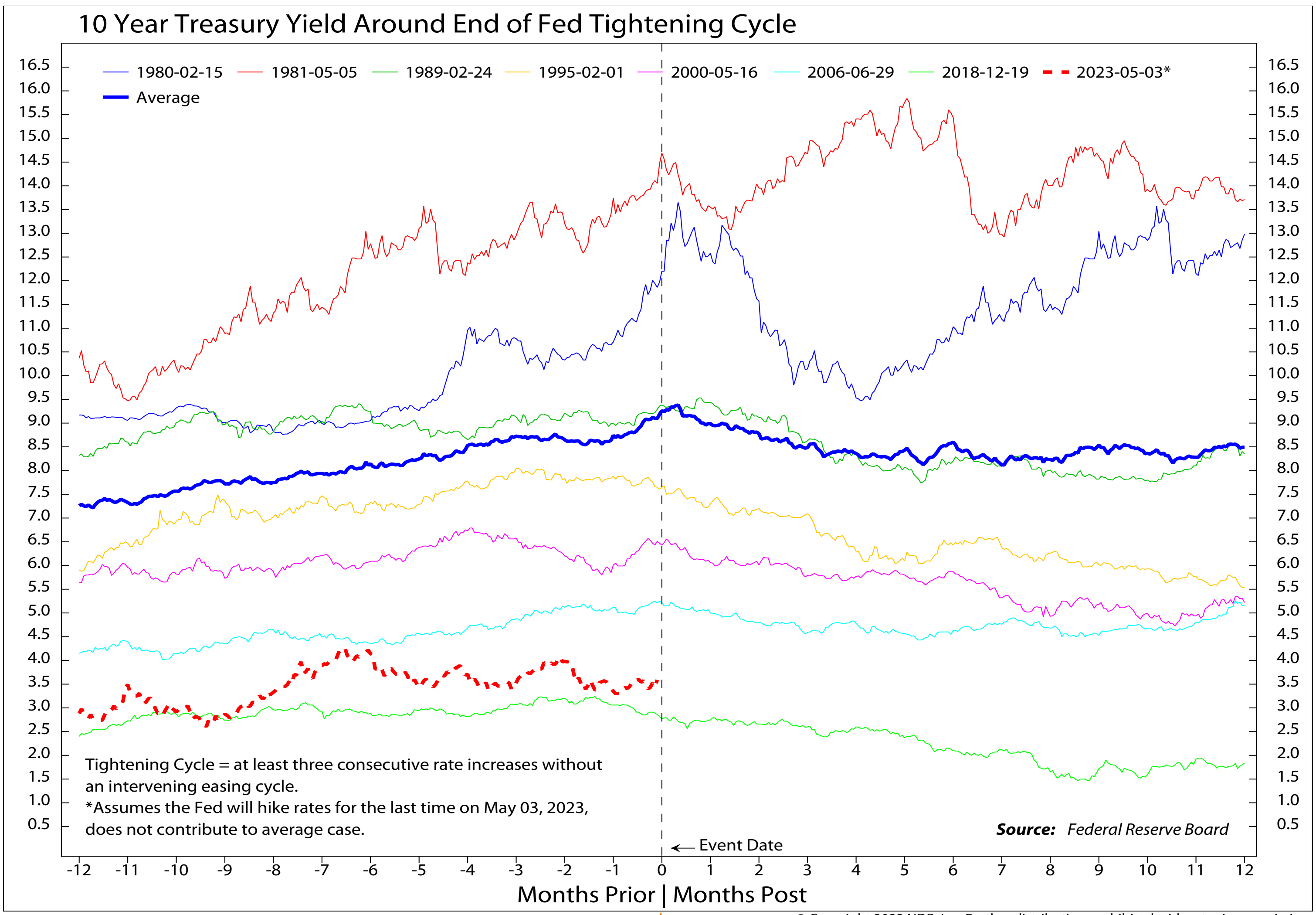
After a gain of over 2.5% in March, the performance of the Bloomberg Barclays U.S. Aggregate Bond Total Return Index moderated—the index gained less than 1% in April. Returns have been positive for six of the past 12 months. Breadth has been strong—all nine fixed income sectors we track had positive returns in April.

We expect the Fed to raise the fed funds target range another 25 basis points on Wednesday to 5.00% to 5.25%. We think it will be the last rate hike of this tightening cycle. The Fed, however, will want to preserve its optionality—just in case the economic data doesn't come in as expected before the next meeting in mid-June. Quantitative tightening will continue to roll on.

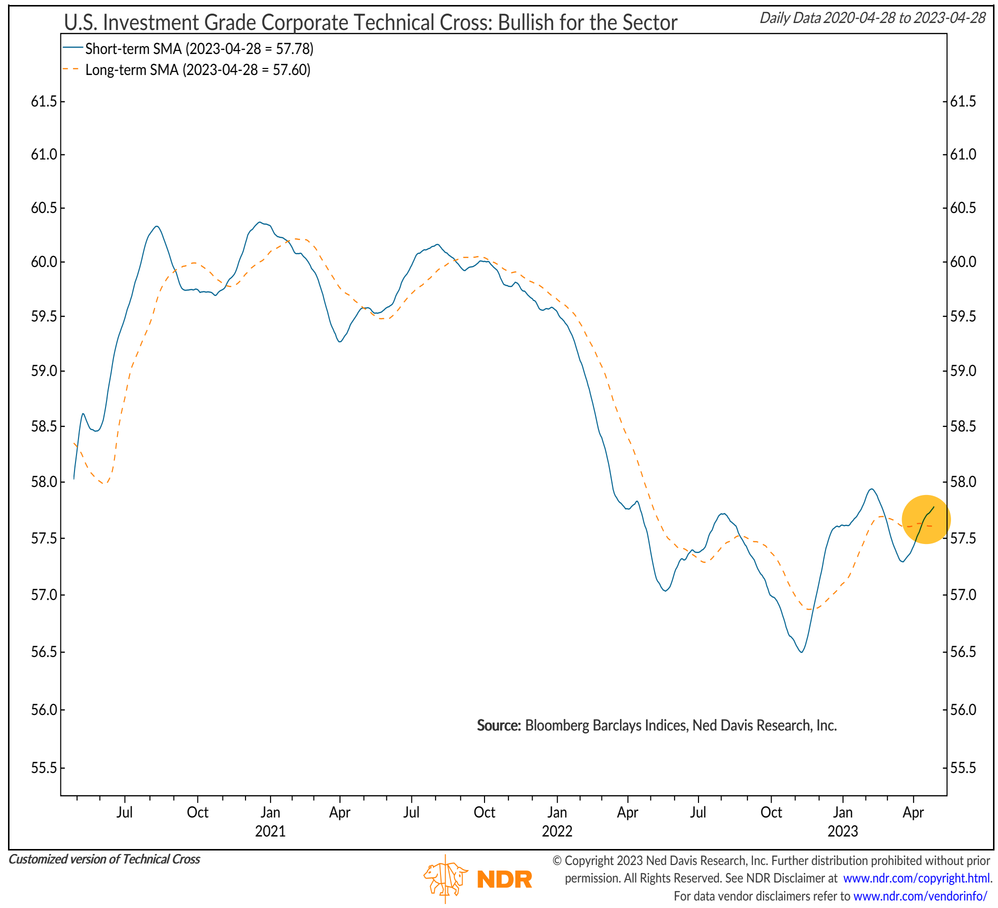
Although this has been the most aggressive Fed tightening cycle in history, we never started out in such a deep hole in terms of the real fed funds rate. The Fed hopes inflation comes down to allow the real fed funds rate to rise above 1.5% and prays that nothing else breaks.

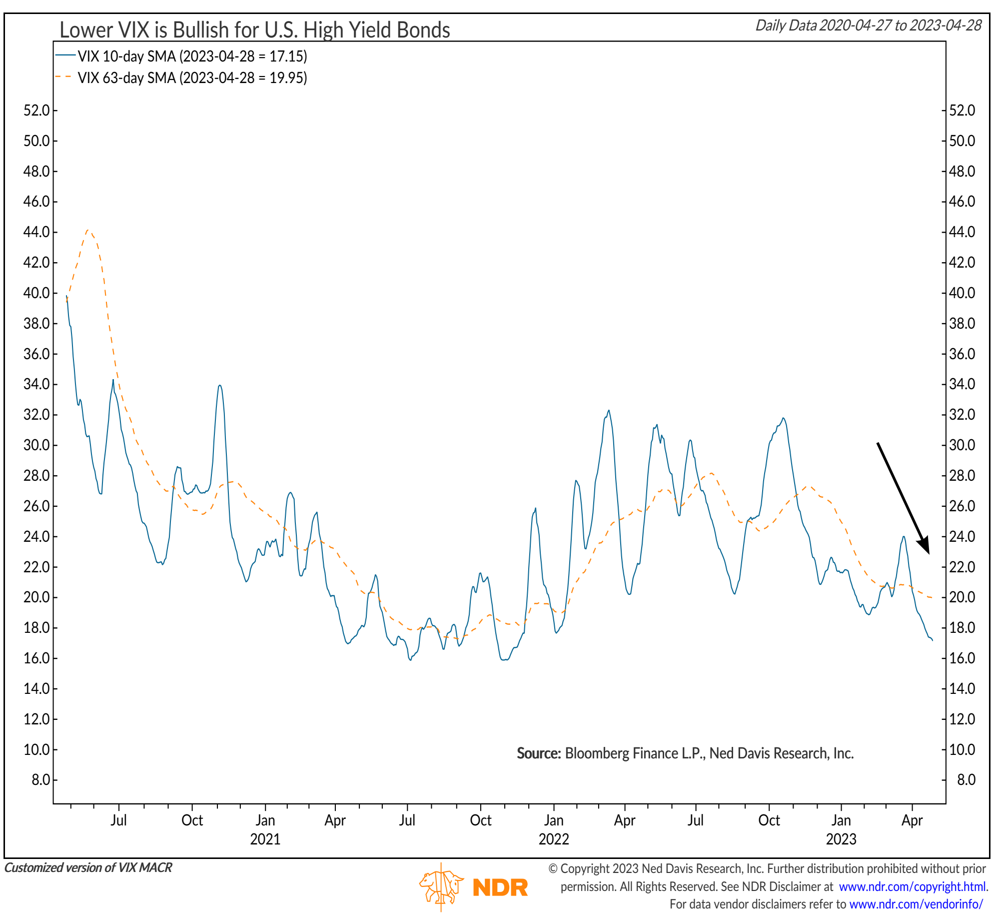
Looking at history, typically yields fall and the yield curve steepens after the end of the tightening cycle (chart below). This will have implications for fixed income sector leadership.

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



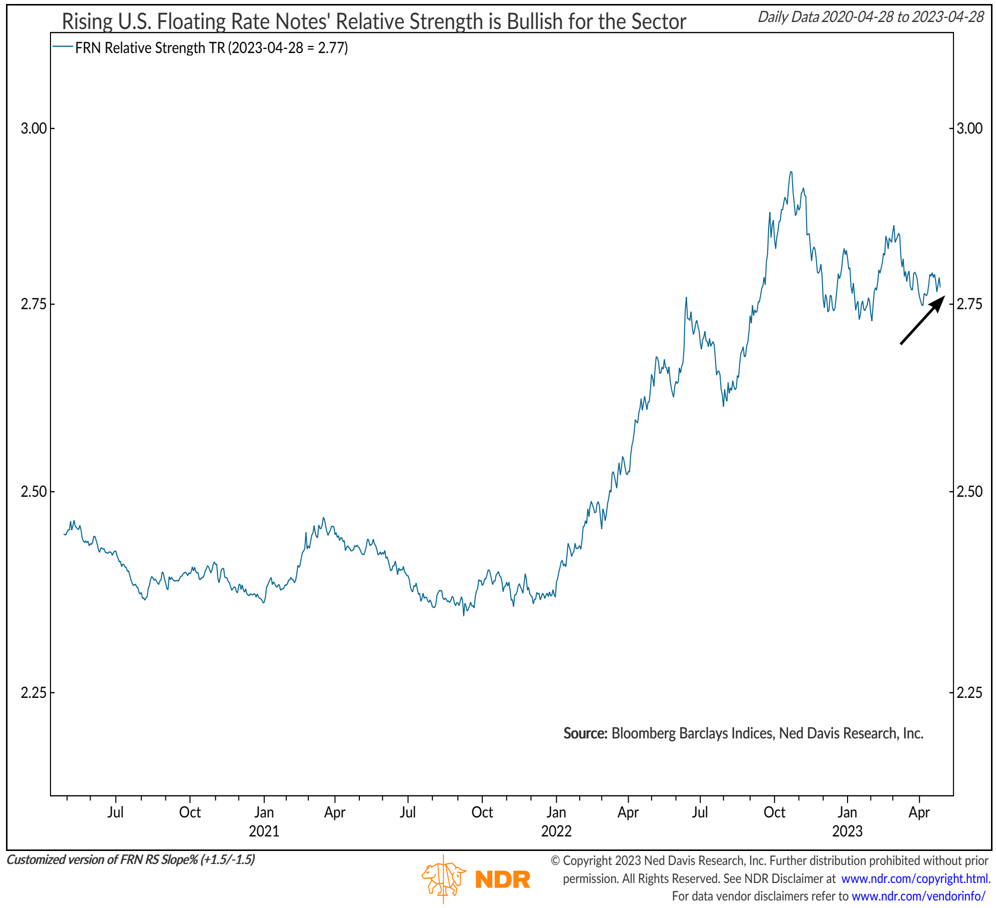
U.S. Investment Grade Corporate's allocation improved from neutral to overweight. Implied volatility and credit default swaps both moved bullish during the month. This was confirmed by technicals, as the short-term moving average crossed above the long-term moving average, a bullish signal for the sector (chart right).

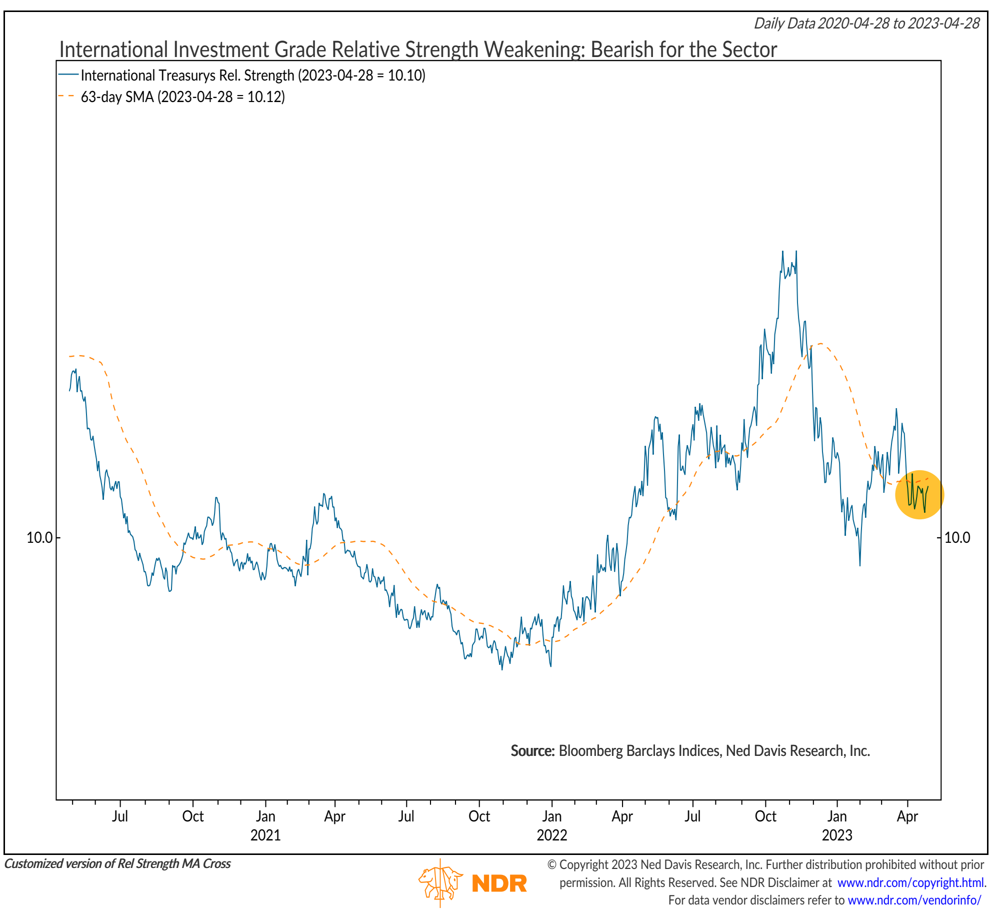




High Yield bonds' allocation rose sharply in April, moving it from underweight to overweight. Indicators are mixed. Bullish breadth and absolute trend are offset by a weaker small-cap equity trend and moving average cross measure. One indicator improved to bullish last month—lower short-term market volatility, which indicates investors' appetite for riskier assets (chart left).

Floating Rate Notes' allocation improved slightly but remains the largest underweight position. Floating rate notes typically outperform during a rising rate environment—yields have recently been in a trading range. Four of five indicators remain bearish. The only improvement this past month was from the relative strength slope indicator, which moved bullish for the sector (chart right).





International Investment Grade bond's allocation dropped sharply from the largest overweight position to a significant underweight position. While external indicators such has high-yield returns vs. inflation and U.S. swaps remained neutral for the sector, all three technical measures flipped from bullish to bearish for the sector, including international investment grade bond relative strength trends (chart left).

Summary

Unlike the stock market, investors shifted allocations to riskier fixed income sectors during April. Entering May, the fixed income allocation model is overweight Emerging Market bonds, U.S. Investment Grade Corporate, U.S. High Yield Bonds, and U.S. Treasury Inflation-Protected Securities, while Floating Rate Notes and International Investment Grade are underweight.

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