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Fixed Income Allocation Strategy

JANUARY 2024

Fixed Income Market Update

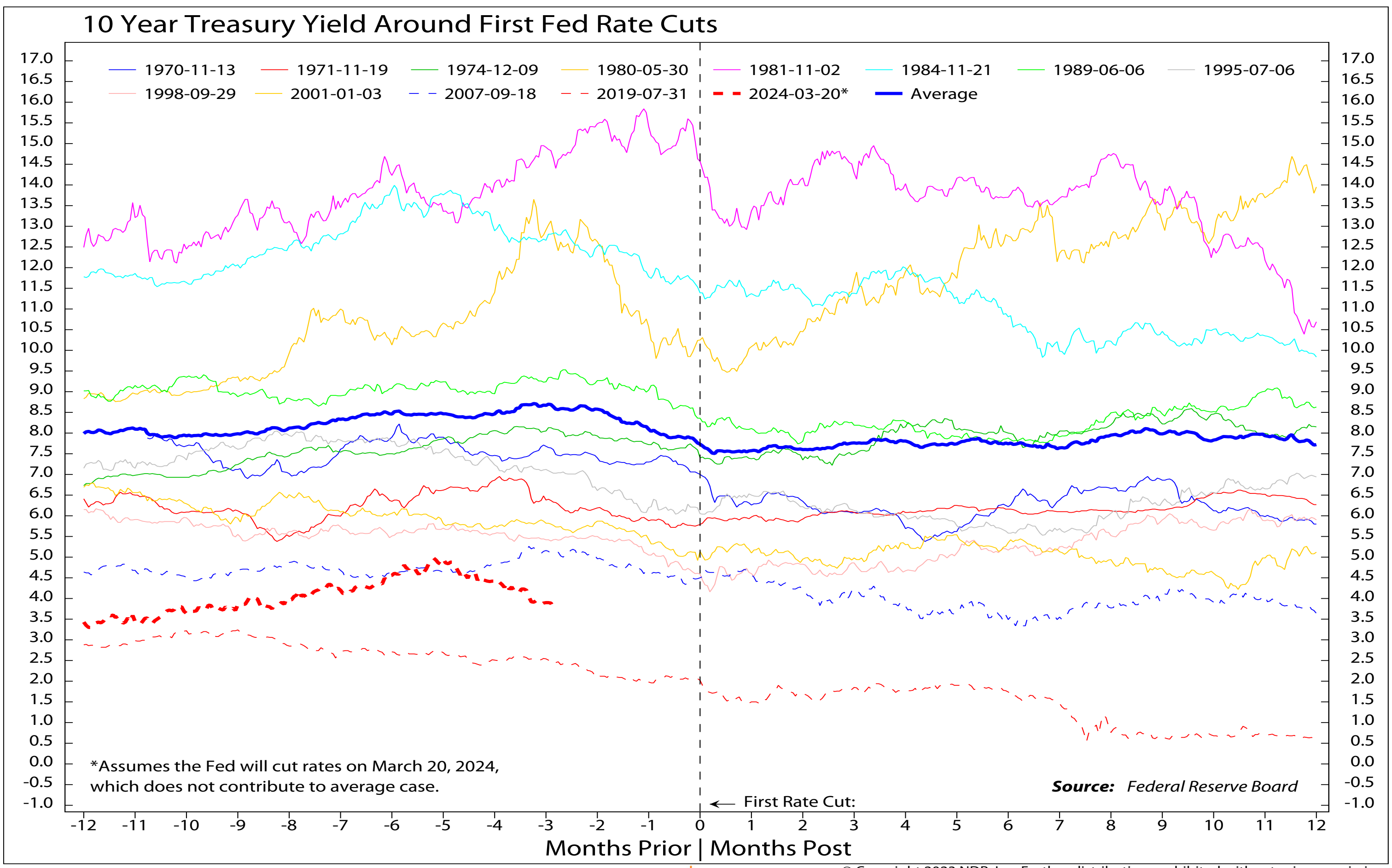
After the strong performance by the Bloomberg Barclays U.S. Aggregate Bond Total Return Index in November, the index rebounded further and gained 3.8% in December. Breadth was strong—all nine fixed income sectors we track had positive returns in December.

Ten-year Treasury yields have always fallen in the 2-3 months before the first rate cut going back to 1970 (chart below). The market is tracking a March first rate cut. After the cut, yields tend to stabilize. Over the easing cycle, 10-year Treasury yields generally declined, with a median drop of 67 basis points.

Spreads between Baa and Aaa tend to widen modestly heading into the first rate cut. Similarly, excess returns declined heading into a rate cut. Higher quality sectors generally performed well during an easing cycle. Credit spreads between Baa and Aaa were little changed in past easing cycles.

Although the TIPS market has a shorter history, they show a clear pattern of falling going into the first rate cut. And except for the Long Term Capital Management incident, real yields kept falling in the months after the first cut. Over the entire easing cycle, real yields have fallen significantly (around 100 basis points or more) except for 1998, when they rose modestly after liquidity concerns dissipated.

Entering January, the fixed income allocation strategy continued to favor risk-on leadership and didn't rebalance. The model remains overweight Emerging Market bonds, U.S. High Yield, U.S. Investment Grade Corporate, and U.S. Mortgage-Backed Securities. The model remains underweight U.S. Floating Rate Notes, U.S. Long-Term Treasurys, U.S. Treasury Inflation-Protected Securities, and International Investment Grade.



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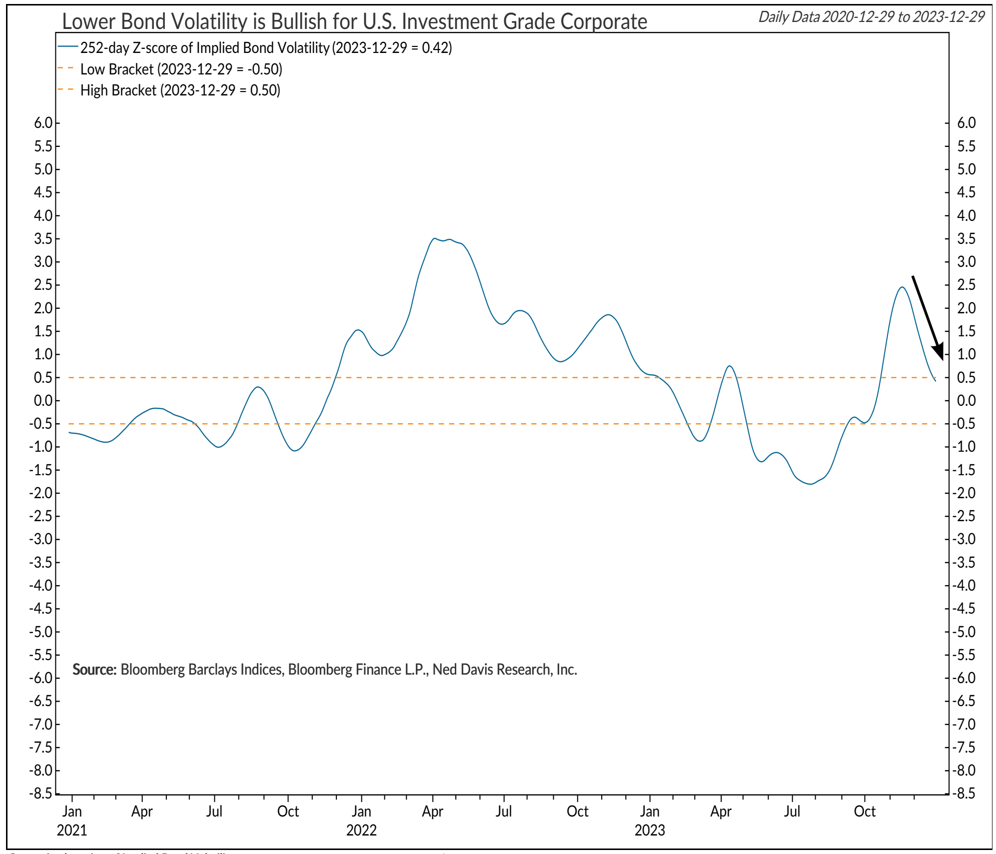
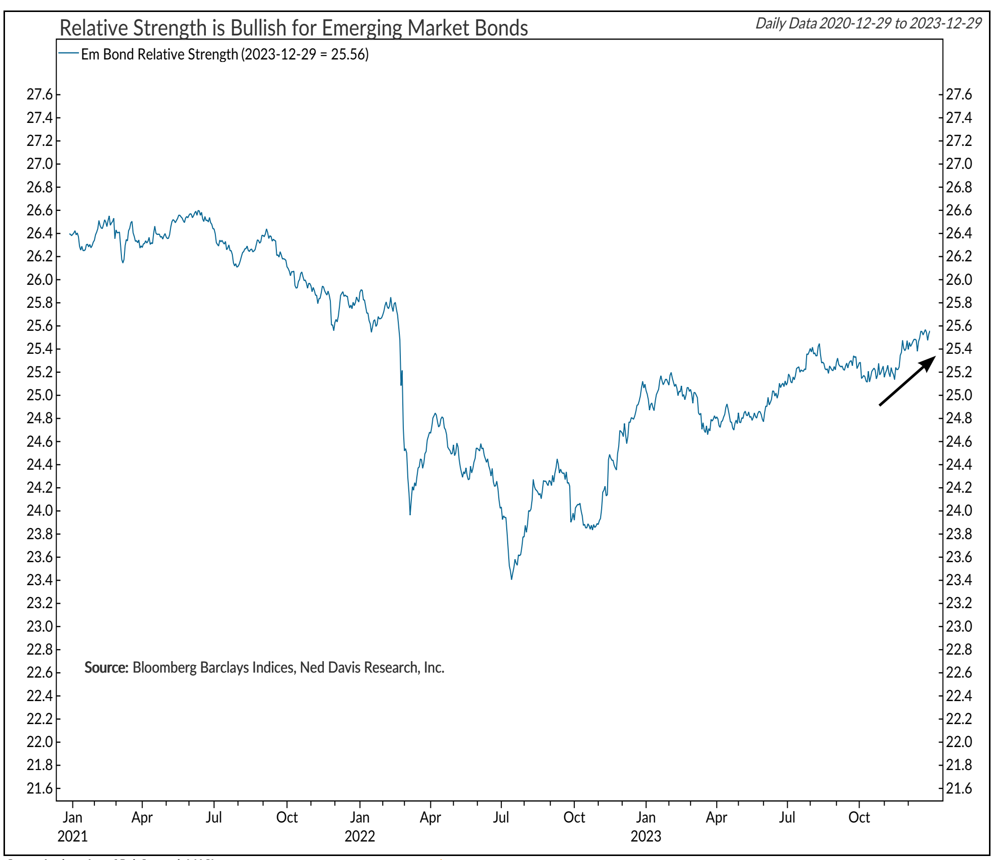
U.S. Investment Grade Corporate bonds' allocation remained steady as the largest overweight position. Four of the six indicators are bullish. Two indicators changed during the month—widening option-adjusted spreads was offset by lower bond volatility (chart right).



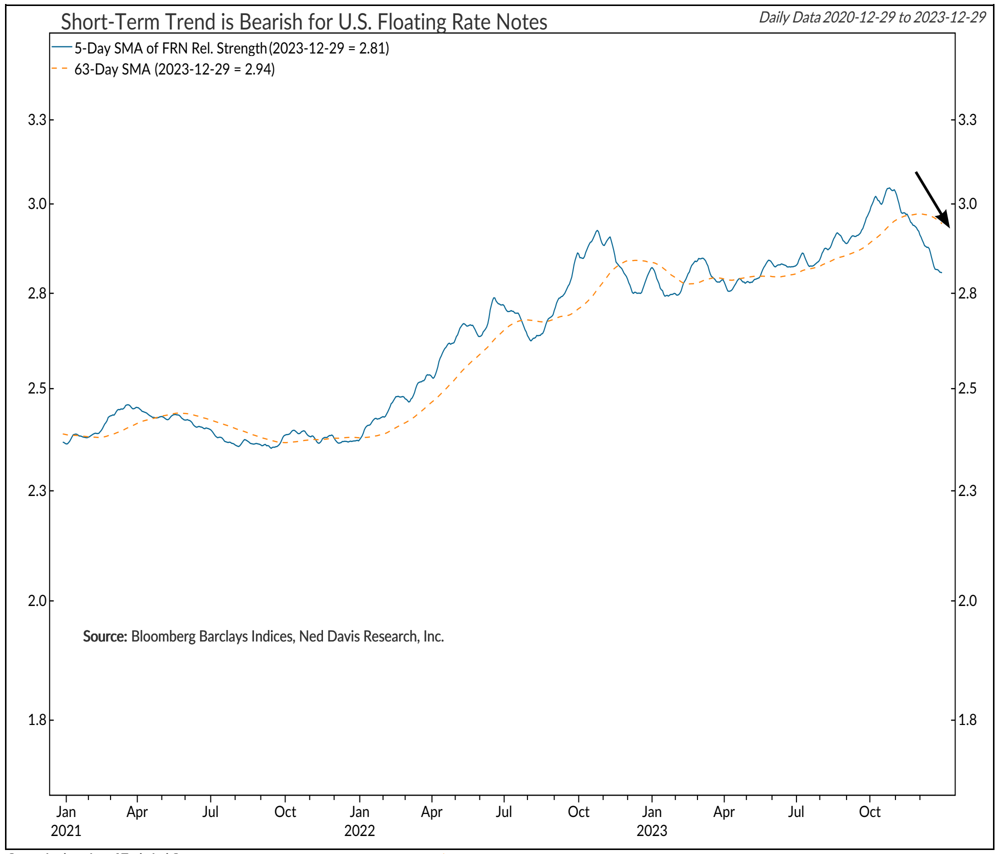
Customized version of Implied Bond Volatility



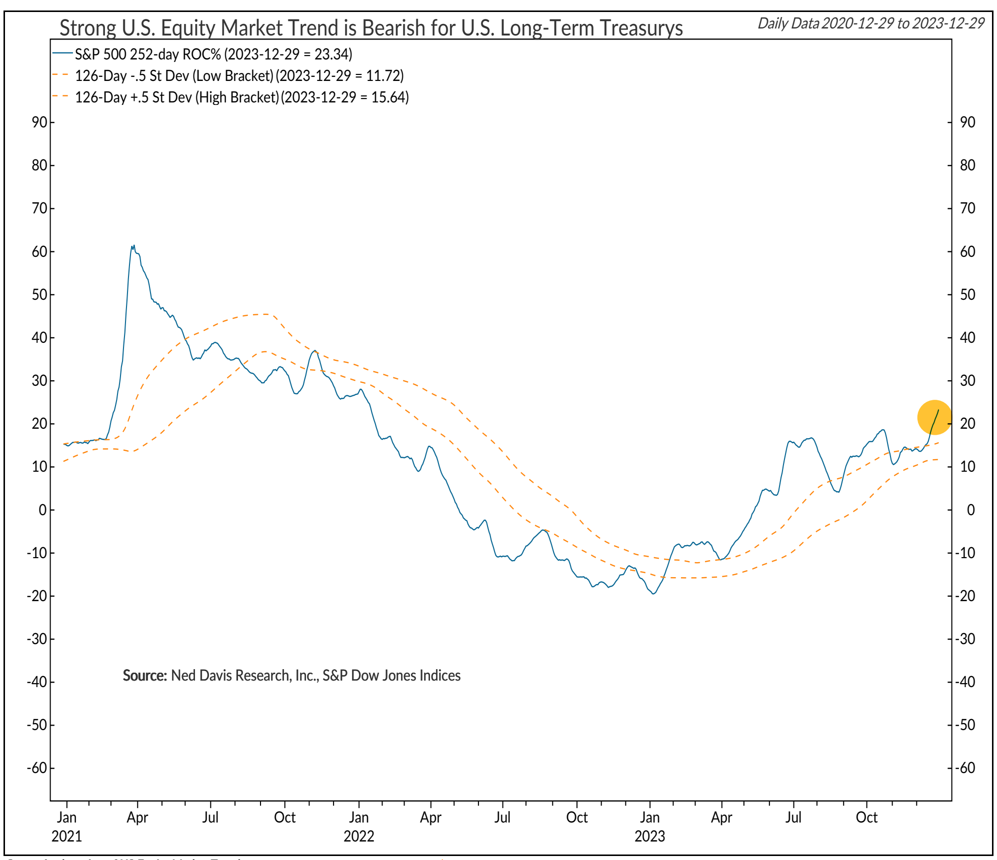
Customized version of Rel. Strength MASL

Emerging Market bonds rallied by over 4% in December. The model's allocation to the sector was steady, and it remains a significant overweight. Four of five indicators remain bullish for the sector including Emerging Market relative strength (chart left).

U.S. Floating Rate Notes' allocation remained steady as the largest underweight position. Floating rate notes typically outperform when rates are rising. With the further drop in rates in December, the sector continued to underperform. All five indicators remain bearish for the sector including short-term trend (chart right).



Customized version of Technical Cross



Customized version of US Equity Market Trend

U.S. Long-Term Treasurys' allocation remained steady at underweight. The sector's performance rebounded for the second month in a row in December, which was picked up by the two price-based measures—trend and momentum. However, the stronger trend in U.S. equities became a headwind for the sector during the month (chart left).

Summary

Entering January, the fixed income allocation strategy continued to favor risk-on leadership and didn't rebalance. The model remains overweight Emerging Market bonds, U.S. High Yield, U.S. Investment Grade Corporate, and U.S. Mortgage-Backed Securities. The model remains underweight U.S. Floating Rate Notes, U.S. Long-Term Treasurys, U.S. Treasury Inflation-Protected Securities, and International Investment Grade.

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