Advisory Blog

Timely insights on the issues that matter most to advisors and their clients

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Fed | Inflation | Markets and Economy | Rates

EV Forward: Mixed Signals in the Market? Consider a Barbell Approach for Bonds

By: EV Forward | August 2, 2022

New York - Data series in the market are at odds with each other, sending mixed signals to investors depending on whether they consider inflation — a lagging indicator — or sentiment and survey data on economic activity, which are more forward-looking measures.

This trend is not uncommon and tends to emerge around inflection points in the economic cycle. Now that we are at such a point, we think a nuanced, barbell approach is required to effectively counteract the conflicting signals.

At an inflection point

The inflection point today reflects the transition in consensus expectations from a soft landing for the U.S. economy to a hard one, potentially recessionary. This change in consensus is fueled by the acknowledgment that the U.S. Federal Reserve will likely continue to hike rates aggressively into any downturn.

The Fed typically ends its rate hiking cycle when sentiment and survey data bottom out, but this time is different, because inflation has remained obstinately high.

Nominal versus real data

Adding to the confusion is a comparison of *nominal* data, which does not account for inflation, to *real* data that does. For instance, the release of retail sales data in June showed a sharp increase of 1% month-over-month in *nominal* terms. Yet headline inflation rose 1.3% over the same period, meaning that consumer economic activity actually fell -0.3% in real terms.

A deeper dive into the data indicates that consumers are spending more, but buying fewer goods, suggesting that profit margins and earnings may shrink. Making matters worse, inventories will eventually decline, another factor that weighs heavily on GDP growth.

Businesses may be forced to lay off workers, something that is already starting to happen. In fact, despite all the talk of rising nominal wages, real wages, when adjusted for inflation, have actually fallen -3.4% through May.

So which data should an investor follow, *nominal* or *real*? As you can see with our wage example above, we think the *real* data is more informative and a better predictor of future economic activity.

The message is clear — the Fed will likely keep hiking rates to address inflation, all at the expense of real economic activity, which will likely fall. In fact, the 2 year/10 year U.S. Treasury yield curve is already sniffing this out as it both flattens and inverts, with shorter maturity bond yields already higher than longer ones at multiple points along the curve.

Investing in a mixed signal market

Our approach to investing in fixed income during these cryptic times is to employ a barbell strategy. This involves balancing the ownership of floating rate and short duration bonds designed to take advantage of rising rates, while simultaneously owning longer duration and high quality core fixed income as a counterweight. Our goal is to strike a balance and create a bond portfolio with approximately 3 years in overall duration.

Jim Caron
Chief Fixed Income Strategist

For more insights on navigating higher inflation, please visit the Inflation Resource Center

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Risk Considerations: *Fixed income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. Longer-term securities may be more sensitive to interest rate changes.*

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