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NAVIGATING THE CURVE | OUTLOOK

2024 Outlook: Multi-Sector Fixed Income, Return of the Core

By: Vishal Khanduja, CFA | & Brian S. Ellis, CFA | December 19, 2023

A Myriad of Macroeconomic Drivers Are in Play; However, We See a Stronger Backdrop for Fixed Income Markets in 2024

KEY POINTS

1. A decade of extremely low interest rates followed by the Federal Reserve's aggressive policy normalization created a challenging environment for bond investors over the last two years. The breakdown of the inverse correlation between long-term, risk-free rates and spread sectors has led investors to rethink their fixed income allocations.

2. We see a compelling backdrop for fixed income in 2024, where inflation continues to decelerate, and higher interest rates continue to slow growth and the Fed clearly pivots from their restrictive stance. Under that scenario, we believe fixed income will return to its traditional role of providing investors with income and portfolio diversification.

3. We believe the Fed has ended its aggressive hiking cycle and has recently indicated their intention to pivot in 2024. We think the pace of inflation and magnitude of economic growth will keep monetary policy variable, aiding active fixed income managers.

What We Are Seeing

U.S. growth has shown remarkable resilience during the most aggressive Fed tightening cycle in decades, supported by a tight labor market and the lingering effects of pandemic stimulus. We believe there is minimal risk of a hard landing in 2024 and a moderate recession is a highly probable outcome. At the same time, valuations in certain sectors have adopted a "very soft landing" mentality and priced out any variability of economic, monetary policy and geopolitical outcomes. We broadly divide our opportunity set into three categories: Sovereign, corporate and consumer. While corporate and consumer balance sheets have remained conservative and thus resilient, sovereign balance sheets have borne the brunt of rising debt service costs and an increase in term premiums.

In our view, the market is pricing in a substantial easing cycle beginning in March, which was further solidified in the latest Fed statement. Under the scenario we see unfolding, we believe high-quality, fixed income strategies offer a compelling opportunity from both relative and absolute value perspectives in 2024. We are seeing the lowest yield pick-up between U.S. aggregate and U.S. high yield issues in over a decade. We believe markets may be mispricing how long it will take for the economy to feel the full impact of cumulative Fed tightening. In our opinion, many of the lagged effects of higher interest rates have just begun to play out.

Higher quality and liquid fixed income sectors offer historically attractive starting valuations, and we expect them to outperform some of lower-quality sectors on a risk-adjusted return basis in the coming quarters as growth becomes more challenging and defaults accelerate.

What We Are Doing

We have consistently increased interest-rate sensitivity (duration)[1] and quality across our portfolios. The overall credit quality of the portfolios is closest to its highest level over the last three years.

Along with a now-neutral duration bias, we have positioned portfolios to benefit from steepening of the yield curve. As the Fed has paused with the hint of a pivot, we believe the front end of the yield curve is anchored and the long end remains vulnerable to the fiscal deficit issues and weakening demand.

We favor an overweight to investment-grade corporates, particularly financial sector money center and super regional banks, which have strong balance sheets, wider relative valuations and, in our view, will be better able to adapt to expected volatility. We are increasing exposure to agency mortgage-backed securities (MBS), which have seen significant spread widening from weakening technical demand in the market. We believe valuations are extremely attractive and compensate for the deteriorated technical demand.

We maintain a moderate allocation to below-investment-grade corporates primarily via select high-yield bonds versus the bank loan market. We have maintained our cautious positioning and continue to prefer defensive corporate sectors that trade wide of historical norms.

As household balance sheets have generally normalized to pre-COVID levels, we are taking a tiered approach to non-agency MBS (particularly collateral that has benefited from strong home price appreciation) and commercial MBS (focusing on hospitality and select industrials while avoiding offices). Finally, we find compelling value in certain investment-grade tranches of collateralized loan obligations (CLOs).

What We Are Watching

Central banks are still at the fulcrum of global capital markets: What is the pace of future policy changes, and will we see increasing dispersion among central bank policies?

U.S. vs EU economic outlooks diverging: With the U.S. economy weakening more slowly, will European markets offer better fixed income investment opportunities in 2024?

Defaults (both corporate and consumer) and layoffs picking up: While the labor market continues to show signs of strength, are pockets of weakness growing? And, with the consumer defaults returning to pre-COVID levels, how does this impact the U.S. economy?

Conflicts in Middle East and Ukraine: As the conflicts in Ukraine and the Middle East continue, how do these geopolitical issues impact global growth?

Fiscal policy: If the current path of fiscal policy continues during the 2024 U.S. presidential election year, it could increase pressure on markets and could continue to drive term premiums.

In sum, we think a global regime change characterized by deglobalization, higher structural inflation, quantitative tightening, increased geopolitical risk and higher government debt suggests that 2024 is the start of a new era for fixed income investing.

1. Duration is a measure of the sensitivity of the price of a bond to a change in interest rates. In general, the higher the duration, the more a bond's price will drop as interest rates rise (and the greater the interest rate risk).

Risk Considerations: *Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. As interest rates rise, the value of certain income investments is likely to decline. Investments involving higher risk do not necessarily mean higher return potential. Diversification cannot ensure a profit or eliminate the risk of loss. Debt securities are subject to risks that the issuer will not meet its payment obligations.* ***Mortgage- and asset-backed securities*** *are sensitive to early prepayment risk and a higher risk of default and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks.* ***High yield securities ("junk bonds")*** *are lower rated securities that may have a higher degree of credit and liquidity risk.* ***Public bank loans*** *are subject to liquidity risk and the credit risks of lower rated securities.*

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"Under the scenario we see unfolding, we believe high-quality fixed income strategies with flexible guidelines offer a compelling opportunity from both relative and absolute value perspectives in 2024."

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