ALTMAN
INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

FEBRUARY, 2024

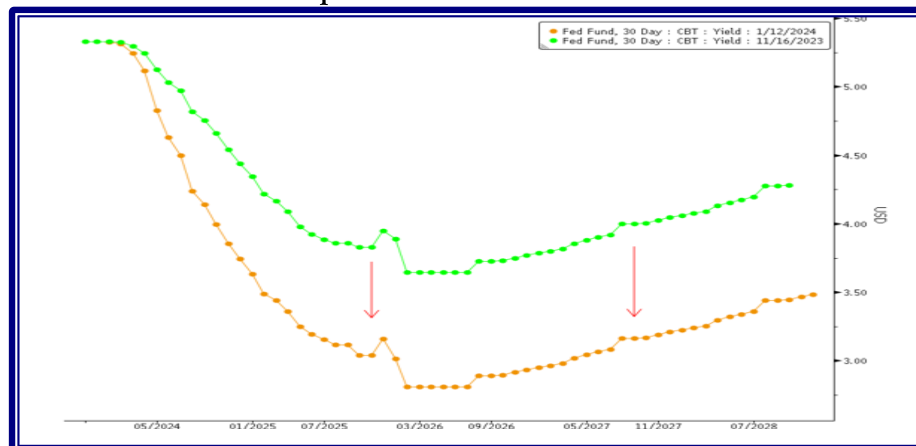
IN BRIEF: The U.S. Fixed Income Markets

With the latest CPI report of 3.1% year-over-year growth in January, inflation is proving to be stickier than anticipated. The majority of economists are looking for inflation to cool as supply disruptions continue to ease on the goods side of the equation. Rent prices are also tapering as well. However, overall price levels remain higher than pre-pandemic levels propped up by services. The Federal Reserve anticipates being able to cut rates later in the year, which the market is currently pricing in. However, they await a continuation of good data in order to confirm the trend downward towards their 2% target is sustainable.

An end to quantitative tightening generally improves market liquidity, as inflation concerns abate. Should this materialize, a rally in bonds accompanied by a decline in bond yields would be expected. But uncertainty remaining over the timing and amount of a reversal in policy could mean a bumpy ride for bonds in the short term. According to economists, the market is currently pricing in about 4-6 rate cuts for 2024 which could make for a volatile year depending upon how many, and even if, any Fed cuts materialize.

Exhibit I

Renewed Rate Cut Expectations Drove Down the Entire Yield Curve

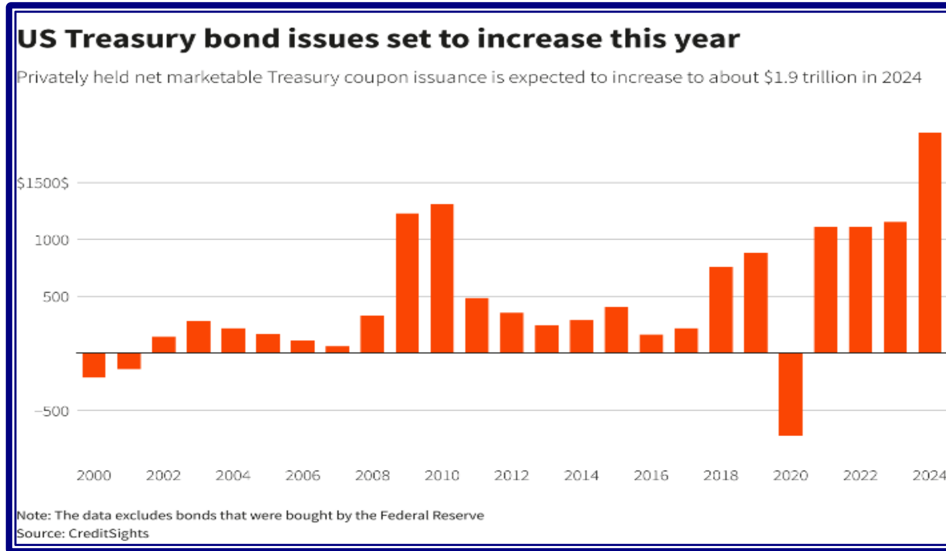


Source: Bloomberg Financial & Richard Bernstein Advisors

In today's marketplace, interest rate risk stems from the direction of inflation, economic growth, supplies levels and the ability of the Fed to translate all this data into effective and successful monetary policy. Specifically, the volatility anticipated in yields this year is due to the expectation of Fed cuts versus anticipated supply increases in treasury issuance (see Exhibit II). On one end, according to Reuters, futures tied to the Fed's main policy rate reveal investors are pricing in more than 150 basis points of cuts which equates to nearly twice the amount policymakers projected last month. On the other end, the U.S. Treasury announced plans to increase its bond auctions into Q1 of 2024 to address its growing debt load amidst rising borrowing costs.

We anticipate improvement in the economy this year, as central banks around the world start easing. There are early signs that global manufacturing and service business activity are already trending upwards, paving the way for a strong U.S. economy. Market "bears" are focusing on what they see as vulnerability in consumer spending from the depletion in excess savings and rising credit costs. However, rising personal incomes and low unemployment are working to offset contracting savings rates. Baby boomers are in a strong position to spend from pent-up net worth and limited mortgage exposure. Plus, household net worth is robust. Furthermore, technological improvements are setting the stage for productivity gains and should contribute to overall economic growth as well.

Exhibit II



Q4 Sector Performance and Strategy:

During 2023, the BofA Corporate, Government, Agency Bond Index's yield climbed to 5.12%. High yield bonds led the fixed income market with a total return of 13.5%, followed by intermediate corporates at 6.57%. Mortgage- backed securities, agencies, and municipals all came in the mid to low 4%s respectively. The 10-year Treasury yield finished the year at 3.88% and has since climbed back up to 4.26% in mid-February. We will continue to gradually move out along the treasury yield curve with a preference for the 5–7-year range.

Having avoided a recession, and a soft landing looking more likely, credit spreads have tightened. On the corporate bond side, we compared the OAS spread of both the high-yield (HY) and high-quality (HQ) indexes over Treasuries. The HY market looks overvalued at a 300-bps spread versus the HQ at 95-bps over the Treasury reinforcing our preference for quality. Combined with our outlook for economic improvement this year, our preference leans in favor of investment grade over more speculative securities.

Exhibit III

High Yield Valuations Look Stretched

Municipal yields were not immune to bond market volatility during 2023, as the 10yr AAA yield whipsawed off last year's lows to hit a new high in late October. Muni yields in early February 15, 2024 enjoyed a back-up in yield. The current yield level of 2.4% presents selective opportunities to lock in higher rates going out 10+ years where the curve is upward sloping. Anticipated market volatility, however does present some potential for reinvestment risk as shorter maturities come due. But even with municipal yield spreads at multi-year lows, we caution against aggressively chasing higher yields by way of lower quality municipal issues.

Keeping with a relatively short duration target, we are taking opportunities to move out on the yield curve into Treasuries and high-quality corporate issues. The uncertainty surrounding Fed policy has bond investors jockeying between the potential for rates cuts that begin in 2024 or an environment with higher-for-longer rates. Regardless of the outcome, quality bond issues should perform well and we recommend taking opportunities to begin to position for a more normalized yield curve.

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