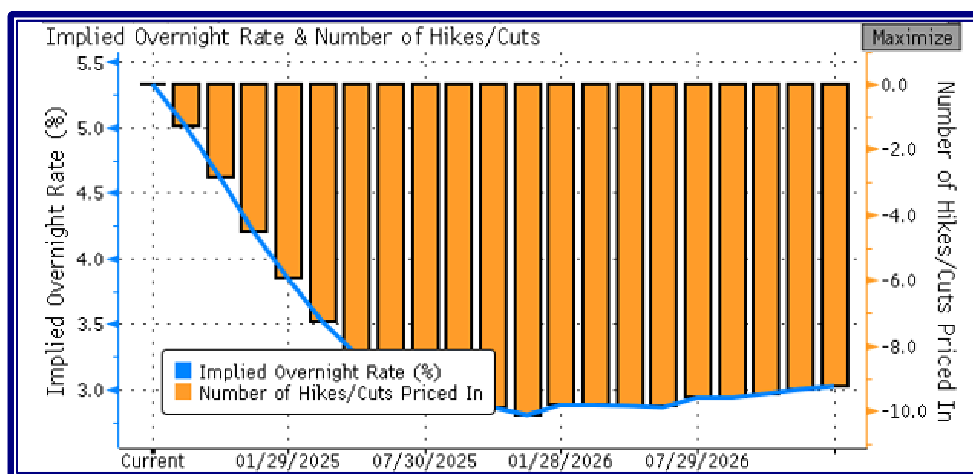
ALTMAN
INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS SEPTEMBER, 2024

IN BRIEF: The U.S. Fixed Income Markets & Strategy

The trajectory of disinflation is providing the Fed with support to begin unwinding its restrictive policy, as it seeks to keep the jobless rate from rising. The market is already pricing in ~3 cuts totaling 75 basis points throughout year end, plus another 6-7 cuts the following year. The Fed's current expectation for its key rate is 4.1% and 3.1%, by the end of 2025 and 2026 respectively. This forecast includes only one rate cut for the remainder of the year. An update this month will likely incorporate additional rate cuts and lower the Fed's 2-year rate forecast. The long run projected Fed Funds Rate currently stands at 2.8%.

Implied Overnight Rate & Number of Rate Hikes



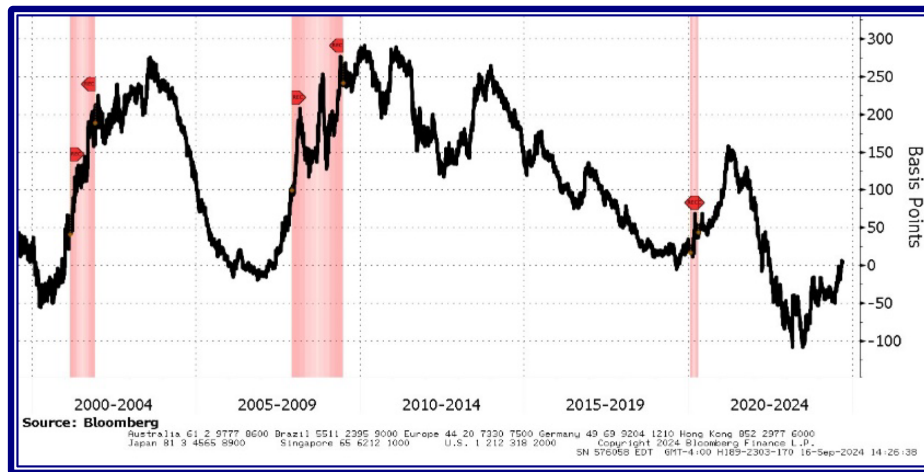
Source: Bloomberg

The yield curve became un-inverted this month as yields at the long end rose on softer employment data (refer to chart on page 2). Generally, the inflection towards dis-inversion signals a recession as the economy absorbs the impact from the wake of a tightening cycle. However, this time the job market is cooling but not at a level that is consistent with a recession call. August payrolls produced gains in healthcare, leisure and hospitality and construction that were partially offset by declines in manufacturing employment. Average weekly hours rose to record highs alongside growth in average hourly earnings. At least up to this point, layoffs do not seem to be fueling unemployment levels, rather the unemployment rate edged higher this year mostly due to an increase in the supply of workers.

Even with an initial Fed reversal in policy, interest rates may return to levels above 4% considering the rising national debt level and the potential for inflation to remain sticky. Government spending continues to outpace revenues, thereby increasing the need for government borrowing in the form of short-term treasury bills and notes. Higher treasury supplies mean higher yields. Inflation is now on a trajectory towards the Fed's target rate of 2%, however we anticipate the path will not be a straight one. Interest rates in the short term may fall on the shift in policy but longer-term inflationary pressures such as sky rocketing healthcare costs and ageing demographics, plus the potential for higher oil prices, could pressure rates above 4%. Despite geopolitical concerns, oil has sold off sharply in recent weeks. But due to weakening demand from China, OPEC may delay production increases that were scheduled to start next month. We believe oil is oversold as the falling geopolitical risk premium creates a negative near-term view of the commodity, thus improves the near-term outlook for bonds (higher bond prices, lower yields).

However, protectionist policies proposed by both parties in this year's election could restore inflationary fears - and materially lift government bond yields and private sector borrowing rates above 4% and warrants monitoring.

10-yr Treasury minus 2-year Treasury Yields



Source: Bloomberg

Is the recent Rally in U.S. Bonds Sustainable:

The recent drop in bond yields has been supported by somewhat softer economic data in recent months than investors had expected. However, this is largely because the expectations were lifted substantially in the early months of 2024, due to very strong growth and inflation data. Regardless, the Citi Economic Surprise Index for the U.S. is now depressed, despite investors markedly revising back down their growth forecasts, leaving ample room for upside surprises in the months ahead.

The biggest source of economic angst among investors is the rise in the unemployment rate. The Fed has used this as justification for starting its rate cutting cycle by suggesting that "downside risks to the employment mandate are now real" according to recent Federal Reserve comments. Yet, the rise in unemployment has been due to an increased supply of labor and not due to weakening economic activity and layoffs. The unemployment rate may rise further in the near run to accurately reflect the actual increase in immigration but should not impact compensation or consumption, according to MRB Research. Accordingly, initial unemployment insurance claims remain very low and other surveys do not point to an increase in layoffs. This is consistent with solid and improving corporate earnings and profit margins, which should support employment demand. Net employment conditions have decelerated from unprecedented heights reached earlier in the decade but are far from weak. Bond investors have also been comforted by a moderation in underlying inflation rates, supporting hopes that inflation was indeed "transitory" in the end. However, we have concluded that the Fed and bond market are both overly complacent in the inflation outlook. We believe that previous globalization and deleveraging drags on inflation are no longer present.

In our opinion, the U.S. economy is operating above its long-run potential which suggests that the risks over time are tilted towards higher U.S. inflation. Of course, it bears mentioning there are the base effects of inflation will no longer be as supportive as the year progresses which could cause annual inflation rates to trend higher and encourage investors to pare back rate cut expectations.

We conclude that U.S. government bond markets are overbought setting the stage for a rebound in bond yields from current levels - provided the economic data remains firm. Against this backdrop, we continue to recommend a below average duration in fixed income portfolios. The Bank of America U.S. Corporate Bond to Treasury spread climbed to 104 up from 89 points in June. Relative to historical averages, however, spreads are still quite narrow. Any upside in higher quality issues is limited but opportunities remain in select investment grade issues. Strong corporate earnings coupled with solid fundamentals also support our bias towards investment grade corporates issues over treasuries.

IN CONCLUSION:

We are not expecting the Fed's tightening cycle to trigger a recession, despite the lagged effect these cycles often exhibit. This time, around usual factors that fuel recessions such as a banking or energy crisis, or an abrupt end to a speculative bubble, are not imminent. Rather, we are optimistic that the Fed funds rate is best characterized as normalizing. Aggressive hikes peaked at a level of 5.25-5.50% off the near zero policy. It makes sense that as inflation is on a path towards a 2% target seemingly without disrupting the labor market, that the Fed rate would begin to mitigate towards a more neutral sustainable level.

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