APRIL 2024

Fixed Income Observations

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A Resilient Economy Complicates the Fed's Plans

Mixed economic data left market participants grappling with uncertainty regarding the timing and magnitude of Fed rate cuts.

Insight from sub-adviser Wellington Management

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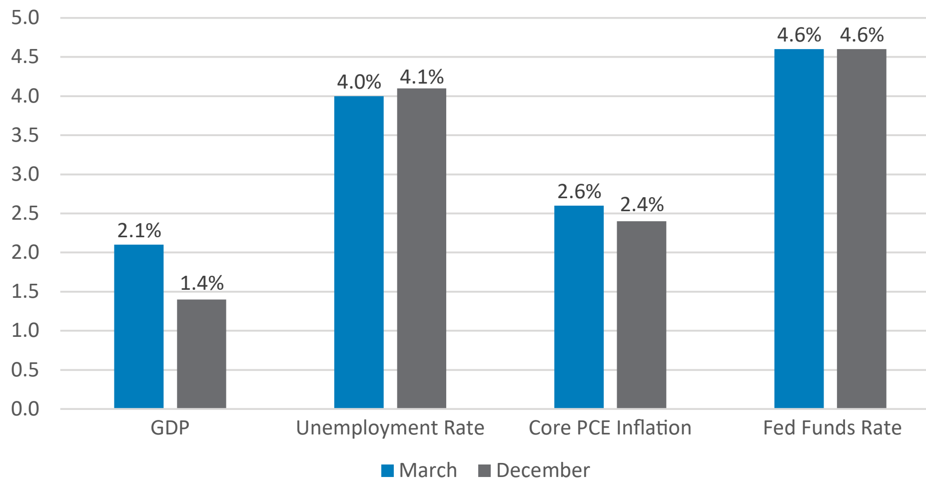
What's Driving Markets…

1. **The Federal Open Market Committee (FOMC)**[1] **statement and ensuing press conference from Chair Jerome Powell** represented the key driver of market sentiment over the course of March. From our perspective, the chief takeaways from the event included:

   - The Federal Reserve (Fed) considers the January and February inflation prints, both of which exceeded economists' consensus estimates, as beginning-of-year "noise." The FOMC intends to look through this noise and expects inflation to continue to move downward, helped by (a) a gradually looser labor market and (b) the expected pass-through effects of moderating shelter costs driven by lower rents.
   - The FOMC upgraded its expectations for economic performance, moving up its median forecasts for real GDP and inflation, while also projecting slightly weaker unemployment (**FIGURE 1**). So how does the Fed envision a 2024 outcome with stronger growth, modestly lower unemployment, and slightly higher inflation—and yet still have three cuts in its median forecast? This is a communications challenge for the Fed that is directly contributing to current volatility.

FIGURE 1: Economic Forecast: Are Rate Cuts Still Justified?
FOMC's Summary of Economic Projections for 2024 (%)



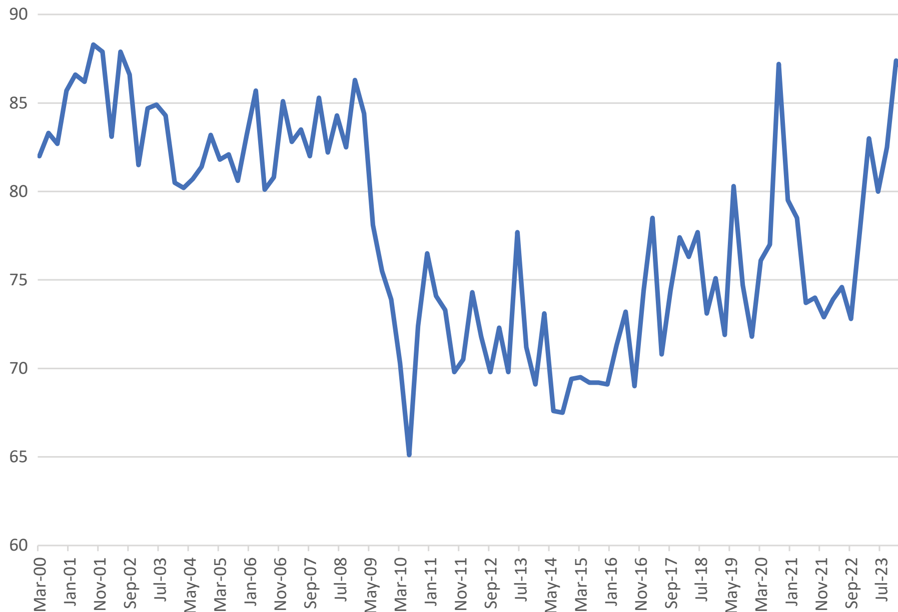
As of 3/31/24. Sources: Federal Open Market Committee, Wellington Management, and Hartford Funds.

   - However, there was strong pushback by Fed officials late in the month on the recent market exuberance. Governor Waller and Chair Powell delivered hawkish messages, asserting that the economy is in robust shape and rate cuts need careful consideration. Markets initially exhibited a muted reaction, focusing on the recent Personal Consumption Expendures (PCE)[2] numbers, which were in line with expectations. It was only after a strong ISM[3] print (see **FIGURE 4** below) on April 1 that a strong bear steepening[4] began, as long-dated yields sold off faster than short-dated yields.[5]

2. **Congress averted a government shutdown** by passing a $1.2 trillion budget deal, subsequently signed by President Joe Biden. The bill will keep the government funded until October 1 and avoids a shutdown, which last occurred in 2019. While disruptive, shutdowns generally result in minimal economic impact since furloughed workers eventually receive back pay. Treasury's financing strategy thus far has been very modest in terms of duration[6] (**FIGURE 2**); substantial changes in that duration supply could lead to narrower swap spreads[7] and/or a steeper yield curve[8] via term premia.[9]

FIGURE 2: Increased Issuance Balanced by a High Percentage of Bills

Treasury Bills Within Net Issuance (%)



As of 3/31/24. Sources: US Treasury, Wellington Management, and Hartford Funds.

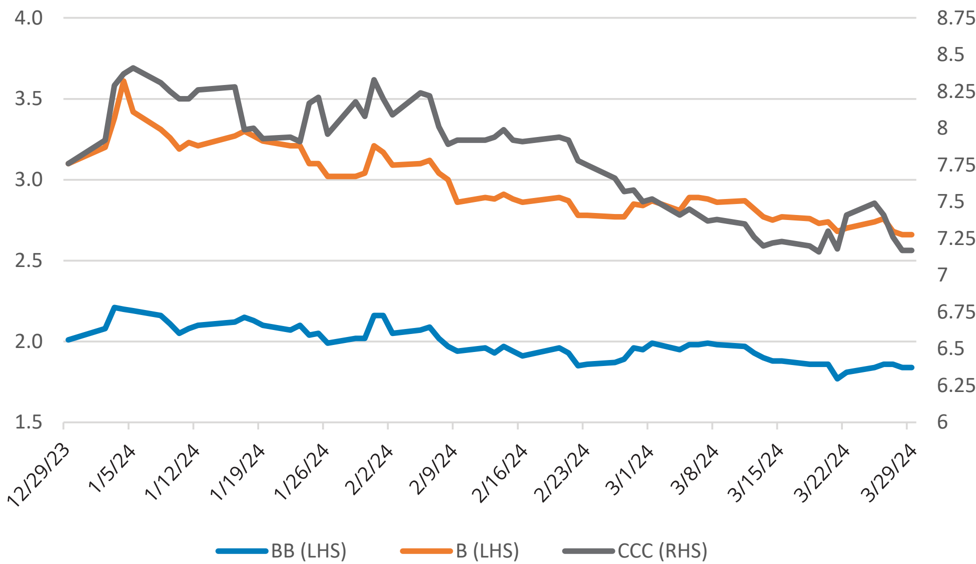
The Bank of Japan began to unwind its negative interest-rate policy, an unorthodox policy regime that has existed for more than eight years.

3. **The Bank of Japan (BOJ) began to unwind its negative interest-rate policy,** an unorthodox policy regime that has existed for more than eight years. The BOJ stated that it would allow its short-term policy rate to move up from -0.10% to a range of 0 to 0.10%. In addition, the BOJ will partially roll back the maximum amount of bond purchases for different maturities. While these actions signal a departure from the prior leadership of Governor Haruhiko Kuroda, they fell shy of market expectations, leading to a sharp sell-off in the yen and a steepening of the yield curve. Both the Ministry of Finance and the prime minister have signaled that active currency intervention could take place.

4. **High-yield spreads continued to compress,** with CCC-rated issuers leading the way (**FIGURE 3**). While economic conditions in the US remain relatively robust (and supportive of near-term spreads), there are rumblings from across the Atlantic as the heavily levered[10] French telecom giant Altice faces corruption probes in France and Portugal. Altice's leveraged loans are embedded in several collateralized loan-obligation (CLO)[11] structures. Its most recent ratings downgrade to CCC means that it could impact overcollateralization tests in CLOs, which could potentially lead to forced sales of the securities.

FIGURE 3: High-Yield Spreads Compress to New Levels of Cycle Tightness

Option-Adjusted Spreads[12] by Credit Rating[13] (%)



As of 3/31/24. Source: Bloomberg, Wellington Management, and Hartford Funds.

5. **US economic data remains firm, including a notable improvement in the manufacturing ISM**, demonstrating the positive reflex from easing financial conditions (**FIGURE 4**). Although we still expect real GDP to moderate, the recent improvement in ISM data reduces the downside growth risk at the margin. Should the Fed underdeliver on the magnitude of cuts priced in (75 basis points[14] for 2024) financial conditions could tighten. This would likely require the labor market to stay tighter for longer, causing concern from the Fed with respect to the sustainability of wages and services inflation coming down toward target.

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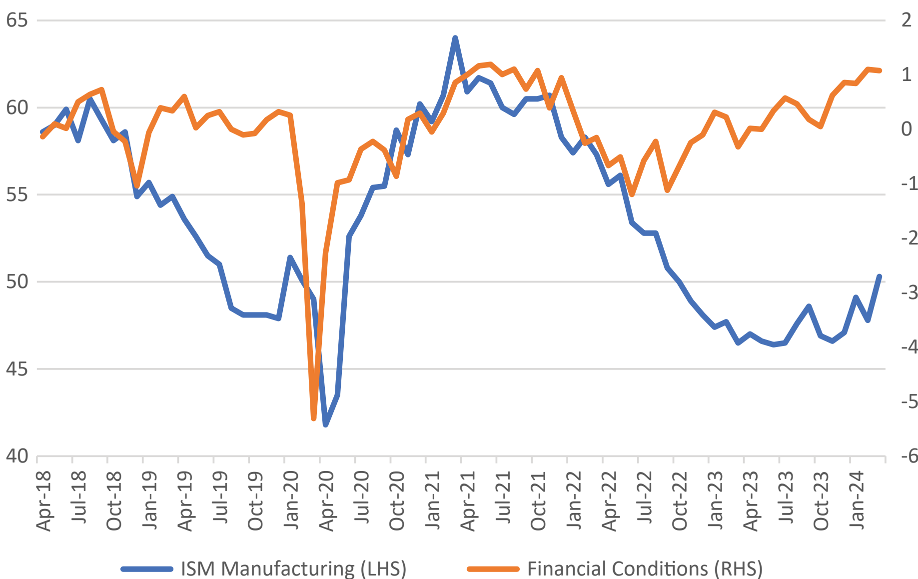
FIGURE 4: Manufacturing Sector Rebounds As Financial Conditions Ease Further

ISM Manufacturing vs. Financial Conditions, 2018-2024



As of 3/31/24. ISM manufacturing data based on the ISM Manufacturing Index. Financial-conditions data based on the Bloomberg Financial Conditions Index.[15] Sources: Bloomberg, Wellington Management, and Hartford Funds.

What's Keeping Us Up at Night…

1. **Underlying inflation pressures remain firm**, which may challenge the Fed's resolve to deliver on its rate-cut projections. With the labor market showing signs of slowing, along with the sharp downward trajectory of owners' equivalent rent,[16] we don't think recent inflation data is yet sufficient to move the Fed away from its easing bias this year. However, it's a strong reminder that, should the cycle trough and re-accelerate without inflation sustainably back to target, inflation could prove even more difficult for the Fed to manage over the medium term.

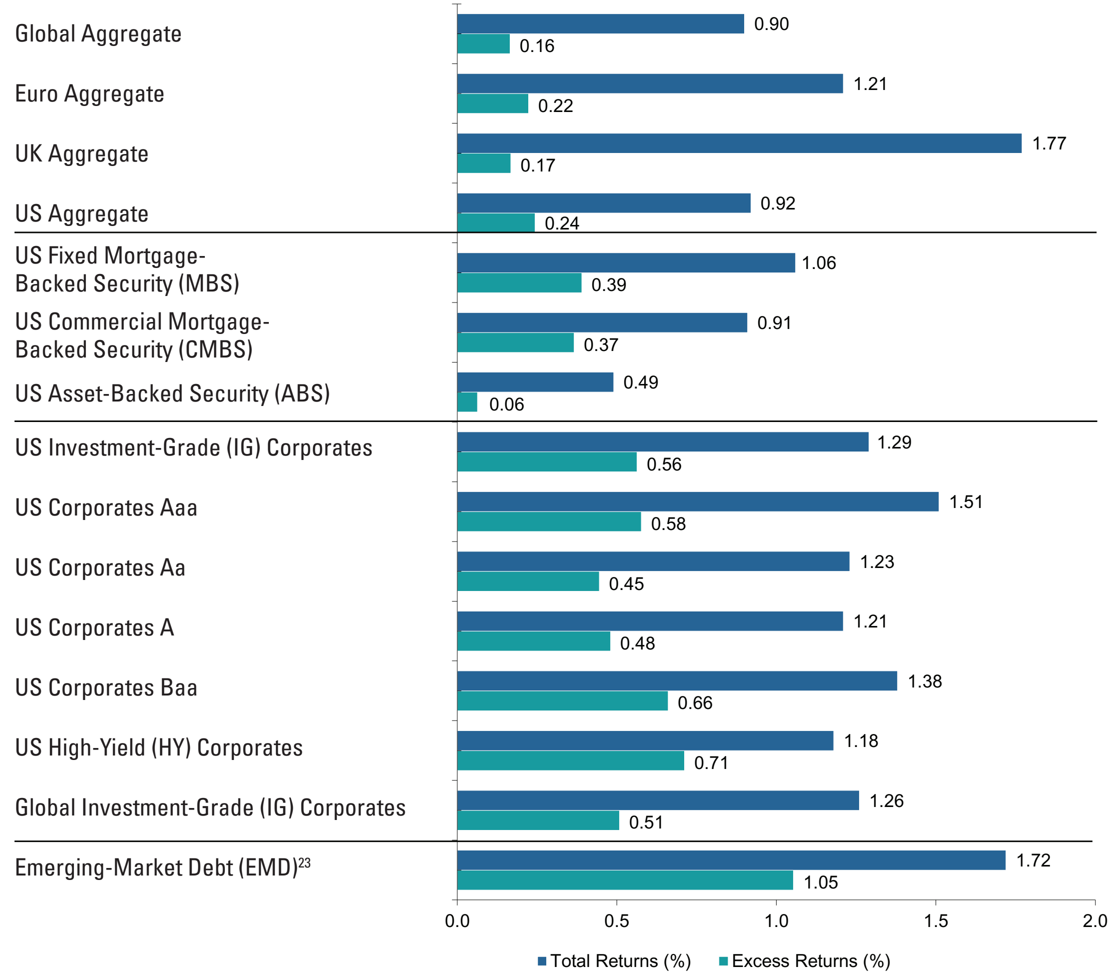
2. **US election uncertainty remains top-of-mind**, though it's still relatively early in the cycle prior to the party conventions. At stake, from a market perspective, are: tariff policy, tax policy, and regulatory frameworks for a variety of sectors. US term premia may be vulnerable due to the US election fiscal implications and/or selling from large overseas holders. But because the US enjoys reserve-currency[17] status, that mitigates concerns over its ballooning federal deficit.

3. **Geopolitical tensions remain high** with the conflict in Gaza continuing with little end in sight. The US abstained from voting as the UN Security Council passed a resolution calling for an immediate ceasefire in the Israel-Hamas conflict. Israel's foreign minister stated that the country will not comply with the resolution, attributing this decision to unclear wording regarding the release of Israeli hostages. The potential for escalation increased as Israel attacked an area near the Iranian embassy in Damascus, killing two senior members of the Iranian Revolutionary Guards. Iran may retaliate directly or via its proxies in the Middle East, which could include confrontations to global shipping in the Straits of Hormuz.

Investment Implications for Consideration

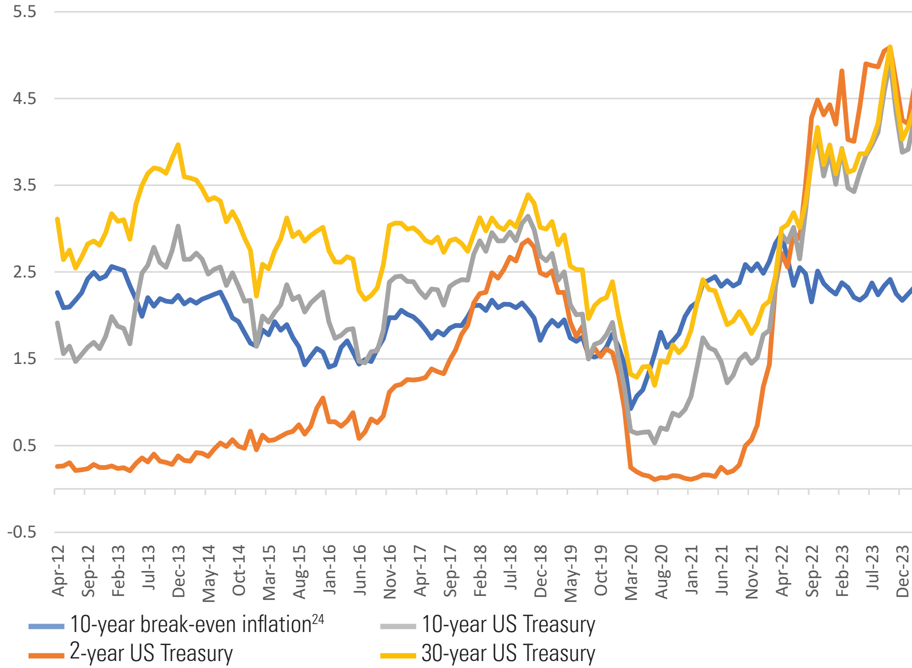
- Given how drawn out and uncertain the rate cycle has been, we still favor total-return strategies that are less constrained by benchmarks. These could include global sovereign and currency strategies that potentially shine during these periods or "go-anywhere"[18] strategies that may be able to navigate the late cycle.
- We acknowledge the tumult of rate markets this year. But, given where spread levels are in many sectors, core-bond and core-bond-plus[19] positions could make sense as we emerge from the end of the tightening cycle. The gradual cooling of inflation and slowing of the economy makes higher-quality fixed income potentially attractive from a recessionary perspective, as well as for positive convexity.[20] These strategies also make sense as a way to mitigate the risk of a hawkish policy mistake by the Fed (i.e., if the central bank leaves policy rates too high for too long).
- Securitized credit[21] could be a potential hedge against rate volatility since it generally offers attractive risk-adjusted spreads. Senior parts of the capital structure, in particular, seem attractive in case the cycle turns faster than expected.
- High yield, despite its strong performance in 2023, warrants a cautious approach given how late in the cycle we are and the normalizing of default rates relative to current spreads. However, the robust carry[22] may make high yield a good equity substitute. For all higher-yielding credit, including high yield, bank loans, and convertible debt, we favor an "up-in-quality" issuer bias in case the slowing economy undershoots a soft-landing scenario and default/downgrade rates accelerate.

FIGURE 5: Fixed-Income Sector Excess Returns



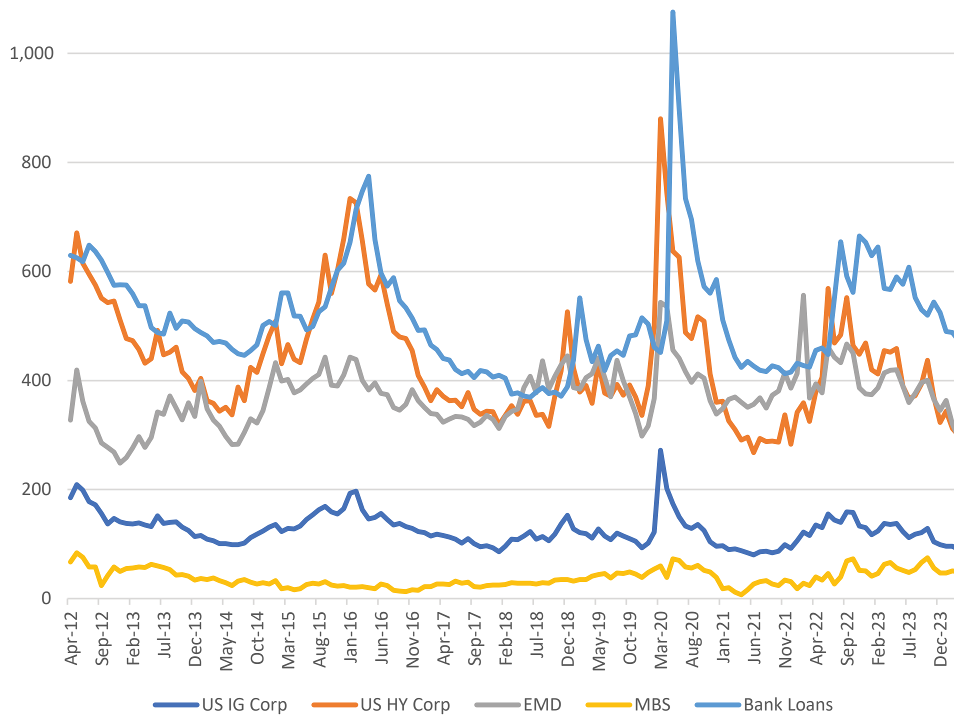
As of 3/31/24. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. Excess returns are calculated by taking the return of each individual security in the index and comparing it to a duration-equivalent US Treasury yield. Each security's contribution to the index excess return is determined by its weight in the index. See last page for representative index definitions. Sources: Bloomberg, JP Morgan, and Wellington Management.

FIGURE 6: US Yields (%)



As of 3/31/24. Sources: Bloomberg and Wellington Management.

FIGURE 7: Fixed-Income Spreads (basis points)



As of 3/31/24. US IG Corp is represented by the **Bloomberg US Corporate Bond Index**; US HY Corp is represented by the **Bloomberg US Corporate High Yield Bond Index**; EMD is represented by the **J.P. Morgan EMBI Global Diversified Index**; MBS is represented by the **Bloomberg US MBS Index**; Bank Loans are represented by the **Morningstar/LSTA US Leveraged Loan Index**. See last page for representative index definitions. Sources: Bloomberg, JP Morgan, Morningstar LSTA, and Wellington Management.

Fixed Income Observations

[1] The Federal Open Market Committee (FOMC) is the division of the Federal Reserve that sets monetary policy by managing open-market operations. By doing this, the Fed influences the fed funds rate, which impacts other interest rates.

[2] The Personal Consumption Expenditures (PCE) price index is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

[3] The Institute of Supply Management (ISM) Manufacturing Purchasing Managers Index (PMI) Report on Business is based on data compiled from monthly replies to questions asked of purchasing and supply executives in over 400 industrial companies.

[4] A bear steepener is the widening of the yield curve caused by long-term interest rates increasing at a faster rate than short-term rates. A bear steepener is usually suggestive of rising inflationary expectations—or a widespread rise in prices throughout the economy.

[5] Long-dated yields, (i.e., the long end of the yield curve) usually refer to yields that are 10 years or greater. Short-dated yields (i.e., the short end of the yield curve) refer to yields that are generally less than one year.

[6] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[7] A swap spread is the difference between the fixed component of a given swap and the yield on a government security, usually from the U.S. Treasury, with the same maturity. Swaps are derivative contracts to exchange fixed interest payments for floating-rate payments. Since a Treasury bond (T-bond) is often used as a benchmark and its rate is considered risk-free, the swap spread on a given contract is determined by the perceived risk of the parties engaging in the swap. As perceived risk increases, so does the swap spread. For this reason, swap spreads can be used to assess the parties' creditworthiness.

[8] The yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

[9] The term premium is the excess return that an investor obtains in equilibrium from committing to hold a long-term bond instead of a series of shorter-term bonds.

[10] A levered firm refers to a firm in which borrowed money (i.e., debt) forms a part of its capital structure. A firm with no debt is called an unlevered firm, with all owned funds in the capital.

[11] A collateralized loan obligation (CLO) is a single security backed by a pool of debt. CLOs are often backed by corporate loans with low credit ratings or loans taken out by private equity firms to conduct leveraged buyouts.

[12] Spreads are the difference in yields between two fixed-income securities with the the same maturity but originating from different investment sectors. The option-adjusted spread is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to account for an embedded option (defined as provisions included with some fixed-income securities that allow the investor or the issuer to take specific actions, such as calling back the issue).

[13] An investment-grade rating is a rating that signifies whether a municipal or corporate bond presents a relatively low risk of default. Bond-rating firms such as Standard & Poor's (S&P), Moody's, and Fitch use different designations, consisting of the upper- and lower-case letters "A" and "B," to identify a bond's credit quality rating. "AAA" and "AA" (high credit quality) and "A" and "BBB" (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ("BB," "B," "CCC," etc.) are considered low credit quality and are commonly referred to as junk bonds.

[14] A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

[15] The Bloomberg US Financial Conditions Index is a Z-score tracking the overall level of financial stress in the US money, bond, and equity markets to help assess the availability and cost of credit. A positive value indicates accommodative financial conditions, while a negative value indicates tighter financial conditions relative to pre-crisis norms.

[16] Owners' equivalent rent measures how much money a property owner would have to pay in rent to be equivalent to their cost of ownership.

[17] A reserve currency is a large quantity of currency maintained by central banks and other major financial institutions to prepare for investments, transactions, and international debt obligations, or to influence their domestic exchange rate. A large percentage of commodities, such as gold and oil, are priced in the reserve currency, causing other countries to hold this currency to pay for these goods.

[18] Go-anywhere strategies are typically benchmark-agnostic and not bound by limits on exposure by sector, quality, currency, or country. Whereas traditional core-bond-plus strategies generally have flexibility to invest across the fixed-income landscape, they generally have upper limits on the amount that can be invested in securities rated below-investment-grade, domiciled outside the US, non-US-dollar-denominated, or reside in a particular sector (e.g., emerging markets).

[19] Core/core plus strategies typically invest in a baseline of investment-grade bonds such as government, corporate, and securitized debt. Core-plus funds can take that baseline and add additional sectors such as corporate high-yield, emerging-market debt, or non-US currency exposures to enhance returns.

[20] Convexity is the relationship between bond prices and bond yields.

[21] Securitized credit involves pooling a large number of loans into an investable asset. Examples include mortgage-backed or asset-backed securities.

[22] Carry is the difference between the yield on a longer-maturity bond and the cost of borrowing.

[23] Emerging-market debt (EMD) are debt instruments issued by developing countries. These bonds tend to offer higher yields than Treasuries or corporate bonds in the US. Emerging-market issues tend to carry higher risks than domestic debt instruments.

[24] The break-even inflation rate is a measurement that aims to predict the effects of inflation on certain investments, by analyzing known market inflation rates from recent years. It can be calculated by comparing the yield of an inflation-based bond (such as Treasury Inflation-Protected Securities, or TIPS) with a nominal bond of the same maturity period. The difference represents the break-even inflation rate, or the rate that inflation would have to be for an investor to "break even"—or earn the same return—between purchasing TIPS or nominal Treasuries.

To learn more about opportunities in fixed income, please talk to your financial representative.

Representative Indices from Figure 5:
Global Aggregate: Bloomberg Global Aggregate Bond Index; Euro Aggregate: Bloomberg Global Aggregate Bond Index - European Euro; UK Aggregate: Bloomberg Global Aggregate Bond Index - United Kingdom; US Aggregate: Bloomberg US Aggregate Bond Index; US Fixed MBS; Bloomberg US MBS Index; US CMBS: Bloomberg CMBS ERISA Eligible Index; US ABS: Bloomberg Asset-Backed Securities Index; US IG Corporates: Bloomberg US Corporate Bond Index; US Corporates Aaa: Bloomberg Aaa Corporate Bond Index; US Corporates Aa: Bloomberg Aa Corporate Bond Index; US Corporates A: Bloomberg A Corporate Index; US Corporates Baa: Bloomberg Baa Corporate Bond Index; US High-Yield Corporates: Bloomberg US Corporate High Yield Bond Index; Global IG Corporates: Bloomberg Global Credit - Corporate Bond Index; Emerging-Markets Debt: Bloomberg Emerging Markets Hard Currency Bond Index.

Index Definitions:
Bloomberg Global Aggregate Bond Index is a broad-based measure of the global investment-grade fixed-rate debt markets.

Bloomberg Global Aggregate Bond Index - European Euro includes fixed-rate, investment-grade Euro denominated bonds.

Bloomberg Global Aggregate Bond Index - United Kingdom includes fixed-rate, investment-grade sterling-denominated bonds.

Bloomberg US Aggregate Bond Index is composed of securities from the Bloomberg Government/Credit Bond Index, Mortgage-Backed Securities Index, Asset-Backed Securities Index, and Commercial Mortgage-Backed Securities Index.

Bloomberg US MBS Index tracks fixed-rate agency mortgage backed passthrough securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Bloomberg CMBS ERISA Eligible Bond Index measures the performance of investment-grade commercial mortgage-backed securities, which are classes of securities that represent interests in pools of commercial mortgages. The index includes only CMBS that are Employee Retirement Income Security Act of 1974.

Bloomberg Asset-Backed Securities Index, the ABS component of the Bloomberg US Aggregate Index, has three subsectors: credit and charge cards, autos, and utility.

Bloomberg US Corporate Bond Index covers all publicly issued, fixed rate, nonconvertible, investment-grade debt.

Bloomberg Aaa Corporate Bond Index is designed to measure the performance of investment-grade corporate bonds that have a credit rating of Aaa.

Bloomberg Aa Corporate Bond Index is designed to measure the performance of investment-grade corporate bonds that have a credit rating of Aa.

Bloomberg A Corporate Bond Index is designed to measure the performance of investment-grade corporate bonds that have a credit rating of A.

Bloomberg Baa Corporate Bond Index is designed to measure the performance of investment-grade corporate bonds that have a credit rating of Baa.

Bloomberg US Corporate High Yield Bond Index is an unmanaged broad-based market-value-weighted index that tracks the total return performance of non-investment grade, fixed-rate, publicly placed, dollar denominated and nonconvertible debt registered with the Securities and Exchange Commission.

Bloomberg Global Credit - Corporate Bond Index is an unmanaged index considered representative of fixed rate, non-investment grade debt of companies in the US, developed markets, and emerging markets.

Bloomberg Emerging Markets Hard Currency Bond Index includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers.

Morningstar/LSTA Leveraged Loan Index is a market-value-weighted index that is designed to measure the performance of the US leveraged loan market based upon market weightings, spreads, and interest payments.

J.P. Morgan EMBI Global Diversified Index is a broad-based, unmanaged index which tracks liquid, US Dollar emerging-market fixed- and floating-rate debt instruments issued by sovereign and quasi-sovereign entities.

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