April 4, 2024

Fixed Income: Finding Some Zen in a Garden of Volatility

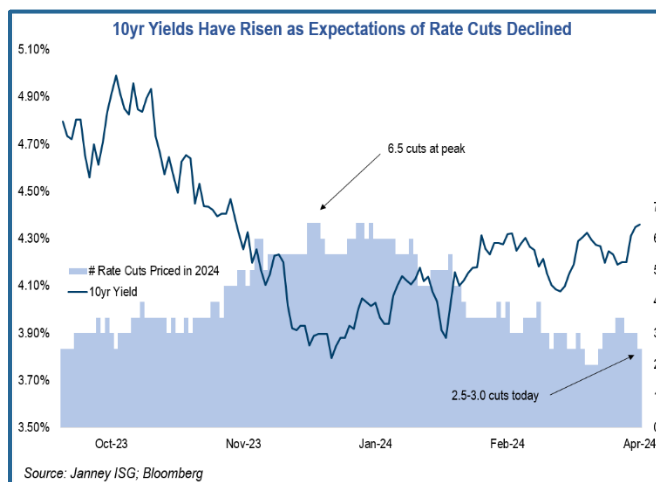
Guy LeBas | Chief Fixed Income Strategist

In 2022, rapidly rising interest rates led the U.S. bond markets to their worst performance in contemporary history. In 2023, wild swings in interest rates cut a broad swath across the bond markets. In 2024, there is a veritable army of fixed income professionals desperately pleading with their preferred market deity for just a little bit of peace and quiet. And thus far, the bond markets have been seemingly well-behaved, if tilted towards weakness. Three months in, 10-year yields at 4.37% and 2-year Treasury yields at 4.70% are both higher by 0.50% and are trading near their highest since November. As it turns out, 2024 is off to the fourth-worst start in the last three decades! The fact that many market participants seem unconcerned is a testament to just how volatile the last two years have really been.

Our thesis for 2024 was that the bond markets would be largely range bound in 2024, though 6–8 week trading trends would extend further than purely economic or policy fundamentals might suggest. So far, that theme is playing out, and yields have moved from the low end of our expected trading range to the high end. The catalyst for this move has been (noisily) elevated inflation readings, which have in turn convinced markets to be more circumspect about 2024 Federal Reserve (Fed) rate cuts. Essentially, markets have swung from an extreme of pricing in six rate cuts to a "neutral" of pricing in between two and three. Current pricing offers the first good entry point to add duration in fixed income portfolios since 2023.

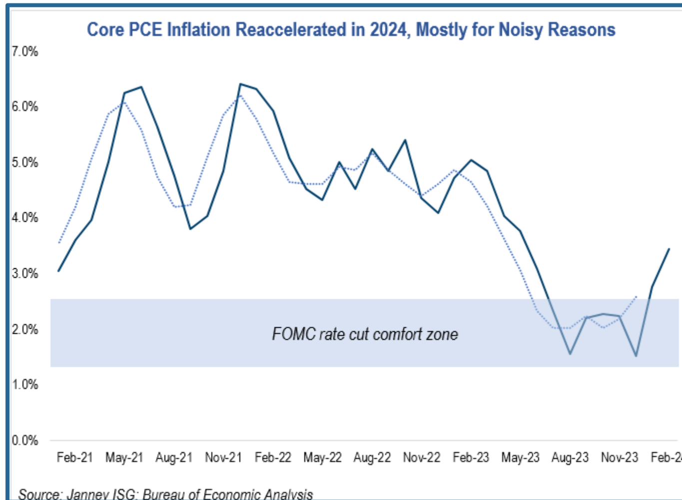
Economic Outlook & Fed Policy

Federal Reserve officials hiked interest rates sharply in 2022 and 2023, in an effort to slow economic growth and reduce the decidedly uncomfortable level of inflation. Since the last rate hike, economic growth has remained surprisingly resistant to higher borrowing costs. There is no shortage of theories as to why the U.S. economy has proven so resilient, but between income growth, housing demand, and productivity gains, something is going right. Just as importantly, depressed sectors of the economy, such as manufacturing, are showing signs of rebound. The risk of recession is qualitatively quite low in the short term.



Source: Janney ISG; Bloomberg

Inflation, meanwhile, has decelerated significantly. The core PCE, the Fed's preferred measure for inflation, fell to a 2.0% annualized pace in 4Q2023. That said, early-2024 inflation readings have re-accelerated. We believe the shift is more about the noisy process of measuring inflation and associated methodological vagaries than any real change in trend.

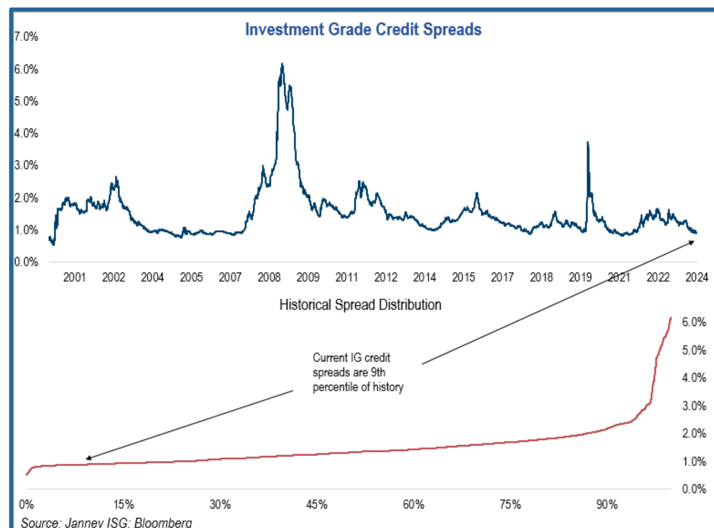


At some point, Fed policymakers are going to embark on what Alan Greenspan termed in 1994 a "mid-course correction." In other words, Jay Powell and his colleagues will bring rates down to avoid slowing the economy too quickly. In each of the (successful) mid-course corrections over the last three decades, the Fed has cut rates three times by a total of 0.75%. Recent inflation readings have served to delay, though not forestall, the next mid-course correction. While it remains unclear when the Powell Fed will begin cutting, it seems likely that it will ultimately follow the same three-cut path.

Credit Markets

While interest rate markets are priced relative to our expectations, it's harder to argue the same about the corporate credit markets. Over the last six months, credit spreads have narrowed considerably from average to below average to historically tight. At present, investment grade rated corporate bonds generate just 0.90% over Treasuries, the 9th percentile historically. High-yield bond spreads are similarly expensive at 3.00%, the 8th percentile historically.

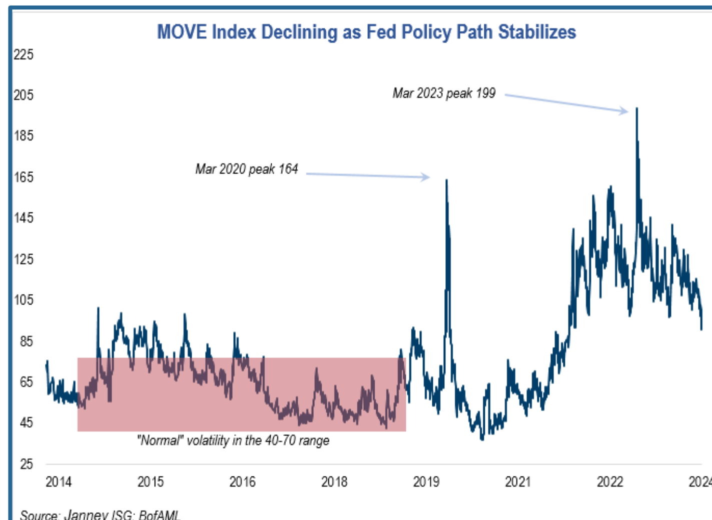
While pricing is expensive, there are a few fundamental reasons why these narrow spreads could sustain. First, corporate balance sheets are in aggregate quite healthy. Second, corporate profits in aggregate are growing in 2024 and probably will in 2025 as well, which should make debt burdens more affordable. Third, massive inflows into private credit strategies mean that there is willing liquidity to help refinance any debt maturities, even for riskier issuers. There have been a pair of scenarios in which strong fundamentals helped credit spreads remain tight for several years: the mid-1990s and the mid-2000s. While both scenarios ended poorly for idiosyncratic reasons (fraud and the housing crash, respectively), tight spreads in and of themselves are a bad reason to sell credit. Instead, we advocate adopting an up-in-quality approach. Spreads between A-rated and BBB-rated names, for example, are at the narrow end of their range. As a result, the income given up from adopting an up-in-quality approach is relatively low. That approach strikes a balance between healthy fundamentals and expensive pricing.



Falling Volatility

There's no such thing as a free lunch, and now, with credit pricing expensive, even cheap snacks in the bond markets are hard to find. The only place we think is notably mispriced is the market for bonds with embedded options, that is, bonds exposed to volatility. Interest rate volatility, as measured in

pricing for bond options, is a crucial aspect of the bond markets outlook. In 2022 - 2023, volatility surged amidst Fed rate hikes; since that point, it has declined. In 2024, the clearer economic outlook and more predictable and stable path of Fed policy should help implied volatility fall even further.



One constructive way to gain exposure to falling volatility is in agency mortgage-backed securities (MBS). Since mortgage loans can get refinanced, MBS can get "called away" from owners when interest rates fall sharply. MBS are therefore exposed to big swings in interest rates and accordingly perform well when volatility is falling (individual MBS vary widely in characteristics and in their sensitivity to changes in interest rates). Unlike IG corporates, MBS spreads are roughly in line with their historical averages, so on a relative basis they appear attractive.

Conclusions

After substantial increases in interest rates in early 2024, we view the fixed-income markets as fairly valued relative to the economic and Fed outlook. These valuations mark the first opportunity to add duration since the cautious position we advocated in our Outlook 2024. While duration is now reasonably priced, credit spreads are historically quite tight, so we hold an up-in-quality bias when it comes to the credit markets. The one cheap snack in fixed income could come from falling interest rate volatility, which should benefit the MBS sector particularly well.

From a portfolio construction standpoint, fixed income should remain a more consistent source of returns, not just in 2024 but in the years to come as well. When interest rates were near zero in 2020-2021, mistiming a purchase dramatically affected return. A 0.25% move in interest rates could wipe out a year's worth of income. Now that interest rates are in the 4% - 5% range, there is a vastly wider cushion against higher interest rates.

Disclaimer

This report is provided for informational and educational purposes only and shall in no event be construed as an offer to sell or a solicitation of an offer to buy any securities or a recommendation for any strategy or to buy, sell, or hold any product. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. Employees of Janney Montgomery Scott LLC or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed here. The information described herein is taken from sources which we believe to be reliable, but the accuracy and completeness of such information is not guaranteed by us. The opinions expressed herein may be given only such weight as opinions warrant. This Firm, its officers, directors, employees, or members of their families may have positions in the securities mentioned and may make purchases or sales of such securities from time to time in the open market or otherwise and may sell to or buy from customers such securities on a principal basis. This report is the intellectual property of Janney Montgomery Scott LLC (Janney) and may not be reproduced, distributed, or published by any person for any purpose without Janney's prior written consent. This presentation has been prepared by Janney Investment Strategy Group (ISG) and is to be used for informational purposes only. In no event should it be construed as a solicitation or offer to purchase or sell a security. Past performance is no guarantee of future performance and future returns are not guaranteed. There are risks associated with investing in stocks such as a loss of original capital or a decrease in the value of your investment. For additional information or questions, please consult with your Financial Advisor.