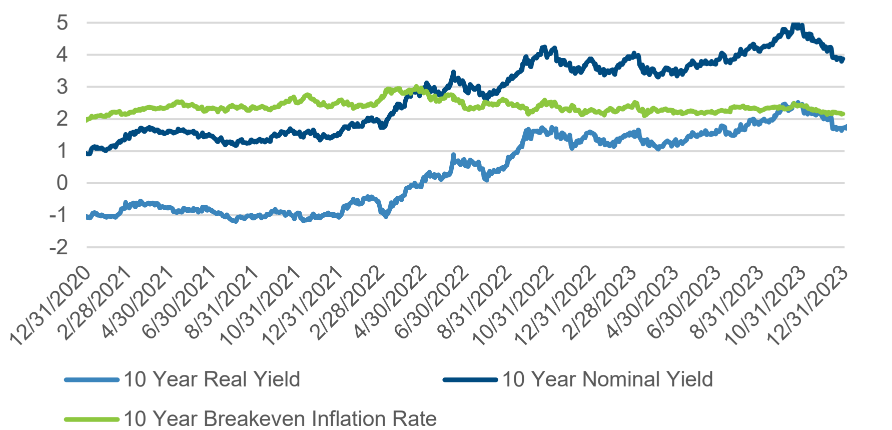
Why it Might be Time to Invest in Bonds Despite Recent US Treasury Volatility

Julia Zhu
Senior Vice President, Market and Security Research

Market Recap

In the fourth quarter, we witnessed unprecedented volatility in the U.S. Treasury market. In October, the 10-year yields rose sharply to almost 5% amid resilient economic data, and then retreated significantly in November and December with lower-than-expected inflation data and speculations that the Fed will be able to pull off a soft landing. The nominal 10-year U.S. yields ended the quarter at 3.88%, down from 4.57% at the end of the previous quarter. The primary factor behind this shift was the decrease in real yield (by 52 basis points), while inflation expectations, measured by the 10-year inflation breakeven rate, saw a slight decline from 2.35% at the end of the third quarter to 2.16% (see Exhibit 1).

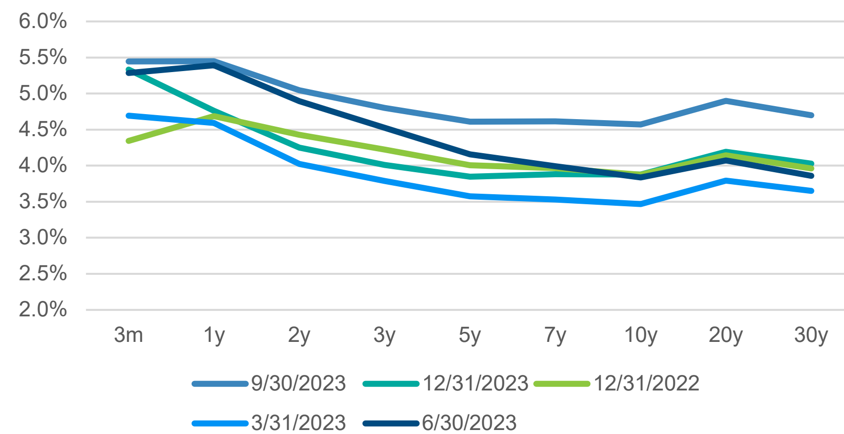
Exhibit 1: Treasury yields declined significantly in the fourth quarter of 2023



Source: Bloomberg.

Treasury yields across all maturities decreased for the fourth quarter, with 3-month yields moving down the least, leading to a more inverted yield curve. The 3-month yield decreased marginally from 5.45% to 5.33%, a level 1.45% higher than the 10-year yields (compared with 87 bps higher than the 10-year yields at the end of last quarter, see Exhibit 2). The 10-year and 30-year bond yields decreased by around 70 basis points each but remained high historically.

Exhibit 2: U.S. Treasury Yield Curve



Source: Bloomberg.

Macro Landscape

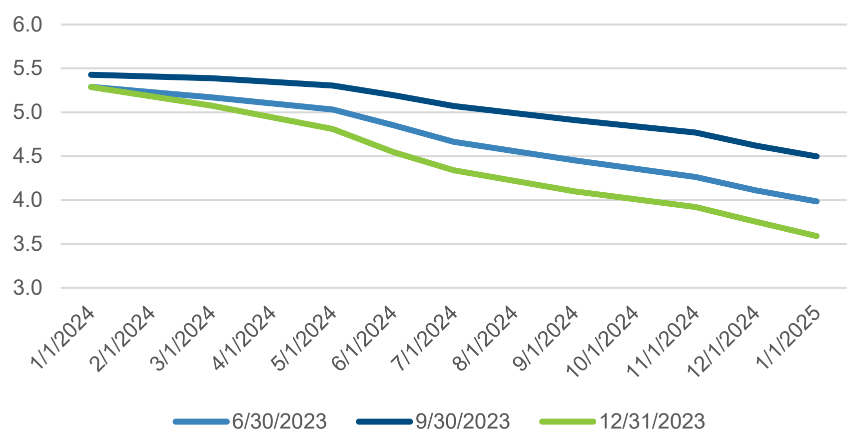
Growth Prospects: This year, a series of positive economic data has lifted market sentiments, and markets seemed to price out near-term recession risk, becoming increasingly confident about a soft landing. Digging more carefully into individual signals, however, we believe that uncertainty is still elevated, and we expect a slowdown in the economy in the coming year. The PMI index was in negative territory in 2023, suggesting that the U.S. manufacturing industry continued to face strong headwinds with a downbeat outlook. The Conference Board's Leading Economic indicator continued to decline, indicating cautionary signals that the economy is heading for a slowdown. The labor market has also shown signs of cooling this quarter.

We believe that the tailwinds that have supported the economic strength this year will likely fade, including robust consumer strength, a tight job market driven by a mismatch of labor supply and demand, and a huge fiscal stimulus. Recent household liquidity statistics showed that 80% of excess consumer savings from the Covid period have been depleted. Also, delinquencies in credit card and auto loans, as well as Chapter 11 filings, are increasing. We expect the headwinds from tight monetary policy and credit stress will be more evident in 2024, leading to a slowing economy and moderating inflation. Other risks including geopolitical uncertainty and the resumption of student loan payments could also weigh on the markets.

Fed Policy: During its December meeting, the Federal Open Market Committee (FOMC) again chose to maintain its policy rate at a range of 5.25% to 5.5%. The markets viewed December's meeting as the most dovish since the tightening cycle, as the committee signaled that it would likely cut interest rates by 75 basis points next year (compared with 50bps in September's projection). Also, for the first time, the post-meeting statement acknowledged that "growth of economic activity has slowed" and "inflation has eased." More encouraging is that December's Summary of Economic Projections indicated that the Fed expects a soft landing, with projections for real GDP and the unemployment rate little changed.

Market outlook on the possible paths of monetary policy in the US has seen significant shifts during the last quarter (See Exhibit 3). The Fed funds futures market is currently indicating a total of 150bps in rate cuts by the Fed in 2024.

Exhibit 3: Fed Funds Rate Implied by the Futures Market



Source: Bloomberg.

Inflation surprised on the downside: The most recent inflation data continued its descent, bringing the year-over-year headline CPI and core CPI in November to 3.1% and 4.0%, respectively. More encouragingly, core PCE (personal consumption expenditure), the Fed's preferred inflation measure, rose marginally by 0.1% in November, while the headline PCE index fell 0.1%, marking its first monthly decline since April 2020. Inflation expectations also improved dramatically in December, according to the University of Michigan survey, with 1-year inflation expectations plummeting from 4.5% to 3.1% and five-year expectations dipping from 3.2% to 2.9%.

We expect inflation to continue to fall for the following reasons: 1) Although the CPI for shelter (about 40% of core CPI) remained a significant contributor to inflation recently, we believe that the current inflation data has not fully reflected the slowdown in rents due to a lagging effect. 2) We expect the CPI for core services excluding shelter - a key metric referred to by the Fed as "supercore" to continue its downward trend. This inflation component is most sensitive to the labor market, with wage inflation playing a key role. Our wage index has declined to 3.9% YOY in November, down from its 6.0% peak in July 2022. Recent labor market data has shown signs of decelerating job growth and quit rates have fallen back to their pre-Covid level.

Why it Might be Time to Invest in Bonds

With high nominal yields, declining inflation and the Fed reaching the end of its rate hikes cycle, we believe that we are entering an optimal time for fixed income investments, in which bonds offer significantly more value, both in terms of total returns and as diversification within a balanced portfolio.

Although the initial levels of bond yields are not always a perfect indicator, they have been highly correlated with bond future returns. Despite a decrease in yields during the fourth quarter, nominal yields for high quality bonds remained high historically, with the yield-to-worst for the U.S. Aggregate Index at 4.6%. Empirical data shows that current yield levels have been typically followed by appealing returns from 5% to 7.5% over the next five years.

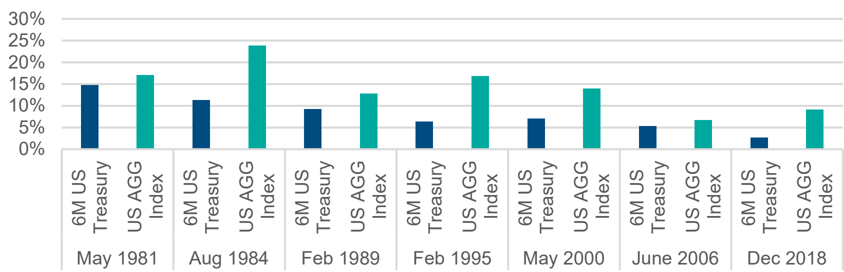
The current higher yields act as a cushion against market volatility, and ultimately, the end of the tightening cycle will also improve fixed income performance. Empirical data has shown that since the 80s, 10-year rates have consistently decreased (by an average of 1.07%) during the time periods between the last rate hike and the initial rate cut (see Exhibit 4). Not surprisingly, bonds have shown strong performance after the Fed stopped raising interest rates. Data in Exhibit 5 illustrates that bonds outperformed cash in every instance since the 80s (by an average of 6.3%) in the 12-month period after the end of hiking cycles.

Exhibit 4: Federal Reserve Rate Hike Cycle and Changes in 10-yr Yields

Last Rate Hike	First Rate Cut	Change in 10yr Yields Between Last Hike and First Cut
Feb-1989	Jun-1989	-0.95%
Feb-1995	Jul-1995	-1.48%
May-2000	Jan-2001	-1.51%
Jun-2006	Sep-2007	-0.73%
Dec-2018	Jul-2019	-0.70%

Source: Bloomberg.

Exhibit 5: US Aggregate Bond Index Performance One Year After End of Rate Hike Cycle



Source: Bloomberg.

Also, current bond valuations are attractive relative to equity. One of the common measures to compare the valuation of bonds vs. equity is to use equity risk premium by taking the difference between the 10-year U.S. Treasury yield and the earrings/price ratio of the S&P 500. As shown in Exhibit 6, the equity risk premium currently stands at 0.5%, among the lowest levels in two decades, suggesting that it is probably a prime time to overweight bonds in dynamic asset allocation portfolios.

Exhibit 6: S&P 500 Equity Risk Premium

Source: Bloomberg.

Investment Implications

Looking across investment opportunities, we found fixed incomes stand out for their attractive valuation, appealing income prospects, and substantial diversification benefits in the backdrop of elevated market uncertainty, slowing economic outlook, and moderating inflation. In this time of increased uncertainty, we believe it is crucial to prioritize high-quality investment and diversification while maintaining portfolio flexibility. Thus, our allocation among fixed income sectors remains up-in-quality, while also preparing to take opportunities in other sectors as prices adjust to reflect changes in underlying fundamentals. We have started to extend the duration in our tactical portfolios and slightly overweight the duration in our less dynamic portfolios. For YTD ending December 31, 2023, our Tactical Income strategy returned 6.1% net of fees, slightly underperforming the Global Aggregated Bond Index by 0.6%, but outperforming U.S. Aggregate Bond Index by 0.3%. In the fourth quarter, we focused on several key themes in our strategies, outlined below:

- **Add duration:** While we acknowledge that current cash rates are still appealing compared with historical levels, we believe duration is expected to outperform cash with the Fed at the end of its rate hiking cycle. We prefer to move out along the yield curve and have added TLH (iShares 10-20 Year Treasury Bond ETF) and TLT (iShares 20+ Year Treasury Bond ETF) positions during the quarter.

- **Mortgage-backed securities:** We kept a significant allocation to U.S. agency mortgage-backed securities through investing in MBB (iShares MBS ETF) as we found the sector remain appealing with attractive spread of MBS, strong liquidity and government or agency guarantees.

- **Neutral in investment-grade (prefer high quality):** We kept our neutral position to investment-grade corporate bonds. We acknowledge that fundamentals remain resilient for U.S. investment-grade companies, and we expect the sector's attractiveness from a yield and duration perspective will remain intact. However, we are also aware of the risks stemming from high interest rates, wage inflation pressures and diminishing consumer demand.

- **Continued to hold bank loans:** In our portfolio, we have allocated 5% to the Invesco Senior Loan ETF (BKLN), which has generated a YTD return of 12.6% as of 12/31/2023. Looking forward, we expect bank loans to continue to offer attractive coupon rates. However, it is essential to maintain a cautious stance as we also anticipate an increase in defaults with borrowers facing high interest expenses and slower earnings growth.

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