NorthCoast Fixed Income Outlook

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Moving Forward with Uncertainty – Growth, Inflation, and the Fed

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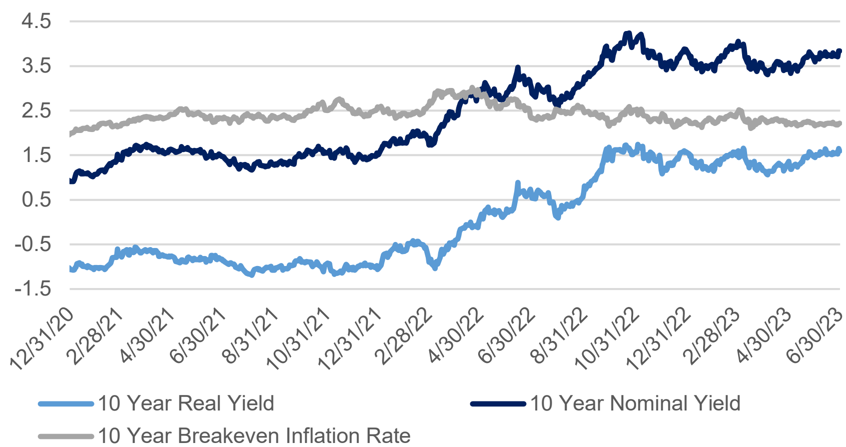
Market Recap

Treasury yields rose in the second quarter and fixed income assets generated slightly negative returns, with the U.S. Aggregate Bond Index and the Global Aggregate Bond Index returning 0.8% and 1.5%, respectively, for the quarter. In May, the heated debt ceiling debate led to dislocation in short-term U.S. Treasury bills and contributed to higher yields and weakness in credit markets. While the debt ceiling agreement averted a potential financial crisis at the end of May, investors' attention promptly shifted back to inflation and Fed policy. The yield curve rose again after the Fed delivered a hawkish hold at its June policy meeting. The U.S. nominal 10-year yields ended the quarter higher at 3.84%, compared with 3.47% at the end of the first quarter. The real yield contributed primarily to the move (up by 43bps), while inflation expectations (measured by the 10-year inflation breakeven rate) were slightly down to 2.22% from 2.32% at the end of last quarter. (See Exhibit 1).

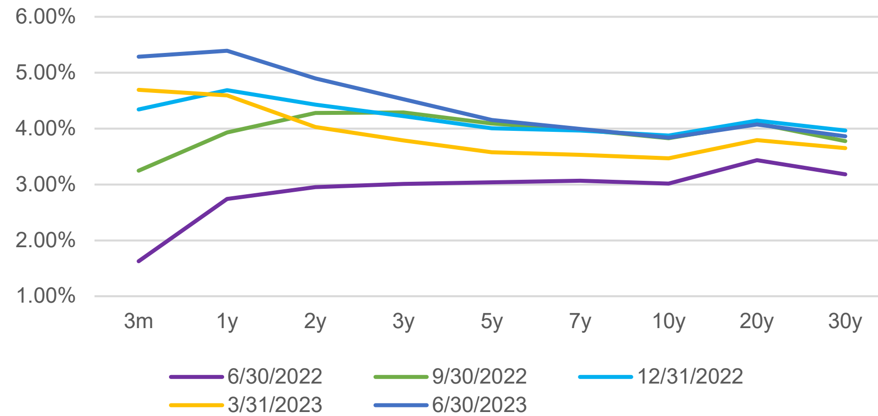
Exhibit 1: Treasury Yields rose in the second quarter of 2023



Source: Bloomberg.

Rates across the U.S. Treasury yield curve increased for the quarter, led by the front end, leading to a deeper inversion of the yield curve for the quarter. The 2-year yield, which is highly sensitive to the expectation of the Fed funds rate, rose from 4.03% to 4.90%, a level 1.1% higher than the 10-year yields (see Exhibit 2). The 30-year bond yield, which is more sensitive to changes in long-term economic prospects, increased slightly from 3.65% to 3.86%.

Exhibit 2: U.S. Treasury Yields Curve



Source: Bloomberg.

Amid the uncertainties surrounding this year's market narratives, such as debates between a hard or soft landing, resilient growth versus recession risks, moderating overall inflation versus stubborn core inflation, and the Fed's pause or dovish pivot, one theme has emerged and stayed consistent: bonds are back. At current yield levels, we believe that fixed income can provide an appealing balance between generating attractive income and hedging against economic downturns (refer to Exhibit 3 for current yields across multi-asset classes). In this newsletter, we will address three primary uncertainties that concern most fixed income investors: growth prospects, inflation, and Fed policy.

Exhibit 3: Yields and YTD Returns of Key Fixed Income Markets

	6/30/2023	12/31/2022	12/31/2021	2023 YTD Return
Treasuries				
2-Year	4.9%	4.4%	0.7%	0.6%
5-Year	4.1%	4.0%	1.3%	0.7%
TIPS	1.6%	1.5%	-1.0%	1.8%
10-Year	3.8%	3.9%	1.5%	2.2%
30-Year	3.9%	4.0%	1.9%	3.5%
Sectors				
U.S. Aggregate	4.8%	4.7%	1.8%	2.1%
IG Corps	5.5%	5.4%	2.3%	3.2%
Convertibles	7.9%	7.1%	3.7%	8.4%
U.S. HY	8.5%	9.0%	4.2%	5.4%
Municipals	3.5%	3.6%	1.1%	2.7%
MBS	4.8%	4.7%	2.0%	1.9%
ABS	6.2%	5.9%	2.0%	2.4%
Leveraged Loans	11.2%	11.4%	4.6%	6.5%

Source: Bloomberg.

Growth – Resilience with Concerning Signs

Recent economic indicators have generally shown strong economic momentum in early 2023. The US GDP rose a healthy 2% in the first quarter, bolstered by sizable increases in consumer spending. The labor market has remained resilient, with nonfarm payrolls growing by an average of 314,000 monthly and a 6.0% wage growth in May according to the Atlanta Fed. Despite mortgage rates reaching as high as 7%, the housing sector in the US has shown positive signs, as homebuilder confidence surpassed the 50-point threshold and construction spending has witnessed consistent growth for three consecutive months.

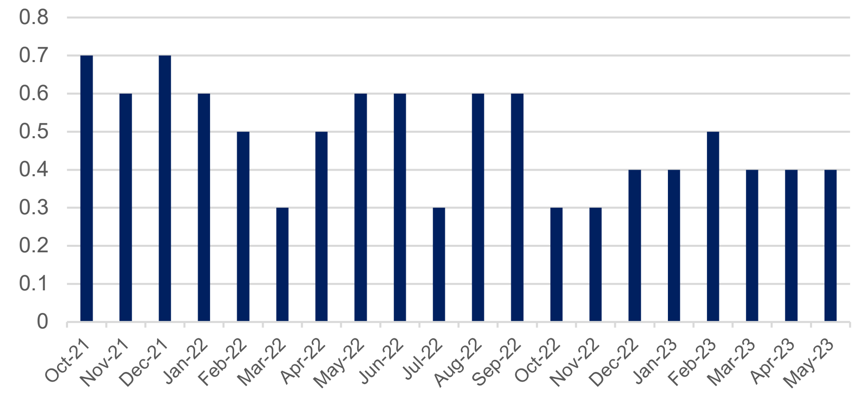
However, beneath the surface there are concerning signs emerging. So far this year, employment growth has been a notable highlight in this year's economic data, but we are starting to see some cracks develop with initial jobless claims reaching their highest level since late 2021. At the same time, the PMI index indicates that manufacturing activity in the US has contracted for the seventh month in a row, and the leading economic index has entered a recessionary phase.

Looking forward, we anticipate a deceleration in growth during the latter half of the year, reflecting lagged effects of the Federal Reserve's tightening policy and bank credit restrictions. The duration of the lag effect resulting from monetary policy can vary, but it is typically longer than two years. Meanwhile, we expect a potential recession (which many economists have predicted to occur in the US in 2024) will likely be mild, given continued resilience in the labor market, tailwinds from lower energy prices, and China reopening.

Inflation – Not Moderating Fast Enough

While overall inflation is on a downward trend in the U.S., core inflation, which excludes food and energy, has remained stubbornly persistent and is unlikely to decrease fast enough to allow for much room for policy easing in the next few months. Exhibit 4 shows that monthly core inflation has been consistent at 0.4% despite some decline in housing inflation.

Exhibit 4: Core CPI was persistently high around 0.4% in 2023



Source: Bloomberg.

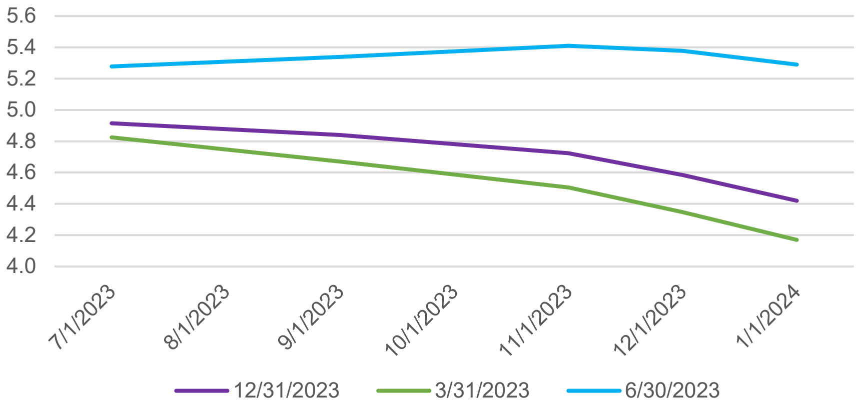
Investors have been very focused on Owners' Equivalent Rent (OER)* given its weight of more than 40% in core CPI. Encouragingly, the CPI for OER rent rose by 0.5% for the third consecutive month, a notable slowdown from the 0.7% increase in February. However, it's worth noting that the impact of future disinflation from OER on core PCE inflation (the Fed's preferred measure) would be less significant due to its lower weight of 17%.

Another contributor to elevated core inflation is wage growth, which is driven by a shortage of labor. Despite a slowdown in demand and weakening growth, companies are hesitant to lay off workers due to labor shortages, resulting in upward pressure on core inflation. Our wage index indicates that wage inflation was still running at 5.0% YOY in May, only a slight moderation from 5.7% at the end of last year.

Fed Policy – A Fresh Uncertainty

The resilient economy and sticky inflation are leading the Federal Reserve to keep policy tight. After ten consecutive rate hikes, the Fed chose not to raise the target range of the federal funds rate, keeping it steady at 5% to 5.25%. However, there were upward revisions in the projections for the peak of the Fed funds rate, which increased from 5.1% in March to 5.6%, implying two more rate hikes down the road. Market perceptions on the possible paths of monetary policy in the US have also seen significant shifts during the last quarter (See Exhibit 5). Market-implied Fed terminal rate dropped to a low of 4.8% due to credit crunch concerns in March but reached 5.4% after the Fed's hawkish surprise in its June meeting.

Exhibit 5: Implied Rates shifted significantly higher in the second quarter of 2023



Source: Bloomberg.

We expect the rates to be higher for longer. While markets have priced out cuts from 2023, they are still factoring in too many cuts in 2024 (about 120bps), which we think is hard to justify for several reasons. First, the US economy has demonstrated considerable resilience in the face of previous hikes. Our baseline suggests a very mild contraction that cannot justify aggressive rate hikes. Second, there is an upward risk to the anticipated core PCE inflation, with the possibility that it may not fall to 2.6% next year as forecasted by the Fed. The policy rate path could rise further if inflation does not fall fast enough. We believe that the stubbornness of inflation, the strength of the economy despite significant tightening, and the Fed's cautious approach to further tightening all point towards a higher policy rate trajectory.

There is fresh uncertainty about whether the Fed will keep pausing or quickly pivot toward rate cuts. However, irrespective of the chosen course of action, historical evidence suggests that fixed income investments can provide appealing return potential, particularly when compared to equities. Empirical research indicates that if the Fed pauses after reaching its peak rate and the U.S. economy enters a recession, holding the 10-year U.S. Treasuries (as a proxy for fixed income investments) would result in flat returns over the following 12 months, while the S&P 500 could experience a significant decline. In the other case, if recession materializes and the Fed promptly pivots by cutting rates, history data indicates that bonds would still outperform equities.

Investment Implications

Given our base case of the Fed nearing the end of its hiking cycle and a mild recession in the U.S., we continue to see a compelling case for investing in fixed income for its diversification, yield advantages, and potential for upside returns. For YTD ending June 30, 2023, our Tactical Income strategy returned 1.9% net of fees, outperforming the Global Aggregated Bond Index by 0.4% and slightly underperforming the U.S. Aggregate Bond Index by 0.2%.

We slightly underweight duration in our tactical portfolios and maintain our neutral stance on duration in less dynamic portfolios. We favor treasuries and higher-credit-quality corporate and securitized bonds that offer income and total return potential.

For treasuries, we believe that buying high quality duration in the front end of yield curves creates attractive yields, and we added short-term (SHY) and intermediate-term government bonds (IEF). For credit, we believe this is an environment where we make active decisions to balance near-term caution and a long-term focus on high-quality assets. This quarter, we reduced our overweight position in corporate bonds by selling 5% IGIB as we see tightening credit and financial conditions. Additionally, we sold our position in HYGH (iShares Interest Rate Hedged High Yield bond ETF) as this asset class is more vulnerable to economic downturns. With the Fed closer to the end of the hiking cycle, we believe the benefit of interest hedging is diminishing.

We maintain our position in MBB (iShares MBS ETF) as we find U.S. agency mortgage-backed securities remain appealing with cheap valuation, strong liquidity and government or agency guarantees. We believe investing in a wide variety of assets can further help investors meet their income needs in this environment and have additionally kept our exposure to alternative asset markets.

* Owners' equivalent rent (OER) is the amount of rent that would have to be paid in order to substitute a currently owned house as a rental property.

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