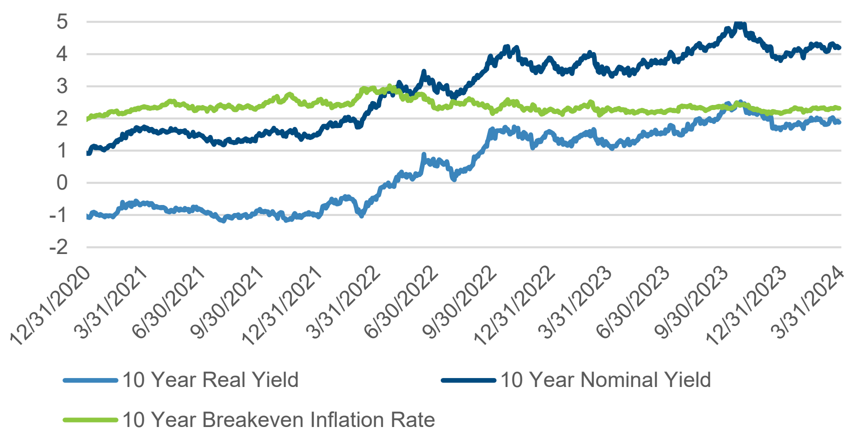
Bright Outlook for Bonds

Julia Zhu
Senior Vice President, Market and Security Research

Market Recap

In the first quarter, U.S. Treasury yields generally saw an upward trend as investors digested strong economic data and the Fed's pending easing decisions. Continued healthy economic data and the upside surprise in inflation have forced investors to reassess their expectations for interest rate cuts, with the timing of the first Federal funds rate cut being pushed back. The nominal 10-year U.S. yields ended the quarter at 4.20%, up from 3.88% at the end of the previous quarter. The increase in real yield and inflation expectations contributed evenly to the shift, with real yield up by 16 basis points for the quarter, while inflation expectations, measured by the 10-year inflation breakeven rate, also saw a slight increase from 2.16% at the end of the third quarter to 2.32% (see Exhibit 1). Throughout the first quarter of the year, the 10-year Treasury yield was modestly rangebound between 3.9% and 4.3%. In contrast, it reached a peak of nearly 5% in October 2023.

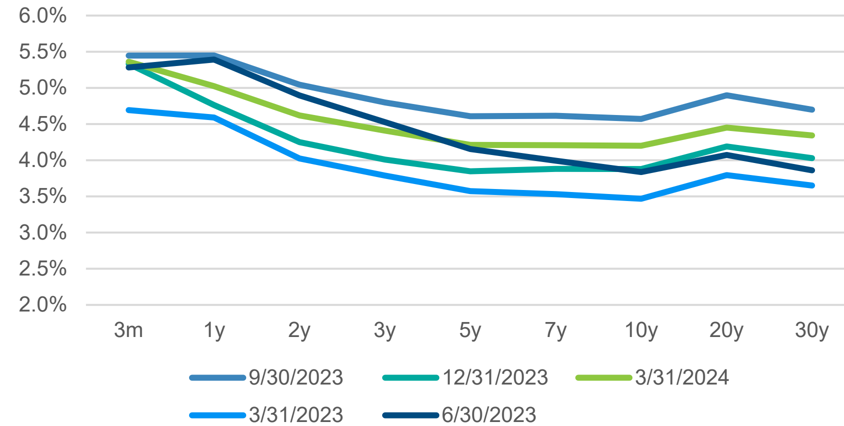
Exhibit 1: Treasury yields increased in the first quarter of 2024



Source: Bloomberg.

Treasury yields across all maturities increased for the first quarter, with 3-month yields moving up the least, leading to a slightly less inverted yield curve. The 3-month yield increased marginally from 5.33% to 5.36%, a level 1.16% higher than the 10-year yields (compared with 1.45% higher than the 10-year yields at the end of last quarter, see Exhibit 2). The 10-year and 30-year bond yields increased by around 30 basis points each but remained high historically.

Exhibit 2: U.S. Treasury Yield Curve



Source: Bloomberg.

Macro Landscape

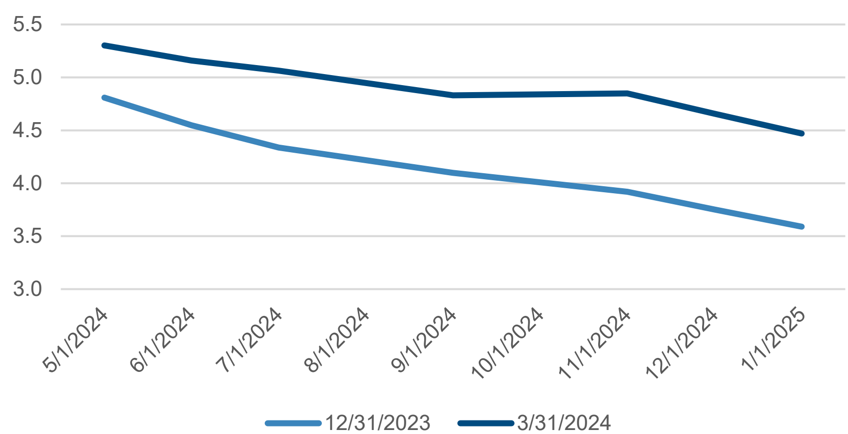
Growth prospects: Most U.S. economic indicators exceeded expectations during the first quarter, including payrolls (an average of 265,000 per month), the unemployment rate (below 4%), February retail sales (up 0.6%), housing prices (up 6.6% year over year), affirming the resiliency of the U.S. economy. Survey data also beat market forecasts in general, indicating improved business and consumer sentiment. The ISM manufacturing index surged to 50.3 in March, indicating an expansion in the U.S. manufacturing sector following 16 months of contraction. Homebuilder confidence (NAHB index) also exceeded the 50-point neutral threshold, reflecting favorable building conditions. The University of Michigan consumer sentiment index averaged 77.5 during the first quarter, up from 69.7 in December, with increased optimism about the inflation outlook, recent stock market gains, and resilient labor market.

Despite a slew of economic data that surprised to the upside, we expect growth slightly below trend in 2024. While February's headline payroll beat forecasts, it came with significant downside revisions in December and January, showing evidence that the labor market is softening. Consumer spending is anticipated to sustain growth this year, benefiting from low unemployment and moderating inflation. However, the prospect of high-for-longer interest rates will likely weigh on growth by tightening financial conditions and increasing consumer and corporate debt costs. We see corporate margin pressures as companies deal with weakened pricing power, higher interest expenses, and elevated labor costs.

Fed policy: As widely expected, in its March meeting, the Federal Open Market Committee (FOMC) kept the federal funds rate target unchanged at 5.25% to 5.5%. Despite higher-than-expected inflation data in January and February, the committee's latest Summary of Economic Projections suggests 75 basis points rate cuts in 2024. Also, the committee seems more confident about the possibility of a soft landing, with its GDP forecast for 2024 revised upward from 1.4% to 2.1%. At the same time, Chairman Power reiterated the need for greater confidence in the sustainable inflation trend before reducing the target range.

Since the beginning of the year, market expectations about the Fed's schedule for policy easing have been pushed back significantly (See Exhibit 3). As of 03/31/2024, the Fed funds futures market indicated a total of 70bps in rate cuts by the Fed in 2024, compared with 150bps cuts estimated at the end of last quarter.

Exhibit 3: Fed Funds Rate Implied by the Futures Market



Source: Bloomberg.

Inflation surprised to the upside: February's Consumer Price Index (CPI) came in slightly higher than expected for the month, with the headline CPI and core CPI rising by 3.2% and 3.8% year over year, respectively. However, the report's details were more benign as CPI for shelter decelerated modesty and core services prices also slightly cooled. More encouragingly, PCE (personal consumption expenditure), the Fed's preferred inflation measure, rose 2.5% year over year in February. Inflation expectations also continued their downward trajectory, according to the University of Michigan survey.

We maintain our view that shelter prices will ease in 2024, which is a primary factor supporting our view that inflation will moderate gradually in 2024. At the same time, our concerns persist regarding the tight labor market's impact on inflation, with wage inflation significantly higher than levels consistent with the inflation target. Our wage index has only marginally declined to 4.10% YOY in February, from 4.14% at the end of last quarter.

Bright Outlook for Bonds

After heightened interest rate volatility over the past two years, our outlook for fixed income investments appears bright. Primary drivers of optimism are 1) the attractive starting level of yields across fixed income sectors; 2) the beginning of the Fed's easing policy anticipated later this year; and 3) moderating inflation and inflation expectations.

First, the current starting yields are among the highest levels in over a decade, which could not only boost potential bond returns but also offer a buffer against further interest rate volatility. Last year is a good example highlighting the importance of high starting yields. Despite considerable intra-year rate volatility in 2023, many yields ended the year close to their starting levels of the year. This round trip in yields has led to attractive bond returns that were primarily driven by attractive starting yields. Looking forward, starting yields in 2024 (4.5% for Bloomberg US Aggregate Bond Index) are close to the starting levels in 2023 (4.65%), indicating a brighter environment for bonds compared to 2022 with a 1.7% initial yield.

Second, the beginning of easing monetary policy will further improve fixed income performance. Empirical data has shown that in every circumstance since the 70s, the US Treasury (measured by the Bloomberg US Treasury Index) has demonstrated strong performance after the Fed started its first rate cut, regardless of whether a recession occurred (see Exhibit 4).

Exhibit 4: U.S. Treasury Index Performance after First Rate Cuts

First Fed Rate Cut	Business Cycle	US Treasury Returns after First Cut 3-month	6-month	12-month
Jul-74	During Recession	3.7%	8.4%	10.1%
Apr-80	During Recession	15.1%	9.8%	13.1%
Jun-81	Before Recession	-2.2%	7.2%	13.6%
Apr-82	During Recession	4.2%	17.8%	26.1%
Sep-84	No Recession	7.1%	9.4%	20.6%
Nov-87	No Recession	5.7%	3.1%	7.8%
Jun-89	No Recession	0.8%	4.6%	6.8%
Jul-95	No Recession	3.7%	7.5%	5.1%
Jan-01	Before Recession	0.3%	3.6%	6.6%
Sep-07	Before Recession	4.0%	8.6%	8.7%
Aug-19	Before Recession	-1.1%	3.4%	7.0%
	Average Before Recession	**0.3%**	**5.7%**	**9.0%**
	Average During Recession	**7.7%**	**12.0%**	**16.4%**
	Average No Recession	**4.3%**	**6.2%**	**10.1%**

Source: Bloomberg.

Thirdly, the decline in inflation provides bonds with an environment where they have historically performed well. Historical analysis has shown that over the period from 1982 to 2023, the Bloomberg US Aggregate Index returned 9.3% annually during decreased inflation regimes, in sharp contrast to a 1.1% annual return in increased inflation regimes.

Investment Implications

Against the backdrop of a below-trend economic outlook, moderating inflation, and the expectation of the Fed's easing later this year, our discussions with clients since 2023 have explored the opportunities for increasing fixed income allocations while better balancing risks in their investments. 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 are neutral in duration in our more static portfolio and slightly underweight duration in our more dynamic portfolios. In the first quarter of 2024, our Dynamic Income strategy returned 0.2% net of fees, outperforming the Global Aggregated Bond Index and U.S. Aggregate Bond Index by 2.3% and 1.0%, respectively. In the first quarter, we focused on several key themes in our strategies, outlined below:

- **Less cash:** While short-term yields are still higher and cash investments may remain attractive in the near future, we believe that it is time to revisit the cash position. As the Fed begins to cut interest rates, front-end yields tend to decline quickly, which usually results in lower cash returns.
- **Mortgage-backed securities:** We kept a significant allocation to U.S. agency mortgage-backed securities through investing in MBB (iShares MBS ETF), as the MBS sector is supported by solid fundamentals and wider-than-historical average spreads.
- **Bank loans:** We have allocated 5% to the Invesco Senior Loan ETF (BKLN) in our portfolio. Floating-rate loans have a much shorter duration and have low correlations with other fixed income sectors. BKLN offers a current yield of 7.5% and returned 1.9% YTD as of 03/31/2024.
- **High yield bonds:** We recently added a modest position (2%) in the iShares iBoxx $ High Yield Corporate Bond ETF (HYG). Given the resiliency of the U.S. economy, we expect the relatively benign default rates (2.5% - 3%) will likely continue in the high yield corporate bond sector.
- **AMLP:** During the quarter, we slightly increased our allocation to Alerian MLP ETF (AMLP) from 3% to 5%. Infrastructure MLPs are likely to benefit from the expected modest growth of the U.S. energy sector this year. AMLP offers a generous current yield of 7.5% and returned 13.9% in the first quarter.

Important Disclosure Information

The information contained herein has been prepared by NorthCoast Asset Management ("NorthCoast") on the basis of publicly available information, internally developed data and other third-party sources believed to be reliable. NorthCoast has not sought to independently verify information obtained from public and third-party sources and makes no representations or warranties as to accuracy, completeness or reliability of such information. All opinions and views constitute judgments as of the date of writing without regard to the date on which the reader may receive or access the information and are subject to change at any time without notice and with no obligation to update. This material is for informational and illustrative purposes only and is intended solely for the information of those to whom it is distributed by NorthCoast. No part of this material may be reproduced or retransmitted in any manner without the prior written permission of NorthCoast. NorthCoast does not represent, warrant or guarantee that this information is suitable for any investment purpose, and it should not be used as a basis for investment decisions.

NorthCoast Asset Management is a d/b/a of, and investment advisory services are offered through, Connectus Wealth, LLC, an investment adviser registered with the United States Securities and Exchange Commission (SEC). Registration with the SEC or any state securities authority does not imply a certain level of skill or training. More information about Connectus can be found at www.connectuswealth.com.

PAST PERFORMANCE DOES NOT GUARANTEE OR INDICATE FUTURE RESULTS.

This material should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any securities or investment products or to adopt any investment strategy. The reader should not assume that any investments in companies, securities, sectors, strategies and/or markets identified or described herein were or will be profitable and no representation is made that any investor will or is likely to achieve results comparable to those shown or will make any profit or will be able to avoid incurring substantial losses. Performance differences for certain investors may occur due to various factors, including timing of investment. Investment return will fluctuate and may be volatile, especially over short time horizons.

INVESTING ENTAILS RISKS, INCLUDING POSSIBLE LOSS OF SOME OR ALL OF AN INVESTMENT.

The investment views and market opinions/analyses expressed herein may not reflect those of NorthCoast as a whole and different views may be expressed based on different investment styles, objectives, views or philosophies. To the extent that these materials contain statements about the future, such statements are forward-looking and subject to a number of risks and uncertainties.

NorthCoast
Asset Management