Continued US Economic Resilience with Challenges Ahead

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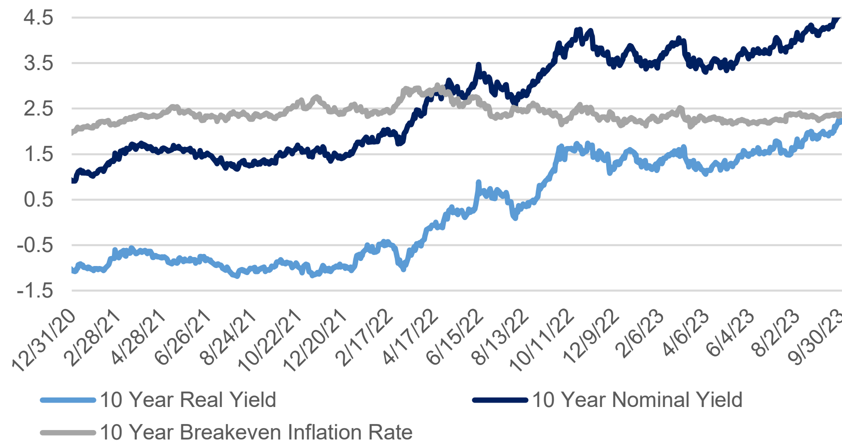
Market Recap

U.S. government bond yields climbed significantly during the third quarter, with yields on benchmark Treasurys hitting 16-year highs. This surge was primarily prompted by a series of robust economic data and speculations that central banks will keep interest rates high for longer to quell inflation. Part of the move is also due to the U.S. Treasury's decision to increase its long-term debt issuance driven by significant budget deficits and an unexpected adjustment in the Bank of Japan's Yield Curve Control policy. The nominal 10-year U.S. yields ended the quarter at 4.57%, up from 3.84% at the end of the previous quarter. The primary factor behind this shift was the increase in real yield (by 65 basis points), while inflation expectations, measured by the 10-year inflation breakeven rate, saw a slight increase from 2.22% at the end of the second quarter to 2.35% (refer to Exhibit 1).

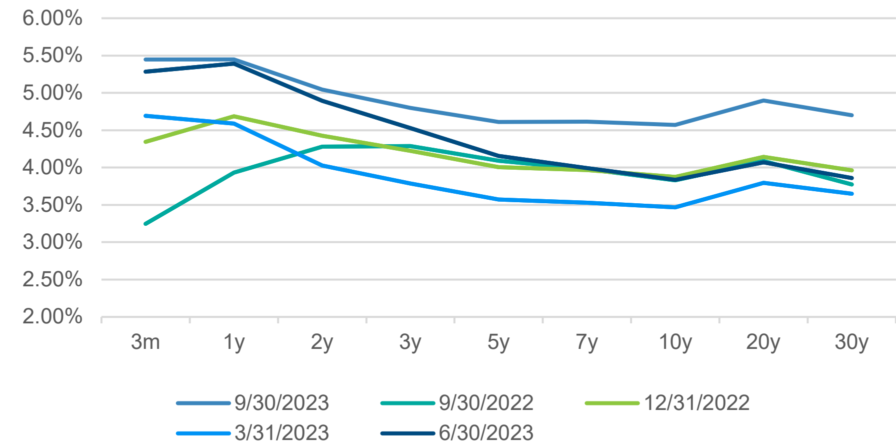
Exhibit 1: Treasury Yields rose significantly in the third quarter of 2023



Source: Bloomberg.

Treasury yields across all maturities increased for the third quarter, with longer-term yields moving up the most, leading to a less inverted yield curve. The 2-year yield, which is highly sensitive to the expectation of the Fed funds rate, rose from 4.90% to 5.04%, a level 47bps higher than the 10-year yields (compared with 1.1% higher than the 10-year yields at the end of last quarter, see Exhibit 2). The 30-year bond yield, which is more sensitive to changes in long-term economic prospects, increased more significantly from 3.86% to 4.70% at the end of third quarter.

Exhibit 2: U.S. Treasury Yields Curve



Source: Bloomberg.

Macro Picture: resilient US economy with higher probability of soft landing

This year, a notable surprise has been the resilience of the US economy despite the Fed's aggressive interest rate hikes. Forecasts for an upcoming recession have consistently been postponed and toned down. The markets swiftly adjusted their expectations towards a U.S. soft landing in late August and early September. In our view, various factors support this resilience, with the durable labor market and the stability of the US housing sector standing out as potentially the most crucial ones.

While it's true that the rate of job creation has slowed down, the unemployment rate remains close to historically low levels. Strong job market and higher real wages supported by decelerating inflation have continued to bolster consumer spending, which accounts for one-third of the total GDP.

The recent resilience is also partly attributed to the robust U.S. housing market. Although existing home sales experienced a significant drop due to rising mortgage rates, there has been a sustained high level of employment in the construction sector. This sector holds significant importance in the U.S. labor market, as it is one of the primary areas where job losses usually occur during a hiking cycle. Various factors have contributed to the housing market's performance this cycle, including a historical trend of insufficient home construction in the U.S. and an uptick in household formation. Cyclical factors, such as a reduced supply of existing homes due to potential sellers holding onto low mortgage rates, have also driven more demand for new homes.

Despite the recent better-than-consensus activity data in the U.S., our view is that the U.S. economy is not heading for a re-acceleration. Rather, we anticipate a mild slowdown with lagged impacts of elevated interest rates, sustained credit restrictions, surging energy costs, and the start of student loan repayments. Several leading indicators, such as decreasing leading economic index, contracting PMI index, and continued tightening of bank lending standards, all point towards a potential downturn on the horizon.

Fed Policy: Higher for Longer

As widely expected, at its September meeting the FOMC chose to keep the fed funds rate unchanged at the range of 5.25% to 5.5%. At the same time, there were notable shifts in the FOMC's economic forecast in the September Summary of Economic Projections, predicting higher real GDP growth (from 1% in June to 2.1%) and lower unemployment (from 4.1% to 3.8%) in 2023, while core inflation forecasts were trimmed from 3.9% to 3.7% for 2023. However, the FOMC's stance was generally viewed by the market as a hawkish pause as it maintains a bias toward tightening, with dot plots 50bps higher (the Fed dot plot is a chart showing projections for the fed funds rate) and a postponed timeline for the first rate cut.

While the Federal Reserve currently pivots to a soft-landing narrative, we believe that the rates will be high for longer due to at least the following factors:

- In the near term, we see two headwinds for the Fed policymakers, including surging energy prices and the ongoing United Auto Workers strike. Hence, we anticipate one more potential uptick in headline inflation next month, followed by a subsequent decline. Should this materialize, it increases the probability of an additional rate hike in 2023.
- The robustness in economic activity presents a double-edged sword, as a stronger economy could reignite inflationary pressures.
- Although inflation has moderated, it is still well above the target, and the risk of inflation remains elevated until further softening of the labor market.
- The Fed has affirmed its commitment to the 2% inflation target. We believe major central banks will take necessary measures to maintain longer-term inflation expectations in line with their established targets.

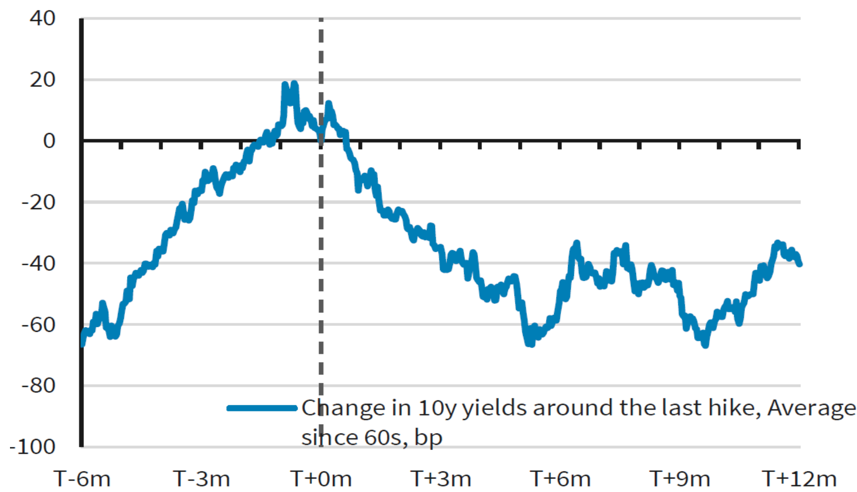
As a result, we have increased confidence in our belief that the Fed will be cautious in cutting rates, and we anticipate that the lagging effects of rate hikes will precipitate a mild slowdown. While there is an elevated level of uncertainty for market conditions, we believe that this backdrop favors extended high short-term interest rates and provides appealing opportunities for high-quality investments across our various strategies.

Bonds have historically done well after the Fed stops raising interest rates.

The current higher yields act as a cushion against market volatility, and ultimately, the end of the hiking cycle could improve fixed income performance. Historically, bonds have shown strong performance after the Federal Reserve stopped raising interest rates. Data in Exhibit 3 illustrates that, on average, the 10-year yield has decreased by approximately 60 basis points in the twelve months following the final rate hike in a cycle since the 1960s. In addition, Exhibit 4 highlights the impressive outperformance of various fixed income sectors 12 months after the end of hiking cycles since 1995.

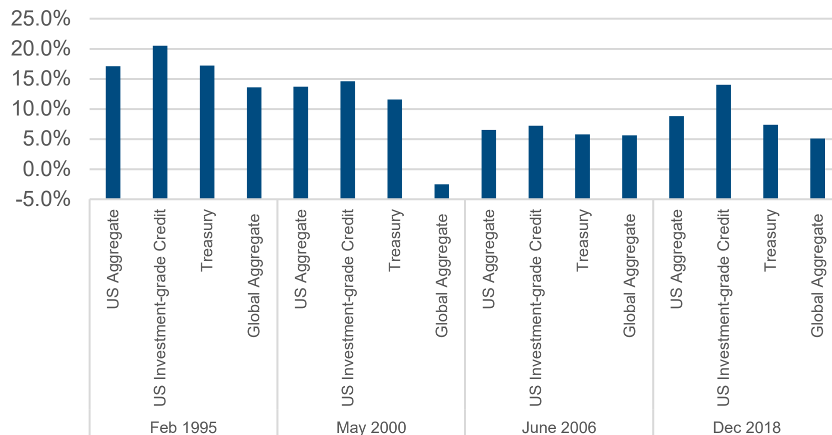
We understand that different factors can differentiate each rate hiking cycle, and the inflation data in the upcoming quarters will ultimately determine when the first rate cut occurs. However, due to the recent steepening of the yield curve, the initial conditions have become more favorable, with the 10-year U.S. treasury yield over 4.8%, trading above the expected average policy rate. With a fed funds rate heading into restrictive territory, there is potential for fixed income to deliver equity-like returns as policy rates ultimately normalize.

Exhibit 3: Change in 10yr yields at the end of the last hike



Source: Bloomberg, Barclays Research.

Exhibit 4: Fixed Income performance one year after end of rate hikes



Source: Bloomberg.

Investment Implications

With the recent substantial repricing of the fixed income market, investors may be able to achieve the highest real yields in over a decade without assuming uncomfortable risks. Given the current starting yield levels, which are typically highly correlated with subsequent total returns, high quality fixed income could potentially deliver equity-like returns with less volatility and greater downside protection. We believe that in this time of increased uncertainty, it is crucial to prioritize high quality investment and diversification while maintaining portfolio flexibility. Thus, we continue to emphasize high-quality fixed income sectors, while also preparing to take opportunities in other sectors as prices adjust to reflect changes in underlying fundamentals. We slightly underweight duration in our tactical portfolios and maintain our neutral stance on duration in less dynamic portfolios. For YTD ending September 30, 2023, our Tactical Income strategy returned -0.7% net of fees, outperforming the Global Aggregated Bond Index and U.S. Aggregate Bond Index by 1.5% and 0.5%, respectively. In the third quarter, we focused on several key themes in our strategies, outlined below:

- **Short-term treasuries still preferred:** We lean towards short-term government bonds over credit. Driven by aggressive Fed interest rate hikes, the yields on short-term government bonds have increased together with the long-term yields, making the short-term U.S. treasury deliver comparable yields as high-quality credit without assuming any credit risks. We overweight the short-term treasury and hold our 6% cash in a money market mutual fund, which earns a 5% yield.
- **Neutral for investment grade credit:** We reduced our exposure to investment grade corporate bonds from overweight to neutral. We have observed early indications of a shift in the credit cycle, as downgrades are surpassing upgrades for corporate credits. We believe that high-quality corporate bonds offer limited compensation for any possible lower return due to wider spreads and sensitivity to economic downturns.
- **Cautious to add duration:** Investors are now finally getting modest compensation for term premium after the recent significant rise in long-term yields. Nevertheless, we still hold a cautious stance and are not yet ready to take more duration risks given the challenges from massive budget deficits and our view of a mild economic slowdown down the road.
- **Continued to hold bank loans and added high-quality CLO:** With a coupon rate standing at 9%, the highest since 2001, we believe that bank loan yields adequately compensate for the increasing credit risk. In our portfolio, we have allocated 5% to the Invesco Senior Loan ETF (BKLN), which has generated a YTD return of 9.1% as of 09/30/2023. Regarding collateralized loan obligations (CLOs), we foresee a restrained issuance and expect the spreads to remain relatively stable for the rest of the year. We prefer senior CLO tranches due to their appealing carry and higher credit ratings. We recently added a modest position of the BlackRock AAA CLO ETF (CLOA), which primarily invests (92%) in AAA-rated tranches and currently offers a yield of 6.6%.

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